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## PG. 2

A ruling in favour of Apple by the General Court of the European Union (EU) in *Ireland v European Commission* in 2020 on an appeal from the European Commission (EC) *Case T-892/16* revealed that Irish authorities granted Apple a tax advantage estimated at approximately 13 Billion euros.

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## PG. 3

In 2015, Kenya ratified the Convention on Mutual Administrative Assistance in Tax Matters (MCMAA), a multilateral treaty that promotes international cooperation to guide the operation of national tax regimes.

## THE IMPACT OF THE FINANCE BILL 2022 ON TRANSFER PRICING

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*Disclaimer: This Article does not form part of a Legal Opinion and is purely informative.*

### INTRODUCTION

The Finance Bill No. 22 of 2022 was brought for its first reading on April 12, 2022. With the rising cost-push inflation (also known as wage-push inflation), there is a need for the national government to increase revenues, reduce bond yields, and raise interest rates. Accordingly, the Finance Bill 2022 introduces several changes that seek to increase taxes in Kenya, including the increase of capital gains tax from a mere five (5) percent to fifteen (15) percent. More importantly, significant changes will have a glaring impact on multinationals (MNCs) and Kenyan companies that conduct business within preferential tax regimes (PTRs).



## TRANSFER PRICING DEFINED

Transfer pricing also referred to as transfer cost, arises either in cross-border transactions between a subsidiary and its parent company or between divisions of the same company located in different jurisdictions. In most cases, the beneficial owners between the two entities are usually related and are using PTRs to reduce taxable income globally.

Transfer pricing is, at its core, a strategic tool used by MNCs in decision-making in order to realize core activity goals and to shift profits from one company to another in order to gain tax benefits with the overall objective of maximizing profits by operating subsidiaries in countries with lower tax rates, where profits are consolidated to obtain higher profits after taxation.<sup>1</sup>

## THE CASE OF APPLE: THE EU INTERPRETATION OF TRANSFER PRICING

Apple's intellectual property (IP) licences for the manufacture, sale and distribution of Apple Group products outside North and South America are allocated to both the Irish branches of the Apple Group companies and Irish incorporated (but not Irish resident) subsidiaries of the Apple Group. This arrangement allows Apple to allocate sales as operation costs resulting in a tax benefit. A ruling in favour of Apple by the General Court of the European Union (EU) in *Ireland v European Commission* in 2020 on an appeal from the European Commission (EC) *Case T-892/16* revealed that Irish authorities granted Apple a tax advantage estimated at 13 Billion euros.

Notably, both judgments relied on the *OECD* Transfer Pricing Guidelines (TPG) focusing on two tests: the "*least complex test*" which looks at the source and process of sales and the "*functional test*" which examines the entity's function. The EC stated that the sales figure of the Irish corporate subsidiary (Apple Sales International) should be used rather than the operating costs of the Irish branch (Apple Operations Europe) which were mainly related to Apple IP. The EC posited that sales provided a more accurate reflection of the Irish branch activities and risks and its overall contribution as a subsidiary.

On appeal, the General Court (EU) noted that *OECD* TPG provide that the choice of profit-level indicator is not fixed for any type of function, provided that the indicator reflects the value of the function in question. The General Court (EU) also noted that the EC failed to show that the "operating costs" of the Irish branch were incapable of reflecting the value which the branch contribute to Apple Sales International operations.

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<sup>1</sup>Perčević, H., & Hladika, M. (2017). Application of transfer pricing methods in related companies in Croatia. *Economic Research-Ekonomska Istraživanja*, 30(1), 611–628. <https://doi.org/10.1080/1331677x.2017.1305779>





Notwithstanding, the General Court upheld the EC's right to apply the arm's length principle because it provided a benchmark that ensured that non-resident companies operating through a branch in Ireland were not granted preferential treatment in comparison to Irish resident companies whose taxable profits reflected prices negotiated at arm's length in the market.

