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Navigating the Arm's Length Principle: Bridging the Gap Between Transfer Pricing and Customs Valuation in the East African Community

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Abstract

The role of the arm's length principle is significant in both transfer pricing and customs valuation for revenue collection between related multinational corporations (MNCs) within the East African Community (EAC). Taxing related MNCs is challenging when the same transaction is taxed under both transfer pricing and customs valuation frameworks using the arm's length principle. MNCs are subject to double taxation or unfair tax risks, while revenue authorities face the risk of revenue loss by handling the same transaction under different legal frameworks, despite having the same objectives. Although full harmonization is generally considered unattainable, certain areas of law can be harmonized to promote the consistent application of the arm's length principle in both contexts. This article seeks to reveal the legal challenges faced by income tax and customs departments in applying the arm's length principle. Using doctrinal and comparative methods, the study found discrepancies between domestic income tax and customs laws within the region, and that EAC laws do not fully adopt international standards for harmonizing these two sets of laws. It recommends amendments to income tax and customs laws to enhance coherence.

Keywords: *Arm's length, transfer pricing, customs valuation, multinational corporations.*

1.0 Introduction

Tanzania, Kenya, and Uganda are member states of the East African Community (EAC).[1] These countries are required to, among other things, harmonize their tax policies to eliminate tax distortions, thereby promoting a more efficient allocation of resources within the community.[2]

[1] EAC is a regional intergovernmental organization of eight (8) partner states Tanzania, Kenya, Uganda Rwanda Burundi, Democratic Republic of Congo, South Sudan and Somalia established under Treaty for Establishment of East African Community (EAC Treaty) in 1999 which came into force in 2000 available at https://www.eac.int/overview-of-eac (last accessed 26 October 2024).

[2] EAC Treaty, Art 83 (2) (e).

In implementation, the EAC member states have signed the protocol for the establishment of the EAC Customs Union as a single customs territory[3] implemented by the EAC Customs Management Act, 2004 (EACCMA). Similarly, have established EAC Agreement on Avoidance of Double Taxation and Prevention of Fiscal Evasion with respect to Taxes on Income 2011 (EACDTA).[4] Additionally, the EAC is obligated to increase trade in industrial goods within the region and to facilitate the export of industrial goods from the partner states.[5] In promoting industrial development, the EAC Treaty requires member states to harmonize and rationalize investment incentives to promote the community as a single investment area.[6] These commitments are meant to increase revenue, among other things, for the benefit of their people.

However, the EAC countries are capital importers depending on foreign investments from developed and emerging economies. In this context, the search for foreign investment is an openly declared agenda, backed by community instruments.[7] Despite the common objective of attracting foreign investment, Tanzania, Kenya, and Uganda, have seen a steady increase in foreign direct investment compared to the rest of the member states.[8] Therefore, taxation of income generated from international investment operations through related multinational corporations (MNCs) becomes essential in generating revenue.[9]

As cross border trade and investment increase, the transfer and importation of goods between related MNCs in the EAC, as a single customs area, is bolstered. This is particularly taxation of related MNCs where goods are transferred and sold across borders between related MNCs in a controlled transaction. The cross-border transfer of goods between related parties involves transfer pricing in which income tax is paid to the revenue authority based on the profit obtained. Similarly, in the cross-border transaction between the same related parties importing goods, customs duty is paid to the customs authority based on customs value. The fact that transactions in either transfer pricing or customs

[3] Ibid, Art 75.
[4] Ibid, Art 142 (1) (d).
[5] Ibid, Art 79 (b) read together with Art 5.
[6] Ibid, Art 80 (f).
[7] Ibid, Arts 75,76, 79 and 80 (d).
[8] UNCTAD, (2020), FDI Inflows into EAC Region 2014-2019, Word Investment Report 2020 available https://www.eac.int/operating-environment/eac-investment, (last accessed 26 November 2024).
[9] A. W. Oguttu., *Base Erosion and Profit Shifting: A Blueprint for Africa's Response,* IBFD, 2021, p. ix.

valuation are made between related parties and are not controlled by market forces creates a likelihood of the price being influenced by their relationship. To avoid the influence of such a relationship on the price or customs value, transactions between related parties must be made at a market price by applying the arm's length principle.

Although both transfer pricing and customs valuation apply the arm's length standard for determining transfer prices or customs value, their results are not always consistent. Many scholars argue that fully aligning transfer pricing and customs valuation results is challenging due to differences in their structural focus, timing, and policy objectives.[10] Additionally, variations in operational functions, determination methods, documentation requirements, audit and dispute resolution mechanisms further complicate the alignment.[11] Scholars suggest that harmonization can be achieved by selecting appropriate methods, addressing timing differences, and classifying post-importation adjustments for transfer pricing at the customs level.[12] These literature focus on global, regional, or country-specific challenges in applying the arm's length principle in transfer pricing and customs valuations. As a result, there is a legal gap in how transfer pricing and customs laws is harmonizing the arm's length principle in the EAC.

The objective of this article is to examine transfer pricing and customs valuation legal frameworks in determining arm's length prices or customs values within the EAC. It identifies legal gaps between EAC income tax legislation and customs law and explores the potential for harmonized the application of the arm's length principle in both fields. The article asks how can the legal frameworks of transfer pricing and customs valuation be harmonized to bridge these gaps and ensure a more consistent application of the arm's length principle. This article employs a doctrinal

[10] T.F.M. Duarte Reis., *The tension between transfer pricing and customs valuation*, Masters Dissertation, Universidade Tenica Delisboa, 2012 p.18*;* M. Atci., Transfer Pricing and Customs Valuation Overlap: Is it possible to Bridge Two Worlds? *GAZI Journal of Economic business, 6 (1) 2020:* (71-85) p.72; V. Hendriksen.,'*The use of transfer pricing for customs valuation purposes: What should be the criteria for a transfer price in order to meet the custom valuation rules*? Master's Thesis International Business Tax Law, Faculty of Law, Tilburg University, January 2020.

[11] L. Ping and C. Silberztein, 'Transfer Pricing, custom Duties and VAT Rules: Can We Bridge the Gap? *World Commerce Review* 2007 (36-38) p.36. available at https://www.oecd.org/tax/transferpricng/39265412.pdf

[12] M.Atci., Transfer Pricing and Custom Valuation Overlap: Is it possible to Bridge Two Worlds? *above at note 10 p.80.* See also P. Habimana., Towards a Harmonization EAC Tax Systems: Current status, Challenges and Way Forward, *Law and Word Journal, 2023.*

research method to critically analyse the existing EAC customs and transfer pricing laws, case law, and scholarly literature. It also employs a comparative approach to assess transfer pricing laws in selected EAC countries, drawing insights from best practices found in international customs and transfer pricing instruments. Through these methods, the study will identify legal inconsistencies and propose amendments to the law for aligning EAC tax and customs laws to better apply the arm's length principle.

