IN THE TAX APPEALS TRIBUNAL 2018/TAT/03/DT
HOLDEN AT LUSAKA

IN THE MATTER OF: THE INCOME TAX ACT, CHAPTER 322 OF THE LAWS OF ZAMBIA

AND

IN THE MATTER OF: THE TAX APPEALS TRIBUNAL ACT NO. 1 OF 2015

AND

IN THE MATTER OF: ASSESSMENT NOTICES ADDRESSED TO NESTLE ZAMBIA TRADING LIMITED DATED 29 MAY 2017

BETWEEN

NESTLE ZAMBIA TRADING LIMITED APPELLANT

AND

ZAMBIA REVENUE AUTORITY RESPONDENT

Before the Vice Chairperson and Members of the Tax Appeals Tribunal

For the Appellant: Mr S. Chisenga and J. Kawana, Corpus Legal Practitioners

For the Respondent: Mr F. Chibwe and Ms. M Chanda, The Zambia Revenue Authority

CORAM: D. Tembo (Chair), G. Nonde (Member) and G. Mazakaza (Member)

Court Reporters: Mr W. Siame and Ms C.K. Chali

On 30th October 2018, 31st October 2018 and 28th March 2019

RULING

Authorities and Legislation referred to:

Legislation

1. **The Income Tax Act, Chapter 323 of the Laws of Zambia**
2. **Income Tax (Transfer Pricing) Regulation No. 20 of 2000** (the **TP Regulations**)

Others

1. **OECD Guidelines on Transfer Pricing**
2. **United Nations Manual on Transfer Pricing for Developing Countries**

Brief Facts, Appellant's Grounds of Appeal and Respondent's Arguments

This is an appeal by the Appellant against the decision of the Respondent on an assessment resulting from a Transfer Pricing audit covering the period 2010 to 2014 wherein the Respondent adjusted the Appellant's profit to ZMW56,579,048.00 and further levied a gross tax of ZMW13,860,103.00 on it. Having been dissatisfied with the Respondent's Transfer Pricing assessment, the Appellant filed an appeal in this Tribunal on 16 February 2018.

There are Six (6) Grounds of appeal upon which the Appellant is challenging the Respondent's assessment. These are;

1. That the Respondent erred in law and in fact when it wrongfully assessed that the Appellant was liable to pay to the Respondent the total sum of ZMW13,860,103.00 as gross income tax payable for the charge years 2010, 2011, 2012, 2013 and 2014 when it did not carry out any tests on the

Appellant's transactions to assess whether the Appellant was compliant with the arm's length principle as envisaged by the law.

2. That the Respondent erred in law and fact when it based its assessment on the premise that the Appellant could not run at a loss since incorporation when all the evidence provided to the Respondent clearly showed the various factors which led to the Appellant's loss making;

3. That the Respondent failed to objectively test the related party transactions to which it raised transfer pricing concerns but made assumptions and estimates that were excessive and unreasonable

4. That the Respondent erred in law and fact when it categorised the Appellant as a low risk distributor when it was shown beyond doubt that the Appellant was an independent full fledged distributor company undertaking all of the sales and distribution functions as well as the typical risk incurred in performing this function. That the Appellant buys, holds and sells products/offerings, as appropriate. Additionally, the Appellant undertakes both operational and entrepreneurial functions relating to the marketing, distribution, and sales activities, and bears the risks associated with these activities such as credit, inventory and market risk. The Appellant also develops customer relationships and third party distribution network on the Zambian market. The Appellant operates with a local board of directors which guides and follows its own strategic direction and that its own local management team executes the Appellant's objectives and bears all the risks appurtenant to its business.

5. That the Respondent erred in law and fact when it used benchmarks that are neither comparable to the nature of the Appellant's business in Zambia nor the macro and micro economic conditions in Zambia; and

6. That the Respondent erred in law and fact when it added back unrealised foreign exchange losses attributable to a loan when the same were not included as expenses in the Appellant's financial statements.

The Respondent has argued, in relation to the Appellant's Ground One, that the Respondent carried out adequate tests on all related party transactions and the analysis of the contracts and transactions revealed that the Appellant's transactions were mainly with various related parties. It also argued that the Appellant was paying royalties to Nestle South Africa for the exclusive use of Nestle trademarks, patents as a distribution company in violation of the arm's length principle. The Respondent also contends, with respect to the Appellant's Ground Two that the losses came from huge payments of related party costs such as royalty payments, management fees and purchase of Nestle products from related companies. In relation to Ground Three, the Respondent argued that the transfer pricing assessments were made under section 97A (3) of the Income Tax Act, Chapter 323 of the Laws of Zambia and therefore, are not estimates or assumptions. With regard to Ground Four, the Respondent argues that the conclusion that the Appellant is a low risk distributor was anchored on the following factors, inter alia;

(a) the fact that control of the Appellant's operations is done by Nestle Zimbabwe, a manufacturing company of the group
(b) staff from Nestle Zimbabwe oversee operations here in Zambia
(c) sourcing of Nestle products and invoicing of the products is done through Nestle Ghana
(d) inventory risk does not entirely lie with the Appellant but is partly borne by suppliers who are Nestle manufacturing companies
(e) the fact that the level of investment in the Appellant is low which shows that most of the risks do not lie with them
(f) the operation of the Appellant has a lean staff who are mainly in marketing, stores and accounting; and
(g) customers pick ordered products from the Appellant's warehouses using their own transport.

The Respondent further argued, in relation to Ground Five, that Nestle products were already known and available on the Zambian market long before the Appellant was incorporated and as such it was not a developing market. In responding to Ground Six, the Respondent contends that foreign

exchange loss adjustment is a secondary adjustment which arises from imposing tax on secondary transactions and the Respondent was justified in doing so on in order to ensure that the allocation of profits is consistent with primary transfer pricing adjustment of the Appellant's operating margin for the period under review.

