

Sagamore Hill.

Tax Newsletter.

ISSUE 031 June, 2024.



Navigating the Complexities of Transfer Pricing: Strategies, Updates, and Best Practices for 2024

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Every month, we publish the most downloaded tax case law with the most downloads from our [database](#). In this month’s newsletter, we will look into an ever evolving global landscape of transfere pricing making our reference to the case of BASF East Africa Vs Kenya Revenue Authority.

KRA conducted a post clearance audit that arose from referral by the Valuation Unit as a result of the Appellant filling an application for review of a decision to adjust the custom value of one of it’s products.



Appellant case was premised on the following issues.

- > The respondents erred in law and fact in finding that the relation between appellant and related party BASF Germany, influenced the price of the imported agricultural products in total disregard of the circumstances of the sale test.
- > The respondents erred in law and fact in finding that the gross commission paid to the appellant were not in tandem with the expected business practice and by incorrectly adjusting the transaction value of identical goods only by 10%.
- > The respondents erred in law and fact in by failing to take into account that the differences in functions performed and risk assumed by the appellant and third party importers in determining whether the prices declared by the appellant were low.
- > The respondents erred in law and fact by alleging that the appellant did not appropriately demonstrate that the transaction value closely approximated the custom value determined by using the deductive method, disregarding that they price paid by the appellant was determined using the RPM.
- > That the respondent in the application of the transaction value of identical goods did not make appropriate adjustments for differences in commercial and quantity

- levels and did not take into account the time difference in accordance with ECCMA.
- > The respondents erred in law and fact in finding that the license fees paid by the appellant to BASF Construction Research and Technology related to the imported goods and were paid as condition of sale in accordance with ECMMA.
 - > The respondents erred in law and fact by compounding the late payment interest imposed on what it alleges to be outstanding import taxes relating to license fees.

The respondents case was as follows.
The demand notice was raised based on two issues, being,

1. Undervaluation of agricultural products from January 2018 to July 2019
2. An adjustment to the transaction value of the 4% license fees paid/payable to BCRT.

The respondent contended that the Transaction Value closely approximated the unit value upon the application deductive value methods because,

1. The 15% rebate indicated did not appear in any of the commercial invoices as a term and neither the sales agreements availed support the same.
2. The factors of the percentage variance calculation have not been indicated.
3. The exchange rate used to convert the transaction value arising from the application of deductive value method was not revealed.

The responded argued that the fact that the goods were bought from a related party, the application of the transaction value was inappropriate and did not reflect the arm’s length transaction.
The respondent contended that a review of the appellant’s records established it paid license fees which ought to be used for local manufacture of construction materials since the payment was a condition of sale by clauses of the licensing agreement.

Submission of the parties.
On relationship between the parties and the influence on the price.

As regards the relation between the appellant and it’s related party influencing the price, the appellant correctly contended that the transaction value as provided for in the fourth schedule of the Act is the primary method of custom valuation as imported goods are to be valued whenever the conditions set therein are met. The notes make it clear that it is only when custom value cannot be determined under the provision of the next method used in the sequence can be used. Paragraph 2(2) further clarifies that the determination of the transaction value should not be deemed to be unacceptable merely because the buyer and seller are related parties. That in instances where the buyer and seller are related parties, circumstances surrounding the sale shall be examined and the transaction value shall be accepted provided the relationship did not influence the sale.
“2. Subparagraph 2 (a) provides that where the buyer and the seller are related, the circumstances surrounding the sale shall be

examined and the transaction value shall be accepted as the customs value provided that the relationship did not influence the price. It is not intended that there should be an examination of the circumstances in all cases where the buyer and the seller are related. Such examination will only be required where there are doubts about the acceptability of the price. Where the proper officer have no doubts about the acceptability of the price it should be accepted without requesting further information from the owner. For example, the proper officer may have previously examined the relationship, or it may already have detailed information concerning the buyer and the seller, and may already be satisfied from such examination or information that the relationship did not influence the price”
Under the **circumstance of sale test**, customs is required to examine relevant aspect of the transaction as detailed in subparagraph 3 which outlines the following aspects to be examined.