2.0 What is the arm's length principle, and why does it matter?

The arm's length principle describes a situation where related parties in a business are required to operate independently as if they are unrelated. The principle requires goods and services sold between related parties to be transferred at market prices where a competitive market exists.[13] In the absence of a competitive market, the prices of goods and services between related parties should be based on the marginal cost of producing them.[14] In this context, related entities are treated separately as if they are independent while taking into account the risks assumed, functions performed, and assets used for each entity. The arm's length principle originates from the economic and accounting theories of transfer pricing for MNCs operating across countries.[15] The market prices in a competitive market or marginal cost of production prices in the context of an organisation are meant to solve organisational problems such as evaluation performance and resource allocation within an organisation[16] on top of profit maximisation. However, prices set in a controlled transaction purely considered organisational interests, and host countries where related MNCs operate were not considered.[17] In the absence of external regulations, the transfer prices between related parties may be influenced by the party's relationship leading to the loss of revenue by host countries.

Consequently, host countries would need the transfer prices between related parties to be beneficial in yielding the revenue required for their

[13] J. Hirshleifer, 'On the Economics of Transfer Pricing', *29 The Journal of Business 1956,* 172-184 p.172.
[14] Ibid. p.176.
[15] A. w Oguttu., *Curbing Offshore Tax Avoidance: The Case of South African Companies and Trusts*, PhD Thesis, University of South Africa, 2007 p. 48.
[16] Organization strategy theory and Mathematical programming transfer pricing theories.
[17] H.B Kiunsi, '*Transfer Pricing in East Africa; Tanzania and Kenya in Comparative Perspective'* PhD Thesis, the Open University of Tanzania 2017 p.56.

countries' development. Therefore, market price where a competitive market exists was also seen by host countries as an ideal to protect their interest. The market price is preferred because everyone is free to enter the market, and there may be no possibility of a relationship to influence prices because market forces determine prices. Thus, specific rules to regulate transfer pricing commonly known as the arm’s length principle were established, and enshrined under international, regional [18] and domestic tax laws.[19] Internationally, the principle is enshrined under Article 9 of the 2017 Organization for Economic Cooperation and Development (OECD) Model Tax Convention on Income and on Capital, the 2017 United Nations Double Taxation Convention between Developed and Developing Countries (UN Model).[20] The transfer pricing methods are provided under the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2022 (OECD Guidelines). In the EAC the principle is enshrined under Article 9 (1) of the EACDTA. The transfer pricing methods are enshrined under domestic transfer pricing Regulations namely; - the Tax Administration (transfer Pricing) Regulations 2018 (TP Rules 2018) of Tanzania, Income tax (Transfer pricing) Regulations 2011 (TP Rules 2011) of Uganda and Income tax (Transfer pricing) Rules 2006 (TP Rules 2006) of Kenya.

The arm's length principle as prescribed in the laws is important in determination of prices between related parties. It counteracts transfer prices influenced by the relationship between related parties by regulating them while considering the interests of host countries where the related MNCs operate. This is because the market context of transfer pricing aligns well with tax laws, which establish the arm’s length principle, such that any transaction between related parties conducted at a market price is considered to comply with the law.[21] In addition, the arm's length principle in law considers separate entity norms which require related entities to be treated separately when determining transfer price between them. Furthermore, it considers functional analysis in determining transfer price because the principle is based on comparing different

[18] Art 9 (1) EACDTA.
[19] Sec 33(1) of Income Tax Act 2019 RE of Tanzania, (ITA Cap 332), Sec 18 (3) Income Tax Cap 370 of Kenya (ITA Cap 370), Sec 90 and Income Tax Act Cap 340 of Uganda (ITA Cap 340) and R 3 of Tax Administration (Transfer Pricing Rules) 2018.
[20] It should be noted that for the purposes of this Article, reference will be made to the OECD Model.
[21] Kiunsi H.B., *Transfer Pricing in East Africa; Tanzania and Kenya in Comparative Perspective’ above at note 17.*

comparable situations in the market, functions performed and risks assumed. In comparing such situations, independent transactions are used as a test upon which the transaction between related parties is tested.

The law also obliges related entities to provide specific transfer pricing documentation to tax administrators demonstrating the related party's operations. In this context, related parties are obliged by the law to transfer goods at market price while following special methods and procedures prescribed in the law. Where related parties fail to comply with market prices, the revenue authorities are empowered to adjust prices to reflect the market price.[22] Essentially, the arm's length principle regulates prices between related parties that are not made at arms' length for tax purposes.

Although the arm's length price originates from the transfer pricing field, it is applied similarly in customs valuation to ensure the transaction value between related parties is not influenced by their relationship. From the customs valuation perspective, the arm's length principle regulates the transaction value of goods between related parties. Internationally, the principle is enshrined under Article VII of the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO) Agreement on Implementation of Article VII of the GATT 1994 (WTO Agreement). In the EAC, it is enshrined under section 122 and the Fourth Schedule of the EACCMA (Fourth schedule). The customs law provides requirements for comparability, documentation, and specific methods of customs valuation in order to determine an arm's length transaction value.

The rationale of using the arm's length principle in both sets of laws is that it places both related and unrelated parties in a transaction on equal footing by being regulated by market forces. Hence, the transfer price obtained by applying the arm's length principle is called the transfer price or arm's length price. Similarly, the transaction value obtained using the arm's length principle is called the transaction value or the arm's length value. However, the drawback of the arm's length principle is that it produces different outcomes when applied in different contexts, despite serving the same purpose.

[22] Sec 33 (2) ITA Cap 332, Sec18 (3) ITA Cap 370 and Sec 90 ITA Cap 340.