The Appellant's Evidence

The Appellant called two witnesses. The first was Mr Simbarashe Mudawapi (AW1), a Zimbabwean National resident at 6 Salisbury Place, Avondale, Harare, Zimbabwe and the Financial Controller in charge of finance operations within the Nestle South Cluster for three (3) countries, namely Zambia, Zimbabwe and Malawi. His evidence was that in April 2016 the Appellant received from the Respondent, a notice marked (TM1) in the Appellants Affidavit in Support of Notice of Appeal, advising that the Respondent will conduct a transfer pricing audit for the period 2010 to 2014 and therefore sought information which the Appellant provided. Arising from this, a benchmarking study was conducted by the Respondent and it notified the Appellant of the findings of the transfer pricing audit (TM2 and TM3) which adjusted the Appellant's profit to ZMW56,579,048.00. AW1 stated that the Appellant objected to the findings by letter marked TM4, TM5 and TM9 explaining that the benchmarking was erroneous, contending that the aggregation method of the Appellant's transactions should not have been used, instead it should have been on transaction by transaction basis; that the benchmarking was done against entities in Western Europe which were not at all comparable to the Appellant and that it was wrong to categorise the Appellant as a low risk distributor instead of a full fledged distributor. He testified that the Appellant did not pay interest on the loan, that the loan did not form part of the Profit and Loss Account and further that the parent company, Nestle SA, forgave the interest component. He added that the Appellant gets 90% of the products it sells from Nestle SA and 10% from Brazil and Zimbabwe. He further added that the Appellant has been on growth trajectory of between 20% to 30% growth and that its negative net profit was as a result of start up costs and challenges in the ease of doing business such as exchange rate losses. AW1 also testified that the Appellant derives value from shared services with related companies such as the invoicing being done by

Nestle Ghana which invariably means that clerical work is being done elsewhere through a centralised software operating system. He bemoaned the Respondent's assessment as being unfair and urged the Tribunal to reverse the same.

In cross examination, AW1 confirmed that the large volume of the Appellants' business is with related parties. He stated that the Respondent's position is that there were no internal comparables and further that there were no comparables with sub Saharan Africa. He admitted that aggregation is one of the acceptable methods that the Organisation for Economic Corporation and Development Transfer Pricing Guidelines (OECD Transfer Pricing Guidelines) and the United Nations Manual recognises where there are no internal comparables. AW1 testified that the appropriate method should have been on transaction by transaction basis. He stated that he was not aware if there was investment of equity in the Appellant by the shareholders. When referred to page 58 of the Appellants Bundle of Documents, he testified that the Appellant strategic management was a shareholder activity, as such the Appellant paid for it. He added that the Appellant, save for Technical Support, receives the following services from its related parties;

i. Strategic Management
ii. Sales Support Services
iii. Marketing Support
iv. Finance, Accounting and Legal Services
v. Procurement and Supply Chain Management
vi. Human Resources Management (HR)
vii. Information Technology Support (IT)

He further stated that the Appellant is in a better position to negotiate a contract with related parties than would an unrelated or third party. He confirmed that the expenses incurred in payment for services above did impact on the profits of the Appellant and that it has been registering losses for the last five (5) years. AW1 further testified that the Appellant does derive benefits from the relationship with related parties despite losses it was incurring. He told the tribunal that the Nestle group as a whole was making profit but the Appellant was not. He stated further that it is not only the manufacturers that pay royalties when referred to the Appellants bundle of documents at page 3 on the definition

of "knowhow". AW1 also testified that the Appellant delivers to its customers but there are some that also collect from the Appellant's warehouse.

In re-examination, AW1 clarified that there were no internal comparables in Zambia and further that the appropriate comparable would have been to go to individual transactions. He stated that there was lack of proper benchmarks and that the Respondent did not ask for cost of the Appellant's marketing. He further stated that the Appellant's relationship with its related parties is not exclusive as supermarkets chains such as Shoprite or Pick n Pay can bring into the Country the same products as the Appellant. AW1 clarified that on the debt equity ratio, the loans only started in 2012 to 2013. He further stated that the services the Appellant paid for were mainly for strategic direction and assistance. He further added when referred to "MC3" in the Affidavit in Support of the Respondent's Statement of Case, that the Appellant made loss projections because of the volatility in the currency which invariably would eat into its profitability. He stated that a loss making company can close down but the Appellant's strategic long term is to later on venture into manufacturing. He added that the Appellant would still be in loss making even without related party costs. AW1 read contents of the definition of "know how" on page 3 of the Appellant's bundle of documents and what it entailed to him.

AW2 (Expert Witness) was Mr Malcom Gurudas Jhala, a Chartered Account and Associate Director in General Tax, Transfer Pricing and International Taxation in the employ of Deloittes and Touche with Eleven (11) years experience in Tax. He confirmed having sworn and filed a Witness Statement in this matter which he sort to rely on as part of his evidence. He testified that the Transfer Pricing Regulation of 2000 was not detailed enough in dealing with guidance on arm's length and that Zambia follows the OECD Guidelines which were applicable to the matter at hand but that where there is a conflict between the Zambian Transfer Pricing Regulation and the OECD Guidelines, the Zambian regulations take precedent. He testified that there are basic steps to take in determining whether a transaction is in compliance with arm's length; firstly identification of associated parties to the transaction, if there is common control on management, then identification and description of the related party transactions, then performing a functional asset and risk analysis, once this is done, there is now

need to identify controlled transactions between or among the related parties within the context, economic conditions, the functions of each related party of the transaction. He added that the economic analysis then tests similar transactions, under similar conditions between or among related parties with independent transactions between or among independent parties. This is a process of comparability and is done through benchmarking studies where related party transactions are tested against independent transactions to assess them for arm's length compliance and this is what is referred to as arm's length range. He added that the price range of goods and services of the controlled transaction is then compared with the range resulting from the benchmark study.

AW2 further stated in his testimony that loss or profit making are not factors in determination of transfer pricing but loss making can be indicative to a tax authority of risk and that there could be an issue of pricing of goods and services between or among related party transactions but not necessarily that the business in loss making is not conducting its business at arm's length. He added that in benchmarking, the price of goods and services in a controlled transaction should be compared to the price of those goods and services in an independent transactions and that without a benchmark study, it is not possible to determine arm's length. He stated that transactions ought to be tested individually and that in multinational corporations, the majority of transactions happen in the manner transactions happened with the Appellant after perusing documentation that was availed to him.

In the case in issue, and in his view, the Appellant tested each transaction to determine transfer pricing policy with related parties. He stated that in this case, the Respondent just looked into risk factors but neglected to scrutinise transaction by transaction to draw a conclusion and that there is no requirement to restrict volume of transactions or loss making. He added that the aggregation done by the Respondent was wrong as it was not going to yield accurate results. He added that in order to test the arm's length nature of the transaction, the return on capital employed by a manufacturer in manufacturing was benchmarked against that of independent manufacturers. He further added that the Transfer Pricing Regulations in Zambia allow for different methods to be used such as the Transactional Net Margin Method (TNMM). According to him,

in order for the Respondent to test whether the Appellant has substantiated arms length nature of the transaction, it ought to test the Appellant's related manufacturing entity and that the controlled transaction in this case is the purchase of goods but further that only if the margins of the distributor, in case the Appellant is tested, will be far off the arms length price. The better option would be to test the controlled returns which are directly linked to the Appellant's transactions.

