REPUBLIC OF KENYA

IN THE TAX APPEALS TRIBUNAL AT NAIROBI

TAX APPEAL NO. E422 OF 2024

CIPLA KENYA LIMITED…………………………..……………….. APPELLANT

-VS-

COMMISSIONER OF DOMESTIC TAXES……………………..…RESPONDENT

JUDGMENT

BACKGROUND

1. The Appellant is a limited liability company incorporated in Kenya and a subsidiary of Cipla Medpro South Africa with the ultimate holding company being Cipla Limited India (hereinafter referred to as "Cipla India"), a company headquartered in Mumbai, India. Its principal business activity is the marketing and distribution of pharmaceutical products purchased from Cipla India in the Kenyan market.

2. The Respondent is a principal officer appointed under Section 13 of the Kenya Revenue Authority Act, CAP 469 of Kenya's Laws (hereinafter "the Act"). Under Section 5 (1) of the Act, the Kenya Revenue Authority is an agency of the Government for the collection and receipt of all tax revenue. Further, under Section 5(2) of the Act with respect to the performance of its functions under subsection (1), the Authority is mandated to administer and enforce all provisions of the written laws as set out in Part 1 and 2 of the First Schedule to the Act for the purposes of assessing, collecting and accounting for all revenues in accordance with those laws.

3. The Respondent conducted an audit exercise on the Appellant's tax affairs and subsequently issued corporation tax assessment vide a letter dated 13th December 2023 for the year 2018 wherein the Respondent assessed the tax at Kshs 78,575,943.00 being principal tax, interests and penalties. The Appellant lodged its Notice of Objection against the additional assessments vide letter dated 12th January 2024.

4. Upon review of the Appellant's objection, the Respondent issued its objection decision dated 8th March 2024 partially allowing the Appellant's objection and thereby reducing its initial principal CIT assessment from Kshs 49,109,964.00 to Kshs 31,596,856. Dissatisfied with the Respondent's objection decision, the Appellant filed this Appeal through the notice of appeal dated and filed on 5th April 2024.

THE APPEAL

5. The Appellant lodged its memorandum of appeal dated 19th April 2024 raising the following grounds of appeal:

   (a) That the Respondent erred in law and in fact by misinterpreting the provisions of Paragraph 3.57 and 3.62 of the Organisation for Economic Co-operation and Development Transfer Pricing Guidelines (hereinafter "OECD TP") which prescribe the circumstances under which a measure of central tendency such as the median can be used;

   (b) That the Transactional Net Margin Method (hereinafter "TNMM") does not require use of perfectly identical products between the comparables of the tested party, and the Respondent is misguided in making an adjustment to the median point on the basis of lack of perfectly identical products;

(c) That neither the Income Tax Act, CAP 470 of the Laws of Kenya (hereinafter "ITA") nor the Kenya Transfer Pricing Rules ("hereinafter "KTP") prescribe the use of the median as the arm's length point in a range of comparables;

(d) That the Respondent erred in law and in fact by disallowing employment costs amounting to Kshs 91,662,330.00 as pursuant to the provisions of Section 16(1) of the ITA; and

(e) That the Respondent erred in law and in fact by alleging that the Appellant did not provide documentation to support alleged untaxed employment costs.

APPELLANT'S CASE

6. The Appellant filed its statement of facts dated 19th April 2024. Further the Appellant also filed written submissions dated 19th February 2025 on even date.

(i) <u>Whether the Respondent erred in law and in fact by misinterpreting the provisions of Paragraph 3.57 and 3.62 of the OECD TP Guidelines which prescribe the circumstances under which a measure of central tendency such as the median can be used.</u>

7. The Appellant stated that in its Transfer Pricing (TP) report applied the TNMM in testing the returns it earned for the marketing and distribution of pharmaceutical products purchased from Cipla India. The Appellant stated that it carried out a benchmarking study contained in its TP documentation. As

outlined in the benchmarking study, the interquartile operating margin of the comparable companies selected by the Appellant ranges from 1.60% to 9.14% with a median of 5.08%. The Appellant asserted that it earned an operating margin of 3.02% which is within the interquartile range.

8. It was the Appellant's case that the Respondent reviewed the benchmarking study and identified alleged comparability defects relating to the twenty-one comparables selected by the Appellant. That according to the Respondent, the comparables identified by the Appellant included companies that deal with veterinary and herbal products. As a result, the Respondent noted these are not ideal products without material adjustments due to significant differences that affect profitability such as regulation, target, marketing, branding and different levels of competition. The Respondent further stated that different industries face different levels of competition, may have different risk profiles and different investment requirements.

9. The Appellant stated that the Respondent, due to the alleged comparability defects, it made a TP adjustment from the operating margin of 3.02% earned by the Appellant to the median point of 5.08%. In making the adjustment to the median point, the Respondent relied on paragraphs 3.57 and 3.62 of the OECD TP.

10. The Appellant contested the Respondent's use of the median on the basis that the Respondent grossly misinterpreted the provisions of paragraph 3.57 of the OECD TP. It argued that paragraph 3.57 clearly provides the following two conditions for application of the median:

(i) The median is only used due to deficiencies in the process of identifying comparables such as limitations in available information; and

(ii) The identified comparability defects cannot be readily identified and or quantified and therefore an adjustment cannot be made.