1. Has the price been settled in a manner consistent with the normal pricing practices of the industry in question of the industry in question or the way in which seller settles for buyer who are not related to the seller.
2. Is the price adequate to ensure recovery of all the costs plus a profit which is respective of the firm’s overall profit realised over the respective period of time?

Further, subparagraph 2(b) provides that several factors must be considered when determining whether one value closely approximates to another. These include;

- a. Nature of the imported goods
- b. Nature of the industry
- c. The seasons in which the goods were imported.
- d. Whether the difference in values is significantly different.

The appellant however contended that the following facts of the circumstances of the sale demonstrate that the relationship between the appellant and BASFSE did not influence the price.

1. Whereas the price of goods imported under the agency model included commissions, the price of identical goods imported under the merchandiser model did not include commissions.
2. The appellant under the agency model entered to in 2014 was to only obtain customer offers and submit them to BASF for conclusion of the sale contract. The goods were then imported directly and cleared through customs by the third party consumer.



3. As per the Agency Agreement, the appellant earned a gross commission as compensation for performance of duties assigned under the agreement. The gross commission was computed as follows.
Commission = Gross Commission Rate X Brokered sales.
The transferee pricing guidelines the Gross commission rate was computed as follows.

$$\text{GCR} = (\text{Cost incurred/Brokered sales}) + \text{Targeted earnings Before interest and Taxes margin}$$

It was clear that the gross commission incurred by the appellant in relation to the agency business covered the costs and allow an appropriate profit in light of the functions performed and risks assumed.

On differences in functions performed and risk assumed by the appellant and third party importers should be considered when comparing the prices.
The fourth schedule mandates the customs to examine the relevant factors of the transaction to determine whether the relationship influenced the price.
The distribution agreement and the TP rules of the appellant, obliged the appellant to perform various functions, assume risks and own assets in the course of distribution of its imported products. These functions include, Marketing, warehousing functions and customer services at its own expense and these functions were further supported in the financial statement of the appellant. The appellant further contended that the third party the respondent was comparing with did not perform such functions and therefore the transaction value of identical goods should be adjusted for the cost element related to **functions performed, risk assumed and assets** owned by the appellant.

The application of transaction value of identical goods.

The respondent erroneously adjusted the custom value of the identical goods previously declared by third party importers for commissions paid under the agency model at a rate of 10% which was a gross understatement for failure to make proper adjustments for differences in quantity and commercial level in its application of the transaction value of identical goods method. Note 1 of interpretative Notes P3, of 4th Schedule of EACCMA provides that in applying this method of valuation, the officer shall use a sale of identical goods at the same commercial level and in substantial and where such doesn't exist, the following three condition may be used.

1. a sale at the same commercial level but in different quantities;
2. a sale at a different commercial level but in substantially the same quantities; or
3. a sale at a different commercial level and in different quantities;

2. Having found sale under any one of these three conditions adjustments will then be made, as the case may be for:

- ❖ Quantity factors only;
- ❖ Commercial level factors only; or

- ❖ Both commercial level and quantity factors;

The appellant and is the sole distributor of the products in Kenya and EA region and the third parties who previously imported directly from BASF SE under the agency model, currently purchase the same products from the appellant. Therefore, the appellant and the third party customers operate in different commercial levels. The appellant imports significantly higher quantities of the product compared to quantities previously imported by third party customers.



On time differences were not considered in applying the transaction value of identical goods method
Paragraph 3 of EACCMA provides that when the transaction value of the identical goods method is used, the identical goods must have been exported to the partner states at or about the same time as the goods being valued. Further, the EAC custom Valuation Manual provides that the allowable period is flexible but commercial practice and market conditions must be taken into consideration. To be pragmatic, it is advisable to allow a 90 days period for comparison but it can be altered if circumstances dictate yet in this case, the respondent was using the goods imported for the periods between 1 and 3 years.

On the prices of agricultural products sold to the appellant are based on the Resale Price Minus (RPM) method, which is consistent with the deductive value method in the 4th Schedule of EACCMA.
As per the TP rules of the appellant, the appellant contended that the use of Comparable Uncontrolled Price (CUP) method is applied where the third party comparable transaction exists. However, where such doesn't exist, as is the case, RPM is applied, where the price is determined by deducting the gross margin from the appropriate resale price at which the products are sold by the appellant to third party customers. The computation of the intercompany price is done on product level article using the following formula.

