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Zambia decision demonstrates tension between commercial aims and tax environment; Tax Appeals Tribunal decision

The Tax Appeals Tribunal (“TAT”) issued a decision for the Zambia Revenue Authority (“ZRA”) in a case concerning transfer prices used with respect to its cross-border related-party transactions and business model.

The case is: *Nestlé Zambia Trading Limited v. Zambia Revenue Authority* [2018] TAT 03 (On 30th October 2018, 31st October 2018 and 28th March 2019).

Overview

The ZRA performed a transfer pricing audit with respect to Nestlé Zambia’s operations on the basis that Nestlé Zambia had reported losses for the financial years 2010 to 2014. The ZRA further noted that the company had been continuously declaring these losses from incorporation and the net profit margins were negative for the five year period under review.

The ZRA’s attention was specifically drawn to the following:

- there were significant related party transactions and shared services with related parties;
- management fee payments; and
- payment for the use of intellectual property.

Following the audit the ZRA adjusted Nestlé Zambia’s profit to ZMW 56 579 048 (approximately ZAR 65 217 373) and levied a gross tax of ZMW 13 860 103 (ZAR 15 976 223) on it.

Three key points outlined by the ZRA as the basis for the additional assessment were that:

- the taxpayer earned continuous negative operating margins for a period of more than five years;
- there were continuous losses for a period of five years; and
- significant volumes of related party transactions took place.

Appeal

On 16th February 2018, Nestlé Zambia filed an appeal with the Tax Appeals Tribunal regarding the ZRA assessment. There were six grounds of appeal upon which Nestlé Zambia challenged the ZRA's assessment namely that the ZRA had:

1. incorrectly assessed Nestlé Zambia being liable to pay to the ZRA the total sum of ZMW13 860 103 as gross income tax for the period 2010 to 2014 as no tests were carried out to assess compliance with the arm's length principle;
2. based its assessment on the premise that Nestlé Zambia could not run at a loss since incorporation despite evidence explaining the losses being put forward by the appellant;
3. failed to objectively test the related party transactions, but rather relied on assumptions and estimates that were considered excessive and unreasonable;
4. re-categorised Nestlé Zambia as a limited risk distributor ("LRD") despite evidence being lead to the contrary;
5. performed a benchmarking study that was neither comparable to the nature of its business nor the economic conditions in Zambia; and
6. added back unrealised foreign exchange losses attributable to a loan when these losses were not included as part of expenses in the financial statements of Nestlé Zambia (and not claimed as a deduction).

The ZRA's arguments

The ZRA's case was based, *inter alia*, on the following arguments in response to the grounds of appeal (in chronological order):

1. adequate tests were carried out on all related party transactions. Furthermore royalty payments made by Nestlé Zambia were contrary to the arm's length principle;
2. the losses were due to significant related party payments constituting royalties, management fees and product purchases;
3. the transfer pricing assessments were made under section 97A(3) of the Income Tax Act ("the Income Tax Act"), Chapter 323 of the Laws of Zambia and were therefore not estimates or assumptions;
4. with regards to the reclassification of Nestlé Zambia as a LRD, the following factors, *inter alia*, were considered decisive:
 - control of the Zambian entity's operations were undertaken by Nestlé Zimbabwe;
 - staff from Nestlé Zimbabwe oversaw the operations of Nestlé Zambia;
 - sourcing of Nestlé products and invoicing was performed by Nestlé Ghana;
 - inventory risk was shared between Nestlé Zambia and other Nestlé Group companies;
 - the level of investment in Nestlé Zambia was low;
 - there was a lean staff complement in Nestlé Zambia;
 - customers facilitated their own logistics arrangements when ordering product.
5. Nestlé products were already known and available in the Zambian market before Nestlé Zambia was incorporated. In the ZRA's view, Nestlé Zambia was therefore not developing the market.

6. The foreign exchange loss adjustment was a secondary adjustment which arose from imposing tax on secondary transactions. This was justified in order to ensure that the allocation of profits was consistent with the primary transfer pricing adjustment of Nestlé Zambia's operating margin.

