REPUBLIC OF KENYA

IN THE HIGH COURT OF KENYA

AT NAIROBI

INCOME TAX APPEAL NO. 753 OF 2003

UNILEVER KENYA LIMITED
(formerly East African Industries Limited) ……….…. APPELLANT

VERSUS

THE COMMISSIONER OF INCOME TAX ………. RESPONDENT

(An Appeal from the decision of the Local Committee of the Income Tax Department in Case Nos. 18/23/2003 and 18/24/2003-09-025 delivered on 17th September, 2003).

JUDGMENT

The Appellant Unilever Kenya Limited (UKL) once known as East African Industries Limited is engaged in the manufacture and sale of various household goods including foods, detergents and personal care items. The appellant is a part of the world-wide Unilever group of companies. Unilever plc., a company incorporated in the United Kingdom has a very substantial shareholding in the UKL. UKL and Unilever Uganda Limited (once known as Uganda Associated Industries Limited) (hereinafter referred to as "UUL") are related companies as defined in section 18 of the Income Tax Act, Cap. 470 Laws of Kenya (The Act). I will refer to section 18 of the Act later during the course of this judgment.

It is not in dispute that UKL and UUL entered into a contract dated 28th August, 1995 whereby UKL was to manufacture on behalf of UUL and to supply to UUL such products as UUL required in accordance with orders issued by UUL. UKL supplied such products to UUL during the years 1995 and 1996. It is also not in dispute that

www.kenyalaw.org

www.kenyalaw.org

UKL manufactured and sold goods to the Kenyan domestic market and export market, to customers not related to UKL.

It is further common ground that the prices charged by UKL for identical goods in domestic export sales are different from those charged by it for local domestic sales. The prices charged by UKL to UUL differed from both the above sales and were lower than those charged in domestic sales and domestic export sales for identical goods. In other words, UKL charged lower prices to UUL then it charged its domestic buyers and importers not related to UKL.

The respondent, that is, the Commissioner of Income Tax, raised assessments against UKL in respect of the years 1995 and 1996, in respect of sales made by UKL to UUL on the basis that UKL's sales to UUL were not at what is called at "an arm's length" prices. The respondent in raising such an assessment relied on Section 18 (3) of the Act which reads:-

> ***"18(3) where a non-resident person carries on business with a related resident person and the course of that business is so arranged that it produces to the resident person either no profits or less than 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 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 arms length".***

A literal reading of section 18(3) as reproduced above simply dictates a meaning to the effect that a seller in Kenya is bound to pay income tax on profits which he/it could have earned had he/it sold its products to an out of country buyer as such a price as would be "an arms length price" so that the respondent is entitled to calculate the tax-payer's profits on such basis.

However, the important and relevant words in the said sub-section are:

> ***"The course of that business is so arranged that it produces to the resident person either no profits or less than ordinary profits which might be***

> ***expected to accrue from that business if there had been no such relationship………"***

Hence the most important issue that arises for determination is whether or not the course of business between UKL and UUL **<u>was so arranged as to produce less profits</u>**. The respondent submits that as a result of special relationship between UKL and UUL the transactions between them resulted in less taxable profits to UKL. The respondent argues that the sale of products by UKL to UUL at a price lower than the comparable prices charged to Kenyan buyers or to outside Kenya importers represents a transfer price and hence the difference becomes subject to taxation on the basis of sales at arms length prices.

www.kenyalaw.org

The appellant responds to the respondent's said argument by stating that the term "transfer pricing" describes the process by which related or connected entities set the process at which they transfer goods or services between each other and that the term "transfer pricing" therefore is simply a reference to the price at which related parties transfer goods and services to each other. The respondent does not, however, dispute that the prices charged by UKL for sales to UUL represent a "transfer price" but he adds that the transfer pricing arises, where as a result of a special relationship between two or more enterprises, transactions between them result in less taxable profits than that which would have been obtained or earned if the trading transactions were done with a non related enterprise that is at an arm's length. The respondent puts forward a further argument to the effect that the prices charged by UKL to UUL are nothing but "discounted prices".