The differences between the EC's and the General Court's judgments, demonstrate the possible interpretations of transfer pricing and their impact on taxation.

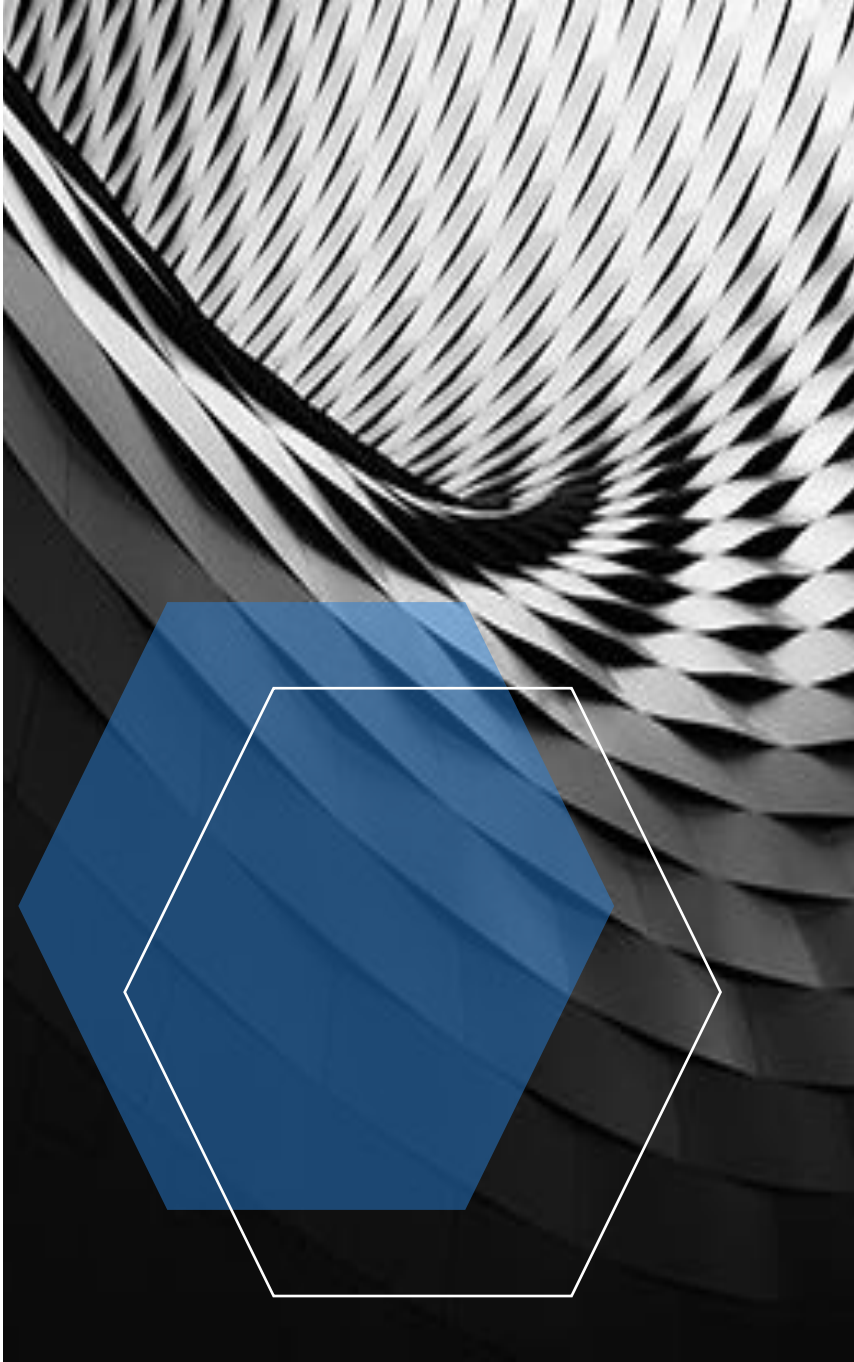
## **TRANSFER PRICING IN KENYAN LAW**

Kenya firmly recognizes and operates a source-based taxation system pursuant to Section 3(1) of the Income Tax Act (Cap 470). Kenya's transfer pricing regulatory framework under the Income Tax Act and the Income Tax (Transfer Pricing) Rules 2006 further requires a taxpayer within Kenya engaging in transactions with non-resident related parties to document and maintain a transfer pricing policy governing their business dealings in accordance with the arm's length principle. Additionally, the Kenyan High Court has also recognized the OECD TPG as supplementary guidance though not as a legally binding instrument within the Kenyan jurisdiction (see [Unilever Kenya Ltd v Commissioner of Income Tax \[2005\] eKLR](#)).

It is against this backdrop that the proposed Finance Bill 2022 seeks to introduce key amendments such as expanding the scope and definition of a PTR vide section 11. Notably, section 11 defines a PTR as a foreign jurisdiction that does not tax income, has a lower tax rate than Kenya or does not share banking information nor have a framework for exchange of ownership information. In effect, a Kenyan business importing goods, or yielding services from a country with a PTR within the expanded definition under the proposed Finance Bill 2022, such as Dubai, Mauritius, or other similar PTR, will be deemed to have conducted the transaction by an independent person dealing at arm's length or if none of the parties were located in a PTR. This may result in the reclassification of certain accrued incomes and expenses, and further lead to an increase in taxable income payable to KRA for both MNCs and local companies.

