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# TRANSFER PRICING ALERT – TAX APPEALS TRIBUNAL (TAT) EMPHASIZE TAXPAYER'S BURDEN OF PROOF IN TRANSFER PRICING (TP) DISPUTES

## Synopsis

On 9<sup>th</sup> February, 2024, the TAT delivered its verdict in the *Tax Appeal No. 866 of 2022*. The key issues being contested was whether the Appellant (Taxpayer) applied arm's length price when selling products to its related parties (in Uganda, Tanzania, Ghana, and Nigeria) and whether the TP method applied was the most suitable one. The Appellant applied the Transactional Net Margin Method (TNMM) in determining the intercompany prices. However, during the tax audit, the Kenya Revenue Authority ("Respondent") held that the Comparable Uncontrolled Price (CUP) method should have been applied.

## Background and Key Arguments by the Parties

According to the detailed judgement by the TAT:

- The Appellant manufactures pharmaceutical products in Kenya for distribution in the local and export markets. Local sales primarily occur between the Appellant and distributors and in some cases retailers. Export sales mainly comprise sale to related parties and are governed by distribution agreement signed with each of the related parties.
- The Appellant chose the TNMM using EBIT as the Profit Level Indicator (PLI) in setting the consideration for its intercompany sales. This is because TNMM considers the full supply chain of the product until the product is sold to third party customers.
- The Respondent contended that the CUP method (*which compares price of a similar product sold between related parties and third parties*) as the most appropriate to set the intercompany prices between the Appellant and its related parties. This is because the transaction in question is sale of goods which is similar in nature to third parties and related parties.
- On 20<sup>th</sup> November, 2021, the Respondent issued a notice of assessment of **KShs 480,175,287** to the Appellant which the Appellant objected to vide a letter dated 23<sup>rd</sup> December, 2021.
- On 5<sup>th</sup> July, 2022 the Respondent issued an objection decision rejecting the Appellant objection and upholding its assessment. Dissatisfied with the objection decision, the Appellant filed Notice of Appeal on 4<sup>th</sup> August, 2022.

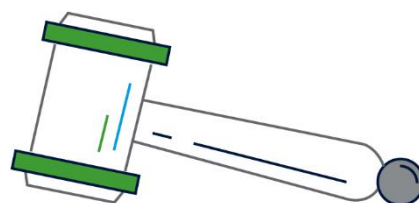


Appellant's Case	Respondent's Case
<p>The Appellant contended that:</p> <ul style="list-style-type: none"> <li>The Respondent issued an objection decision in total disregard of the clarifications and documentation provided;</li> <li>The Respondent only considered product comparability and ignored other differences in the two transactions the Appellant highlighted. Thus incorrectly determined that the transactions were comparable without any adjustment.</li> <li>For CUP method to be applied as reference for intercompany prices, the following adjustment should have been considered: <ul style="list-style-type: none"> <li>✓ Cost of transport;</li> <li>✓ Cost of insurance;</li> <li>✓ Selling, promotion and distribution costs incurred;</li> <li>✓ Volume based adjustment;</li> <li>✓ Adjustment for credit risk exposure; and</li> <li>✓ Adjustment for differences in market price</li> </ul> </li> <li>If CUP method was applied with the above adjustment, the intercompany price would have been reduced by approximately 95.5% leading to absurd results.</li> <li>The adjustment by the Respondent is punitive and fails to consider that related entities had paid their rightful share of taxes in their countries.</li> </ul>	<p>The Respondent contended that:</p> <ul style="list-style-type: none"> <li>That the audit established that the Appellant sells similar products to third party distributors in Kenya and to its related parties with a similar terms. These similarities sets a clear presence of internal comparable to apply the CUP method in accordance with the OECD TP Guidelines;</li> <li>The Appellant's Related Parties sales were concluded at lower prices compared to third party sales;</li> <li>That the Appellant's TP policy states that the related parties were the tested parties and has operating margin (OM) of 5% to 8% on distribution. However, the Appellant failed to provide: <ul style="list-style-type: none"> <li>✓ Information to show how the OM of 5% to 8% was achieved;</li> <li>✓ List of costs related to business development activities in relation to third party sales;</li> <li>✓ Information used to select the tested party;</li> <li>✓ Segmented information to verify the choice of TNMM; and</li> <li>✓ Other comparability factors (ledgers) other than freight costs.</li> </ul> </li> <li>Based on the information available, the Respondent applied the CUP method using internal comparable.</li> </ul>

