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UNILEVER
vs
COMISSIONER OF INCOME TAX
INCOME TAX APPEAL 752/753 OF 2003

ATAF-OECD WORKSHOP
ON
TRANSFER PRICING IMPLEMENTATION ISSUES
KIGALI, RWANDA
September, 2011

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CASE SELECTION

- Unilever Kenya (UKL) had posted progressively heavy losses continually for a period of three years between 1994 and 1996.
- Heavy claims for investment deductions on plant and machinery in 1995 and 1996 (approx US $ 4M.
- The company was also making major claims for industrial building allowances which allowances claim indicated that the firm had undertaken major expansion works.

The audit was commenced in mid 1998 by an audit team responsible for large taxpayers.

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BACKGROUND

- Unilever Kenya is a manufacturer and distributor of fast moving consumer goods including detergents, personal products and food products.
- The products offered by the company were the dominant market leaders in the region.

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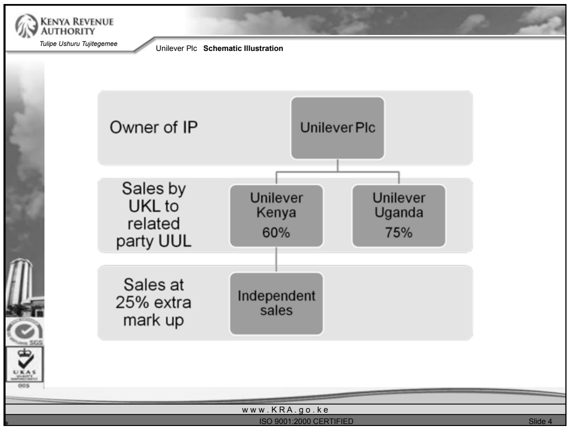

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AUDIT

- During audit, major differences were noted in prices offered to related party- Unilever Uganda (UUL) based in Uganda (with exclusive marketing rights) were approximately 25% lower than those offered to the independent third parties exporting to the Tanzanian market.
- The prices offered to the related party,
- KRA formed the opinion that these transactions offended the arm's length principle as set out in Section 18(3) of the Kenya Income Tax Act (the Act). The provision is set out below;

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Section 18(3) of the Kenya Income Tax Act

- *'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 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 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.'*
- According to Section 18(6) of the Act, the two companies were related by virtue of the fact that a third person (Unilever Plc) participated directly or indirectly in the management, control or capital of the business or both.

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Functions

UKL

- Sourcing raw materials
- Warehousing of raw materials
- Manufacture
- Transportation
- R&D and product development

UUL

- Selling & Distribution
- Marketing
- Warehousing of finished goods

FUNCTIONAL ANALYSIS

ASSETS

UKL	**UUL**
Manufacturing Plant & Equipment	Unknown
Factory/ warehouse buildings	
Trucks/Vehicles	
RISKS	
Inventory risk	Market risk
Transportation	Foreign exchange risk
Import/Export procedure	
Legal regulatory compliance	
Credit	

Key aspects of inter-company annual supply contract between UKL and UUL.

- UKL which carries on manufacture and sale of various products has at the request of UUL agreed to supply to UUL with the **finished products** on the following terms;
- Subject to availability of stocks
- UUL shall from time to time notify UKL of its requirements of the products which shall be provided on a monthly basis.
- Property in the products shall pass upon delivery to UUL premises.
- UKL shall keep accounts of goods supplied and send monthly statement of accounts payable by UUL within 90 days of receipt.
- The contract may be terminated by either party giving three months notice.

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CONTENTS OF SUPPLY CONTRACT

- The prices of the goods will be the aggregate of
  - costs of material on predetermined basis at a rate determined quarterly with adjustments to be made for variances between actual and predetermined costs.
  - Predetermined variable operating costs to be advised on quarterly basis.
  - Fixed operating costs at a a rate per tonne of the goods based on UKL factor's total fixed operating costs attributed to UUL's purchase of goods in proportion to the factory's theoretical production of the goods if 85% of its manned capacity were utilized and assuming efficient production.

