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Effect of Transfer Pricing on Corporation Tax Compliance Among Multinational Corporations in Nairobi Kenya

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Abstract

Purpose: Tax is a compulsory contribution that is made by the citizens of a country to the government for the provision of public utilities. It is evident from the National Tax Policy, 2024 that the Kenya Revenue Authority (KRA) and the government at large have recently shown a lot of interest in multinationals due to the complexity of their operations and the tendency for them to come up with complex tax avoidance mechanisms. This has also been complicated by the widespread abuse of transfer pricing models adopted when dealing with multinational corporations operating in Kenya. This study looked into effect of transfer pricing on corporate tax compliance among multinational corporation companies in Kenya**.** The study was guided by the following theories, AS theory, the Slippery Slope Framework, and the theory of the planned behavior.

Methodology: The study employed **an** explanatory research design. The target population was 221 multinational corporations' companies and a sample size of 142 respondents. Questionnaires were used to collect primary data and analysis was descriptive statistics include frequency, percentage, and mean while inferential statistics included correlation and multiple regression.

Results: The study findings found out most companies in Nairobi, Kenya have transfer pricing policies that are moderately but not adequately in line with domestic tax statutes. Most companies will use transfer pricing as a tool to reduce their tax liabilities. Further, KRA is moderately but not adequately efficient in monitoring and regulating transfer pricing practices in our company.

Conclusion: The study results concluded that transfer pricing affects corporation tax compliance Based on the findings, the study recommends there is a need for exchange of information and more international collaborative efforts from a policy, legal, and academic front to address aggressive tax avoidance practices from MNCs. Therefore, future studies can be conducted on the impact of Dispute resolution mechanism on corporation tax performance.

Keywords: *Multinational Corporations, Transfer Pricing, Corporate Tax Compliance*

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1.0 Introduction

Despite the growing need for FDI more so for a developing country like Kenya, various challenges arise and are posed when it comes to multinational enterprises and corporate tax compliance in particular the issue of tax avoidance strategies employed by the said MNCs. Tax authorities, academic scholars and various other stake holders have identified the need to seal tax leakages amongst multinational corporations due to the inequality it brings in the global economy and the negative distributional consequences tax avoidance schemes create (Garcia-Bernardo & Janský, 2024).

The growing concern revolving around taxation of MNCs is a thorny issue not only for developing countries but also for developed countries such as the United States of America. For instance, in 2019, studies through the U.S National Bureau of Economic Research estimated that the U.S. government was losing over Kshs. 1 trillion in revenue through aggressive profit-shifting schemes (Wier & Zucman, 2022). Since the growth of MNCs is not stopping any time soon, these worrying tax leakages amongst already established hegemons are a wake-up call to developing countries like Kenya to strengthen their regulations, policies, and laws around the taxation of the so-called MNCs.

The Kenyan judicial system is also not a stranger to issues or disputes revolving around tax avoidance and this has manifested itself in several case with one of the most recent cases being the Court of Appeal Case of Kenya Nut Company Limited v Commissioner of Domestic Taxes (Appeal 575 of 2022) [2023] KETAT 334 (KLR) (9 June 2023) (Judgment), which emanated from a dispute revolving around the Finance Bill, 2020 which sought to introduce a minimum tax of 1% on gross turnover. The said tax was challenged because it violated the Constitution of Kenya together with sections 3 and 15 of the Income Tax Act, Cap 470. In the Court's judgment, the 3 Judge bench underscored the importance of fair taxation through the prevention and addressing of tax avoidance and evasion practices. The Learned Judges held as follows: - *in verbatim*

> " the concept of Fair taxation or a fair tax burden has no linear definition as addressed in Discussion Paper: "Perspectives on Fair Tax," by Francis Chittenden, and Hilary Foster. The threshold for fairness is "… ensuring that everyone bears their fair share of taxation and pays the correct amount and which is seen to be fair by vigorous pursuit of tax avoidance and evasion.""

It should also be noted that tax avoidance is not only a domestic Kenyan issue but also a vice that many other countries globally face. See the cases of Erasmus v Commissioner for the South African Revenue Service (9706/21) [2023] ZAWCHC 215; [2024] 1 All SA 153 (WCC); 86 SATC 56 (18 August 2023), Sasol Oil Proprietary Limited v Commissioner for the South African Revenue Service (923/2017) [2018] ZASCA 153; [2019] 1 All SA 106 (SCA) (9 November 2018) and even the US Court of Appeals, Federal Circuit case in Coltec Industries, Inc. v. US, 454 F.3d 1340 (Fed. Cir. 2006) whereby in all these disputes the Court grappled with the concept of tax avoidance, aggressive tax planning and the thin line that permits or disallows such practices.

