

Tax & Legal Alert
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Tax Alert

The Draft Income Tax (Transfer Pricing) Rules, 2023

The Commissioner General on behalf of the Cabinet Secretary, National Treasury and Economic Planning has reviewed the Income Tax (Transfer Pricing) Rules, 2006 and developed Draft Income Tax (Transfer Pricing) Rules, 2023 ("Draft Rules") aimed at providing guidance on the implementation of Sections 18, 18A, 18B, 18C, 18D and 18F of the Kenya Income Tax Act.

The Draft Rules were published via a public notice dated 4th September 2023. In compliance with the Statutory Instruments Act, 2013, the public has been invited to submit their input and comments for consideration before finalisation of the Draft Rules.

In this alert, we summarise the key highlights of the Draft Rules and provide our view on the same. You are advised to read this alert together with the [Draft Rules](#) for more details.

Background

In a bid to provide guidance on the implementation of Sections 18 to 18F of the Kenya Income Tax Act (ITA), the Commissioner General of the Kenya Revenue Authority has issued Draft Income Tax (Transfer Pricing) Rules, 2023 (“Draft Rules”).

Upon gazettment, the Draft Rules will revoke the existing Income Tax (Transfer Pricing) Rules 2006 (“the 2006 TP Rules”), which are currently in force.

Key Proposed Amendments

We provide below a summary of the key proposed amendments under the Draft Rules:

A. Choice of transfer pricing method

- The draft rules require a taxpayer who is subject to the rules is to choose the most appropriate transfer pricing method from among the five methods specified in paragraph 7 of the rules to determine the arm’s length price. The following are the five transfer pricing methods:
 - Comparable Uncontrolled Price (CUP) method
 - Resale Price (RP) method
 - Cost Plus (CP) method,
 - The Profit Split method, and
 - The Transactional Net Margin method (TNMM)
- Paragraph 7(1)(f) of the draft rules empowers the Commissioner to prescribe other methods from time to time, where the Commissioner is of the opinion that based on the nature of the transactions, the arm’s length price cannot be determined using any of the above five methods.

B. Determination of the arm’s length price for import and export of certain commodities

- The draft Rules define “commodities” to include agricultural produce, fisheries products, solid or liquid or gas minerals, hydrocarbons and derivatives thereof, other products or natural minerals or mineraloids obtained from the land or waters, and, in general, goods where publicly quoted price exists.
- The Draft Rules propose the use of publicly quoted prices as the most appropriate TP method for determining the arm’s length price for commodities.
- The arm’s length price shall be the average of the prices five days before and after the shipping date. However, where the agreed price for exports between unrelated parties is higher or for imports is lower than the average quoted prices, the agreed price shall prevail.
- In essence, this method disregards the five transfer pricing methods recommended under the OECD guidelines and adopts the other method introduced at the discretion of the Commissioner.





C. Documentation to be requested by the Commissioner

- The Rules have been amended to expand the scope of the information that the Commissioner may request from a taxpayer.
- The key information relevant to each category of controlled transaction include:
 - Detailed description of the transaction stating the entities involved, transactional values and timing contractual agreements, functional analysis, industry and economic analyses,
 - Comparability analysis and explanations of how the controlled transactions are similar to or different from that of uncontrolled transactions,
 - Advance pricing agreements or similar arrangements in other countries relevant to the controlled transaction under review, and
 - Any other documentation or information necessary to establish compliance with the arm's length principle with respect to the controlled transactions.
- The following financial information also need to be provided:
 - Audited financial statements of the taxpayer for each accounting year;
 - Financial statements of the parties to the controlled transaction including where the tested party has been selected as a party outside the country,
 - Segmented financial reports showing turnover, costs and expenses, allocation keys where the controlled transaction relate to a part of the business,
 - Summary of the financial information used in applying the TP methodology and how the financial data ties to the financial statements,
 - Summary of the relevant financial data for selected comparables used in the benchmarking analysis and their sources, and
 - In case of transactions involving commodities where the commodity is exported to a connected person who subsequently sells the commodity to unconnected persons, the third-party agreements and sales invoices relating to that sale will be required. The rules places an extended obligation on a person to provide third party information including agreements and invoices if the commodity is sold to a related party who ultimately sells it to an unrelated party.
- All the documents should be prepared or translated and maintained in English language