11. With regard to the first condition, the Appellant stated that the use of the phrase *'given the process used for selecting comparables and limitations in information'* in paragraph 3.57 of the OECD TP means that the application of the median is only required where there is an identified specific limitation in the process of identifying comparables or a limitation in the information used. It noted that the word '*given*' means that these conditions must be present for the median to be applied.

12. It argued that paragraph 3.57 further provides that the application of the median is required where, given the limitations in the process of identifying comparables, comparability defects remain that cannot be identified and or quantified meaning that the key condition is a limitation in the process of identification of comparables. Due to this limitation in the process, comparability defects remain that cannot be identified and or quantified. It gave an example where an open internet search is used to identify comparables and there is limited information available publicly on the identified comparables, it would be reasonable to conclude that there are limitations in the process of identifying comparables and the comparability defects cannot be reliably quantified and therefore, use of the median is appropriate.

13. The Appellant stated that 21 comparables were identified through a benchmarking process on the Oriana database which is proprietary database

maintained by Bureau van Dijk ("BVD") Electronic publishing services. As outlined in the the benchmarking, the process of identifying the comparables is documented and the business of the comparable companies was reliably identified. As such, the Appellant asserted that there was no limitation in the process of identifying the comparables or limitation in the information used. The Appellant therefore asserted that the question of limitation in the process or in the information used does not arise and there was no reasonable ground to apply the median.

14. The Appellant noted that the Respondent clearly identified the comparability defects as items such as nonidentical products, regulation, target marketing and branding. Therefore, its averment that comparability defects were not identifiable were to justify application of the median. The Appellant argued that this is in accordance with the wording of paragraph 3.57 of the OECD TP.

15. In support of this position, the Appellant relied on the case of **Spain vs "SGGE WT Spanish branch," January 2023, TEAC, Case No Rec. 00/07503/2020/00/00**, where the Appellant noted that the said judgement noted that paragraph 3.57 refers to defects that cannot be identified and or quantified and hence a specific adjustment is not possible. In the case at hand, the Appellant asserted that the Respondent specifically identified what it considered to be comparability defects as nonidentical products, regulation, target marketing and branding. Therefore, Appellant stated that in fulfilment of Paragraph 3.57, what the Respondent should have done was to quantify the impact of the differences.

16. The Appellant also argued that the process used by the Appellant in identifying the comparables has been well documented and the comparables have been

selected from a reputable database maintained by a third party. It stated that the Respondent in its objection decision did not identify the limitations either in the process of identifying the comparables or the source of the information and therefore, had no grounds to rely on use of the median.

17. In light of the foregoing, the Appellant stated that the Respondent grossly misinterpreted the provisions of paragraphs 3.57 and 3.62 of the OECD TP Guidelines and has no valid basis to adjust the Appellant's operating margin to the median point of comparable companies.

(ii) <u>Whether the Transactional Net Margin Method (TNMM) does not require use of perfectly identical products between the comparables and the tested party, and whether the Respondent was misguided in making an adjustment to the median point on the basis of lack of perfectly identical products.</u>

18. According to the Appellant, the product comparability must be interpreted in the context of the OECD TP on comparability and application of TNMM. It relied on Paragraph 2.75 of the OECD TP which provides that *"Prices are likely to be affected by differences in products, and gross margins are likely to be affected by differences in functions, but net profit indicators are less adversely affected by such differences.*"

19. According to the Appellant, net profit indicators as used in TNMM are less affected by differences in product meaning that there is no expectation that the products distributed by a tested party should be perfectly identical to those distributed by the selected comparables and it would be adequate for the products to only be broadly similar. In the case at hand, the Appellant stated that companies that trade in supplements and nutritional products could be

viewed as trading in broadly similar products as those sold by the Appellant as such differences would not have an impact on the operating margin attained.

20. The Appellant also relied on Paragraph 1.108 of the OECD TP to support its case. It asserted that under paragraph 1.108 of the OECD TP, TNMM which is one of the transactional profit methods is more accommodative of product differences unlike the other TP methods such as the Comparable Uncontrolled Price ("CUP") which requires a significantly high level of product comparability.

21. The Appellant also referred to Paragraph 1.110 and of the OECD TP to support its case.

(iii) <u>Whether the ITA and the Kenya Transfer Pricing Rules prescribe the use of the median as the arm's length point in a range of results</u>

22. According to the Appellant, the KTP have not prescribed that the median is the arm's length point in a range of comparable companies. Accordingly, in practice any point within the inter-quartile range is considered to be arm's length. The Appellant further noted that Section 18(3) of the ITA provides only that a resident person deals at arm's length with its non-resident related party and does not prescribe that the median is arm's length. The Appellant cited the case of **Check Point Technologies Kenya Ltd. V Commissioner of Domestic Taxes, [2024] KETAT 114 (KLR)** to support its position.

23. The Appellant maintained that neither the KTP rules, nor the ITA contain any reference to the median as the arm's length point and therefore the Respondent has misguided itself in making an adjustment to the median point. Consequently, the Appellant prayed that the Respondent's additional assessment in this regard be vacated in its entirety.