3.0 Conceptualizing Transfer Pricing and Customs Valuation

Traditionally, the process of setting prices for goods and services, including intangibles and finances transferred between related parties, is called transfer pricing.[23] From a legal perspective, transfer pricing under income tax is a system of setting the prices of goods and services between related parties at a market price by applying the arm's length principle. This is thought to be achieved by applying specific transfer pricing methods enshrined under international law[24] and domestic laws.[25] The price set is then used to sell goods between related parties, allowing governments to obtain their rightful share of income tax, while the MNCs receive their rightful share of profit.[26]

Customs valuation is a procedure applied to determine the customs value of imported goods.[27] Goods brought into the EAC for free circulation are subject to duties based on the applicable tariff, either in specific terms or as an ad valorem tariff. The former refers to a fixed charge for a quantitative description of the goods, for example, Tanzanian shillings 1000 per item per unit. The latter is a charge of duties based on the value of the goods, whereby the customs valuation is multiplied by an ad valorem rate of duty for example five percent to arrive at the amount of duty payable on imported goods.[28] However, the concept of value in the valuation of goods in international transactions is interpreted differently. This is because value does not belong to the goods themselves but to the perception of the individual assigning value to them, which is regulated by law.[29]

The concept of value is interpreted from three angles. The first is subjective valuation, which entails an individual's evaluation of goods. The second is intersubjective valuation, which commonly known as a

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[23] C.T Horngren and G.L Sundem, '*Introduction to Management Accounting*,' 9th ed, Prentice Hall International Inc, 1993 p.336. It is worth noting that the transfer pricing concept is not legal; rather, it draws from economics, accounting, mathematics, and tax.
[24] Part II and III of the OECD Guidelines.
[25] R5 1(f) TP Rules 2018, R 7 (f) TP Rules 2011, R 7 of TP Rules 2006.
[26] H.B. Kiunsi, '*Transfer Pricing in East Africa; Tanzania and Kenya in Comparative Perspective*' *above at note 17 p.32.*
[27] World Trade Organization (WTO) Technical Information on Customs Valuation available at https://www.wto.org/english/tratop_e/cusval_e/cusval_info_e.htm (last accessed 20 September, 2024).
[28] World Trade Organization (WTO) above at note 27.
[29] E.C. Barreira, Valuation of Goods in International Transactions: Diverging interpretations Among National Agencies, *World Customs Journal, Vol 10 No 2 2016*, (37- 46) p.37.

positive notion.[30] The last approach is supposedly objective valuation, based on an idealized pattern in which third parties are involved with a specific interest, commonly known as a theoretical notion.[31]The theoretical context of value originates from an idealized economic market value that does not arise from a particular operation. Instead, it considers the price obtained in multiple unrelated operations involving similar goods, under certain ideal conditions of an agreement.[32]

This means that the valuation of an object is subjective, as it does not stem from the object itself but from the individual making the assessment. The buyer's valuation of the object may differ from the seller's, even though it is the same object at the same time.[33] As a result, the buyer and seller perceive the transaction value of the goods differently, each considering factors that influence the acquisition of the goods from their own perspectives. In this context, the parties agree on the value of the goods being sold, expressed in a monetary price.[34] The price is then added to the specific or ad valorem percentage for customs purposes. Intersubjective valuation, reflected in the price agreed upon in the transaction, directly results from the conditions set by the parties involved in specific cases, is a valid valuation.

The concepts of transfer pricing and customs valuation are different, although both apply the arm's length principle in setting prices or customs values between related MNCs. There are differences in their meaning, scope, methods, interpretation, and theoretical manifestations. These differences form the basis of the rules that govern transfer pricing and customs valuation. Transfer pricing is regulated by income tax law, while customs valuation is governed by customs law. These rules provide different methods for determining the arm's length price or value.[35] They are administered by different departments within the same revenue authority.[36] Additionally, these departments subject taxpayers into

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[30] Enshrined under Art 1 of the WTO Agreement.
[31] Ibid, Arts 2 to 7.
[32] E.C. Barreira., Valuation of Goods in International Transactions: Diverging interpretations Among National Agencies, *above at note 31. p 37.*
[33] Ibid.
[34] Ibid. p.38.
[35] See for example r 5 TP Rules 2018 for transfer pricing and Paras 2,3,4,5,6 of Fourth Schedule for customs valuation methods.
[36] For example, in Tanzania transfer pricing is under the Large Tax Department while Customs Valuation is under the Customs and Excise Department. In Kenya and Uganda, Transfer pricing is under Domestic

different audit systems and documentation requirements to demonstrate compliance with the arm's length.

Using two sets of rules and two unrelated administrative departments with different methodologies in the same transactions complicates the situation for both taxpayers and revenue authorities. The taxpayers may be affected by being subjected to unfair or double taxation. This happens when the customs department, after assessing the imported goods for customs valuation, the tax administration may find the value of imported goods understated contrary to arm's length price, and the taxpayer may be subjected to more tax than expected.[37] In the case of *BASF East African Limited v Commissioner of Customs and Border Control*[38] The court set aside additional taxes demanded by the Kenya Revenue Authority made after the clearance audit.

Likewise, in *Wallpaper Kenya and Commissioner of Customs and Boarder Control,*[39] it was ruled that the Commissioner of Customs and Border Control errored in law and in fact in uplifting customs duty on the appellant's imported goods. Accordingly, when taxpayers are re-assessed after an audit, they may be required to pay additional taxes.[40] In *L'Oréal East African Limited v Commissioner of Cross Border and Control*[41] the appellant failed to demonstrate that the declared value was at arm's length and subsequently paid the additional uplifted taxes. This situation subjects' taxpayers to double administration, which is costly and undesirable, and may drive them toward more aggressive tax planning to reduce tax liability.[42] In such circumstances, compliance issues may arise due to the application of different laws, leading to disputes between related parties and the revenue authority.

Tax Department while customs under the Customs and Border Control Departments Uganda is Customs Department.

[37] Deloitte., *The Link between Transfer Pricing and Customs Valuation*, 2018 Country Survey, p1.

[38] [2020] TA 115.

[39] Tax appeal no 297 of 2020

[40] L. Ping and C. Silberztein, 'Transfer Pricing, custom Duties and VAT Rules: Can We Bridge the Gap? *above at note 11*.

[41] [2021] TA. 259

[42] M. Atci, *Transfer Pricing and Custom Valuation Overlap: Is it possible to Bridge Two Worlds*? *above at note 10 p. 75.*

4.0 International standards for application of arm’s length in transfer pricing and customs valuation

Internationally, the determination of the arm’s length price for transfer pricing purposes is enshrined in the OECD model. The model sets five standards that must be observed when determining the arm’s length price. These standards include first, the threshold for identifying related parties for tax purposes. Second, the requirement for adjustments when the price between related parties does not reflect the market price provided under Chapter I of the OECD Model. Third, the comparability factors used to test controlled transactions against independent transactions in comparable circumstances as provided under Chapter III of the OECD Model Fourth, specific transfer pricing documentation standards that related parties must provide regarding their operations. Fifth, specific methods for determining the arm’s length price, include the comparable uncontrolled price method, the resale price method, the cost-plus method, the profit split method, and the transaction net margin method.[43]

The determination of arm’s length for customs valuation originates from Article VII of the General Agreement on Tariffs and Trade (GATT). This article sets the principle that customs value for imported goods should be assessed on the actual value of the goods imported.[44] The implementation of this principle is done through the WTO Agreement. The WTO Agreement establishes five standards upon which arm's length customs value can be determined. These standards include the threshold for identifying related parties for customs valuation purposes. The adjustment requirements to arrive at the transaction value as provided under Article 8 of the WTO Agreement, and comparability factors, which use the circumstances surrounding sales between independent parties as a test for controlled circumstances between related parties as provided under Article 2(b) of the WTO Agreement.