Intercompany Price = Resale price x (1-Gross margin)
Whereas gross margin is computed based on a SBU (**strategic business unit**) level as per this formula
Gross Margin = (Cost incurred/Sales) + EBIT.
The resale price are the actual or preceding selling prices and the costs included costs attributed directly and indirectly to the merchandise business of the product which include Marketing, warehousing, distribution, import duties, inland transport costs. This therefore aligned well with the provision of paragraph 6 of 4th schedule of ECCMA as the unit price of imports was the selling price to third parties less profit margin and general expenses incurred in the distribution of the goods.
The appellant therefore submitted that the gross commission did not feature anywhere in the computation of intercompany price using the RPM.

On license fees paid by the appellant should not be included in the calculation of custom value in accordance with Paragraph 9(1)(c) of 4th Schedule of EACCMA.
The respondent erred in law and fact by contending that the license fees paid by the appellant related to the imported goods being valued and were paid as a condition for sale. The agreement has been signed in 2014 which granted the appellant non-transferable and non-exclusive use of the intellectual property and know how relating to the goods and owned and controlled by BCRT and the rate of 4% of net sales **of all the product**. In 2016, two notable terms were changed which were,

1. Royalties would only be payable with respect to own manufactured goods
2. Basis of royalties computation would be the net sales value of **own manufactured goods**.

The royalties were thus not payable on imported goods, they would only be paid on manufactured goods. The provision of EACCMA 9(1)(c) provides that royalties should be included in the custom value to the extent that royalties and fees;

1. Are related to the goods being valued,
2. Are a condition of sale of the goods being valued,
3. Are not included in the price actually paid or payable;

Two questions must then be answered in light of the above.

1. Is the royalty paid related to the imported goods.
2. Is the royalty paid as a condition of sale.

The World Customs Organisation 25.1 provides guidance regarding the interpretation and application of Article 8(1)(c) of the Agreement on Implementation of Article VII of the general Agreement on Trade and Tariffs GATT and provides that it is important to consider all documents and including royalties and license fees agreements.
The Key determinant in whether royalties are paid as a condition for sale is establishing whether the buyer is unable to import the goods without having to pay the license or royalties fees and the same is embedded in the sale documentation and if not included in the sale document, other factors may be used to determine whether

- there’s a condition on sale, and the include;
- a. A sales agreement can be terminated as a consequence of breaching the royalty or license agreement because the buyer doesn’t pay the royalty or license fees to the licensor. This would indicate a linkage between the royalty fee payment and the sale of goods being valued
 - b. There is a term in the royalty agreement indicating if royalties or license fees are not paid, the manufacture is forbidden from manufacture and sale of goods incorporating the licensors intellectual property to the importer.
 - c. The royalty or license agreement contains terms that permit the licensor to manage the production or sale between the manufacturer and importer (Sale for export to the country of importation) that go beyond quality control

In the reliance of Bata shoes Company Kenya Vs Kenya Revenue 2011 where the revenue authority had mandated the company to include royalty payments in the calculation of custom value, the High Court ruled that “**Unless the vendor is entitled to refuse to sell goods to the purchaser or repudiate the contract of sale where the purchaser fails to pay royalties or license fees then the condition of sale is inapplicable**” Bata had relied on the case of Deputy Minister of National Revenue Vs Mattel Canada Inc 2001 where the supreme court of Canada held that it only if the vendor can rescind the sales contract and refuse to sell the goods to the importer that they payment of the royalties would be considered to be a condition for sale and therefore dutiable. The appellant argued that the licence fees does not relate to the import of raw materials from BCRT and further that there was no reference to the sale of the raw materials in the contract, the royalties were payable from the sale of finished goods and not raw materials. The respondents’ argument that making reference to commentary 25.1 that royalties and license fees paid to a third party related to the seller of the imported goods was countered by the appellant that this particular provision relates to a third party related to the licensor whereas in this case the BCRT is a related party.

On compounding of late payment interest has no legal basis.
Section 249 of EACCMA states that **Where an amount of duty or other sum of money which is due under this Act remains unpaid after the date upon which it is payable, an interest of two per cent per month or part of the month, of the unpaid amount be charged.** Whereas this provision does not specify as to whether the applicable rate should be simple interest or compound interest, it has been held severally that any ambiguity in such a law must be resolved in favour of the taxpayer and not the republic revenue which is responsible for implementation.