(iv) Whether the Respondent erred on law and in fact by disallowing employment costs amounting to Kshs 91,662,330.00.

24. The Appellant noted that the Respondent, in its objection decision disallowed employment costs amounting to Kshs 91,662,330.00 on the basis of Section 16(1) of the ITA.

25. According to the Appellant, the Respondent in the Notice of Assessment dated 13th December 2023 stated that there was an averred variance between the Company's employment costs (salaries and wages) as declared in its Corporate Income Tax return (T2C") versus employment costs as per its Pay as You Earn ("PAYE") returns for the year of income 2018 amounting to Kshs 150,039,359.00. Consequently, the Respondent added back the variance of KES 150,039,359.00 pursuant to the provisions of Section 16(1) of the ITA on the basis that the amount stated was not wholly and exclusively incurred in the production of income.

26. The Appellant argued that through its notice of objection, the Appellant highlighted that the Respondent failed to take into consideration other employment costs amounting to Kshs 11,969,309.00 that it declared in its Audited Financial Statement as well as its IT2C for the year of income 2018 and provided the Respondent with the correct variance as: Employment costs claimed in IT2C amounting to Kshs 165,504,611.00, Salaries as per PAYE returns amounting to Kshs 3,495,943.00 resulting to a variance of Kshs 162,008,668.00. The Appellant averred that it provided a summary of the variances of the employment costs declared in its IT2C return as against those reported in its PAYE returns for the 2018 year of income.

27. The Respondent in its objection decision allowed the salaries and wages outsourced from Imperial Heath Sciences Kenya Limited (Imperial) costs item amounting to Kshs 58,377,029.00. However, the Appellant noted that the Respondent disallowed the other employment costs. The Appellant maintained that the remaining employment costs amounting to Kshs 91,662,330.00 are fully supported and should be considered allowable costs as per Section 15 of the ITA. In support of its case, the Appellant relied on the case of **Mars Logistics Limited vs Commissioner of Domestic Taxes Income Tax Appeal No. 6 of 2018**

(a) <u>Intercompany costs charges amounting to Kshs 58,222,606.00.</u>

28. The Appellant noted that the Respondent disallowed these costs on the basis that these amounts have not been dealt with in the Appellant's TP policy and that the Appellant did not provide any support to show how these employees were assigned roles in Kenya. The Appellant averred that the staff costs recharges from South Africa (SA) relate to three employees, namely Abofele Khoele, Thula Ngcobo and Zwelethu Bashman, who had been engaged to serve in different capacities as shown on its organogram in its TP policy. It argued that their roles were meant to develop the local market (Kenya).

29. The Appellant maintained that the staff cost recharges from Uganda relate to one (1) employee, namely Naveen Sukumaran, who was engaged as the Associate Director of the Appellant and Regional Head of Sales in the Sub-Saharan Africa region.

30. The Appellant also stated that the roles of each of the above four employees were covered in its TP policy and detailed in their respective employment

contracts. It alleged that through emails dated 15th February 2024 and 7th March 2024, the Appellant provided the Respondent with these documents in relation to the intercompany recharges.

31. Therefore, the Appellant maintained that it discharged its burden of proof and established a prima facie case that it proved its position by providing the necessary documentation.

(b) <u>Bonus and leave accruals amounting to Kshs 13,323,974.00.</u>

32. The Appellant stated that the Respondent disallowed bonus and leave accruals amounting to Kshs 10,654,663.00 and Kshs 2,669,312.00 respectively on the premise that the Appellant failed to provide support to demonstrate authorisation and build-up of the bonus payments. On the other hand, the Appellant averred that it provided its pays out bonuses in line with its guidelines. The Appellant confirmed that it provided the Respondent with these guidelines vide electronic mails dated 15th February 2024 and 7th March 2024.

33. Further, the Appellant stated that it processed the actual bonus paid out to employees in the year 2018 via payroll and accounted for PAYE on these amounts. The Appellant added that it provided the Respondent with the payroll reports for the 2018 year of income vide emails dated 15th February 2024 and 7th March 2024.

34. According to the Appellant, as part of its management reporting requirements as provided under the accounting principles accrual concept, the Appellant accrues for bonus and leave. The Appellant also stated that it disallowed both these bonuses and leave accruals in its corporate income tax calculation and return for the year 2018 as provided for under Section 16 of the ITA. Therefore,

the Appellant argued that it accounted for corporate income tax on the amount of Kshs 13,323,974.00.

(c) Medical aid costs amounting to Kshs 6,864,193.00

35. The Appellant averred that it provided the Respondent with invoices from Imperial which demonstrate the quantum of recoveries, including medical insurance premiums, sought in relation to amounts expended on outsourced employees vide its email dated 15th February 2024.

36. The Appellant relied on Section 5(4)(b) of the ITA to support its case that the medical expenses were not taxable on the employees.

(d) Reimbursement costs amounting to Kshs 23,507,727.00.

37. Whereas the Respondent disallowed reimbursement costs on the basis that the Appellant did not provide supporting documentation for these costs, the Appellant averred that it outsourced labour in the form of sales representatives from Imperial in the year 2018. The Appellant stated that it provided the Respondent with this agreement vide emails dated 15th February 2024 and 7th March 2024.