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CONTENTS OF SUPPLY CONTRACT

- All products will carry an indirect predetermined charge.
- Transport costs from Nairobi to Kampala will be to the account of UUL.
- Profit mark up equal to a yield of 7% after tax on fixed assets, based on the capital used for production of the goods. A charge on working capital will be made on average working capital employed.
- The price will not be less than full variable cost + 10% profit mark up plus actual transport costs. Insurance will be for the account of the buyer.
- Prices may be adjusted taking into account increases or decreases in prices of raw materials, exchange rate, import duty on raw materials and changes in prices of other inputs.

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Transfer Pricing Policy

- The Policy provided that

  'where free and open market exists, transfer pricing will be based on prices set in comparable transactions between unrelated parties dealing at arm's length.(CUP)

  *… where CUP not available apply **Cost Plus Return On Capital Employed** by recovering the supplying company's costs plus an appropriate return on capital employed or*

  *…the **Resale Minus method** where the buyer performs the role of a mere distributor and does not add substantial value to the goods before resale. (By way of branding or marketing).'*
- The Group Transfer Pricing Policy, which became effective on 1st January 1996, was issued presumably based on OECD Guidelines, 1995.

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TECHNICAL ISSUES

- KRA took the position that CUP method was the most appropriate method in the case since both buyers of UKL goods were purchasing the same finished goods in all respects. UKL contended that there were no available CUP for comparison with the functions it was carrying out on behalf of UUL.
- UKL claimed to be a manufacturer providing basic manufacturing service intended to take up its idle capacity and that the prices offered to UUL were therefore at arm's length in line with the Group TP Policy.

CONDUCT OF THE AUDIT

- The Audit team of four officers conducted the audit in UKL premises. The team was provided with books of accounts which included cash books, ledgers, journals. Interviews were also conducted with senior officers of the organization. The audit lasted for a period of three weeks.
- On examination of the sales account and invoices, major differences were noted in prices offered to related parties against local customers and independent (third party) exporters of the same commodities to the Tanzanian market. The prices offered to the related party, Unilever Uganda (UUL) based in Uganda (with exclusive marketing rights) were approximately 25% lower than those offered to the independent third parties.

CONDUCT OF THE AUDIT

- Section 18(3) of the Kenya Income Tax Act provides;
- *'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 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 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.'*

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AUDIT

- Price to 3rd Parties per tonne xxx
- Price to related parties xxx
- **Difference** **xx Adjustment**
- It was assumed that this difference was the benefit passed on to UUL and the difference added back to the UKL profits was **24.05%** and **17.44%** for 1995 and 1996 respectively.
- In 1999, KRA raised an additional assessment in respect of 1995 and 1996 based on these average prices. UKL appealed against this assessment in September 2000.

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LOCAL COMMITTEE

- The taxpayer contended;
- That the average prices used by K.R.A are not "Comparable uncontrolled prices" because there was a wide difference in selling prices per unit weight of the different products and no two sales will comprise a similar mix of products in similar proportions.
- That K.R.A should make allowance for the functional differences carried out by UUL vis a vis the independent third party functions.
- That UKL incurred the costs of promoting its goods in countries where UKL had no sister companies.

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LOCAL COMMITTEE

- The taxpayer further contended;
- That if UKL were to sell to UUL at prices comparable to local or foreign (third party) buyers then UUL would rather buy from Unilever India or South Africa and UKL would lose its market.
- That the prices charged by UKL on domestic sales was a result of recovery of additional costs and not as result of any "discount" given to UUL.
- That it was not possible for UKL to estimate with accuracy the amount of additional costs in Uganda.

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LOCAL COMMITTEE

- The Local Committee adjourned repeatedly to get the parties to agree on the correct figures- No agreement reached.
- The Committee received representations from both parties gave its decision on 18th September 2003 **adjusting the mark up downwards by 50% to 12.03% and 8.72% for 1995 and 1996 respectively.**
- No reasons for this decision were given**.**
- It is this decision by the Local Committee (LC) that gave rise to Income Tax Appeals 752 & 753 of 2003 popularly known as the '**Unilever case**'

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COURT CASE

UKL appealed on grounds that the Local Committee erred as follows:

- In finding that UKL had arranged its business with UUL in such a manner that the profits which accrued to UKL from the business were lower than the profits which might have been expected to accrue to it if the course of the business had been conducted by independent persons dealing at arm's length.
- In arbitrarily finding that the profits of 12.03% and 8.72% of the actual profit which accrued to UKL from its business with UUL should be deemed to have accrued as profits of UKL pursuant to Section 18(3) of the Act.
- In comparing UKLs business with its related party UUL with that of domestic exporters and further erred by using average prices.
- In failing to find that Unilever Plc policy and the formula applied thereunder based on OECD Guidelines, 1995 was a valid method of ensuring that the prices charged in sales between UKL and UUL were at arm's length.