Unless the vendor is entitled to refuse to sell licensed goods to the purchaser, or repudiate the contract of sale where the purchaser fails to pay royalties or license fees, the section that requires the fees paid be incorporated in custom valuation is inapplicable.

The court findings were as follows.

- ❖ On whether the relationship between parties influenced the price, the court held that the respondent did not adequately subject the appellant transactions and the commercial relationship to the “Circumstance of Sale” test before concluding whether the relationship influenced the price. This is because, when the model of business was changed from that of Agency to a Merchandiser, there was a change in functions, risks and assets and all these were well stipulated in the audited financial statements and that the formula used captured these changes as well. Further, the respondent did not demonstrate how the new arrangement should have been factored in the pricing of the goods.

World Custom Organisation provide that a key consideration of sale is establishing whether the buyer is unable to purchase the imported goods without paying the license or royalty fees

- ❖ On whether the respondent erred in applying the transaction value of identical goods method for custom valuation of the imported goods, the court found that, as discussed elsewhere on this newsletter, that the sale of identical goods did not take place at the same commercial level and substantially the same quantities as the goods being valued.
- ❖ On whether the RPM was the correct method that closely approximated the custom value of identical goods determined using the deductive value method, the groups internal transfere pricing policy stated that where a third party comparable transaction does not exist, RPM is used. The price under RPM is arrived at by deducting the gross margin from the appropriate resale price at which the products are sold by the appellant to third party customers. Further, EACCMA Paragraph 2(b) part 1 of the fourth schedule provides that the transaction value shall be accepted whenever the importer demonstrates that such value closely approximates the custom value of identical or similar goods as determined under the deductive method which the appellant did. Other issues as regards the variance in the pricing, we not necessary as the act only require the importer to demonstrate that the goods are valued appropriately and RPM was consistent with the deductive methods of valuation for the agricultural products.
- ❖ As regards the license paid by the appellant to BCRT ought to be included in the custom value, the agreement entered to after the change of the business model from agent to merchandiser, the appellant was only required to pay a license fee on own

manufactured products. Further, the agreement provided that termination would be initiated by either of the parities upon issuance of a six months’ notice, upon insolvency, bankruptcy, non-performance, or changes in the control license or if the licensor sell, or transfers it’s assets. **The agreement did not provide that non-payment of license fees is a condition of importin goods or producing them. World Custom Organisation provide that a key consideration of sale is establishing whether the buyer is unable to purchase the imported goods without paying the license or royalty fees. Further, when royalty or license fees is payable to a third party related to the seller of the imported goods then it is likely that the fee is paid as a condition sale.** In the earlier discusses case of Bata, the royalty fees paid were regarded to too remote from the value of the goods since they were paid on imported and locally manufactured goods and they were therefore regarded to be paid for use of trademark in Kenya and had nothing to do with the price of the import. Further, if the lawmaker intended that royalty and license fees be paid on all imports, nothing prevented them from doing so.

The Canada case further buttressed the fact that unless the vendor is entitled to refuse to sell licensed goods to the purchaser, or repudiate the contract of sale where the purchaser fails to pay royalties or license fees, the section that requires the fees paid be incorporated in custom valuation is inapplicable.

- ❖ On the compounding of the late payment interest imposed, section 249 does not indicate whether the late payment interest should be simple interest or compounded interest, as ruled elsewhere, in the event of ambiguity in law, then the matter be resolved in the tax payers favour, this means that interest payable, if any, is simple interest.

The appeal was allowed by the tribunal.

Our commentaries and what to take away.

In the recent past, we have seen the Kenyans courts make decisions on cases about transfere pricing, an area that is becoming complex by day. In some of the cases, the revenue authority challenged the choice of transfere pricing method applied and successfully won most of these case. A choice of the method of transfere pricing, therefore, has to be justified in the institutions’ transfere pricing document policy.