38. The Appellant averred that it provided the Respondent with a breakdown and listing of these reimbursement costs vide its email dated 15th February 2024. The Appellant contended that it provided the Respondent with sufficient information on these reimbursed costs. As such, the Respondent had the opportunity to request for additional documentation in support of the same in the event they deemed the information provided to be insufficient.

(e) NSSF contribution amounting to Kshs 1,016,330.00.

39. Whereas the Respondent disallowed the amount of Kshs 1,016,330.00 on the basis that the Appellant did not provide any support for the same, the Appellant maintained that the amount includes National Social Security Fund (NSSF) contributions paid for the 2018 year of income and confirms that it provided the Respondent with a ledger demonstrating its monthly contributions vide its electronic mail dated 15th February 2024.

40. The Appellant averred that it provided the Respondent with payroll reports for the 2018 year of income showing the employer NSSF contributions made for this period vide its electronic mails dated 15th February 2024. It also asserted that employer contributions to the NSSF which are not in excess of the amount specified in Section 22A of the ITA are deductible for corporate income tax purposes.

(f) Pension fund costs amounting to Kshs 288,201.00.

41. The Respondent contended that the pension fund costs of Kshs 288,201.00 did not form part of the salaries and wages therefore the Respondent rejected the Appellant's assertion that these pension fund costs comprise the variances noted in its employment cost reconciliation. The Appellant asserted that these costs relate to employer contributions to a non-registered pension fund and form part of its total employment costs of Kshs 165,504,611.00.

42. The Appellant reiterated that it provided the Respondent with a reconciliation of its total employment costs as reported in its audited financial statements for the 2018 year of income to those reported in its monthly PAYE returns for the same period and explained the variance of Kshs 162,008,668.00. The Appellant averred that the Respondent's rejection of its assertion that the

pension fund costs comprise the revised variance lacks merit and results in an unfounded demand for additional tax.

(g) Relocation costs amounting to Kshs 38,000.00

43. The Appellant averred that these costs are deductible for corporate income tax under Section 15(1) of the ITA since they constitute business expenses. The Appellant asserted that it provided the Respondent with a ledger showing the composition of these relocation costs vide its electronic mail dated 15th February 2024.

(h) Training costs amounting to Kshs 295,638.00.

44. The Respondent disallowed training costs amounting to on account of them being unsupported. The Appellant asserted that that it provides training to its employees to facilitate their continuous improvement in their work. The Appellant averred that it provided the Respondent with a ledger demonstrating the nature of its training expenses for the year 2018 vide its electronic mail dated 15th February 2024.

45. The Appellant further asserted that these training expenses comprised employment costs which are deductible for corporate income tax under Section 15(1) of the ITA which provides for deductibility of expenses wholly and inclusively incurred in the generation of income.

(i) Accruals from payroll consultants amounting to Kshs 1,539,611.00.

46. The Appellant stated that the amount of Kshs 1,539,611.00 relates accounting adjustments made at the close of the 2018 year of income to reverse prior-period accruals of costs relating to their payroll consultants.

(j) Expatriate expenses amounting to Kshs 1,110,600.00.

47. The Appellant noted that the Respondent disallowed expatriate expenses amounting to Kshs 1,110,600.00 on the basis that the Appellant did not provide supporting documentation for this amount. The Appellant asserted that these costs relate to school fees paid for the children of some of its employees. The Appellant relied on ledger to demonstrating that the Appellant incurred these costs.

48. The Appellant further stated that it disallowed these costs in its corporate income tax computation and return for the 2018 year of income pursuant to Section 16(2)(a)(iv) of the ITA.

(k) <u>Loan restatement amounting to Kshs 1,577.00</u>

49. The Appellant averred that this is an accounting adjustment and does not constitute an actual expenditure.

(l) <u>Work permit expenses amounting to Kshs 523,629.00</u>

50. The Appellant asserted that the Respondent disallowed work permit expenses amounting to Kshs 523,629.00 The Appellant averred that these costs relate to fees paid by it to acquire permits for some of its employees who are foreign national to validly work in Kenya. The Appellant relied on a ledger to demonstrate that the Appellant incurred these costs. It asserted that it provided this ledger to the Respondent vide its email dated 15th February 2024.

51. The Appellant further stated that these work permit expenses comprised employment costs which are deductible for corporate income tax under Section 15(1) of the ITA. Based on the foregoing, the Appellant alleged that it provided supporting information on the work permit expenses amounting to

Kshs 295,638 and that the Respondent's assessment for additional tax by disallowing these costs is erroneous and should be vacated in full.

(v) Whether the Respondent erred in law and in fact by alleging that the Appellant did not provide documentation to support alleged untaxed employment costs

52. According to the Appellant, the Respondent acknowledged in the objection decision that the Appellant provided a reconciliation of the alleged untaxed employment costs amounting to Kshs 150,039,359.00.However, the Respondent argued that the Appellant did not provide supporting documentation for alleged untaxed employment costs amounting to Kshs 91,662,330, and on this basis, it proceeded to disallow the said costs.