In cross-examination, AW2 confirmed that the essence of benchmarking would be to obtain comparables and that this would be independent, not a related party to the Appellant. He stated that in the absence of independent comparables, the transaction by transaction method may be difficult. He added that the absence of comparables does not necessarily entail use of aggregation method but that this can only happen when there is a close economic nexus between or among the transactions. He stated that where the tax payer fails to avail documentation, the tax authority is at liberty to reject the transfer price and that the tax authority should give reasons why it has rejected and further that he was not aware that the Respondent in this case had given reasons why it rejected transfer pricing method used by the Appellant. When referred to TM1 in the Affidavit in Support of Notice of Appeal, AW2 confirmed that the Respondent asked the Appellant for benchmarking report and was further referred to "MC3" of the Respondent's Affidavit in Support and confirmed that the Respondent did inform the Appellant. He admitted that the last sentence in his Witness Statement (MG1) in paragraph 48 that the Respondent did not provide any reasons for rejection of the Appellant's analysis was factually incorrect. He stated that where risk is shared, each party assumes that risk but ultimately it is the bearer of the risk that takes up the burden. AW2 confirmed that in functional analysis for low risk distributor, functional assets and risk characterisation is considered. He added that if the risk is shared, no one entity singularly bears that risk.

In re-examination, AW2 clarified that where it is impracticable or in the absence of comparable information, it is possible to adopt the aggregation method with respect to that transaction. He clarified that his explanation on the import of the authority in the Malawian case is that once the tax authority rejects a tax payers method of demonstrating its application of the arms length principle, the burden

of proof shifts to the tax authority, in this case, the Respondent to actually challenge the merits, steps, process or benchmarking performed by the tax payer. He added that if the Appellant were to be tested, there is no information to be used to do so as there is no requirement to test the Appellant.

This marked the close of the Appellant's case.

The Respondent's Evidence

The Respondent called one witness, Mr Martin Chileshe (RW1), a Senior Inspector, Transfer Pricing in the Large Payer - Domestic Taxes Department of the Respondent.

He testified that they did an analysis of the Appellant and discovered that it was continuously declaring losses from incorporation and that net profit margins were negative for the five (5) year period under review together with a lot of related party transactions and shared services with related parties. The Appellant was also paying for management and use of intellectual property. He added that in usual business there are costs that are incurred but in the case of the Appellant, they did, like any other business incur costs but these costs were more than the sales it was declaring and as a result it had negative net position in terms of profit and loss. He referred the tribunal to paragraph 4.1 of appendix 1 of MC3 in the Respondent's Affidavit in Support where he explained that in selecting the companies in the different regions, the Respondent was trying to come up with the best comparable companies to use to make adjustments and they selected thirteen (13) companies contained at paragraph 5.1 of the same document. The 13 companies were the best comparable the Respondent had and they were all from Western Europe. He stated that these companies' margins were lower than the Appellant's margins it found in its own benchmarking study. He referred the tribunal to MC4 also produced in his affidavit in support. This is the Transfer Pricing documentation submitted by the Appellant to the Respondent. He stated that the margins from Asia, Oceania and Africa were higher than the margins the Respondent adjusted and added that the lower quota was 4.72, the Median was 4.85 and the upper quota was 6.71. He stated that when they did the benchmarking, they came up with a range of values that was the arms length range. He added that in terms of royalties, the Respondent picked the median range which is also what the Appellant had picked and on the

purchase of products, this is how they were able to make the adjustment on the aggregation level. He added that the Appellant used the same process to arrive at its arms length range and further that in terms of services, the Appellant also used comparable information from Europe. He testified that the net effect of using a lower margin is that the Appellant was going to pay lower taxes compared to the taxes they would have had to pay if the Respondent had used higher margins.

RW1 testified that the Respondent did not use the transaction by transaction method because it becomes difficult where there are no comparables. In the case of the Appellant, there is no comparable company in Zambia that does what the Appellant is doing. He added that where a tax payer does not provide an internal comparator, the only option left for the tax authority is to aggregate. He added that that is in conformity with the UN manual of Transfer Pricing which states that, where there are no internal comparables it is justifiable to use entity level comparability and in this respect if accepted to aggregate the transactions to arrive at arms length range. He added that even the OECD Guidelines on Transfer Pricing recognize the use of aggregation by a tax authority to achieve the best results. He stated that the Respondent explained to the Appellant in detail why it used aggregation after the Appellant objected to the Respondent's assessment. This is explained at pages 14 to 21 of MC3 and that it was explained to the Appellant that the application of the arms length principle is done in terms of Section 97(a) of the Income Tax Act which empowers the Respondent, where controlled transactions are not done at arms length, to revise these transactions so that they are computed on arms length basis. He referred to page 14 of MC3 and added that there was no internal comparable, the comparable uncontrolled price method could not be appropriate to use and this left the Respondent with the transactional net margin method.

RW1 testified that the Appellant had given reasons of being new and trying to penetrate the market and also that it was difficult to compete with other Nestle products that were already on the market as being the reason for its loss making. He further stated that international best practice allowed secondary adjustments which can come with a foreign exchange adjustment or can come in form of a dividend. In this case, the adjustment arose out of the debt to equity position as the Appellant had less equity which invariably did not have arms length equity.

He stated that this is against the recommendation of OECD of having at least 10% of the total value of the company in equity. He added further that the Appellant had borrowed heavily from its parent company and that this position meant that the Appellant was thinly capitalized as can be seen at page 20 of the report MC3. He told the tribunal that there are three capitalization rules legislated which only apply to mining companies but for none mining ones such as the Appellant, they are expected to follow best practice contained in the OECD Guidelines and the UN Manuals on Transfer Pricing. He testified that the Appellant fell short of the minimum capital to operate under the arms length principle and further that the capital had been eroded because of the huge debt it had from a related party, as such, the adjustment was made to ensure that the Appellant conformed to the OECD Guidelines.

RW1 added that the adjustment was made because the Appellant already had sufficient operating profit within and it therefore, did not need to borrow. He added that this adjustment is made whether a company made a profit or not in that it is a transfer pricing adjustment. He stated further that although the Appellant did not claim the exchange losses, they did make tax adjustments but if they had not adjusted, the Respondent would not have done anything.