Where the transaction value is not in line with independent transaction value, the value must be adjusted upwards or downward to reflect the arm’s customs value. Moreover, specific methods to arrive at customs value are prescribed whereby the transaction value is the primary method of customs valuation for assessment of the customs duty.[45] In case the

[43] Chapter II part I and II of the OECD Guidelines.
[44] Para 2 of the Art VII of the GATT
[45] Art 1 of the WTO Agreement.

transaction value method cannot be applied the rules require the transaction value of identical goods, the transaction value of similar goods, the deductive value, the computed value, and the fallback value to be applied in a hierarchal manner.[46] In Tanzania, Kenya and Uganda, the principle and methods of determination of Customs value are deduced under Section 122 and Fourth Schedule of the EACCMA.

International standards provide a sound benchmark for countries to mirror in their domestic tax laws. This is because the international standards create frameworks for domestic income tax and customs legislation to tax related entities, which state parties have already mirrored or agreed upon in their domestic laws. Since states mirror or adopt these standards, they provide a recognized, objective, and neutral set of guidelines to arrive at arm's length prices or customs value, ensuring that governments obtain their rightful share of tax and related MNCs receive their rightful share of profit.

Although both Model Tax and Customs convention provide for arm's length, their application in terms of methods to determine market price differs. While customs valuation requires a hierarchy of methods, no such requirement exists under transfer pricing. Consequently, the scope of related parties, comparability factors, and documentation requirements are not compatible with each other. Additionally, the adjustment criteria differ. Adjusting an arm's length transaction value between related parties typically occurs after a transfer pricing audit, which may necessitate price adjustments. In such cases, any adjustment whether increasing or decreasing the customs value subjects the taxpayer to additional audit. However, there have been different interpretations across countries regarding whether upward or downward adjustments should be considered in determining retroactive adjustments. For example, in the *Hamamatsu Photonics Deutschland GmbH v Hauptzollamt München*,[47] it was ruled that retroactive transfer pricing adjustments, either upward or downward, should not be considered when determining customs value.

This means that international laws generally agree that no complete convergence can be made in the application of the arm's length principle in transfer pricing and customs valuation. Recognizing this challenge, and

[46] Art 2 to 7 of the WTO rules
[47] C529/16 German Federal Court (Bundesfinanzhof).

in order for countries to achieve minimum standard alignment, international law sets basic standards requiring transfer pricing documentation to provide useful information to customs regarding related parties' transactions.[48] Similarly, customs valuation can be used by tax administrations to evaluate the arm's length aspect of transactions between related parties in the context of transfer pricing. Additionally, different departments within revenue authorities must foster cooperation to reduce costs and minimize disputes that are likely to arise in the context of transfer pricing and customs valuation.[49] In general, the international standard provides an objective foundation for harmonizing the application of the arm’s length principle in transfer pricing and customs valuations, and at each stage, it can facilitate aligned results.

5.0 Legal challenges in the Application of Arms' Length Principle in transfer pricing and customs valuation

5.1 Different Thresholds for Related Parties

The scope of application of the arm’s length principle for determining market prices is limited to related parties. In transfer pricing, related parties are defined as entities with control over ownership, which can be measured by the percentage of voting power, capital, or involvement in the company's management, either directly, indirectly, or through one or more intermediary companies.[50] The ownership threshold typically ranges from 25 to 50 percent. Additionally, any person who acts, or is likely to act, according to the directives, opinions, or intentions of another party is considered a related party. Permanent establishments and branches are also included as related parties.[51] In the context of customs valuation, the parties to a transaction are considered related if they are officers or directors of each other's businesses, are legally recognized business partners, have an employer-employee relationship, or directly or indirectly own, control, or hold five percent or more of the outstanding voting stock or shares of each other. Additionally, they may be related if they are members of the same family or if one party is an agent or sole distributor for the other.[52]

[48] Para D.5.1.157 of OECD Guidelines, See also WCO, *Guide to Customs Valuation and Transfer Pricing Pricing*,2018, p.5 and Chap 5.
[49] Ibid.
[50] Sec 3 h (i) and (ii)ITA Cap 340, sec 18 (6) of ITA Cap 370 and sec 3 of ITA Cap 332.
[51] R 3 TP Rules 2018.
[52] Para 1 (3) and (4) of the Fourth Schedule.

The requirement for related parties for the arm's length principle to apply differs between the two sets of laws. Unlike in transfer pricing, where related parties arise from transactions and are defined by ownership percentage and permanent establishment, the concept of related parties originates from the primary method of customs valuation, known as the transaction value. Regarding the transaction value method, the related parties' aspect is one of the elements in applying transaction value for customs duties, regardless of whether the parties are related or unrelated, as provided under paragraph 2(1)(d) of the Fourth Schedule. In addition, the ownership threshold in transfer pricing ranges from 25 to 50 percent, while the minimum threshold for customs valuation is 5 percent. In this context, the customs value diverges in a narrow sense, as the minimum ownership percentage threshold for control is lower than that of transfer pricing. The issue may arise when applying a transfer pricing study for customs valuation because any ownership threshold below 25 percent is not considered related parties for transfer pricing purposes. Similarly, transfer pricing laws exclude employee relationships[53], while the concept of related parties under customs valuation includes the employer-employee relationship.

The differences in the thresholds and the interpretation of related parties originating from transfer pricing rules may present challenges in applying transfer pricing documentation for customs valuation purposes. In *Rohto Mentholatum (Kenya) Limited v Commissioner of Customs and Border Contro* [54], the Commissioner submitted that the transfer pricing policy, in which related parties are enshrined, is not applicable in determining the customs value of imported goods.[55] However, the court rejected this argument and upheld the appeal. This means that MNCs are subject to different ranges and are likely to arrive at different results. Nonetheless, both transfer pricing and customs valuation rules establish certain criteria for determining the relationship between the parties in line with international standards.