53. The Appellant stated that following its lodging of its notice of objection it had a meeting with the Respondent to discuss and review its grounds of objection on 5th February 2024. Subsequently, the Respondent requested for supporting documentation as regards the reconciliation via email dated the same day. The Appellant averred that in compliance with the law and the Respondent's request dated 5th February 2024, through an email dated 15th February 2024 and 7th March 2024, the Appellant furnished the Respondent with the requested supporting documentation and explanations.

54. The Appellant averred that it was the Respondent's duty to consider the supporting documentation provided by the Appellant as provided for under Article 47 of the Constitution of Kenya 2010 (hereinafter "the Constitution"), which guarantees a right to administrative action that is expeditious, efficient, lawful, reasonable, and procedurally fair. The right to a fair administrative

action entails taking into consideration explanations and information availed by the party against whom an assessment is made.

55. The Appellant cited the case of **Nizaba International Trading Company Limited v Kenya Revenue Authority [2000] eKLR** where the High court held that failure to consider material facts presented by a party against whom an assessment had been raised amounts to an abuse of legislative provisions and such an assessment cannot be acted upon.

56. It also relied on **Republic v Kenya Revenue Authority ex-parte Amsco Kenya Limited [2014] eKLR** where the court held:

"Further an administrative action cannot be said to be procedurally fair where a decision is arrived at based on an opinion formed as a result of the consideration of the version of only one side since by a consideration of one side one cannot be said to have felt certain about the truth of the matter in dispute."

57. The Appellant also relied on the case of **Kenya Medical Association Housing Cooperative Society Limited v Attorney General & another [2016] eKLR** where the court held that it was a breach of the rules of natural justice to fail to consider the person against whom a decision is made.

58. The Appellant also cited the case of **Ridge v Baldwin [1963] 2 ALL ER 66 at page 81** wherein the Court emphasized that, *"Time and again in the cases I have cited it has been stated that a decision given without regard to the principle of natural justice is void.*"

59. In its written submissions, the Appellant submitted that the appeal was filed on time. It added that the Appellant inadvertently attached the wrong Notice of

Appeal dated 18th April 2024 which is for distinct and separate appeal before this Tribunal. It maintained that the correct Notice of Appeal is dated 5th April 2024.

60. The Appellant submitted that the correct Notice of Appeal was timely filed on the judiciary portal as well as physically before this Tribunal. The Appellant maintained that the error was purely administrative.

61. The Appellant relied on the following case laws:

- **Mars Logistics Limited v Commissioner of Domestic Taxes Income Tax Appeal No. 6 of 2018**
- **Nizaba International Trading Company Limited v Kenya Revenue Authority [2000] eKLR,**
- **Republic v Kenya Revenue Authority ex-parte Amsco Kenya Limited [2014] eKLR**
- **Kenya Medical Association Housing Cooperative Society Limited v Attorney General & another [2016] eKLR**
- **Reid in Ridge v Baldwin [1963] 2 ALL ER 66.**

62. The Appellant prayed for the following reliefs:

(a) This appeal be allowed;

(b) The Respondent's decision dated 8th March 2024 be partially set aside;

(c) The principal tax of Kshs 31,596,856 and attendant penalties and interest demanded by the Respondent be vacated;

(d) The costs of and incidental to this Appeal be awarded to the Appellant; and

(e) Any other orders that the Tribunal may deem fit.

RESPONDENT'S CASE

63. In response to the appeal, the Respondent filed its Statement of facts dated and filed on 22nd May 2024; witness statement of Ms. Karen Korir filed on 7th November 2024; witness statement of Mr. George Wamae filed on 8th November 2024 and written submissions dated and filed on 19th February 2025.

64. In response to the appeal, the Respondent stated that the basis of the assessment were documents and explanations provided by the Appellant as well as correspondences and engagements between the Respondent and the Appellant.

65. In its assessment, the Respondent noted that the Appellant purchases pharmaceutical products from Cipla India for sale in the Kenyan market and for this controlled transaction, the Appellant characterized as a distributor was selected as the tested party and the TNMM with a return on sale (ROS) as the Profit Level Indicator (PLI) was selected as the most appropriate method.

66. The Respondent noted that the Appellant reported a return of 3.02% on its operating revenue following a benchmarking study using the Oriana database which return is lower than the median return obtained in their benchmarking analysis. In light of the above, the Respondent recomputed the Appellant's profit for the year 2018 leading to additional income of Kshs 13,660,522.00.

67. The Respondent further raised PAYE assessments on the Appellant as the audit on salaries and wages costs in their financial statement vis a vis their i-Tax returns revealed a significant variance of Kshs 150,039,359.00. From the foregoing, the Respondent made the necessary adjustments and raised assessments amounting to Kshs 78,575,943.00 being the total outstanding tax, penalties and interest. The Appellant then lodged its notice of objection to the additional corporate income tax assessments vide letter dated 12th January 2024. The Respondent then issued its objection decision dated 8th March 2024 partially allowing the objection and confirming taxes due hence this appeal.

68. The Respondent raised preliminary objection on the basis that the Appeal was filed out of time contrary to the provisions of Section 51 (12) of the TPA and Section 13 of the TATA.