In cross examination, RW1 testified that at the time of the audit in this case the applicable law was Section 97(a) of the Income Tax and the Regulations of 2000 and confirmed that Statutory Instrument 24 of 2018 was not yet in force. He added that without a benchmarking study, it would be difficult to test a transaction for arms length where there is no comparable, but if there is a comparable, it is possible to test a transaction without a benchmarking study and clarified that without a benchmarking study, it is not possible to accurately test for arms length. The witness stated that there were three (3) main points that had motivated the assessment on the Appellant namely that there were continuous negative operating margins for a period of more than five (5) years, that there was continuous losses for a period of five (5) years and that the Appellant had huge volumes of transactions with related parties. When referred to TM1, RW1 admitted that there was no evidence brought to the tribunal to indicate that the Respondent had protested the absence of certain documents. He further confirmed that the Appellant is part of the Nestle Group and that documents it availed to the Respondent were from 2011 upwards. He further stated that the

Respondent brought to the attention of the Appellant that it would use aggregation of the transactions. He testified that the Respondent did not dispute the contents of the documents appearing as MC4 during the audit period. He stated that the products from the European countries were not the same as those that the Appellant was dealing with in here. He added that the 13 companies used were old companies that have been operating for a long time as can been seen from TM4 while acknowledging that the Appellant had only been in operation for five (5) years. He admitted that the Respondent did not respond to the letter, TM10, from the Appellant. When referred to paragraph 10 of his Affidavit in Reply, the witness stated that a huge payment is the K4,500,000.00 paid by the Appellant in management fees when it only had capital of K2,300,000.00 and stressed that this amount is huge when compared to the capital. He admitted that the Respondent did not test this huge payment for arms length and further admitted that the Respondent did not also test the royalties for arms length.

In re examination, RW1 clarified that the Appellant, in its infancy was paying huge sums of money to the related parties compared to the investment made into it. He added that the Respondent analysed these payments and the impact they had on profitability of the Appellant and thus decided that the best way to test arms length was to aggregate rather than deal with individual transactions. He stated that the letter that came from the Commissioner General did not address the unrealized foreign exchange losses because it had already been addressed in previous correspondence. He reiterated that the level of investment in the Appellant was very low compared to what it was paying out and when the debt is compared to equity, it is found that the Appellant was thinly capitalized from inception. He added that due to the position in relation to debt and equity and also the huge payments the Appellant was making, he concluded that a company intent on making a profit would not make such decisions. RW1 added that in relation to purchases from Brazil, he reiterated that these were not availed. He further added that the Respondent did not dispute the Transfer Pricing documentation supplied by the Appellant.

This marked the end of the Respondent's case and invariably the end of testimonies from both the Appellant and Respondent.

Analysis of the Case and Findings

We have carefully analysed the evidence in testimony, and the documents availed and admitted into evidence. We will deal with the issues as they are brought out in the statement of case. However, it is evident to us that Grounds One and Three, below, are related or the issues raised therein are closely linked. We will therefore deal with these grounds together.

1. *That the Respondent erred in law and in fact when it wrongfully assessed that the Appellant was liable to pay to the Respondent the total sum of ZMW13,860,103.00 as gross income tax payable for the charge years 2010, 2011, 2012, 2013 and 2014 when it did not carry out any tests on the Appellant's transactions to assess whether the Appellant was compliant with the arm's length principle as envisaged by the law.*

3. *That the Respondent failed to objectively test the related party transactions to which it raised transfer pricing concerns but made assumptions and estimates that were excessive and unreasonable*

At the time of this case, the applicable law was the Income Tax (Transfer Pricing) Regulation No. 20 of 2000 (the **TP Regulations**) and the principal Act, the Income Tax Act, Chapter 323 of the Laws of Zambia (the **Income Tax Act**). There is also an acknowledgment for use of the Organisation for Economic Corporation and Development Transfer Pricing Guidelines (**OECD Transfer Pricing Guidelines**) and the United Nations Transfer Pricing Manual for Developing Countries (**UN Manual**) where there is a lacuna in these legislations. It must be noted however, that the current law, the Income Tax (Transfer Pricing) Regulation No. 18 of 2018 is not applicable and any reference or insinuation of or to any requirements thereunder, are equally inapplicable in these proceedings.

We have perused the law. **Section 97A (1) of the Income Tax Act** provides, -

"In this section –"actual conditions" means conditions which are made or imposed between any two associated persons on their commercial or financial relations;

"arms length conditions", means subject to section ninety-seven AA where that section applies, conditions or no conditions which would have been made or imposed if persons were not, associated with each other.

(2) This section shall apply where a taxpayer engages in one or more commercial or financial transactions with an associated person and the actual conditions made or imposed in that transaction or transactions are different from the arm's length conditions and there is, except for this section, a reduction in amount of income taken into account in computing the income of one of the associated persons referred to in subsection (1), in this section referred to as "the first taxpayer" chargeable to tax for a charge year, in this section referred to as "the income year"(Emphasis ours)

The law recognizes and permits transactions between or among related parties as long as they are conducted at arm's length. There is therefore, nothing wrong in transacting with related parties. The issue in contention is whether the Respondent was correct at law in not testing but aggregating the Appellant's transactions as a way of determining compliance with the arms' length principle. In resolving this issue, we will look at circumstances, reasons and ingredients that need to be present in each circumstance to warrant aggregation of controlled transactions and the effect of not having the transactions tested.

The law under Regulation 12 (1) states,

"The Commissioner General shall cause to be determined the arm's length remuneration of a controlled transaction by applying the most appropriate transfer pricing method to the circumstances of the case"

The law further stipulates the methods to be applied in Regulation 12 (3) wherein it states;

"For purposes of sub-regulation (1), the following transfer pricing methods may be used:

(a) comparable uncontrolled price method;
(b) resale price method
(c) cost plus method
(d) transaction net margin method; or
(e) transaction profit split method.

In addition, the law also provides for ingredients that ought to be considered when seeking to apply the appropriate method depending on the circumstances of the case. Regulation 12(2) provides;

"The Commissioner General shall cause to be selected the most appropriate transfer pricing method from among the approved transfer pricing methods set out in sub-regulation (3), taking into consideration the –

(a) *respective strengths and weaknesses of the methods in the circumstances of the case;*

(b) *appropriateness of the approved transfer pricing method, having regard to the nature of the controlled transactions, determined through an analysis of the functions undertaken by each person in that controlled transactions and taking into account assets used and risks assumed;*

(c) *availability of reliable information needed to apply the selected transfer pricing method or other transfer pricing methods; and*

(d) *degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments, if any, that may be required to eliminate differences between them.*

Article 6.1.2.1 of the UN Manual provides that, *"the starting point in selecting a method is an understanding of the controlled transaction (inbound or outbound), in particular based on the functional analysis which is necessary regardless of which transfer pricing method is selected".*