5.2 Differences in Comparability Factors Range

In the context of transfer pricing, the arm's length principle requires transactions between associated parties to be compared with those

[53] Sec 3 of ITA Cap 340.
[54] [2023] KETAT 271 (KLR).
[55] Ibid para 42

between unrelated parties under similar circumstances.[56] The comparable factors include the characteristics of the goods transferred, the functions performed while considering the assets used and risks assumed, the contractual terms of the transactions, economic circumstances, and business strategies.[57]A transaction between unrelated parties is considered comparable if the factors of comparability are similar, and no differences between these factors are likely to materially affect the price, cost, or profit.[58] In *Alliance One Tobacco Tanzania Limited v Commissioner General TRA Appeal* [2013] TRAT 33, it was stated that in order to establish whether the price is not influenced, the transaction between related parties must test the related party's price to unrelated party's prices. The price of goods transferred between related parties is also comparable if it falls within the arm's length price range of transactions between unrelated parties, and no material adjustment can be made to the price.[59] In *East African Breweries Limited v Uganda Revenue Authority*, [2017] TAT 14, the tribunal found that the transfer pricing arrangement between the related MNCs was not made at arm's length.

In customs valuation, the comparability aspect of the arm's length principle requires the transaction value between related parties to be compared with that of unrelated parties. If there is doubt about the transaction value, the circumstances surrounding the sale and test values are used. The former refers to how the seller and buyer organize their commercial relationship and set the price.[60] The latter involves transaction values of related parties that closely approximate those of unrelated buyers of identical or similar goods, or the customs value of such goods as determined under the deductive or computed value method, as provided in Paragraph 2(b) of the Fourth Schedule.

The comparison criteria include sales at the same commercial level but in different quantities, sales of substantially the same quantities, and sales at different commercial levels in various qualities.[61]According to the EAC manual, the price of goods between related parties is compared with the sales between unrelated buyers within the region. The comparison can

[56] R 3 TP Rules 2018.
[57] R 6 (1) of TP Rules, 2018, R 4 of TP 2011.
[58] See for example r 6 TP Rules 2018.
[59] See for example r7 (2) of TP Rules 2011.
[60] Interpretive notes 3 to para 2 of the Fourth Schedule.
[61] Ibid notes 3 to para 3 of the Fourth Schedule.

also be made by checking whether unrelated buyers in partner states can purchase the same goods at the price charged between related parties. In the *Rohto* case, it was ruled that it was erroneous to compare the circumstances of a sale where the tested party did not incur the same costs as the other party.[62] If no comparison is available within the EAC, comparisons can be made with unrelated buyers from importers or third countries, provided the market development is sufficiently advanced to allow such comparisons. Thus, the transaction value between related parties will be accepted if it closely matches the transaction value of unrelated parties. If the relationship influences the price, however, the transaction value will not be accepted, and the next method in the hierarchy will be applied.[63]

Although both transfer pricing and customs valuation laws rely on independent transactions in comparable circumstances as a basis to test related-party transactions, there is no legal requirement for the transfer price and transaction value to be exactly the same. The transfer pricing rules rely on a range of prices, with no definitive right answer, as each case is evaluated on its merits. Conversely, the Customs value covers a single product. In this context, the customs authority may not easily accept a transfer pricing study. In *Rohto* case, the responded Commissioner of Customs and Border Control submitted that the transfer pricing policy of an organization is not applicable in determining the customs value of goods imported in EAC.[64] This means that a transfer pricing study is not always accepted by the customs authority until the matter is taken to the tribunal or court of law.

5.3 Uncertain Adjustments in Transfer Pricing for Customs Valuations

Adjustment is the process of adjusting the price of goods between related parties after comparing the transactions of related and unrelated parties. In transfer pricing, the revenue authorities are empowered to make adjustments to prices.[65] The adjustment by revenue authority is made by recharacterizing the source and type of income, loss, amount of payment or apportionment, and allocation of expenditure, including income from a

[62] Rohto case para *above at 54 para 32-38*
[63] Para 5.1.11 to 5.1.1.4 of the East African Customs Valuation Manual, 2012.
[64] Rohto case *above at 54 para 85.*
[65] Sec 33 (2) ITA Cap 332, Sec 18(3) ITA Cap 370 and Sec 90 ITA Cap 340.

domestic or foreign adjustment.[66] The EAC legal instruments provide for primary adjustments and corresponding adjustments.[67] Unlike Tanzania and Uganda, Kenya provides for transactions subject to adjustments, including the purchase, sale, and transfer among other transactions.[68] It also provides for safe harbour provision and encompasses any other transactions likely to affect the profit or loss of the corporation as provided under.[69] The safe harbour may be construed as taking aboard customs valuation on the price charged between related parties for transfer pricing purposes.

The primary adjustments are made by revenue authorities to make transaction prices at arm's length. Once a primary adjustment is made by one country, the other country makes a correspondence adjustment in response to the adjustment made by the first country. The role of the corresponding adjustment is to eliminate the double taxation arising from the first adjustment by the revenue authority. In this context, the transaction subject to adjustments may include customs value, directly impacting the value of imported goods at the time of importation.

In adjusting the transactions, the law requires the revenue authority to recharacterise the source and type of income of the parent company and the permanent establishment or to apportion and allocate expenditure related to the income of the permanent establishment.[70] The revenue authority may recharacterise the transaction by generating an amount that related parties did not incur. It is also challenging to establish the extent recharacterised transactions considering special circumstances that related parties face when transacting with each other a situation independent parties do not experience. However, the income tax laws are silent on the actual characterisation procedure, and the commissioners of revenue authorities are left with the discretion to recharacterise the transaction. In this context, adjustments made will likely affect customs value after the transfer pricing audit.

[66] Sec 33 (2) ITA Cap 332 Sec 91 ITA cap 340.
[67] R 10 of TP Rules Uganda.
[68] R. 6 (1) of Kenya Draft of TP Rules 2023.
[69] R 6 (f) of the TP Rules,2006.
[70] Sec 33 (2) (a) and (b) of the ITA Cap 332 as amended by section 23 of Finance Act 2016 read together with TP Rules 2018, Sec 90 (2) Cap 340.

Adjustment in the context of customs valuation is a process of adjusting the customs value of goods sold between related parties that are not made at arm's length. However, the Fourth Schedule is silent on adjusting customs value in the context of arm's length. Paragraph 9 of the Fourth Schedule provides for the adjustment of the customs value in establishing a transaction value, whether parties are related or not. In this context, the adjustment by customs authority considers either quantity or commercial factors or both commercial and quantity factors.[71] Adjusting the transaction value of an arm's length between related parties occurs after an audit, which may require price adjustments. In such cases, any adjustment, whether resulting in an increase or decrease in the customs value, will subject the taxpayer to additional customs duties. In *Game Discount World Tanzania v. Commissioner General, Tanzania Revenue Authority*,[72] the court upheld the tribunal's decision, requiring the appellant to pay the additional tax assessed in order to comply with section 9(2) of the EACMMA.

