

Tax Appeal Tribunal Supports Use of Interquartile Range Over Median

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Introduction

In a landmark ruling, the Tax Appeal Tribunal has delivered a decision that marks a significant victory for taxpayers facing adjustments to their transfer pricing methodologies by the Commissioner of Domestic Taxes. This alert details the Tribunal's decision to support the taxpayer's use of the interquartile range (IQR) over the tax authority's preference for a median adjustment, aligning with the OECD's guidelines on arm's length principles. This outcome not only reaffirms the flexibility within OECD recommendations with respect to the IQR but also sets a precedent for future transfer pricing disputes. The Tribunal while allowing the Appeal, was guided by Article 3.63 of the OECD Guidelines which stresses that any point in the arm's length range satisfies the arm's length principle as long as the range comprises results of relatively equal and reliable comparables.

Background

The Appellant (Checkpoint Technologies Kenya Limited), an entity incorporated in Kenya and deals primarily with ICT and offers marketing support services to its parent company. The Respondent conducted a review of the Appellant's tax records in 2022 for the periods 2017-2020 covering Corporation tax, PAYE and Withholding tax and issued a tax assessment of Kshs. 26,933,592.00. In this tax assessment, the Respondent adjusted the taxpayers' income by imposing a median range of 5.4% range for the years 2017-2019 and 5.5% for 2020. While the Appellant in reporting its income applied the arm's length range of between 4.9% and 7.3%, in line with the taxpayer's transfer pricing policy and requirements of the Income Tax Act Chapter 476 of the laws of Kenya (ITA).

Taxpayer's Argument

The taxpayer argued that the income it reported was sufficient and in line with its transfer pricing policy and requirements of ITA. That the taxpayer is not mandated to adopt the median position in an arm's length range. Additionally, the median measure need to be adopted when there are questions as to reliability and comparability of the interquartile range as selected from comparable data. That it had been trading with its parent entity at prices within the arm's length range and hence the Respondent did not need to do transfer pricing adjustment by imposing the median measure.

That in aligning its transactions with its parent entity to arm's length standards, the taxpayer used Transactional Net Margin Method (TNMM) with net cost plus basis as the profit indicator. The Appellant submitted that the transfer pricing policy determined the arm's length range (interquartile range) for transactions performed by the taxpayer as between 4.9% and 7.3% with a median of 5.5%. That the signed agreement between the Appellant and its parent company incorporated in Israel, stipulated the mark-up rate for related transactions at 5%. That this 5% markup rate was within the arm's length range as per the transfer pricing documentation prepared by the Appellant.

That by the Respondent imposing the median measure as the arm's length range, it was contravening the OECD Guidelines, which allows a taxpayer to adopt any rate within the arm's length range as the basis of related party transactions. That pursuant to the OECD Guidelines, the Appellant was allowed to adopt any position within the interquartile range.

Respondent's Arguments

The Respondent argued that, the income reported by the taxpayer from its related transactions was not sufficient and not in tandem with its transfer pricing policy. That benchmarking of the taxpayer's transfer pricing policy established that the interquartile range to be between 4.9% and 7.3% with a median of 5.5%, therefore the Appellant was supposed to adopt the median position as the interquartile range. That there was a deviation in the margin rates applied from the recommended rate of 5.5% as stated in the taxpayer's transfer pricing policy document.

The Respondent further argued that, the Appellant did not fulfill the provisions of section 10 of the Income Tax (Transfer Pricing) Rules, 2006 of the income Tax Act; as the taxpayer did not provide all the required documents, it did not determine the arm's length price as prescribed under the guidelines. Therefore, the Respondent had to issue additional income tax assessments as guided by the rate applicable in benchmarking policy which was 5.5%.

Tribunals' Determination

The Tribunal in allowing the appeal, made note of the fact that, 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.