The appellant has taken issue with the word 'discount' as used by the respondent saying that it is misleading in that it implies that there was a standard price which UKL 'discounted' in favour of UUL.

The respondent has not issued any guidelines on how companies are to comply with Transfer Pricing (TP) requirements and he has not responded adequately to the lengthy submissions made by UKL on the main issue raised which is :-

> ***"Whether in the absence of specific guidelines from the Kenya Revenue Authority on this issue, the OECD (The Organization for Economic Co-***

operation and Development) guidelines and the methods prescribed thereunder for the calculation of an 'arm's length price' are a proper, reasonable and objectively acceptable basis for the determination of an arm's length price as required under section 18(3)".

The appellant has set out, at length, what in its view, could be the proper or acceptable methods of determining an arm's length price for the purposes of eventual computation of tax under section 18(3) of the Act. The factors and matters which ought to be considered, according to UKL, in arriving at arms length prices are various. To summarize, these are:-

1. Transfer Prices adopted by a multinational in respect of transactions between its various subsidiaries and affiliates, have a direct bearing on the proportional profit it derives in each country in which it operates. There is a wide agreement amongst revenue authorities and amongst participants in industry that foreign owned businesses in their jurisdiction should not be permitted to pay proportionately less tax than domestic businesses by rigging their inter-group pricing structure to reduce the profits of their branches or subsidiaries.
2. A state is entitled to make appropriate adjustments to tax charged on profits of multinational enterprises in its jurisdiction.
3. Kenya has promulgated transfer pricing legislation adopting arm's length principle which enables Kenya to adjust the transfer price charged on sales between related companies by invoking the arm's length principle.
4. South Africa, Tanzania and United Kingdom have promulgated similar transfer pricing legislations.
5. The intention of promulgating such legislations is to see to it that transactions between related parties are conducted on arm's length principles.
6. These provisions are empowering provisions in that they merely empower the relevant revenue authority to make such adjustments in transfer prices as may be necessary to ensure adherence to arm's length principles.

www.kenyalaw.org

www.kenyalaw.org

7. In the absence of specific guidelienes having been issued by Kenya Revenue Authority under section 18(3) of the Act the determination of these principles ought to be made in accordance with international best practice as represented by the OECD Transfer Pricing guidelines for Multinational Enterprises and Tax Administration Guidelines (The OECD Guidelines).
8. Guidelines adopted by other countries who have promulgated arm's length principle essentially endorse or adopt the principles promulgated by the OECD guidelines and require that these be followed in the determination of the arm's length prices.
9. Countries who are not members of OECD have also adopted these guidelines.
10. The respondent in basing its determination of an arm's length price on what he considers to be 'Comparable Prices' has in fact sought to apply one of the methods endorsed by OECD guidelines but has done so, in this instance, erroneously.
11. It is for UKL to demonstrate the consistency of its Transfer Pricing Policy within OECD guidelines.
12. These guidelines provide a detailed description of various methods that may be used to apply, the arm's length principle, which are traditional transaction methods or transactional profit methods.
13. The respondent has attempted to apply the first and the most direct method recommended in the OECD Guidelines for the determination of an arm's length price, called the Comparable Uncontrolled Price method (The CUP method), which method compares the price charged for goods or services transferred in a controlled transaction to the price charged for goods or services transferred in a comparable uncontrolled transaction (like a transaction between independent enterprises) in comparable circumstances. If any difference is noticed between the two prices the transaction is not deemed to be at arm's length. Where it is possible to locate comparable uncontrolled transactions, the CUP method is considered to be the most direct and reliable way to apply the arm's length principle. Consequently the OECD Guidelines provide

that, in such cases, the CUP method is preferred over all other methods.

14. The respondent having applied the CUP method it ought to be considered whether the average price charged by UKL in Domestic Sales is a 'Comparable Uncontrolled Price' to that charged by UKL in the UUL sales for the purposes of section 18(3) of the Act and whether the average price charged by UKL in Domestic Export Sales is a Comparable Uncontrolled Price to that charged by UKL in the UUL sales for the purposes of section 18(3) of the Act.