The OECD defines transfer pricing as the determination of the price at which goods, services and assets (tangible and intangible) are transferred between affiliated companies situated in different tax jurisdictions (OECD, 2019). When goods, intangibles and services are transferred across the borders within multinational corporations, transfer pricing becomes crucial for fair allocation of profits amongst the different affiliated entities for taxation purposes.

Multinational Corporations play an important role in world economic development in general. Foreign investors provide host countries with the opportunity to import capital and knowledge, and for home countries, the investment in host countries secures resources and consumer markets that these MNCs need.

1.1 Problem Statement

It is evident from the National Tax Policy, 2024 that the Kenya Revenue Authority (KRA) and the government at large have recently shown a lot of interest in multinationals due to the complexity of their operations and the tendency for them to come up with complex tax avoidance mechanisms. This has also been complicated by the wide-spread abuse of transfer pricing models adopted when dealing with multinational corporations operating in Kenya.

It has been estimated that in 2021, Kenya lost 160 billion in illegal financial flows according to the OECD. Statistics from the Kenya Revenue Authority (KRA) show that of the 759,164 companies registered in Kenya, only 504,036 of them filed annual returns for the financial year 2021/2022. Of these, only 84,428 firms declared and paid corporate tax. This means that 84% of companies in Kenya are either loss-making businesses or inactive. It may speak to the business environment in Kenya but also raises concerns about endemic tax avoidance schemes, especially for those companies that are perennial credit filers.

The effect of tax avoidance is its effect on revenue collection thereby giving the government a hard time in performing its obligations such as offering services and infrastructure development. This trend clearly shows that there is a need for the government and the tax authority to review its efforts to seal tax leakages among MNCs. This study therefore seeks to investigate effect of transfer pricing on corporation tax compliance among multinational corporate companies in Kenya.

2.0 Literature Review

2.1 Theoretical Review

2.1.1 Allingham and Sandmo theory (AS theory)

This theory was developed by Agnar Sandmo and Michael Allingham in the year 1972 and it builds on the works of Nobel Laureate Gary Becker who studied the economics of crime in 1968 (Sandmo, 1972). The main aim of the theory is to understand taxpayer behaviour when it comes to tax evasion and what informs tax evasion behaviour. The AS theory in brevity provides that the government will always prevent tax avoidance and evasion practices by strengthening legislation, enacting heavy penalties, and increasing tax audits while on the other hand, a taxpayer will always evade or avoid taxes when the cost of such evasion and avoidance is too low.

The theory is anchored on the fact that taxpayers' behaviour is informed by the cost and benefits of evading taxes. For instance, a taxpayer will evade taxes when the cost of such evasion is lower than the cost of compliance for instance if the probability of being caught is low or if the potential penalties are not severe. Additionally, the theory posits that evasion and/or avoidance may be informed if the cost of compliance is extremely high for example if tax regulations such as filing procedures are too cumbersome.

This theory is founded on the mathematical model $EU=(1-p)U(I-tD)+pU(I-tD-f(I-D))$ where EU is the Expected Utility, I is the assumed income, D is the assumed declared income, t is the Tax Rate, p is the Probability of detection and f is the Penalty. From the mathematical model, a taxpayer has two choices to declare true income and pay taxes on the full amount or declare less income than the true income and evade taxes on the amount undeclared. After the said choices, the theory posits that if a taxpayer chooses to evade taxes the utility will depend on whether they are audited or not.

The theory posits that it is crucial to analyze income and revenue streams since the gains from evasion and avoidance practices together with the risk management aspect is what informs the vice. Risk management is informed by various aspects such as corporate policies, local regulatory environments and other global factors such as international regulatory environment. The theory also questions tax rates and incentives and how they play into compliance. For instance, do high taxes lead to increased tax avoidance? This theory blends with the works of Arthur Laffer and his Laffer Curve theory.

This theory is relevant to this paper due to the unique regulatory environment of MNCs in Kenya. This theory helps understand tax compliance behaviour through various ways such as understanding the efficiency of KRA when conducting audits and enforcing taxation law and how the regulatory environment affects tax compliance. Some of the key questions posed by this theory are for instance whether the cost of compliance is cumbersome due to complex tax regulations or whether the cost of evasion is low through weak tax penalties and enforcement mechanisms.