TAT's Findings

- The TAT dealt with Grounds One and Three together given that these issues were closely correlated. It was the TAT's finding that it was erroneous for the ZRA to have aggregated the transaction as they were unrelated and not closely linked.
- In relation to Ground Two, the TAT restricted its finding to the provisions of the Income Tax Act which was the prevailing legislation for the period under review. In the absence of legislative guidance or 'safe harbours', adjustments may only be made if the loan was not used for business purposes. The adjustment made by the ZRA as a result of the so-called debt to equity ratio was erroneous;
- In relation to Ground Five, the TAT ruled that the benchmarking analysis performed by the ZRA was disproportionate with the consequence that it could lead to an inaccurate transfer pricing adjustment;
- In relation to Ground Six, the TAT ruled that there was no basis for the ZRA to add back the unrealized exchange losses;
- The TAT found for the ZRA on Ground Four with the re-categorization of Nestlé Zambia as a LRD. The TAT's findings were based on, inter alia, the following:
 - There was '*significant control exercised by Nestlé Zimbabwe*' over Nestlé Zambia;
 - '*Essential functions*', such as strategic management, sales and marketing support etc., were provided by related parties; and
 - As Nestlé SA retained '*ownership, property in the products and attendant risk in the know-how*' the ultimate risk in marketing, distribution, storage and/or selling of the products lay with Nestlé SA and not Nestlé Zambia.

KPMG's Observations

- Recognition was given to both the OECD Guidelines and UN Practical Manual on Transfer Pricing for Developing Countries by the ZRA and TAT;
- The approach of the ZRA is in contrast to what we have seen in similar transfer pricing audits. Typically we see the LRD business model being routinely challenged by tax authorities with respect to the limited risk nature of their activities and the low profits associated therein. Tax authorities are arguing, for example, that a company that is being characterized as bearing limited risks "on paper," (i.e., as per an agreement between the limited risk entity and a related-party principal) in substance bears significantly more risks and performs more functions than may be stated in the agreement. For example, a South African perspective, due to its remote location, a South African entity must carry more inventory to service its customers. It is also well documented that South African entities bear currency risks and usually require more local management;
- The fact that Nestlé SA retains exclusive ownership of the 'know-how' does not change the functional profile of Nestlé Zambia to a LRD. For example paragraph 6.2 of the OECD Guidelines states that:
"**...the key consideration is whether a transaction conveys economic value from one associated enterprise to another, whether that benefit derives from tangible property, intangibles, services or other items or activities. An item or activity can convey economic value notwithstanding the fact that it may not be specifically addressed in Chapter VI. To the extent that an item or activity conveys economic value, it should be taken into account in the**

determination of arm's length prices whether or not it constitutes an intangible within the meaning of paragraph 6.6.”

- Paragraph 8.1.3 of Transfer Pricing Practice Note 02/2018 (“Practice Note”)^[1] deals with the concept of development, enhancement, maintenance, protection and exploitation of intangibles (“DEMPE”). As the Practice Note and Zambian Transfer Pricing (Amendment) Regulations 2018, were published after the period under review, will this usher in detailed analyses and application of mind to the ownership and use of the intangibles being used in the value chain going forward;
- Interestingly, from a thin capitalisation perspective the TAT noted that the debt to equity levels in a company are a business driven decision based on the cost of financing;
- Instead of challenging the transactional approach put forward by Nestlé Zambia the ZRA performed its own benchmarking analysis;
- The Transactional Net Margin Method (“TNMM”) was then used on a whole-of-entity basis (referred to as aggregation in the judgement), so as to adjust the results of Nestlé Zambia such that a taxable profit was achieved;
- While the ZRA ultimately won the reclassification issue (Ground Four) case on appeal, it lost some of the key propositions it had hoped to establish through this litigation;
- The decision provides the first substantive judicial guidance in Zambia on the difficult territory of establishing arm's length arrangements between related parties. It gives taxpayers much to consider and apply in evaluating their own arrangements.

Development of Africa's transfer pricing jurisprudence

The decision will no doubt embolden the ZRA, particularly in respect of the other transfer pricing audit cases which are currently underway, in targeting new cases for audit.

Furthermore this case could have far-reaching consequences for multinational enterprises from a Pan-African perspective as it may create an international precedent for the approaches of revenue authorities and courts across Africa.

^[1] The Practice Note, issued by the ZRA, sets out the Commissioner-General's interpretation of Zambia's transfer pricing rules and describes the changes introduced through the Income Tax (Transfer Pricing) (Amendment) Regulations, Statutory Instrument No. 24 of 2018.

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