15. Neither of these prices are 'Comparable Uncontrolled Prices' as there are wide differences in selling prices per unit weight of the different products and no two sales would comprise a similar mix of products in similar proportions.

16. UKL then gives examples of same tonnage but different resultant prices per tonne as a result of different mix of products. It has produced for ease of reference a table (marked F) which illustrates true percentage differences in the prices charged by it on Domestic Sales, Domestic Export Sales and UUL Sales which differences range from 19% in the case of OMO to 48% in the case of Close Up. This table was before the Local Committee.

17. The respondent has made no adjustments to reflect the material effects of differences between Domestic Sales and UUL Sales which would materially affect the price in the open market.

18. The respondent has made no allowances for the cost of marketing goods in Kenya with all resultant overheads as opposed to selling goods directly to UUL for UUL to market the goods in Uganda, at its (UUL's) costs.

19. Similar principles apply to sales to foreign companies in countries where Unilever has no sister company so that UKL has to bear the cost of promotion of its goods in those countries.

20. If in fact UKL were to sell its goods to UUL at prices comparable to local or other foreign buyers it is probable that these buyers would rather buy from Unilever India or Unilever South Africa which would mean UKL would lose its Ugandan and other markets.

www.kenyalaw.org

www.kenyalaw.org

21. The prices charged by UKL on Domestic Sales in the same period were higher than the Transfer prices as a result of UKL's recovery of additional costs and not as a result of any 'discount' given to UUL or as a result of the relationship between the two companies.
22. It is not possible for UKL to estimate with any accuracy the amount of additional costs in Uganda.
23. In other words the only way to make the adjustment would be to assume that UKL had to bear additional costs in Uganda and to add the aggregate of these to the Transfer Price to see whether that price equated with the Domestic Sales price or export prices.
24. On the Domestic Export Sales UKL was entitled to claim as export rebate ("the EPPO benefit") equivalent to the percentage of total product price constituted by import duties paid by UKL on imported ingredients. 5% figure presented by the Respondent is inaccurate since the amount of the rebate is variable between different products depending on the proportion of imported inputs and their cost.
25. These additional costs and EPPO benefits constitute a difference between UUL sales and Domestic Export Sales which would materially affect the price in the open market.
26. If neither the Domestic Sales price nor the Domestic Export Sales prices are comparable prices for the purposes of section 18(3) of the Act, is there a Comparable Uncontrolled Price for the purposes of that sub-section? The answer is that as there was no Comparable Uncontrolled transaction between any other parties to which reference may be had there was no Comparable Uncontrolled Price for the purposes of applying the CUP method.
27. What then is the proper method, that is, in the absence of a Comparable uncontrolled transaction, usable or acceptable for calculation of arm's length price under section 18(3) of the Act?
28. The OECD Guidelines lay down in such case two indirect traditional transaction methods which may be employed. These are the Resale Minus Method and the Cost Plus Method which two methods, in essence, achieve the same result from opposite approaches so that it is usually immaterial which of the two is employed.

www.kenyalaw.org

29. UKL submitted that the cost plus method which is adopted in pricing products sold to UUL has been endorsed by the OECD Guidelines as an appropriate method for determining an arm's length price in uncontrolled transactions.

30. UKL concedes that its internal Transfer Pricing Policy is not binding on the respondent but is in all the circumstances and in the absence of any guidelines by KRA the proper method to be applied in assessing further tax liability of UKL.

31. UKL urges that provided the Transfer Pricing Policy is in accordance with the OECD Guidelines on the application of the arm's length principle, and to the extent that it adopts, without material modification, the methods endorsed by the OECD Guidelines for the determination of an arm's length price, the respondent's arguments against that fail.

32. The Transfer Pricing Policy has been developed in accordance with principles promulgated by OECD and specifically in accordance with OECD Guidelines. That the Transfer Pricing Policy has the arm's length principle as its underlying principle, that is, that the prices set between companies within the Unilever Group "should approximate those set by unrelated parties for comparable goods and under comparable circumstances in an open and free market".

33. In accordance with the arm's length principle the Transfer Pricing Policy requires that pricing between companies in the Unilever Group should, where it is possible to establish a market price, be based on market prices.