The transaction value method also permits adjustments when credit and debit notes are taken into account. In *Century Bottling Limited v Uganda Revenue Authority* [73] it was stated that a credit note showing what was not paid or payable should be considered when determining the price paid or payable.[74] This position aligns with the WCO Guide to Customs and Transfer Pricing. The Guide requires that where an adjustment is initiated by the taxpayer and recorded in the taxpayer's accounts, and a credit note is issued, it impacts the price actually paid or payable.[75] When the adjustment is initiated by the taxpayer, the impact may be limited to the tax liability. In this case, the court set aside the additional assessment arising from the adjustment in the treatment of credit and debit notes.

The adjustments between the two sets of rules occur for different reasons, leading to different results and timing. In the context of transfer pricing, the adjustment aims to align with market prices or to reveal whether the price was influenced by relationships between the parties. Similarly, the adjusted price may indicate that the prices paid or payable were either unaffected by relationships or influenced by them. Where the transfer

[71] Interpretive notes 3 to para 3 of the Fourth schedule.
[72] [2023] TA 20.
[73] [2021] TAT 24,
[74] Ibid p.8.
[75] Commentary 5.3.2 of WCO Customs and Transfer Pricing Guide,

pricing adjustment affecting the price paid or payable, the customs authority may be required to adjust the prices. The problem, however, lies in compliance when making retroactive transfer pricing adjustments to bring realized profit adjustments for customs valuation purposes arising from the transfer pricing study. This is particularly challenging, as it requires the income tax department to prove that the transaction value was influenced by related party relationships, which is not always easy. In the *GlaxoSmithKline (Kenya) Ltd v Commissioner of Customs and Border Control* the Kenya Revenue Authority failed to provide proof, and the court ruled in favour of the taxpayer.[76] The problem is further exacerbated by the fact that transfer pricing and customs valuation are administered by different departments. As a result, audits in each context are conducted at different times. While customs post clearance audits begin promptly, transfer pricing audits typically occur after several years.

In the EAC, any adjustment other than zero is subject to additional tax charged either in the context of transfer pricing or customs. In such a situation, any adjustment made, whether leading to an increase or a decrease in customs value, subjects the taxpayer to additional customs due.[77] In *L'Oréal East African Limited* case,[78] the appellant failed to demonstrate that the declared value was at arm's length and subsequently paid the additional uplifted taxes. Although the customs authority provides for the acceptability of related pricing, there is limited guidance on managing retroactive transfer pricing adjustments arising out of transfer pricing audit. The focus generally remains on ensuring that related party transactions adhere to the arm's length principle as enshrined in the respective laws.

5.4 Unacceptance of Transfer Pricing Methods for Customs Valuation

The arm's length price and transaction value are not determined arbitrarily; specific methods and procedures must be followed. In the transfer pricing context, the methods used include the comparable uncontrolled price method CUP, the resale price method (RPM), and the cost-plus method, commonly known as traditional methods. Other methods include the profit split method, the transactional net margin

[76] [2020] TA 240.
[77] L. Ping and C. Silberztein,'Transfer Pricing, custom Duties and VAT Rules: Can We Bridge the Gap? *above at not 11* p.36.
[78] *Above at note* 41.

method, and any other methods that the Commissioner General of the revenue authority may prescribe.[79] The EAC transfer pricing rules essential adopts the OECD Guidelines.

The CUP method compares the price charged on goods transferred between related parties to the price charged on goods transferred in a comparable uncontrolled transaction under comparable circumstances. The RPM compares profit margins on the price of goods and services between related MNCs and the profit margin of sales by associated parties to an independent company. This is done by reselling goods and services to an independent company with a certain gross profit margin. The resale gross profit margin is subtracted from the resale price, after considering the functions performed, to determine an arm's length price. The gross profit margin obtained is then compared with that of an independent corporation in similar circumstances. Once the gross profit margin of related MNCs is similar to that of the independent corporation, the margin is added to the initial price between associated MNCs to determine the transfer arm's length price.

Cost Plus Method (CPM) involves the cost of production of goods transferred or provided between related MNCs. The CPM compares the gross profit markup earned by the related MNCs with those earned by independent companies while considering functions performed, the assumed risk, and the market condition.[80] A comparison is then made between the profit markup of related MNCs and independent corporations. Thus, the transfer price between related is the cost of goods sold plus arm's length profit markup. The transactional net margin method (TNMM) compares the net profit margin related to the appropriate base, such as costs, sales or assets that a person achieves in a controlled transaction, with the net profit margin achieved in a comparable uncontrolled transaction. Comparison is made between the net margin earned by related MNCs and net margins between independent companies operating in similar circumstances by comparing transactions or functions performed.[81] The TNMM uses profit level indicators based on operating profit to compare the net profit margins of related MNCs of an independent company.

[79] R5 1(f) TP Rules 2018, r 7 TP Rules, 2011, r 7 TP Rules 2006.
[80] Interpretation provisions of Transfer Pricing Rules of the EAC member states.
[81] Interpretation provisions of TP Rules of the EAC.

The transactional profit split method (TPSM) consists of splitting up the profit between the related parties on an economically valid basis, comparing the profit and loss that a person achieves in a controlled transaction with the division of profit and loss between independent persons. The TPSM aggregated profit earned by associated MNCs is split among associates based on the relative value of each related party's contribution based on performed function(s), assumed risk and assets used by each associate. The split profit of related parties is then compared with the split profit that would have been anticipated and reflected in an independent transaction made at arm's length. If the profit is in accordance with the profit of an independent party, then the profit is said to be at arm's length. In all methods the transactions of associated MNCs are comparable to independent transactions if there are no differences that would materially affect the price.[82] If differences exist, they are considered comparable if reasonable and accurate adjustments can be made.[83]

In context of customs valuation, the EACCMA provides six methods of customs valuation: the transaction value method, the transaction value of identical goods, the transaction value of similar goods, the deductive value, the computed value, and the fallback value.[84] Paragraph 2(1) of the Fourth Schedule defines the transaction value for imported goods as the price paid or payable for goods sold for export to the customs territory of the EAC for free circulation, adjusted as per paragraph 9 of the Fourth Schedule under the ordinary course of trade. The price paid or payable refers to the total payment made or to be made by the buyer or for the seller's benefit for the imported goods, and it includes all payments made as a condition of sale by the buyer to the seller.[85]

Paragraphs 2(1) (a) to (d) of the fourth schedule sets four conditions for the customs value method to apply. Transaction value is the primary method to arrive at transaction value. This requirement is in line with Article 1 and 8 of the WTO Agreement. Suppose it is impossible to determine the customs value by using the transaction value. In that case, the next method in the hierarchy should be applied as provided under paragraph 1of interpretive note of the Fourth Schedule. In *Testimony*

[82] See for example Rule 6 (2) (a) and (b) TP Rules 2018.
[83] Ibid. r 3.
[84] Paras 4-10 of Fourth Schedule.
[85] Para 2.1.2 EAC customs Valuation manual 2012.