69. In response to the grounds of appeal, the Respondent narrowed to three issues that it sought to address, as follows:

(i) <u>Whether the Respondent was proper in its interpretation of Paragraphs 3.57 and 3.62 of the OECD TP and subsequently making an adjustment to the median point used.</u>

70. Whereas the Appellant contended in Ground (a) and (b) of its Statement of Facts that in its TP report, it applied the TNMM in testing the returns it earned for the marketing and distribution of pharmaceutical products purchased from Cipla India, the Respondent noted that the Appellant conducted a benchmarking study using the Oriana database which comprised of 21 comparable companies. The results of the database were as shown in the table below:

Three-year weighted average	
EBIT/Operating revenue (2016-2018)	
Maximum	33.62%
Upper Quartile	9.14%
Median	5.02%
Lower Quartile	1.60%
Minimum	0.91%
Tested Party (2018)	3.02%

71. The Respondent placed reliance on the OECD TP which is the framework for TP in financial transactions. According to the Respondent, Chapter III of the OECD TP houses provisions guiding conducting comparability analysis for controlled transactions under review and the uncontrolled transactions that are regarded as potentially comparable. It stated that the steps guiding the process of conducting the comparability analysis are housed in Paragraph 3.4 of the OECD TP Guidelines as summarized below;

Step 1: Step 2:	Determination of years to be covered. Broad-based analysis the taxpayer's circumstances.
Step 3:	Understanding the controlled transaction(s) under examination, based in particular on a functional analysis, in order to choose the tested party (where needed), the most appropriate transfer pricing method to the circumstances of the case, the financial indicator that will be tested (in the case of a transactional profit method), and to identify the significant comparability factors that should be taken into account.

Step 4:	Review of existing internal comparables, if any.
Step 5:	Determination of available sources of information on external comparables where such external comparables are needed taking into account their relative reliability.
Step 6:	Selection of the most appropriate transfer pricing method and, depending on the method, determination of the relevant financial indicator (e.g. determination of the relevant net profit indicator in case of a transactional net margin method).
Step 7:	Identification of potential comparables: determining the key characteristics to be met by any uncontrolled transaction in order to be regarded as potentially comparable, based on the relevant factors identified in Step 3 and in accordance with the comparability factors set out in Section D. 1 of Chapter I.
Step 8:	Determination of and making comparability adjustments where appropriate.
Step 9:	Interpretation and use of data collected, determination of the arm's length remuneration

72. The Respondent stated that it established that though the product offerings of the companies used in the benchmarking analysis undertaken such as veterinary products, botanical drugs and herbal supplements are broadly similar, they are not ideal comparables for pharmaceutical companies without material, or some, adjustments due to significant differences that affect profitability such as regulation, target market and branding. These different products face different levels of competition in the market and may have different risk profiles and even different investment requirements. Therefore, the Respondent noted that

the appropriate adjustments should be made to the comparables' data to account for the impact of these differences on profitability.

73. The Respondent relied on Paragraph 3.57 of the OECD TP, which provides as follows:

"*It may also be the case that, while every effort has been made to exclude points that have a lesser degree of comparability, what is arrived at is a range of figures for which it is considered, given the process used for selecting comparables and limitations in information available on comparables, that some comparability defects remain that cannot be identified and/or quantified, and are therefore not adjusted. In such cases, if the range includes a sizeable number of observations, statistical tools that take account of central tendency to narrow the range (e.g. the interquartile range or other percentiles) might help to enhance the reliability of the analysis.*"

74. The Respondent also relied on Paragraph 3.62 of the OECD TP which states as follows:

"*In determining this point, where the range comprises results of relatively equal and high reliability, it could be argued that any point in the range satisfies the arm's length principle. Where comparability defects remain as discussed at paragraph 357, it may be appropriate to use measures of central tendency to determine this point (for instance the median, the mean or weighted averages, etc., depending on the specific characteristics of the data set), in order to minimise the risk of error due to unknown or unquantifiable remaining comparability defects.*"

75. Consequently, the Respondent stated that the median is the most appropriate point in the range in this case as the TNMM method may tolerate functional and product differences, because of the comparability defects stated above. From the foregoing, the Respondent stated that it was proper in law in its interpretation of Paragraphs 3.57 and 3.62 of the OECD TP and subsequently making an adjustment to the median point used and urged this Honourable Tribunal to uphold the same.

(ii) Whether the Respondent erred in law and fact by disallowing the employment costs as per Section 16(1) of the ITA.

76. In relation to this issue, the Respondent noted that Section 16 of the ITA provides for deductions not allowed in the computation of income.

77. The Respondent averred that salaries and wages form part of the expenditure of a company and unless expressly provided in its financial statements, it cannot allow deductions of the same.

78. Further, the Respondent stated that it requested for a reconciliation of the disallowed employment costs from the Appellant, which the Appellant failed to provide. Therefore, the Respondent maintained that it was justified in disallowing the employment costs and prayed that the Tribunal upholds the same.

(iii) Whether the Appellant discharged its burden of proof

79. The Respondent averred that it allowed employment costs to the extent supported by the Appellant through supporting documents.