34. Where a Comparable Uncontrolled Price or market price is not available, the Transfer Pricing Policy requires the companies to approximate such a price by the application of one of the two internationally accepted methods of which the method known as the "Cost Plus Return Method" is the preferred method.

35. The Cost Plus Return Method approximates a Comparable Uncontrolled price or market price by recovering the supplying company's costs plus an appropriate return on capital employed. The standard pre-tax return on capital employed applied under the Transfer

pricing Policy is 10% which represents the average return on capital made by companies in Unilever Group on sales to unrelated third parties. The price so arrived at is known as the "Standard Transfer Price".

36. That, therefore, the transfer pricing Policy follows the OECD Guidelines to the letter without any departure whatsoever. If correctly applied, therefore, the Standard Transfer Price which results from its applications would be an arm's length price within Article 9 and the OECD Guidelines.

37. There being no Comparable Uncontrolled Price, the parties applied the Cost Plus method by providing in clause 3 of their contract that the price was to be the aggregate of fixed and variable costs incurred by UKL plus a return of 7% (net of tax) on capital. Therefore, the Standard Transfer Price must be regarded as an arm's length price.

38. Unless the respondent can show that UKL did not correctly apply the Transfer Pricing Policy or that the transfer price charged by it in the UUL sales was not equivalent to the Standard Transfer Price arrived at through the application of the Transfer Pricing Policy and that this has never been alleged by the respondent, the court must find that the transfer price in the UUL sales was an arm's length price and that therefore the respondent's stand must fail.

39. The profits resulting from the business of UKL with UUL during the years 1995 and 1996 years of income were not less than the ordinary profits which might have been expected to accrue from the business if the course of that business had been conducted by independent person's dealing at arm's length and accordingly the respondent is neither entitled to deem higher profits than those which actually accrued to UKL in respect of its business with UUL in those years of income nor to levy tax thereon.

In his response the respondent does not dispute that the prices charged by UKL in the UUL sales represent a "transfer price". However, he questions if the transfer pricing arrangement between UKL and UUL resulted in lower prices than the Comparable prices charges in Kenya or to third party exporters in Kenya. The respondent puts it

www.kenyalaw.org

simply and suggests that Transfer Pricing arises, where as a result of a special relationship between two or more enterprises, transactions between them result to less taxable profits than those which would have been obtained or earned if the trading transactions were done with a non related enterprise, that is, at arm's length.

Further the respondent urges that where prices charged between related companies result in less taxable profits than which would have been obtained but for the special relationship, taxes must be recalculated to the extent of normal trading transactions so as to arrive at taxable profits. The respondent puts what he calls "full stop" here.

The respondent takes issue with the methods suggested by UKL in arriving at arm's length principle including references to foreign law and OECD principles etc as not applicable or even worthy of consideration as section 18(3) of our Act does not allow such references.

The respondent after quoting section 18(3) of the Act says, without more, that transfer pricing refers to a "transfer of profits by an en enterprise to another related enterprise".

Again, after referring to section 18(3) of the Act the respondent argues that the same is clear and does not brook of or look at the need for other similar legislations and that he is bound to apply and implement the requirement to the sub-section without wavering or persuasions by what other jurisdictions apply. He says that references to transfer pricing guidelines as in Tanzania, the UK and South Africa do not render section 18(3) of the Act irrelevant or ambiguous in dealing with the transactions between UKL and UUL.

The respondent submits that the Organization for Economic Co-operation and Development Model Tax Convention on Income and on Capital (OECD Convention) and its related guidelines such as "Transfer Pricing" guidelines for Multinational Enterprises and Administration etc do not have any application in this appeal and puts forward the following arguments:-

(1) Those are used to guide countries entering into double taxation agreements and that is not the case here.

www.kenyalaw.org

(2) The tax model guidelines cannot be part of the legislation of that country unless where a country has adopted the recommendations in a tax treaty with another country. Hence that argument is not relevant in this appeal.

(3) The guidelines are not part of the law of this country.