## **MULTINATIONAL CORPORATE REPORTING**

Further amendments on MNC reporting have also been included in the proposed Finance Bill in line with the OECD BEPS Action 13 dealing with transfer pricing. Section 13 adopts the tiered-approach of filing "country-by-country reports" of all financial dealings in addition to filing a master file and local file with the Commissioner. This information covers details on capital accumulated earnings, revenue and other vital balance sheet, cash flow and income statement items, in addition to information on tax rulings and any transfers of intangible assets.



MNCs attempting to conduct any transfer of assets or choose their jurisdiction to declare taxable income in order to take advantage of that PTR, will be obligated to pay the relevant taxes in Kenya through the defined arm's length rule.

The Bill proposes to retrospectively apply the reporting provisions from the year of income 2022 onwards.

## INTERNATIONAL MINIMUM TAX

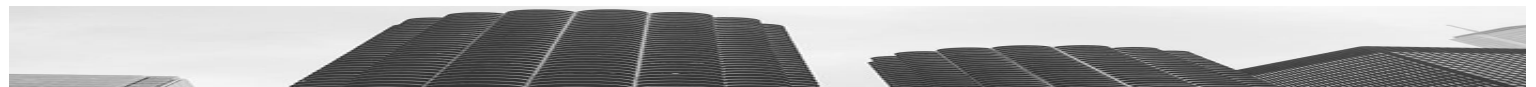
The Biden administration has recently proposed the implementation of an international minimum tax rate of 15%. Given the proposed Bill increase of capital gains tax from five (5) percent to fifteen (15) percent it is likely that MNCs operating in Kenya will face a higher taxation of at least 30%. This may lead to a reduction in foreign investment and a negative impact on the Kenyan economy. Nevertheless, the operation of tax benefits on high capital investments offered to specific industries within the proposed framework, such as hotels, manufacturers and other industries operating outside Nairobi and Mombasa may increase investment in these areas. Moreover, the application of zero duty and VAT on locally manufactured cars might lead to great impacts overall.

## CONCLUSION

The implementation of the proposed Finance Bill 2022 may increase KRAs revenue in the short-term with MNCs being forced to pay higher amounts of taxable income, however without the application of other key benefits such as reduced tax during the first few years of business and dramatically reduced costs, such as electricity, the long-term impact may be grim. The proposed Finance Bill 2022 can be accessed here:

<http://www.parliament.go.ke/sites/default/files/2022-04/The%20Finance%20Bill%2C%202022-1.pdf>

We will publish any further updates.



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