D. Offences, penalties and interest for non-compliance

- The Draft Rules provide that the provisions in the Tax Procedures Act, 2015 (TPA) relating to fraud , failure to furnish returns and underpayment of tax will apply to transfer pricing. Therefore, the penalties relating to these offences will be applicable in case non-compliance with the TP rules qualifies as among the offences or gives rise to an offence under the TPA.

Our View

The revision of the 2006 Rules is a welcome move, as it provides clarity and guidance on the applicability of Transfer Pricing legislation. The Draft Rules broadly seek to align the TP regulations with the changes adopted in the Income Tax Act over the years.

That said, the Draft Rules present various challenges which may impact on the overall success of implementation by the taxpayers as summarised below:

- **Brief/ short of detail:** The draft Rules are general and short on details and therefore do not provide clarity to taxpayers on specific transactions such as management fees, royalty, intercompany financing etc., which have been subject to extensive disputes with the KRA.
- **Materiality of transactions :** Transfer pricing compliance requires extensive analysis, which is costly and time consuming. The Draft Rules should provide for a materiality threshold. Such provisions relieve the compliance burden and provide greater certainty for cases involving smaller taxpayers or less complex transactions. Additionally, the provisions also reduce transfer pricing disputes.
- **Determination of the arm's length price for import and export of commodities:** Although the proposed approach eliminates some of the ambiguity of determining the arm's length price for commodities, the application of quoted prices is, in our view, a simplistic approach since it disregards the key aspects of the transaction such as the functions performed by group entities, long term contracts vis-à-vis spot, prices, etc.
- **Supporting documentation requested by the Commissioner:** the Draft Rules provide for a detailed listing of information to be provided to the KRA. Although the list of documents is extensive, in our view, the same does not provide clarity to the taxpayers on the exact documentation required to justify the arm's length prices for a transaction. The approach adopted seems to support the KRA audit approach where the extent of evidence required is at the discretion of the Commissioner.
- **Advance Pricing Agreement (APA):** The Draft Rules do not have any guidance on Advance Pricing Agreements (APAs) despite the increasing adoption of the same globally. In view of the increased transfer pricing disputes, the Draft Rules should include guidelines on APAs to enhance tax compliance and provide certainty on the TP policies adopted by the companies. This would also reduce the cost of carrying out transfer pricing audits for the KRA.

Conclusion

Should you wish to discuss this further, kindly feel free to contact any of the contacts below or your usual Deloitte contact who will be more than glad to offer you guidance and assistance.



Contacts for this alert

Fred Omondi

Partner, Tax & Legal Leader

+254 719 039 318

fomondi@deloitte.co.ke

Doris Gichuru

Partner

+254 719 039 454

dgichuru@deloitte.co.ke

Lillian Kubebea

Partner

+254 719 039 113

lkubebea@deloitte.co.ke

Walter Mutwiri

Partner

+254 719 039 253

wmutwiri@deloitte.co.ke

Doreen Mbogho

Partner

+254 719 039 225

dmbogho@deloitte.co.ke

James Mwendia

Partner

+254 719 039 210

jmwendia@deloitte.co.ke

Patrick Chege

Associate Director

+254 719 039 322

pchege@deloitte.co.ke

Maurice Lugongo

Senior Manager

+254 719 039 464

mlugongo@deloitte.co.ke

Nelson Ngaira

Manager

+254 719 039 233

nngaira@deloitte.co.ke

Lilian Wanyiri

Manager

+254 719 039 495

lwanyiri@deloitte.co.ke

Daisy Bett

Manager

+254 719 039 066

dbett@deloitte.co.ke

Edell Sirogo

Associate

+254 719 039 587

esirogo@deloitte.co.ke

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