One way of handling transfere pricing audits by the revenue authority, is having a TP policy in place and this shifts the burden to the KRA auditors to question the document, unlike not having a policy document where the taxpayer has to expend a lot of time in handling and

answering the revenue authority. Further, it is important to ensure that the policy document is constantly updated to incorporate such changes as may be introduced in law, and also to factor in decisions made in the courts. Below, are the five transfere pricing methods and when to best apply each one of them. These methods are further subdivided into traditional methods and transactional profit methods.



The traditional transfere pricing methods are;

- I. **The Comparable Uncontrolled Price (CUP) Method.** This is the most direct and reliable way to apply the arm’s length principle. It is a method that compares the price for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. The most appropriate to use if you have access to reliable comparable data for uncontrolled transactions.
- The price applied in a transaction to a related party is compared with
 - 1. The price of a comparable transaction that has been carried out between a related parties and an unrelated party, this is also called internal price, or
 - 2. With the price of a comparable transaction carried out with an unrelated person
 - 3. Where the information and data is publicly available, a comparable transaction entered between unrelated parties and appropriate adjustment done where necessary.
- II. **The Resale Price Method** – This method is applied to transactions related to acquisition or resale goods if the goods are sold by the seller to an unrelated person. The gross profit

margin earned by the reseller in a related party transaction is compared with,

- 1. Gross profit margin earned/ resale price margin earned by unrelated parties in uncontrolled transaction.
- 2. Gross profit margin earned/ resale price margin the reseller earns on goods purchased on the goods purchase and sold in comparable uncontrolled transactions (internal comparable transaction)

- III. **The Cost Plus Method** – In this method, the cost base is analysed and the determination of the price is based on the addition of a market mark-up to these costs, the amount of which depends on the functions, risks, assets involved by the entity. General and administrative expenses, selling costs, and department costs are excluded in the cost. In this method, the cost mark-up applied by the producer of goods is compared to;
 - 1. The sellers/ manufactures cost mark-up in a comparable uncontrolled transaction.
 - 2. The cost mark-up applied in unrelated parties in comparable uncontrolled transaction.

The profit mark-up is calculated as follows.

$$\text{Profit mark-up} = (\text{Selling price} - \text{Cost base}) / \text{Cost base} \times 100\%$$

Transactional profit methods.

A. The Transactional Net Margin Method (TNMM)

The method examines the net profit margin relative to an appropriate factor or base such as costs, sales or assets attained by a multinational Enterprise from a controlled transaction. As it is with the cost plus or resale price methods, this margin should preferably be derived from comparable uncontrolled transactions between the same taxpayer and independent parties and where such is not available, then the comparison can be drawn between two other unrelated entities. This method is useful where it is challenging to compare gross profit margins. Net margins are influenced significantly by factors other than production costs, varying cost structures, competitive positions etc. This therefore means that TNMM should be used in cases where such factors as detailed above have great level of similarity so as to eliminate the effects of these other conditions.

This method can be applied by following the following steps.

- 1. Calculate the net profit (sales price less direct and indirect cost)
- 2. Identify the NPIs of the controlled transaction [net profit / (costs, or sales, or assets)]
- 3. Identify the NPIs of the comparable uncontrolled transaction or group of comparable uncontrolled transactions. While calculating the NPIs, the same

- base should be used, which has been used to calculate the NPI of the controlled transaction.
- 4. Adjust the differences that could affect the net profit and NPIs in the open market
 - 5. Use the adjusted net profit to establish the arm’s length price

B. The Transactional Profit Split

Method. In this method, profit is split between two or more related enterprises. This method is applied to mutually dependent transactions (highly integrated transaction), if comparable transactions between unrelated parties may not be identified as well as in transactions in which a number of related parties are involved. For example, when two related parties work towards developing and launching a new product. The combines profit earned by related entities in the mutual transactions is allocated using an economically justified basis between the related parties involved in the transaction using the contribution that each of the related party made to the transaction.

Over and above this, the Tax Appeal Tribunal rightfully ruled in the case of *Wallpaper Kenya vs Commissioner of Customs & Border Control* that the application of methods of valuation as provided in EACCMA has to be done consequently.



Transfere pricing can be a very complex and risky undertaking that has to be done well. In our [database](#), we have tax case laws arranged in the class of tax that they fall in and every month, we do a case review of the most downloaded caselaw with further notes for your learning. Find our newsletters [here](#).

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