We gather from the article above that one of the cardinal steps to be applied in testing the transaction/s for arm's length is the functional analysis, which is critical in that the results emanating from there will determine what method will be used. The evidence from AW1 was that there were no comparables in the Country and on the Continent and that there were no internal comparables too. The evidence of RW1 collaborated that of AW1 on the lack of internal and other comparables from the sub-Saharan Africa. RW1 also stated that the Respondent did not conduct tests on the transactions. He went further to explain that it was not possible to accurately test for arm's length without conducting a benchmarking study. Benchmarking involves carrying out comparability tests. According to Guideline 3.4 of the OECD Guidelines, this will typically involve a benchmarking process which starts with a "determination of the years to be looked into, an analysis of the circumstances of the tax payer, an understanding

of the controlled transactions, a review of the existing internal comparables, a determination of information on external comparables, selection of the appropriate method, identification of potential comparables, determination and making of comparability adjustments where possible and finally an interpretation of the data collected". The Guideline 3.4 of the OECD Guidelines states that, *"this process is considered an accepted good practice but it is not a compulsory one, and any other search process leading to the identification of reliable comparables may be acceptable as reliability of the outcome is more important than the process (i.e. going through the process does not provide any guarantee that the outcome will be at arm's length, and not going through the process does not imply that the outcome will not be arm's length."*

Our understanding of the above is that it is good practice to conduct comparability tests in the manner enumerated above, but it is not absolute that the process if followed to the letter, will yield results that guarantee arm's length. However, in light of the above and in light of the evidence of both AW1 and RW1, it is inconceivable that a comparability analysis can possibly be done without conducting tests on the controlled transactions especially in the absence of uncontrolled transactions that are potential comparables. We take note that the Respondent by letter of 26 April 2016 (exhibited as TM1) did request a number of pieces of information one of which was the local file. Further, this was also highlighted in appendix 1 in TM3 under paragraph 3 on selection of appropriate method. However, when referred to TM1, RW1 admitted that there was no evidence brought to the tribunal to indicate that the Respondent had protested the absence of these documents. In addition, there was no legal instrument at the time to compel the Appellant to comply with the request. This was, in our view, a weakness of the law at the time.

Our position is that there was no legal requirement under the Income Tax (Transfer Pricing) Regulation No. 20 of 2000 for documenting transfer pricing information and as such the Appellant cannot be faulted for not having had a local file, where internal comparable information could have been. This requirement only arose upon the coming into effect of Income Tax (Transfer Pricing) Regulation No. 18 of 2018 (See Regulation 21(1) thereof). We therefore take the view that the requirement having not been there at the time of the audit,

it will not be feasible to apply current requirements of the law retrospectively. There was therefore, no internal comparables. This, according to the Respondent, necessitated the use of comparables from Western Europe which the Appellant is objecting to.

Further, the Appellant has argued that the transaction by transaction basis is the appropriate method. In support thereof, Paragraph 3.9 of the OECD Guidelines was quoted by AW2, which states;

"Ideally, in order to arrive at the most precise approximation of arm's length conditions, the arm's length principle should be applied on a transaction by transaction basis."

We will handle this argument together with the main one advanced by the Appellant. The Respondent has argued that because there were no internal comparables, this prompted it to aggregate the controlled transactions. That said, it leads us to the issue of whether it is then possible to test such controlled transactions for arm's length by aggregation.

Aggregation, for ease of understanding, simply refers to formation of things into a cluster. In transfer pricing, it refers to a *"combination of transactions between two or among related parties that are closely linked that when or if clubbed together or clustered, shall enumerate the purpose and value of such transactions"*. One of the most important ingredients in aggregation is that the transactions ought to be closely linked or continuous. In short there ought to be a close economic link in purpose between or among the controlled transactions intended for aggregation. Common examples given are usually things like that of printers and cartridges. The two products are so closely linked that they have a common purpose and if separated, a single product will not produce value as a standalone, therefore, a printer will not work without a cartridge and vice versa.

Therefore, for transactions to be aggregated, one element of such transactions is that they cannot be segregated and where they are segregated, then they cannot be evaluated adequately on a standalone basis. To this end, if these transactions are benchmarked separately, they may not bring out the actual value created which the transactions would yield, if put together. In the matter at hand, the controlled transactions that were aggregated comprise purchase of finished

products, payment of royalties, payment for management services and shared services and payment for receipt of intercompany loans.

We do not see how these transactions are closely linked or continuous or related and neither is there a close economic link in purpose in terms of the understanding of the characteristics that ought to be present when making a consideration for aggregation. These characteristics that ought to be present in a transaction ripe for aggregation are clearly spelt out in the UN Manual on Transfer Pricing in 5.3.1.6 which states,

"The transfer pricing analysis should ideally be made on a transaction by transaction basis. However, there are cases where separate transactions are so closely linked that such an approach would not lead to a reliable result. Where the transactions are so closely interrelated or continuous that the application of the arm's length principle on a transaction by transaction basis would become unreliable or cumbersome, the transactions are often aggregated for the purposes of the analysis". (Emphasis ours)

We have problems seeing how the purchase of finished products can be so closely linked or interrelated or indeed continuous to payment of royalties or payment for management services and shared services. It is inconceivable that repayments for receipt of intercompany loans can be closely linked or related to purchase of finished products. These transactions are so unrelated, so disconnected and not closely linked to be bundled together into aggregation as a means for testing for arm's length. In our considered view, aggregating these is synonymous to bundling transactions involving payments for apples, bread, books and payment for fruit fumigation services and treating them as one transaction by aggregating. An inaccurate result will be recorded when applying arm's length principle and as such, a wrong conclusion will be arrived at, which will consequently have a huge impact on the tax assessment. It is therefore, clear that aggregation of these transactions is bound to produce inaccurate results for arm's length principle.

The Respondent has argued for aggregation and relied on 5.3.1.9 of the UN Manual on Transfer Pricing on why it relied on aggregation to determine arm's length. The same states that, *"Aggregation" issues also arise when looking at potential comparables. Since third party information is not often available at the*

transaction level, entity level information is frequently used in practice when looking at external comparables."

It is our view that utilising entity level information is not synonymous to applying the whole entity level approach in testing arm's length of the controlled transactions.

It is our finding therefore, that it was erroneous for the Respondent to have aggregated these unrelated, discontinuous and not closely linked transactions as a means to test for arm's length. It is our view that the most appropriate method, looking at the nature of the transactions, would have been if the arm's length principle was applied on a transaction by transaction basis. This would have taken into account the patent and salient unique nature of each of the transactions considering that each has its own nature distinct from the others. We therefore find, that the use of aggregation and the failure to test each transaction for arm's length produced results that were not only erroneous but also excessive in that they were not *acceptable as reliability of the outcome* was compromised. Grounds One and Three of the Appellant's Appeal succeed.