Motors v Commissioner of Customs Uganda Revenue authority[86] the issue was whether the commissioner application of alternative methods to determine the transaction value contravened the provisions of EACCMA and whether had the power to exclude the transaction value method. The court ruled that the commissioner contravened the Act and had no power to exclude transaction value method.[87] Likewise, in *Auto express limited v Commissioner Customs and border control*[88] it was ruled that the commissioner of customs errored in law by departing transaction value method without giving an opportunity the taxpayer to justify the value declared contrary to forth schedule.[89]

The second method in the hierarchy is the transaction value of identical goods as provided under paragraph 3 of the Fourth schedule. This method compares the transaction value of the identical goods being valued with goods sold for export to the partner states, exported at or about the same time. In the absence of such a comparison, a sale of identical goods at the same commercial level but in different quantities, or at a different commercial level but substantially in the exact quantities, is allowed under paragraph 3(b) of the Fourth Schedule. Goods are considered identical if they are the same in all aspects, including physical characteristics, quality, reputation, and are produced in the same country by the owner of the goods being valued.[90] In *BASF* case[91] it was ruled that the sale of identical goods did not take place at the same commercial and in quantities of the goods being valued. The transaction value is adjusted upwards or downwards to account for the differences attributable to commercial or quantity factors is then the transaction value of identical goods.

The third method is the transaction value of similar goods. This compares the value of similar goods sold for export to the partner states and exported at or about the same time with the goods being valued, as provided under paragraphs 4(a) and (b) of the Fourth Schedule. In the absence of such a comparison, a sale of similar goods at the same commercial level but in different quantities, or at a different commercial

[86] [2021] CA 212.
[87] Ibid, para 10 and 20.
[88] [2018] TAT, 119.
[89] Ibid, para 70.
[90] Para 2.2.2 of the East African Customs Valuation Manual, 2012.
[91] BASF case *above at note 38*, para 108.

level but substantially in the same quantities, or at a different commercial level in different quantities, is allowed as provided under paragraph 4 of the interpretive note of the Fourth Schedule. The transaction value of similar goods is adjusted upward or downward to consider differences attributable to commercial or quantity factors is then the transaction value of similar goods.

The fourth method is the deductive value method, which compares the value of the goods being valued with the value of goods sold to independent customers in the EAC at or near the time of importation, after deducting certain expenses incurred from the importation and sale of the goods.[92] The customs value is based on the unit price of imported or identical or similar goods sold in the large quantity at or about the same time. The fifth method is computed value method whereby the customs value of imported goods shall base on computed value consisting sum of costs or value of the materials, amount of profit and general expenses and all other expenses adjusted in accordance with paragraph 9(2) of the fourth schedule.[93]The sixth is the fallback method, which describes the ability to establish a customs value when the other methods are not applicable. It requires a review of the other methods by abandoning the strict conditions provided under paragraph 8 of the Fourth Schedule. This method requires the transaction value of goods to be determined at a fair market value.

One of the interests for arms' length purposes is that where the seller and the buyer are related, the transaction value is acceptable if the value is adjusted per the law obtained under the ordinary course of trade in a competitive market force.[94] The importer demonstrates that the value closely approximates the transaction value in sales to unrelated buyers of identical or similar goods for export to the partner states , or the customs value of identical or similar goods obtained through the deductive method, or the customs value of identical or similar goods as determined through the computed value method as provided under paragraph 2 (b) of the Fourth Schedule.

[92] Para 6 Fourth Schedule.
[93] Ibid, para 7.
[94] Para 2(1) (d) of Fourth Schedule.

The transfer price and customs valuation methods demonstrate that in both legal frameworks, the arm's length principal mandates that the prices of goods or customs values between related parties be set at market prices. This is meant to prevent related parties from manipulating the price of goods transferred or the customs value. An unrelated price or transaction value is used as a benchmark to test the prices or customs values between related parties. However, under transfer pricing there is no requirement in the law for a hierarchical application of methods; the law simply mandates that the most appropriate method be used[95] In addition, the law requires that, when commodities are involved, the CUP method is preferred over other methods.[96]

In the context of customs, the methods must be applied sequentially, with all transactions first using the transaction value method as the primary method. In *Bidco Oil Refineries v. Commissioner of Customs Services*, [2015] application number 150, the court found that the commissioner failed to apply the valuation methods sequentially, as required by law. This means that other methods may only be applied when the transaction value method cannot provide the arm's length value.

Despite this requirement, the transaction value method is not always accepted by the customs department. In *GlaxoSmithKline (Kenya) Ltd v. Commissioner of Customs and Border Control*, [2020] TA 240 of Kenya, the Commissioner of Customs submitted that the deductive method be used instead of the transaction value method. The Commissioner's rejection was based on the transfer pricing documentation, which applied the transaction net margin and assumed compatibility with the deductive value method. The court ruled in favour of the taxpayer because the revenue authority failed to prove that the relationship influenced the price. This case upholds the position of customs laws, which require the transaction value method to be applied first, before moving on to the next method in the hierarchy. This is true even if other methods seem more relevant in the context of direct tax than the transaction value method.

When it comes to the application of transfer pricing methods in practice in establishing circumstances surrounding the sale for customs valuation

[95] Interpretive note 11 of the 4th schedule requires the valuation methods be applied in sequential order
[96] Rule 12 of TP Rules, 2018.

purposes the customs departments have been reluctant. In *BAS Case*,[97] the issue was whether the resale price method was closely appropriate to the customs value of identical goods determined by using the deductive value method. The tribunal ruled that the product imported by the taxpayer was determined in accordance with the deductive value method.

5.5 Unacceptability of transfer pricing documentation for customs valuation

In the context of transfer pricing, taxpayers are required to prepare specific transfer pricing documentation that explains the structure, nature of the business, actual computations, and other data relevant to explaining the operations of related parties.[98] The submitted transfer pricing documentation is required to be construed consistently with the OECD Model Tax and Guidelines.[99] In case of any inconsistency with domestic law, domestic law should prevail. However, the existing transfer pricing documentation requirements are narrower than those of the TP guidelines, which may lead to insufficient data for customs verification. Related MNCs often use transfer pricing documentation to support customs valuation, provided it demonstrates the arm's length nature of the transactions.