2.1.2 Slippery Slope Framework (SSF)

This theory was coined by Erich Kirchler and it mainly studies the psychological factors of tax compliance. The study builds on the concepts of power and trust and how they interplay with tax compliance. Foremost, Kirchler's work builds on the Becker (1968), AS (1972 and Srinivasan (1973) models. Whilst the aforesaid models have been sufficient in providing a foundational basis for tax compliance, the same has been criticized for not adequately addressing voluntary compliance by taxpayers. This is the reason why the slippery slope framework (SSF) was coined from 2007 to 2008 by Kirchler.

Kirchler posits that tax compliance is based on two main factors the power of tax authorities and the trust in tax authorities. Kirchler in his theory attempts to understand the interplay between the concepts of power and trust. On power of trust of tax authorities, Kirchler argues that the higher the power the less the tax evasion practices. According to Kirchler, power is ability of the tax body to impose penalties, conduct audits and detect tax evasion and avoidance practices. High detection rates, frequent audits, and subsequent penalties for defaulters increases the risk and consequences of being caught and thereby reduce tax evasion and avoidance practices. On the trust aspect, Kirchler argues that if the tax system in the country is fair, transparent and geared towards public interest, there will be more tax compliance.

Kirchler's theory posits that the optimum level of tax compliance arises when power and trust is balanced. This optimum level leads to various compliance such as voluntary compliance caused by trust in the tax body and also enforced compliance caused by power of tax authorities. Audits and sanctions have proved effective in boosting compliance however over-reliance on the same will have negative consequences such as distrust. On the other hand, trust fosters voluntary compliance. In summary, high trust and high-power lead to high compliance and low levels of tax evasion and avoidance practices while low trust and lower power leads to the lowest compliance. On the other hand, low trust and high-power lead to strategic non-compliance whilst high trust and low power lead to voluntary compliance but will not stop all tax avoidance and evasion practices.

This theory is relevant in this research in that shows the need to strengthen our tax system including tax enforcement whilst at the same time building trust amongst the taxpayers in order to foster voluntary compliance. In essence, if Kenya adopts a transparent, fair and integral tax system whilst having strong enforcement mechanisms, corporation tax compliance will increase amongst MNCs. This is a key tool on policy makers when developing an effective tax system.

2.2 Empirical Review

2.2.1 Corporation Tax Compliance

Foremost, before delving into the subject at hand, it is important to note that section 3 of the companies act defines a corporate or a company as a company formed or registered under the Companies Act or an existing company (Companies Act No. 17 of 2015). Whilst there is no specific definition of multinational company under the Kenyan statutory law, the Companies Act attempts to fill that void by defining a foreign company to mean any company incorporated outside Kenya. Section 974 of the Companies Act dictates in mandatory terms that a foreign company can carry on business in Kenya only if it is registered to carry out business in Kenya. (Companies Act No. 17 of 2015)

Having understood what a company it is important to have a grasp on the tax liabilities that accrue on companies. Foremost, all resident companies have a tax liability of 30% on all income accrued or derived from Kenya. On the other hand, non-resident companies are subject to a corporate income tax on profits that can be attributed to a permanent establishment within the Kenyan jurisdiction. A resident company in Kenya is defined under section 2 of the Income Tax Act as a company incorporated under Kenyan law, or a company whose management and control of affair was exercised in Kenya and/or a company gazette by the Cabinet Secretary to be a resident. The reason for the above distinction is because resident and non-resident companies are taxed differently with non-resident companies being taxed at a rate of 37.5%. (Income Tax Act, Cap 470). Further to the above discussion, Kenya also has special taxation rates for various special entities for instance corporates located within the Export Processing Zones (EPZs), companies listed in the securities exchange, and corporates situated within Special Economic Zones (SEZs). (Income Tax Act, Cap 470).

Having understood the basic tenets of what a corporation is under Kenyan law, corporate tax compliance can be defined as the level at which corporate entities strictly comply with taxation laws through accurate filing and remittance of their tax returns derived from accurate financial reports and/or statement (Kenya Revenue Authority, 2012). Corporation tax compliance is crucial for a country's tax system since it ensures adequate revenue collection to enable the provision of goods and services by a government.