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KRA Contentions

- That O.E.C.D transfer pricing guidelines are not applicable in Kenya because:

  Kenya is not a member of O.E.C.D and has not incorporated/adopted the O.E.C.D guidelines to be part of the legislation.

  That the O.E.C.D. guidelines can only be used if Kenya has adopted the same in a tax treaty with another country.
- That section 18(3) of the Act is clear and sufficient and that UKL should have applied it without need to look for similar legislation. The absence of the transfer pricing guidelines does not render section 18(3) irrelevant or ambiguous in dealing with the transactions of UKL and UUL.
- That the average price per tonne to UUL and average price per tonne to 3rd parties were provided by the UKL who accepted the weighted prices should be used as it was impossible for them to compute such prices for each product per tonne.

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KRA CONTENTIONS

- Overheads on sales by UUL in Uganda are not allowable as Sec 18 (4) of the Act.
- That UKL charged UUL an equivalent of local market price and then accorded them an unwarranted discount.
- That UKL had appointed UUL to be the only distributor of its products in Uganda to ensure 3rd parties who would be willing to buy from UKL at a higher price for selling in Uganda do not enter the market.
- That the transfer pricing policy of Unilever was not in line with section 18(3) of the Act.
- That the difference in mark up between prices to UUL and the price to third parties resulted to less than taxable profits to UKL and is taxable in Kenya on UKL.

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COURT'S RULING

- There was no evidence of tax fraud or tax cheating.
- Section 18(3) is obscure and the taxpayer is entitled to demand that his tax liability should be made out of a reasonable clarity.
- The course of business between UKL and UUL were not *'so arranged'* to enable UKL to make no profit or less profits.
- When the Act gives no guidelines other guidelines should be looked at. OECD Guidelines are applicable in Kenya.
- UUL incurs expenses in Uganda which expenses in so far as UKL is concerned, are saved.
- The Income tax Act is silent on various methods of computing Arms length price.

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COURT RULING

- Cost plus method used by UKL is not wrong in arriving at arm's length price in the particular circumstances of this case.
- The taxpayers appeal was allowed with cost.

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PRACTICAL ISSUES ENCOUNTERED IN RESOLVING THE AUDIT

- Lack of specific guidelines on how to test the arm's length principle. OECD Guidelines were enacted in 1995 and were generally still very new.
- Lack of exposure by KRA, taxpayers and their tax agents to this previously untested issue and had no history or precedent to fall back to.
- Process was very protracted. The entire process took eight (8) years.
- The taxpayer reluctance/refusal to provide relevant documentation regarding related parties and its own operations.
- Positions agreed on during audit review meetings were used against KRA during the arbitration and court process.

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COMMENTARY ON COURT DECISION

The decision was inexhaustive of the issues to be determined

- The Court dwelt only on three issues
  - Whether Section 18(3) was sufficient guidance to taxpayers in determination of arms length?
  - Whether the OECD Guidelines apply in Kenya in the event of the insufficiency of Section 18(3)
  - Whether the Cost Plus method prescribed under OECD Guidelines as applied by the taxpayer was an acceptable method?
- Did not call for evidence on computations to determine true comparability.

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CRITIQUE

- KRA failed to look at a number of critical issues which would have assisted to determine the case correctly since the Department did not;
- Critically consider which of the parties was being tested. The analysis shifted between the two parties.
- Was unable to test the correct application of method adopted by the taxpayer
- Verify the cost bases and look into the details and nature of costing to determine what costs were included in the costing of products both to the related party and the independent parties.
- Consider the effect of intellectual property and the royalty costs on the price given this was owned by another party.

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CRITIQUE

- Verify the contentions regarding cost of marketing in other countries where UKL or Unilever was not present.
- Verify the functions performed by UUL to determine whether the assertions of functions performed were in fact correct.
- Consider and analyse other controlled transactions between UKL and Unilever Plc.
- Test or challenge the acceptability of the 10% ROCE proposed in the TP Policy or the applied 7% after tax.