However, customs authorities do not view transfer pricing studies or advance pricing agreements as containing useful information to support the same. In the *Rohto* case, the Commissioner of Customs and Border Control submitted that the transfer pricing policy of an organization is not applicable in determining the customs value of goods imported into the EAC.[100] Similarly, in *GlaxoSmithKline (Kenya) Ltd v. Commissioner of Customs and Border Control*, [2020] TA 240, the revenue authority did not consider GSK's transfer pricing documentation and schedule of prices, which supported that the customs value was set at arm’s length and was not influenced by the relationship. The judicial interpretation is consistent with the manual's stance and aligns with international instruments, which recognize that transfer pricing documentation can serve as a basis for

[97] BASF, *above* at *note 38* para 119.
[98] Sec 35 of Tax Administration Act, 2015 and r7 of the TP Rules 2018, Section 18 (b) of Cap 470 and r 10 of TP
Rules 2006 and r 8 (1) of the TP Rules 2011.
[99] R 8 and 6 of TP Rules 2011, r 7 and 9 of TP Rules 2018.
[100] Rohto case *above at note 54*.

establishing the circumstances surrounding a sale. However, this requirement is not explicitly provided in income tax or customs law.

These cases demonstrate that when such information is presented, the customs department conducts a separate analysis and requires additional evidence to ensure that the transaction value complies with customs valuation rules. This situation suggests that the two departments within the same revenue authority operate independently. As a result, reaching joint agreements on the same price paid or payable for both corporate tax and customs duties is highly subjective. A common assumption is that the initial transaction, where the arm's length principle is applied, should be used as the market price for subsequent analysis, whether for transfer pricing or customs valuation. Typically, customs valuation occurs before profit taxation in the context of transfer pricing. However, this has not been the case. The customs department reluctance to apply transfer pricing is contrary to the requirements of the EAC Customs Valuation Manual, which recognizes that transfer pricing documentation can serve as the basis for establishing the circumstances surrounding a sale.

From the foregoing, the arm's length rules of transfer pricing and customs valuation suggest potential interactions and similarities that support revenue collection from related parties' transactions. First, the application of the arm's length principle is limited to transactions involving related parties. Second, there is a focus on the comparability of transactions between related and unrelated parties. Third, both frameworks require that related party transactions be treated as if the entities were separate and unrelated. Fourth, there is a provision for adjusting prices when they do not reflect arm's length principle. Fifth, specific methods are employed to determine the arm's length price or transaction value.

Despite apparent similarities, customs valuations and transfer pricing are not always fully compatible in accommodating the arm's length principle. In this regard, customs valuation deviates from or modifies the arm's length standard in areas such as related parties, comparability, methods, and adjustments. Accordingly, existing income tax and customs laws do not require that transfer prices and customs values between related parties be accepted for both transfer pricing and customs duties purposes. The differences in transfer pricing requirements among partner states add to the existing challenges. Case law and scholarly works suggest the international standard of using transfer pricing documentation for customs

valuation. This international stance on using transfer pricing documentation for customs valuation points toward partial integration in the application of the arm's length principle in both transfer pricing and customs valuation.

It is argued that, without a legal requirement in both income tax and customs laws, the international approach to partial harmonization may not be fully implemented in the EAC. Similarly, the lack of clear guidelines and coordination in the current efforts to apply the arm's length principle in customs and transfer pricing will continue to be a barrier to enhancing revenue from foreign trade and investments.

6.0 Recommendations

Given the challenges and inconsistencies in the application of the arm's length principle in both legal frameworks, two approaches are recommended: amending the laws and fostering coordination between the income tax and customs departments. The proposed amendments include the following: Firstly, due to the differing thresholds for related parties in transfer pricing and customs valuation, it is recommended that the income tax laws specifically sections 18(6)(a) and (b) of Cap 370 (Kenya), section 3 of Cap 332 (Tanzania), and section 3(h) (Uganda) be amended to include related parties' provisions for customs purposes. These amendments would specify that, for customs documentation related to transfer pricing, legal entities will be considered related if their control threshold is between 25% and 50% or more of voting rights or capital.
Secondly, where transfer pricing adjustment affects customs value, it is recommended that the EAC amend the Fourth Schedule of the EACMA to include a provision that mandates customs authorities to accept transfer pricing documentation demonstrating an arm's length price between related parties for customs valuation, subject to verification by the customs authorities. Similarly, the transfer pricing rules should be revised to require the income tax department to accept customs documentation demonstrating arm's length transactions for transfer pricing purposes, upon verification by the income tax department. This requirement aligns with international standards, which call for the use of transfer pricing documentation to verify the circumstances surrounding the sale.

The law should require the Income Tax and Customs departments to accept transfer pricing adjustments that impact declared prices both before and after the importation of goods. In this context, the law should

specify that customs authorities take into account any pre-importation and post adjustments for customs valuation. Provided such adjustment results affected declared prices for customs valuation purposes. If transfer pricing adjustments do not affect the customs value, no changes should be made to the declared transaction value.

Third, it is recommended that the revenue authorities should establish clear guidelines for handling and coordinating arm's length issues within the revenue departments. These guidelines should consider incorporating elements such as the post-clearance audit manual, transfer pricing audits and price adjustments affecting customs transaction value and transfer pricing. This approach would align with international standards. Partial administrative integration could enhance data sharing, audit planning, and coordination between the two departments.[101]

Fourth, the revenue authorities must embrace judicial interpretation which already upholds the application transfer pricing documentation to demonstrate the circumstances surrounding the sale. This is because the arm's length principles in both transfer pricing and customs valuation cannot replace one another but can instead complement or support each other.

Firth, the EAC member to depict WCO and OECD guidelines in their domestic law. This in particular transfer pricing documentation whereby transfer pricing rules already require such documentation to be construed in line with international standards.

Sixth, the remaining member states that have not signed the EAC DTA should consider signing it to enable the protection against tax distortions that may arise from the inconsistent application of the arm’s length principle in transfer pricing and customs valuation.

7.0 Conclusion

This article examined the legal framework governing the application of the arm’s length principle in transfer pricing and customs valuation, in line with the EAC treaty's requirement to harmonize tax policies and eliminate tax distortions in order to increase revenue. The article

[101] M. Atci., Transfer Pricing and Custom Valuation Overlap: Is it possible to Bridge Two Worlds? *above at note 12*

identified both similarities and differences in the relevant laws. It found that the existing transfer pricing and customs laws do not require transfer pricing documentation to establish the circumstances surrounding sales between related parties, despite this being outlined in the customs manual. Based on case law where the arm's length principle was applied in both transfer pricing and customs, the article found that the customs department is often reluctant to accept transfer pricing documentation and methods for determining the circumstances of a sale until the matter is brought to judicial interpretation. Additionally, the transfer pricing laws within the EAC member states vary. The article recommends harmonizing both sets of laws by amending the identified areas to align with international standards and precedents that already maintain these standards.