2.2.2 Transfer pricing and Tax avoidance

Transfer Pricing is a methodology used to determine prices and conditions in transactions between entities to comply with the principle of a fair relationship. Transfer Pricing is a useful tool in moving profits from one company to another, through a third company (Padhi, 2019). Companies, in general, will take every opportunity available to increase profits and maintain power, one of which is to set transfer prices (Arslan, 2019; Arham et al., 2020). Transfer Pricing can result in reduced potential state revenue from the tax sector of a country because companies tend to shift their tax obligations from countries that have high tax rates to countries that apply low tax rates (Wu & Lu, 2018). Global tax authorities have raised concerns about tax advantages caused by granting transfer pricing (Klassen et al., 2019).

The Organization for Economic Corporation and Development (OECD) revealed in research that more than 60% of global trade is carried out by multinational companies, which means that transfer pricing is a crucial issue. In Indonesia, the practice of transfer pricing has become an issue of concern for the Directorate General of Taxes because this practice has been abused

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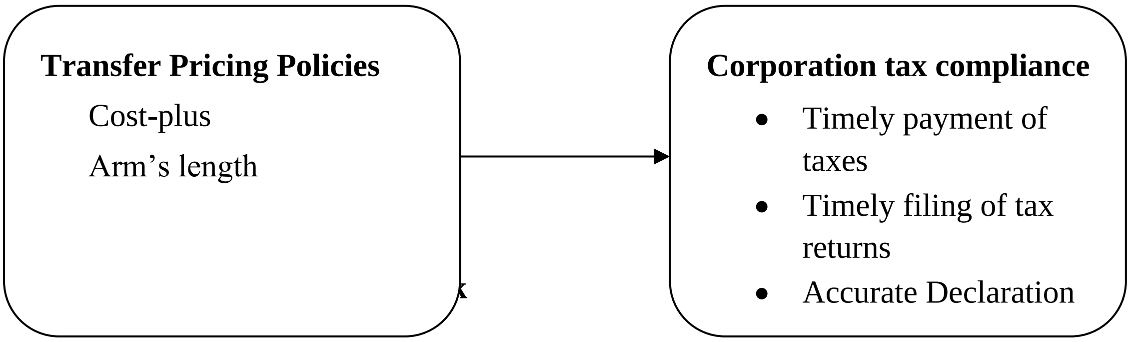
and as a result, state tax revenue has decreased (Hosiana & Tjen, 2022). In other words, the transfer policy is implemented as an exploitation of the price-setting policy for goods and services transferred between related parties, not based on market value with tax rules paid by all affiliated parties (Barker et al., 2020; Asongu et al., 2019; Nguyen et al., 2020). Because of the distribution of disguised income through transfer pricing to increase profitability, multinational companies threaten the country's taxation system (Arslan, 2019). Transfer pricing develops with various calculation methods (Nguyen et al., 2020).

A popular concept that arose due to rampant transfer pricing is the arm's length dealing principle. The United States' judicial system has related related the notion of arm's length dealing to the doctrine of "undue influence". The arm's length dealing principle was introduced in the early reports of the League of Nations as a corollary of the separate accounts principle. The separate accounts principle was introduced for the allocation of taxable income to permanent establishments, which at that time included branches and subsidiaries. Since its introduction in the early reports of the League of Nations, the separate accounts principle and the arm's length principle have become the foundations of Art. concerning the taxation of permanent establishments, and Art. 9 of the OECD Model. When a special article for the taxation of affiliated companies (associated enterprises) was introduced in the League of Nations reports of 1933, the arm's length principle became the underlying principle of this article.

2.3 Conceptual Framework

Creswell (2003) defines conceptual framework as a graphical presentation of the relationship between the study variables. There independent variable was transfer pricing, and dependent variable tax avoidance is further illustrated in Figure 1.



Source: Researcher, (2024)

3.0 Methodology

This study adopted explanatory research design. This study adopts an explanatory research design. The primary purpose of explanatory research is to explain why phenomena occur and to predict future occurrences. The target population of the study constituted 221 MNCs in Nairobi and a sample size was 142 respondents (KRA,2023). The study collected primary data through questionnaires. Sekaran (2003) stated that the reliability of a measure is an indication of the stability and consistency with which the instrument measures the concept and helps to assess the "goodness" of a measure.