80. The Respondent asserted that in the objection decision it explained that it allowed salaries and wages outsourced from Imperial (consultant) as the Appellant provided invoices and the Memorandum of Agreement between the parties. However, the Respondent stated that it disallowed costs relating to accruals from payroll consultants, intercompany cross charges, bonus and leave accruals, loan restatement, reimbursement costs, medical aid, pension fund, relocation costs, training, work permit expenses, expatriate expenses, and NSSF contributions on grounds that the Appellant did not provide supporting documents to reconcile the accounts.

81. The Respondent relied on section 23(1) of the TPA which requires the Appellant to keep records that enable the Respondent to assess its tax liability. Further, the Respondent relied on the provisions of Section 59 of the TPA on the production of documents. The Respondent asserted that these provisions emphasize the fact that the Appellant is bestowed with the mandate to avail the requisite documents in support of its objection and failure to which, the Respondent can only decide in light of information in its possession.

82. The Respondent stated that the Appellant failed to discharge its burden of proving that the Respondent's assessment was erroneous contrary to Section 30 of the TATA and Section 56(1) of the TPA.

83. The Respondent maintained that the Appellant's contentions as laid out in its Memorandum of Appeal and Statement of facts are unsupported.

84. In its written submissions, the Respondent submitted that the Appellant lodged invalid notice of Appeal on the basis that the Appellant filed its Notice of Appeal on 18th April 2024, eleven (11) days outside the statutory timelines envisaged under Section 51 (12) of the TPA and Section 13 of the TATA without leave of the Tribunal.

85. The Respondent submitted that the disputed objection decision was issued on 8th March 2024 and therefore the Appellant ought to have filed its Notice of Appeal on or before the 7th April 2024. The Respondent also submitted that the Appellant sought to regularize this issue through an application dated 27th January 2025, which was dismissed by the Tribunal.

86. It submitted that the Notice of Appeal as filed in this Appeal remains invalid for being filed out of time without leave of the Tribunal.

87. The Respondent relied on the case of **Francis Maragwa Waigwa v Commissioner of Domestic Taxes TAT Appeal No. 371 of 2023** to support the position that statutory edict is not procedural technicality. It is a law which must be complied with.

88. The Respondent submitted that it was justified in adopting the median position within the interquartile range. The Respondent cited the case of **Spain vs Transalliance Iberica SA, November 2022, Audiencia Nacional, Case No SAN 5336/2022,** wherein the court ruled that an adjustment to the median could only be made where the tax authorities established the existence of comparability defects.

89. The Respondent also submitted that it was justified in excluding unsupported employment costs. The Respondent relied on section 16 of the ITA to support its case.

90. Finally, the Respondent cited the cases of **Republic v Kenya Revenue Authority; Proto Energy Limited (Exparte) (Judicial Review Application Eo23 of 2021) [2022];** and **Commissioner of Domestic Taxes v Trical and Hard Limited (Tax Appeal E146 of 2020) [2022]** to submit that whereas the Appellant has a duty to discharge burden of proof, the Appellant failed to discharge the burden.

91. Consequently, the Respondent urged the Tribunal to dismiss the Appeal with costs to the Respondent, as the same was devoid of merit and uphold the Respondent's objection decision dated 8th March 2024.

ISSUES FOR DETERMINATION

92. The Tribunal having carefully evaluated parties' pleadings it is of the respectful view that the issue that call for its determination is as hereunder:

(a) Whether the Appeal was validly lodged.

(b) Whether the Respondent was justified in its interpretation of Paragraphs 3.57 and 3.62 of the OECD TP and subsequently making an adjustment to the median point used.

(c) Whether the Respondent erred in disallowing expenses claimed

ANALYSIS AND FINDINGS

(a) Whether the appeal is validly lodged.

93. The Respondent raised a preliminary objection that the appeal was invalid because the notice of appeal was filed out of time without leave. However, the Tribunal notes that this issue was addressed in a ruling delivered by this Tribunal on 30th January 2025 wherein the Tribunal ruled that the notice of appeal was filed on time, electronically and therefore the Tribunal finds that the Respondent's preliminary objection lacks basis.

(b) Whether the Respondent was justified in applying the median rate in computing the Appellant's net profit.

94. The Appellant in its TP policy applied TNMM in testing the returns it earned for the marketing and distribution of pharmaceutical products purchased from Cipla India. It then earned an operating margin of 3.02% which it argued that was within the interquartile range pursuant to its TP Policy. However, the Respondent adopted a median range of 5.02% on the grounds that though the product offerings of the companies used in the benchmarking analysis

undertaken such as veterinary products, botanical drugs and herbal supplements are broadly similar, they are not ideal comparables for pharmaceutical companies without material/some adjustments due to significant differences that affect profitability such as regulation, target market and branding.

95. Both parties relied on Paragraphs 3.57 and 3.62 of the OECD TP to support their respective cases. Paragraph 3.57 of the OECD TP, provides as follows:

> *"It may also be the case that, while every effort has been made to exclude points that have a lesser degree of comparability, what is arrived at is a range of figures for which it is considered, given the process used for selecting comparables and limitations in information available on comparables, that some comparability defects remain that cannot be identified and/or quantified, and are therefore not adjusted. In such cases, if the range includes a sizeable number of observations, statistical tools that take account of central tendency to narrow the range (e.g. the interquartile range or other percentiles) might help to enhance the reliability of the analysis."*

96. Paragraph 3.62 of the OECD TP provides as follows:

> *"In determining this point, where the range comprises results of relatively equal and high reliability, it could be argued that any point in the range satisfies the arm's length principle. Where comparability defects remain as discussed at paragraph 3.57, it may be appropriate to use measures of central tendency to determine this point (for instance the median, the mean or weighted averages, etc., depending on the specific characteristics of the data*

set), in order to minimise the risk of error due to unknown or unquantifiable remaining comparability defects."