(4) The omitted taxable profits have been based on the difference between 'average' selling price per tonne to UUL and un-related parties (third parties). That UKL is working on hypothetical figures.

(5) The respondent has compared the average price per tonne to UUL and the average price per tonne to third parties.

(6) In answer to UKL's argument to the effect that it has to take into account its Kenyan overheads in selling to countries which have no sister companies and that it does not have to take into account such overheads on sales to UUL the respondent states that it is of no consequence to him as section 18(3) of the Act does not allow expenses incurred in another jurisdiction by a resident of that jurisdiction (Uganda).

(7) The respondent, without more or less, insists that the profits earned by UKL from UUL must be the same as in respect to un-related persons (third parties). UKL, he urges, has accorded to UUL a discount by footing UUL's costs for promotion of Unilever products in Uganda.

(8) UKL and UUL have arranged between themselves as two related enterprises to fixing or setting prices of goods between themselves without considering the market forces.

(9) UKL has sold its products to buyers in Somalia and Tanzania at higher prices than those charged to UUL.

(10) After referring to the OECD Mode Tax Convention in Article 9, the respondent postulates that there is a scheme designed by UKL to cheat on its gross income hence reducing its tax liability. Reference to Indian and South African Unilever Companies otherwise supplying cheaper goods to UUL, the respondent states, is not an acceptable argument. UKL ought to have invited third party customers in Somalia and Tanzania to enter into similar manufacturing contracts so as to show its impartiality; this is, as I understand, this aspect of his arguments.

www.kenyalaw.org

(11) UKL has not demonstrated that the "Transfer Pricing Policy" of Unilever Group of Companies does not offend the provisions of section 18(3) of the Act and that their transactions were at an arm's length principle.

(12) The Transfer Pricing Policy offends the requirements of section 18(3) of the Act, such Policy not being within the provisions thereof.

The Local Committee at its meeting of 17th September, 2003 made the following adjustments:
The taxable benefit brought to charge in the year of income 1995 be reduced by 5% of the Computed Taxable Benefit of 24.5% and for the year of income 1996 a taxable benefits of 17.44%.

www.kenyalaw.org

Unfortunately I do not have the benefit of the reasoning by the Local Committee and I am bound therefore to consider this appeal in terms of arguments advanced before me. I note that the Local Committee allowed an assumed Export Processing Programme Office (EPPO) benefit at 5% for the year of income 1995 and also 5% for the year of income 1996.

I have noticed that the very lengthy submissions made by UKL on guidelines adopted by other countries have been ignored by the respondent on the basis that these simply do not apply to Kenya. Now, these guidelines do not form the laws of the countries in question. They are simply "guidelines", guiding the world of business, that is business enterprises and the taxing authorities of those countries in arriving at proper Transfer Pricing principles for the purposes of computation of income tax. I am, therefore, unable to accept the argument that in view of the alleged clear wording of section 18(3) of the Act, no guidelines are necessary here in Kenya. That is rather simplistic, and devoid of logic. 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.

www.kenyalaw.org

Therefore, I cannot ignore the time-tested experiences and best practices of others, in the argument that section 18(3) of the Act brooks of no ambiguity, and that it is unnecessary to look elsewhere. That would be too limiting an approach to take.

I have no doubt in my mind that the OECD principles on income and on capital and the relevant guidelines such as "Transfer Pricing" principles, the CUP method adopted for calculations of what ought to be the income, the Cost Plus Return method as well as Resale Minus Method adopted for looking into compliance with arm's length principles are not just there for relaxed reading. These have been evolved in other jurisdictions after considerable debates and taking into account appropriate factors to arrive at results that are equitable to all parties. The ways of doing modern business have changed very substantially in the last 20 years or so and it would be fool-hardy for any court to disregard internationally accepted principles of business as long as these do not conflict with our own laws. To do otherwise would be highly short-sighted.

