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Significant Transfer Pricing Disputes – V

Nestlé Zambia-Zambia Revenue Authority-Tax Appeals Tribunal

The Zambia Revenue Authority (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 2010-2014. As a result of the audit, the Revenue had adjusted Nestlé Zambia's profit to ZMW56,579,048 (approx. USD4.4 million), resulting in an additional tax liability of ZMW13,860,103 (approx. USD1.1 million), plus penalties and other levies.

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. These grounds were based on the losses reported by Nestle Zambia, re-categorization of Nestle Zambia as a limited risk distributor, and related party transactions. At the end of the tribunal, Nestlé Zambia succeeded on all grounds of appeal, except for its position on the characterization of the entity as an LRD.

This case is important by three aspects:

1. Company losses in consecutive years have always been attracted the tax authorities' attention. As seen in the Nestlé Zambia case, losses should be supported with economic reasons and reasonable explanations. Also, the LRD business model is 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," in substance bears significantly more risks and performs more functions than may be stated in the agreement.

2. A company that is classified as a limited risk distributor can pay royalty and this situation does not change its limited risk nature. As stated in paragraph 6.2 of the OECD Guidelines, the point to be emphasized is whether an economic value is transferred from these activities.

"…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."

3. Intra group services are another important point in transfer pricing audits. These transactions should be documented in detail and explainable to the authorities in case of a tax audit.