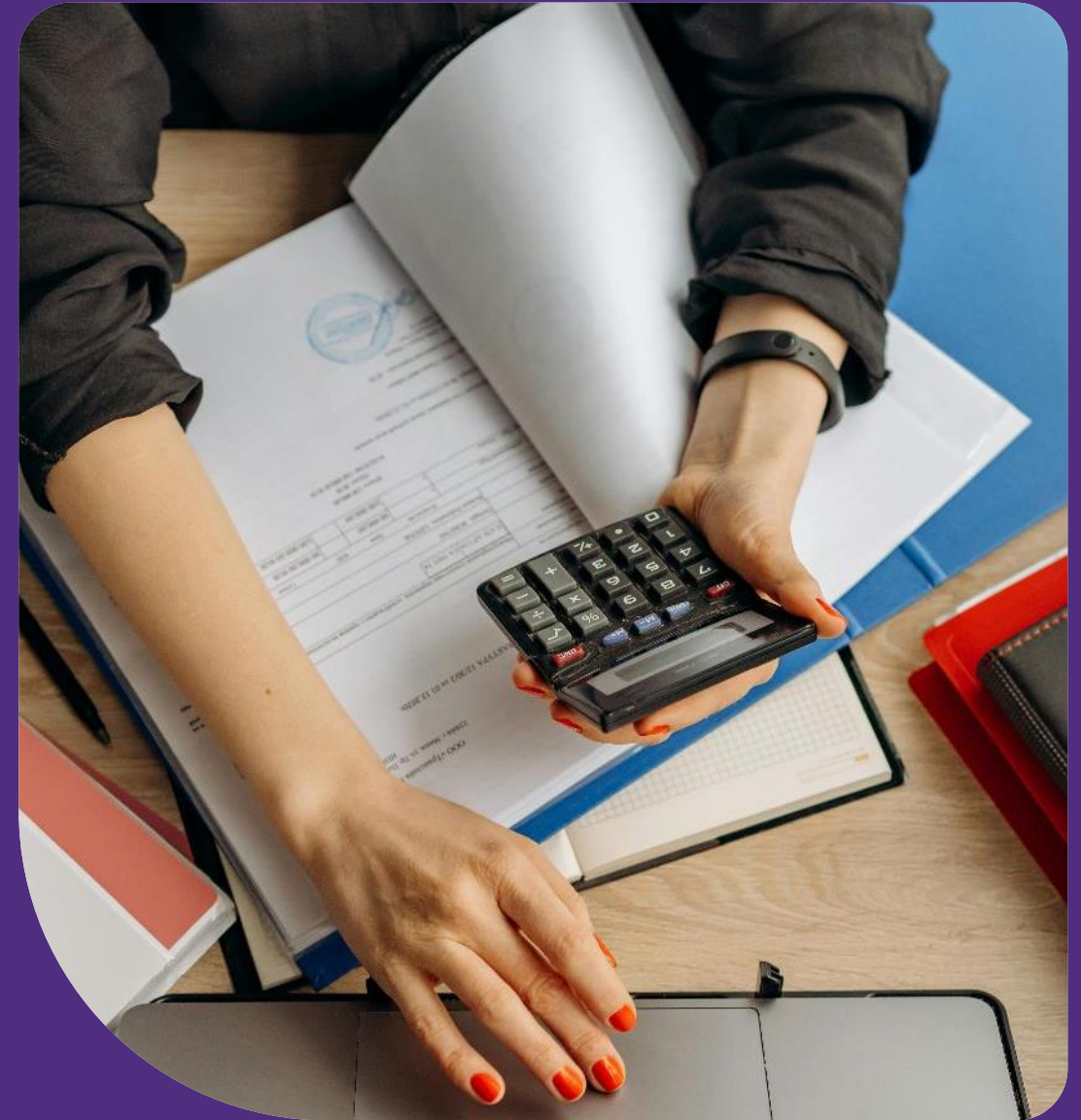
While relying on Article 3.63 of the OECD Guidelines, the Tribunal held that imposing the median measure as the interquartile range is in contravention of the OECD Guidelines, which affords taxpayers to adopt any rate within the interquartile range as the basis of related party transactions. Therefore, the Respondent's decision to impose a median range of 5.4% range for years 2017-2019 and 5.5% for 2020 is contrary to the OECD Guidelines.



Our Comment

Despite the Income Tax Bill of 2018 proposing the median as a reference point for transfer pricing, this concept was notably absent in the Draft Transfer Pricing Rules published in October 2023. This omission could suggest a deliberate regulatory approach to maintain flexibility, allowing alignment with international practices.

This ruling serves as a reminder of the importance of robust compliance with both domestic TP rules and global best practices, emphasizing the need for taxpayers to maintain detailed, verifiable documentation, including benchmarking studies, to support their Transfer Pricing policies effectively.



How Can Grant Thornton Assist You?

At Grant Thornton we offer comprehensive support in ensuring clients' transfer pricing policies are robust and compliant to ensure as a client, you can adapt to the evolving tax landscape.

For further discussion on this alert or any other tax concern, please contact any of the team members below policies effectively.

Samuel Mwaura

Partner - Tax

T +254 (0) 728 960 963

+254 (0) 735 370 009

+254 (0) 20 375 2830

M +254 727 583 755

E samuel.mwaura@ke.gt.com

Parag Shah

Partner - Advisory

T +254 (0) 728 960 963

+254 (0) 735 370 009

+254 (0) 20 375 2830

M +254 722 742 026

E parag.shah@ke.gt.com

Lydia Mose

Manager - Tax

T +254 (0) 728 960 963

+254 (0) 735 370 009

+254 (0) 20 375 2830

M +254 725 594 833

E lydia.mose@ke.gt.com