In order to test the reliability of the instruments, internal consistency techniques was applied using Cronbach's Alpha of 0.7 is a commonly accepted rule of thumb that indicates acceptable reliability and 0.7 or higher indicates good reliability Mugenda, (2003). Table 1 For the study,

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Cronbach's alpha coefficient value was computed. The results indicated that transfer pricing had a reliability of (0.932), and corporation tax compliance (0.814) which indicated the instrument was reliable

Table 1: Reliability test

Variables	Cronbach's Alpha	N of Items
Transfer pricing	0.932	5
Corporation tax compliance	0.814	5

Source: Researcher, (2024)

Validity is the accuracy and meaningfulness of inferences, which are based on the research results (Mugenda & Mugenda, 1999). The study used content validity whereby questionnaires included a variety of questions. Clear instructions were also given and the questions were formulated in simple language for clarity and ease of understanding. The study also improved validity by matching the assessment measure to the objectives of the study.

The analysis of the data started by editing and inspection of the data pieces to identify spelling mistakes, items that were wrongly responded to, and any blank spaces left unfilled by the respondents. The collected data was screened for accuracy, consistency, completeness and then presented in the form of percentages, pie charts and tables. Regression analysis was carried out to establish how the four variables affect excise tax compliance. The study adopted regression analysis as shown

$Y= \propto + \boldsymbol{\beta}_1 X_1 + \boldsymbol{\beta}_2 X_2 + \boldsymbol{\beta}_3 X_3 + \varepsilon$

Where,

Y = tax avoidance

$\propto$ = Constant term

$\boldsymbol{\beta}_1, \boldsymbol{\beta}_2, \boldsymbol{\beta}_3, \boldsymbol{\beta}_4$ = Beta coefficients of the independent variables

X_1 = Transfer pricing

X_2= Treaty shopping

X_3 = Base Erosion and profit shifting

ε = error term

4.0 Results and Discussion

After analysis of the company profiles and participant characteristics, key issues that emanated were that older and larger companies had more intricate taxation structures in place. Further, tax compliance awareness was high amongst financial personnel however challenges arose in compliance more-so with younger corporation due to *inter alia* limited resources and knowledge in application of these rules. Additionally, concerns arose with the ambiguity and high costs associated with full compliance for instance on the resources required to have professionals and which resources may be scarce for small and young corporations.

4.1 Descriptive Statistics

4.1.1 Transfer pricing

Table 1 illustrates the to determine the effect of transfer pricing on corporation tax compliance. Our company frequently reviews and updates its transfer pricing policies with a (mean=4.14, standard deviation= 0. 553). Our Company uses transfer pricing as a tool to manage tax liability (mean=3.34, standard deviation= 1.210). Our Company's transfer pricing policies are in line with domestic tax statutes (mean=4.61, standard deviation= 1.242). KRA is extremely important in monitoring and regulating transfer pricing practices in our company (mean=4.43, standard deviation= 0. 520). Our Company finds Kenya's transfer pricing regulations easy, efficient, and simple (mean=3.77, standard deviation= 0. 816).

Table 1: Transfer pricing

5 = Strongly Agree **4 =** Agree **3** = Neutral **2** = Disagree **1**= Strongly Disagree

	Mean	Std. Dev	Skewness	Kurtosis
Our company frequently reviews and updates its transfer pricing policies	4.14	0.553	-0.001	0.231
Our Company uses transfer pricing as a tool to manage tax liability	3.34	1.210	-0.212	-1.128
Our Company's transfer pricing policies are in line with domestic tax statutes	4.61	1.242	0.566	-1.214
KRA is extremely in monitoring and regulating transfer pricing practices in our company.	4.43	0.520	0.635	0.557
Our Company finds Kenya's transfer pricing regulations easy, efficient and simple	3.77	0.816	-0.391	0.152

Survey Data (2024)

4.1.2 Corporation tax Compliance

The dependent variable was corporation tax compliance. Table 2 illustrates the company files return on income by the prescribed date (mean=3.25, standard deviation= 1.218). The company pays tax dues by the prescribed date (mean=4.43, standard deviation= 0. 245). The company pays fines and penalties for overdue taxes (mean=3.93, standard deviation= 0. 945). (mean=3.26, standard deviation= 0. 838). The company makes timely and accurate tax declarations (mean=4.59, standard deviation= 0.350).