In Ground Two the Appellant avers *"that the Respondent erred in law and fact when it based its assessment on the premise that the Appellant could not run at a loss since incorporation when all the evidence provided to the Respondent clearly showed the various factors which led to the Appellant's loss making;"*

The Respondent has testified that in usual business there are costs that are incurred but in the case of the Appellant, they did, like any other business incur costs but these costs were more than the sales it was declaring and as a result it had negative net position in terms of profit and loss. The Appellant testified that the expenses incurred in payment for services above did impact on the profits of the Appellant and that it has been registering losses for the last five (5) years but that the Nestle group made profits. It is clear from the Respondent's viewpoint that the loss making was problematic and relied on the same, among other things, to make assessments. This being a transfer pricing audit, the Respondent based its findings on the transfer pricing assessment on the issue of continuous loss making. The question before us is whether loss making is a determinant factor in assessing compliance with arm's length principle and whether in this case, it was prima facie evidence of a the Appellant ascribing loss making to itself

so as not to pay the correct amount of tax. As has been stated before, for purposes of assessing compliance to arm's length, loss making can be a trigger to a tax authority that there may be an issue with transfer pricing to be enquired into.

Paragraph 1.129 of the OECD Guidelines provide that, *"When an associated enterprise consistently realises losses while the Multinational enterprise group as a whole is profitable, the facts could trigger some special scrutiny of transfer pricing issues."* *(Emphasis ours)*

It is clear from the facts of the case that the Appellant's loss making triggered the scrutiny of the transfer pricing issues. However, we do not think that merely because the Appellant made continuous losses for five(5) years is in itself an indictment of the Appellant's wrong doing with regard to transfer pricing. The law has provided how losses in a business ought to be treated.

Section 29 (1) of the Income Tax Act provides that, *"Subject to the provisions of this Part-(a) in ascertaining business gains or profits in any charge year, there shall be deducted the losses and expenditure, other than of a capital nature, incurred in that year wholly and exclusively for the purposes of the business; and(b) in ascertaining income from a source other than business, only such expenditure, other than expenditure of a capital nature, is allowed as a deduction for any charge year as was incurred wholly and exclusively in the production of the income from that source.*

Provided that on the amount payable by way of insertion upon money borrowed by any person where the Commissioner General is satisfied that the loan or advance was obtained for capital employed wholly and exclusively for business purposes or in the production of income, a deduction shall be allowed."(Emphasis ours)

The Respondent has argued that had the Appellant had the required amount of equity, the borrowing would have been unnecessary and the losses occasioned by the interest on loans would not have been incurred.

Our finding is limited to the provisions in the Income Tax Act at the time, which states that the loan or advance should be obtained for capital employed wholly and exclusively for the business or in the production of income for it to be

deductible. The Respondent has not demonstrated that the amounts obtained from the related party by the Appellant were not employed in the business, neither has it shown that they were not in compliance with the arm's length principle between the related parties. It has also, in our view, not demonstrated that there was something wrong with the Appellant's transfer pricing in its transactions with the related parties which resulted in the loss making. It is clear that, while loss making is a risk factor to be considered when reviewing transfer pricing, as was the case here, it does not necessarily mean that loans between related parties should be disallowed where they are procured on arm's length terms. This is because the Respondent has not demonstrated any finding that the loans, occasioning the losses, were procured in violation of arm's length principle. In the absence of this finding, we are precluded from thinking otherwise. Further, and in agreeing with Paragraph 1.129 of the OECD Guidelines above, there was nothing wrong in the initiation of the transfer pricing audit or enquiry, the same having been triggered by the continuous loss making position of the Appellant but it is not correct to conclude that loss making is resulting from non compliance to arm's length principle.

It was further argued by the Respondent that some activities for which the Appellant was paying fees should have been borne by the Appellant. Counsel for the Respondent directed AW1 to read the definition of "know-how" under the General Licence Agreement between Nestle SA and the Appellant, exhibited and marked "MC2" in the Respondent's Affidavit in Support of the Respondent's statement of Case, Know-how is defined in the said agreement as *"**Know-how**" shall mean those of LICENSOR's technical and non-technical information and data, whether capable of being patented or not, that are necessary for the industrial reproduction, directly and under the same conditions, of the Products and/or the technical or non technical processes related thereto, including all the LINCENSOR's unpatented secret processes, trade secrets, formulae and other secret information concerning industrial, commercial or scientific experience, and including the processes required for the transfer and /or implementation of the know-how, as LICENSOR shall from time to time be in a position to render or make available on an as-needed basis to LINCENSEE strictly for or in relation to its own or contract–manufactured manufacture, processing, control, packaging, storage, supply, import, export, marketing, promotion, distribution and/or selling of the Products, which have been developed by or*

for or are otherwise available to LICENSOR."(Emphasis ours)

Issues of marketing, import, distribution and storage are all covered in the agreement and includes aspects of the trade that the Appellant ought to pay for. There was therefore, nothing wrong in the use and payment of and for the intellectual property as it was subject of an agreement between the Appellant and its related party. We therefore, find the Respondent's arguments that the Appellant should not have paid for some of these functions for instance, unattainable and therefore, reject it, as it does not hold.

The Respondent has also argued one of the triggers to initiate the transfer pricing audit was, in its view inconceivable for a normal business to make huge payment such as the K4,500,000.00 paid by the Appellant in management fees when it only had capital of K2,300,000.00 and stressed that this amount is huge when compared to the capital. The Respondent formed the opinion that the Appellant was thinly capitalized. From the testimony of AW1 and RW2 and the evidence tendered, it becomes clear that the Appellant is thinly capitalised. Albeit there being thin capitalisation, we note that at the time these transactions took place, the Income Tax Act or any law did not have thin capitalisation provisions that applied to non-mining businesses such as the Appellant. Further, debt to equity ratio is a business decision based on the cost of financing and where the law does not stipulate the required ratios, adjustments can only be made if the loan or advance so procured is not used for the purpose of the business. It is therefore our finding that any adjustment the Respondent made as a result of the debt equity ratio is erroneous in the absence of any legislative prescription. Ground Two of the Appellant's Appeal succeeds.

With regard to Ground Four, the Appellant contends, *"that the Respondent erred in law and fact when it categorised the Appellant as a low risk distributor when it was shown beyond doubt that the Appellant was an independent full fledged distributor company undertaking all of the sales and distribution functions as well as the typical risk incurred in performing this function."*

The Appellant argues that it is a fully-fledged distributor that undertakes all sales and distribution functions as well as bearing the risk of carrying out such functions. It further argues that it undertakes operational and entrepreneurial

functions in distribution, marketing, sales and carries risks such as inventory, market, invoicing and credit risk. It also adds that the Appellant has its own board of Directors and that its structure is typically that of a multinational which includes continental and regional functions that ensure that subsidiaries, such as the Appellant's are strategies in line with the group strategy.