Section 18(3) of the Act has used words "**and the course of that business is so arranged that** ...". The sub-section implies that the business so arranged must be such as to show less income to enable the tax authorities to challenge it. The respondent has submitted that this arrangement has been made deliberately to show lesser earnings. But is that really so? There is no evidence of tax fraud or tax cheating. The only evidence, material, is in regard to **methods** used for computation of tax. Use of different methods, so long as proper or lawful or rather not unlawful, is permissible and ought to be permissible so long as there is no fraudulent trading with a view to "evading" tax. I think the words I have just used makes the language of Section 18(3) of the Act somehow obscure and a tax payer is entitled to demand that his liability to a higher charge should be made out with reasonable clarity, before he is adversely affected. This is the dictum of **Viscount Simon** in ***Scott V. Russell*** ***(1948) 2 ALL E.R. 1*** which dictum was applied with approval in the case of ***Kanjee Nazanjee v Income Tax Commissioner*** ***(1964) E.A. 257 at 262 H***.

I am unable to accept that the State's guidelines are germane only to countries with double taxation guidelines. For example the very second item in the preface to OECD guidelines read:

> ***"These issues arise primarily from the practical difficulty, for both MNES (Multinational Enterprises) and tax administrators, of determining the income and expenses of a company or a permanent establishment that is part of an MNE Group that should be taken into account within a jurisdiction, particularly where the MNE Groups operations are highly integrated".***

I need not repeat the contents of the said preface except to state that these do assist in cases like the present one. The respondent's stand on section 18(3) of the Act is clear as I pointed out earlier. He says the sub-section is not ambiguous at all and must be read as literally as it is. Ordinarily a statute ought to be interpreted as per its wording if the wording is clear. But what when certain words or sentence is amendable to two interpretations? **Was the course of business between UKL and UUL so arranged as to enable UKL to make no profits or less profits? I am unable to see such an "arrangement".**

What when several possible methods are suggested almost worldwide to arrive at arm's length prices for the purpose of taxation? In my view when the Act provides no guidelines, other guidelines should be looked at. In this particular case my task is to decide whether UKL's business with UUL was so arranged as to show, deliberately, less profits. To consider this issue I take into account the fact that if UKL charged UUL prices such as applicable to other importers or customers obviously UUL would buy from elsewhere. I also take into account the fact that UUL has its own programme for selling the products in Uganda for which it incurs expenses which expenses so far as UKL is concerned are saved. I do not smell any special price fixing agreement so as to evade tax.

I was shown the Indian Income Tax (21st amendment) Rules, 2001 Rule 108 thereof sets out at length guidelines for determination of arm's length price under sub-section (2) of section 92 C of the Indian Income Tax Act. It also goes at length into computation of arm's length prices. It refers to CUP method, also to cost plus

www.kenyalaw.org

www.kenyalaw.org

method, transactional net margin method, most appropriate method etc. Unfortunately our Act is silent on such methods to be employed or used. Section 18(3) of the Act does not tell tax payers what KRA will accept as arm's length, or how to prove it to them or if they are willing to negotiate pricing arrangements. I do hope that KRA will lead in the initiative to make rules in this regard as India did as early as in 2001.

Accordingly, and for reasons outlined, I do no think that the costs plus method used by UKL is a wrong method of arriving at an arm's length price in the particular circumstances of this case.

I am constrained to disagree with the respondent's or the Local Committee's method of arriving at arm's length method for computation of tax and I have no alternative but to allow this appeal with costs with the result that the assessment in question is ordered to be annulled to the extent of tax levied by the respondent in accordance with section 18(3) of the Act arising from deemed profits from UKL's business with UUL in 1995 and 1996. It is further ordered that no tax shall be levied by the respondent in accordance with section 18(3) of the Act arising from deemed profits from the business with UUL in 1995 and 1996. These are the orders of the court. As both Appeals, numbered 752 of 2003, and 753 of 2003 were consolidated by consent of the parties, this Judgment shall apply to both those appeals.

Finally, before I close, let me acknowledge this Court's gratitude to all the Counsels – Mr P M Gachuhi and Ms J W Kabiru for the Appellants, and Mr W Gatonye and Mr P M Mutuku for the Respondents, for their eloquent and well-researched submissions, and for their patience in the slight delay in delivering this Judgment.

Dated and delivered at Nairobi this 5th day of October, 2005.

ALNASHIR VISRAM

JUDGE