97. The Tribunal has noted that the Respondent did not dispute the Appellant's TP Policy but chose to dispute the margin rate applied by the Appellant. The Appellant provided its TP policy and upon review of the same, the Tribunal noted that pursuant to the benchmarking study contained in its TP policy, the interquartile operating margin of the companies in the benchmarking study ranged between 1.60% and 9.14% with the median of 5.08%. The Tribunal notes that the Appellant applied the rate of 3.02% to derive its operating margin which was within the interquartile range outlined in its TP policy.

98. This Tribunal while considering a related matter, had the following to say in the case of **Checkpoint Technologies Kenya Limited v Commissioner of Domestic Taxes (Tax Appeal 1181 of 2022) [2024] KETAT 114 (KLR) (2 February 2024) (Judgment)**:

"The Tribunal observes that the Transfer Pricing Rules enacted under the Kenyan Income Tax have adopted the transfer pricing methods as stipulated in the OECD guidelines (OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations) which do not necessarily require a taxpayer to adopt the median position. A taxpayer is thus free to adopt any position within the interquartile range."

99. The Tribunal noted that the Respondent herein did not dispute the fact that the Appellant's operating margin of 3.02% was within interquartile range. However, the Tribunal notes the Respondent averment that the operating margin ought to have been at the median which was the rate of 5.08%.

100. In the case of **Commissioner of Domestic Taxes v Trical and Hard Limited (Tax Appeal E146 of 2020) [2022] KEHC 9927 (KLR)** where it stated the following:

"From the above, it is clear that the evidential burden of proof rests with the taxpayer to disprove the Commissioner and that once competent and relevant evidence is produced, then this burden now shifts to the Commissioner. I have emphasized and underlined 'competence' and 'relevance' because it is only evidence that meets these two tests that demolishes presumption of correctness and swings the burden to the Commissioner. This means that even if one avails evidence but then it is found that the same is incompetent or irrelevant, then the burden continues to remain with the tax payer."

101. The Tribunal notes that the TP policy was sufficient and relevant evidence proving how the Appellant determined its operating margin of 3.02%. Rather than controvert the rate used by the Appellant by carrying out its own analysis, the Respondent based its analysis on Paragraph 3.62 of the OECD TP and chose to apply the median rate of 5.08% as the Appellant's operating margin. The basis that the Respondent used to apply or suggest that the applicable rate was the median rate (5.08%) was not its own benchmarking study but a misinterpretation of the said Paragraph 3.62 OECD TP.

102. The view of the Tribunal is that Paragraph 3.62 of the OECD TP provides that the median rate is usable in order to minimise the risk of error due to unknown or unquantifiable remaining comparability defects. In Paragraph 22 of its Statement of Facts the Respondent identified comparability defects such as regulation, target market and branding and it could not therefore rely on Paragraph 3.62 of OECD TP to state that the comparability defects were

unknown or unquantifiable since it proceeded to identify the comparability defects.

103. The view of the Tribunal is that since the Respondent identified the comparability defects, the guideline under paragraph 3.62 of the OECD TP which provides for the use of the median where the comparability defects are unknown, is inappropriate for application in the instant Appeal.

104. Accordingly, the Tribunal finds that the Respondent was not justified in applying the median rate in computing the Appellant's net profit.

(c) Whether the Respondent erred in adjusting the profit by disallowing expenses.

105. As regards the expenses disallowed by the Respondent, the Tribunal is of the view that the proposed adjustments resulting from the disallowed expenses would result in adjusting the Appellant's profit arrived at using TNMM as analysed in issue (b) above. TNMM examines the net profit relative to an appropriate base that a taxpayer realises from a controlled transaction. In the instant appeal the base upon which TNMM has been used is the turnover. Accordingly, adjusting the taxable profit using the disallowed expenses, would amount to double taxation. The application of the margin rate on the turnover is sufficient in determining the taxable profit.

106. Accordingly, the Tribunal finds that the Respondent erred in adjusting the profit by disallowing expenses.

FINAL DECISION

107. The upshot to the foregoing is that the Tribunal finds and holds that the Appeal is meritorious and makes the following Orders:

(a) The Appeal be and is hereby allowed.

(b) The Respondent's objection decision dated 8th March 2024 be and is hereby set aside.

(c) Each party to bear its own cost.

108. It is so Ordered.

DATED and **DELIVERED** at **NAIROBI** on this **2nd** day of **May, 2025.**

……………………………………
CHRISTINE A. MUGA
CHAIRPERSON

……………………………… **BONIFACE K. TERER** **MEMBER**	……………………………… **ELISHAH N. NJERU** **MEMBER**
……………………………… **EUNICE N. NG'ANG'A** **MEMBER**	……………………………… **OLOLCHIKE S. SPENCER** **MEMBER**