On the other hand, the Respondent argues that it was justified in categorizing the Appellant as a low risk distributor for the reasons, among others that; the Appellants does not control its operations but the same is done by Nestle Zimbabwe, a related party, that inventory risk does not entirely lie with the Appellant but is partly borne by related parties, that operations of the Appellant's are overseen from a related party in Zimbabwe, that sourcing s manufacturing company of the group

The Appellant's contention is that this categorization by the Respondent as a low risk distributor was incorrect based on the following grounds;

i) That the company bears the credit risk associated with the failure of customers to honor their payments as is indicated in the financial reports
ii) The company bears the full risk associated with the inventory that it buys and stored in leased warehouses and that the assumption that it does not have the financial capacity to assume this risk is incorrect.
iii) That though the company receives strategic direction from the head office it bears its own marketing and promotion expenses and the risks associated with it.
iv) That the company bears all the exchange risks associated with the FOREX fluctuations and that this is evident from the financial statements.

The Appellant also filed in an expert witness statement "MJ1" in which AW2 asserts that the Appellant is licensed to sell Nestle products in Zambia and it conducts the business by ordering the products, managing the logistics processes associated with the products, identifying and building customer relationships, undertaking selling and distribution functions, managing inventory and conducting marketing and advertising activities. The AW2 asserts that in view of this, the Appellant can be functionally characterized as a marketer distributor in respect of it conducting business in Zambia. By definition, *a marketer distributor*

undertakes sales and distribution functions as well as the typical risk incurred in performing the function of sales and marketing. In contrast a *limited risk distributor is one who in carrying out its activities has little or no strategic marketing responsibility but may undertake the day-to-day risks delegated by the manufacturer whose products the limited risk distributor buys and sells.*

Based on the testimonies of the witnesses, it is clear that there is a huge amount of control that is exercised by Nestle Zimbabwe over the Appellant with regards the strategic direction of the company and operations. This is evident from the testimony of the AW1 and the fact that it was AW1 that seems to know more about the Appellant's operations and business than any person locally employed and stationed in Zambia. We curiously find that the Appellant, being a full fledged distributor, as contended by the Appellant, did not have someone from within the local office to give testimony on its business operations locally. Seeing that there was none and the Appellant relied on AW1, from Nestle Zimbabwe, goes to aid the Respondent's contention that Nestle Zimbabwe controls the Appellant. Further, AW1 stated in his examination in chief that the Appellant, save for Technical Support, receives the following services from its related parties;

i. Strategic Management
ii. Sales Support Services
iii. Marketing Support
iv. Finance, Accounting and Legal Services
v. Procurement and Supply Chain Management
vi. Human Resources Management (HR)
vii. Information Technology Support (IT)

In our view, the functions outlined above, are all but the essential functions any business requires to not only survive but also thrive as a business. It is therefore clear from the same that there is quite little that the Appellant does on its own without the direction, assistance and control from its related party, Nestle Zimbabwe. Further, the "know-how" under clause 27 of the General Licence Agreement between Nestle SA and the Appellant, exhibited and marked "MC2" in the Respondent's Affidavit in Support of the Respondent's statement of Case asserts that know-how is the exclusive property of the Nestle SA. The said clause

27 states, *"It is acknowledged and understood by the parties hereto that the Know-how (including any improvements therein or developments thereto as foreseen in, but subject to, Clause 18 thereof) shall be and remain the exclusive property of Licensor"*. Know-how is defined in the same agreement as *"**Know-how**" shall mean those of LICENSOR's technical and non-technical information and data, whether capable of being patented or not, that are necessary for the industrial reproduction, directly and under the same conditions, of the Products and/or the technical or non technical processes related thereto, including all the LINCENSOR's unpatented secret processes, trade secrets, formulae and other secret information concerning industrial, commercial or scientific experience, and including the processes required for the transfer and /or implementation of the know-how, as LICENSOR shall from time to time be in a position to render or make available on an as-needed basis to LINCENSEE strictly for or in relation to its own or contract–manufactured manufacture, processing, control, packaging, storage, supply, import, export, marketing, promotion, distribution and/or selling of the Products, which have been developed by or for or are otherwise available to LICENSOR."(Emphasis ours)*

Our understanding of the above is that Nestle SA retains ownership, property in the products and the attendant risks in the know-how. Therefore, the ultimate risks in marketing, distribution, storage and/or selling of the products lies with Nestle SA and not with the Appellant. We therefore, are of the considered view that the functions, assets, inventory risks and know-how risks of the products that the Appellant sales emanating from its related parties, do not lie with the Appellant. By reason of the foregoing, there was nothing wrong with the Respondent categorizing the Appellant as a low risk distributor and as such, the Appellant's Ground Four fails and is accordingly dismissed.

In Ground Five, Appellant contends *"that the Respondent erred in law and fact when it used benchmarks that are neither comparable to the nature of the Appellant's business in Zambia nor the macro and micro economic conditions in Zambia; and*

As stated before, it has already been established that there were no internal or external comparables for benchmarking. The Respondent has, therefore, argued that the absence of internal or external as well as regional comparables necessitated the use of external comparables from Western Europe which the Appellant is objecting to. The sticking issue here is that of comparability in the

benchmarking exercise. It has been argued by the Appellant that the comparability of its transactions to those of companies in Western Europe was *neither comparable to the nature of the Appellant's business in Zambia nor the macro and micro economic conditions in Zambia;* In other words, the use of those comparables was disproportionate.

To begin with, it is important to note that there is nothing wrong in taking comparisons between transactions between or among related parties to those between independent parties.

"A comparison between conditions (including prices, but not only prices) made or imposed between associated enterprises and those which would be made between independent enterprises, in order to determine whether a re-writing of the accounts for the purposes of calculating tax liabilities of associated enterprises is authorised under Article 9 of the OECD Model Tax Convention"

Understanding the principle of comparability is paramount in order to answer the question of whether or not, the use of businesses in Western Europe by the Respondent, was disproportionate. **Chapter I (paragraphs 1.33 -1.79)** and **Chapter III of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations** (hereafter the **"TPG")** extensively discusses and provides understanding of comparability.

In transfer pricing, "Comparable" *does not mean "identical". To be comparable means that:*

i. *None of the differences (if any) between the situations being compared could materially affect the price or financial indicator being examined in the selected transfer pricing method, or*
ii. *Reasonably accurate adjustments can be made to eliminate the effect of any such differences. These are called "comparability adjustments".* (Emphasis ours)

We see from the arguments advanced by the parties that there seems to be a temptation to equate comparable to identical. It is rather about comparison of situations under which the transactions are compared. Invariably, *"application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. In order for such comparisons to be useful, the economically relevant*

characteristics of the situations being compared must be sufficiently comparable." (Emphasis ours)

Therefore, the comparison of the economic characteristics of the situation of the Appellant to those of the businesses based in Western Europe, being the issue, is what requires resolution. The Transfer Pricing Guidelines of the OECD has identified five comparability factors which are important in determining comparability. These are:

1. The characteristics of the property or services transferred.

"Differences in the specific characteristics of property or services often account, at least in part, for differences in their value in the open market. Therefore, comparisons of these features may be useful in determining the comparability of controlled and uncontrolled transactions. Characteristics that may be important to consider include the following:

i. In the case of transfers of tangible property, the physical features of the property, its quality and reliability, and the availability and volume of supply;

ii. In the case of the provision of services, the nature and extent of the services; and

iii. In the case of intangible property, the form of transaction (e.g. licensing or sale), the type of property (e.g. patent, trademark, or know-how), the duration and degree of protection, and the anticipated benefits from the use of the property."(Emphasis ours)

2. The functions performed by the parties (taking into account assets used and risks assumed), in relation to the controlled transaction. An examination thereof is often referred to as a "functional analysis".