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Table 2: Corporation tax Compliance

5 = Very High **4 =** High **3** = Moderate **2** = Low **1**= Very Low

	Mean	Std. Dev	Skewness	Kurtosis
Our company is fully committed to complying with Kenya's tax regulations	3.25	1.218	-0.538	-0.981
The company has ensured that it has adequate measures in place to ensure corporate tax compliance	4.43	0.245	-0.140	-0.153
Our company faces challenges in complying with Kenya's tax statutes. (Challenges not attributed to us but the tax system)	3.93	0.945	-0.371	-0.176
KRA efficiently and fairly monitors and regulates tax avoidance practices related to transfer pricing, treaty shopping and BEPS	3.26	0.838	-0.429	-0.674
Our company has been audited and penalized due to non-compliance with tax legislation	4.59	0.350	-0.142	-0.936

Source: Researcher (2024)

4.2 Correlation Analysis

Table 3; shows the results of the correlation analysis testing the strength and the significance of the linear relationship between Transfer pricing and Corporation Tax Compliance. Transfer pricing had a Pearson Correlation coefficient of r= 0.624, indicating a strong positive correlation with Corporation Tax Compliance

Table 3: Summary of Correlations Statistics of Independent and Dependent Variables

	Corporation Tax Compliance	Transfer pricing
Corporation Tax Compliance	1	0.624**
Transfer pricing	0.624**	1

Correlation is significant at the 0.05 level (2-tailed).

Source: Researcher (2024)

4.3 Regression Analysis

The results in Table 4. revealed that transfer pricing, had a positive correlation with corporation tax compliance up to 62.4% or (R= 0.624). The results reveal that transfer pricing caused a variation of 38.9% or (R^2=0.389 and adjusted R^2 =0.382) on corporation tax compliance. This implies that the remaining 61.1 % of the change was caused by other factors not included in this model.

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Table 4: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.624[a]	.389	.382	.45089

a. Predictors: (Constant), transfer pricing, _mean

Source: Researcher (2024)

The study further carried out ANOVA tests to indicate whether the model is suitable for determining the relationship among the variables. The results from Table 5 indicate an F statistics value of 37.058 with a significance level of 0.000 which was less than the conventional probability of 0.05 level of significance.

Table 5: ANOVA

Model		Sum of Squares	Df	Mean Square	F	Sig.
	Regression	23.458	1	23.458	37.058	.000[b]
1	Residual	72.248	114	.633		
	Total	95.706	115			

a. Dependent Variable: Corporation tax compliance _mean
b. Predictors: (Constant), Transfer Pricing, _mean

H_{01}: Transfer pricing has no significant effect on corporation tax compliance among multinational corporations in Kenya. The independent variable has a positive correlation with corporation tax compliance. The results in Table 6 revealed that p-value was below 0.05, ρ=0.003 which implies that relationship was statistically significant leading to the rejection of this null hypothesis.

Table 6: Coefficients Social Norms on value added tax Compliance

		Standardized Coefficients		Unstandardized Coefficients	t	Sig.
Model		B	Std. Error	Beta		
1	(constant)	2.235	0.317		7.050	0.000
	Transfer pricing	0.253	0.079	0.248	3.202	0.003

a. Dependent Variable: Corporation tax compliance
b. Predictors: (Constant), Transfer pricing

Source: Researcher (2024)

4.4 Discussion

From the results, they indicate that transfer pricing positively influenced corporation tax compliance with a significance level of 0.003 which was less than the conventional probability 0.05 level of significance. The study agrees with Mitchell Carroll (2019), who after conducting studies on legal transactions between the parent and the subsidiary, concluded that such transactions should be conducted in the same manner as similar transactions between independent legal persons. This study also supported numerous findings by the OECD and the United Nations, who have endlessly emphasized that arm's length transfer pricing has been and should always be the international standard for the allocation of taxable income to members of multinational enterprises (MNEs) and permanent establishments for many years.

5.0 Conclusion

The study established that transfer pricing has a positive effect on corporation tax compliance among multinational corporates in Kenya. study findings found that most Companies' transfer pricing policies are moderately but not adequately in line with domestic tax statutes. Most companies will use transfer pricing as a tool to reduce their tax liabilities. Further, KRA is moderately but not adequately efficient in monitoring and regulating transfer pricing practices in our company. Further, KRA is moderately but not adequately efficient in monitoring and regulating transfer pricing practices in our company.

6.0 Recommendations

On this aspect **of Enhancing** International Co-operation MNCs operate at an international level and thus there is a need to foster international technical and administrative co-operation to have a more internationally harmonized approach in countering and addressing tax avoidance practices. There is a need for exchange of information and more international collaborative efforts from a policy, legal, and academic front to address aggressive tax avoidance practices from MNCs. It is also important for Kenya to harmonize its domestic policies and standards to recognized global standards. Another growing area of interest is the relevance of artificial intelligence in the taxation sphere and how can it be utilized to promote tax compliance amongst not only MNCs but all persons.

Future studies can be conducted using different factors such as the impact of dispute resolution mechanisms on corporation tax performance.

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