### Ruling of the Tax Appeals Tribunal

The issue of determination was *whether the change of transfer pricing method by the Respondent was justified*. The Tribunal noted the following:

- While the Appellant stated that it submitted the disputed information listed above, the Tribunal did not sight any document to confirm this. From oral pleadings and oral submissions, it's apparent that certain key documents were not provided by the Appellant during objection and when requested by the Respondent
- The information in dispute is key in determining which transfer pricing method is the most appropriate to be applied on the Appellant's transactions
- If the Appellant provided all the information requested prior to the objection decision, it should have adduced evidence to show that the information was provided
- By failing to provide the evidence, the Appellant did not exhaust its burden of proof under Section 56(1) of the Tax Procedures Act. In the view of the foregoing, the Tribunal the Appeal failed.



## Conclusion and Our View

The burden of proof in civil tax cases rests on the taxpayer to prove that a tax decision is incorrect. In this case, the TAT failed to give its verdict on whether the change of the TP method by the respondent was justified because the Appellant had failed to provide the information that would have guided the TAT in making its determination.

From a transfer pricing it's imperative for taxpayers to:

- Keep supporting documentation of the underlying transaction;
- Carry out routine reconciliations of the transfer pricing policy and the actual result of the transaction to ensure they are harmonized and maintain evidence/support of the same; and
- Provide all the information requested by the revenue authority and the information to support their case during objection to enhance the chances of success of their case.

Should you need any assistance/clarifications in respect of the above, please reach out to the below or your usual RSM contact.

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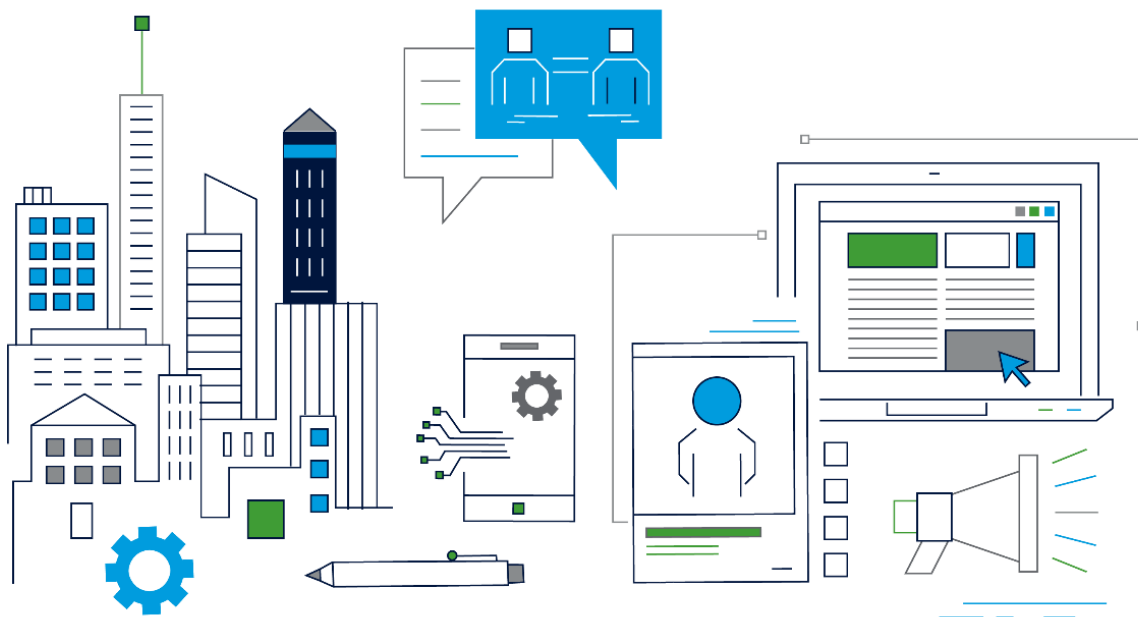
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