"Therefore, in determining whether controlled and uncontrolled transactions or entities are comparable, a functional analysis is necessary. This functional analysis seeks to identify and compare the economically significant activities and responsibilities undertaken, assets used and risks assumed by the parties to the transactions. For this purpose, it may be helpful to understand the structure and organisation of the group and how they influence the context in which the taxpayer operates."

3. The contractual terms of the controlled transaction.
"In arm's length transactions, the contractual terms of a transaction generally define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the parties. As such, an analysis of contractual terms should be a part of the functional analysis discussed above."

4. The economic circumstances of the parties.

"Arm's length prices may vary across different markets even for transactions involving the same property or services; therefore, to achieve comparability requires that the markets in which the independent and associated enterprises operate do not have differences that have a material effect on price or that appropriate adjustments can be made." (Emphasis ours)

5. The business strategies pursued by the parties in relation to the controlled transaction

"Business strategies would take into account many aspects of an enterprise, such as innovation and new product development, degree of diversification, risk aversion, assessment of political changes, input of existing and planned labour laws, duration of arrangements, and other factors bearing upon the daily conduct of business. Such business strategies may need to be taken into account when determining the comparability of controlled and uncontrolled transactions and enterprises." (Emphasis ours)

In all the comparability factors stated above, what is evident is that the environment in which an enterprise operates has a huge bearing on arm's length assessment of that enterprise for purposes of a benchmarking exercise. Having had an understanding of what we have analysed above with regard to the suitability of comparable independent transactions, can we therefore, adjudge the use of businesses in Western Europe to have been disproportionate as contended by the Appellant? We will recite what we already cited above on what comparable means, which is,

i. *None of the differences (if any) between the situations being compared could materially affect the price or financial indicator being examined in the selected transfer pricing method, or*
ii. *Reasonably accurate adjustments can be made to eliminate the effect of any such differences. These are called "comparability adjustments".*

We do not find the use of businesses in Western Europe to benchmark the Appellant to have been proportionate as the situations of the Appellant and those of the businesses in Western Europe are, under the circumstances, incomparable and highly likely to materially affect the transfer price that was being enquired into during the transfer pricing audit conducted by the Respondent. Further, it is evident to us, that it would be very difficult to reasonably eliminate the potential huge differential arising from the transfer price adjustment. Therefore, it would not be possible to ensure that *reasonably accurate adjustments can be made to eliminate the effect of any such differences.*

We therefore find that the benchmark of the Respondent on the Appellant was disproportionate and as such capable of leading to inaccurate transfer price adjustment. Ground Five of the Appellant's Appeal therefore succeeds.

In Ground Six, the Appellant contends, *"that the Respondent erred in law and fact when it added back unrealised foreign exchange losses attributable to loan when the same were not included as expenses in the Appellant's financial statements."*

Regarding the issue of unrealized foreign exchange losses attributable to the loan the Appellant contends that the exchange losses were not included in the expenses under review and as such the add back is unwarranted. In defence of position, the Respondent argues that the exchange losses were disallowed during the period under review because they should have never been incurred in the first place had the Appellant obtained the correct amount of loan.

The law is very clear on what can or cannot be allowed as deductible either in foreign exchange or in losses. Section 29A (1), states that, *"Notwithstanding the provisions of section twenty-nine or any other provisions of this Act, any foreign currency exchange gains or losses, other than those of a capital nature, shall be assessable or deductible, as the case may be, in the charge year in which such gains or losses are realised, that is to say, in the charge year in which the person or partnership concerned is required to pay the additional kwacha or is allowed a rebate or a reduction in settlement of a foreign of a foreign debt or liability." (Emphasis ours)*

It is our considered view that accounts are prepared on an accrual basis and expenses should correspond to the year in which they are incurred. We find

therefore, that the Respondent can only make adjustment for the foreign exchange gains or losses if it can demonstrate that the Appellant has claimed the unrealized gains or losses. From evidence before us and from the testimony of and AW1 and RW1, there is nothing to show that the Appellant claimed these exchange gains or losses. That being the case, it was unjustifiable for the Respondent to add back unrealized foreign exchange losses attributed to the loan. The same were clearly not included as expenses by the Appellant in its financial statements and as such, there is no reason to have it punished by adding back these unrealized exchange losses. Ground Six succeeds and the adding back of the unrealised foreign exchange losses attributable to a loan is quashed.

The summary of our findings is that there was basis for initiating a transfer pricing audit in this case because as has been stated in Paragraph 1.129 of the OECD Guidelines that, *"When an associated enterprise consistently realises losses while the Multinational enterprise group as a whole is profitable, the facts could trigger some special scrutiny of transfer pricing issues."* We opine that the Appellant being in continuous loss making position, triggered an enquiry into transfer pricing issues but the manner in which the Respondent went about the enquiry was wrong. There could be transfer pricing issues that require scrutiny particularly in light of the testimony from AW1 that the Appellant is continuously making losses while its related parties are making profits.

The Appellant succeeds in Grounds One, Two, Three, Five and Six but fails in Ground Four. The net effect is therefore that the assessment by the Respondent that the Appellant was liable to pay a sum of ZMW13,860,103.00 was wrongly arrived at. This is so because the said assessment was based on inaccurate transfer pricing results emanating from use of an inappropriate transfer pricing method, disproportionate comparables and an unjustified add back of unrealized exchange losses. By reason of the foregoing, the assessment by the Respondent is accordingly and hereby set aside.

From what we have said that there could be transfer pricing issues requiring scrutiny, we consequently order that a reassessment be conducted within 180

days from the date of this Decision by the Respondent on an appropriate transfer pricing method. Whatever will be found due, be deducted from what the Appellant has already paid and the difference, if any, refunded to the Appellant.

We award costs to the Appellant to be agreed and in default of agreement, to be taxed.

Leave to appeal is granted.

Delivered at Lusaka this 28th day of March 2019

TAX APPEALS TRIBUNAL
PRIVATE BAG RW 565X
LUSAKA ZAMBIA

CHAIRPERSON

MEMBER

MEMBER