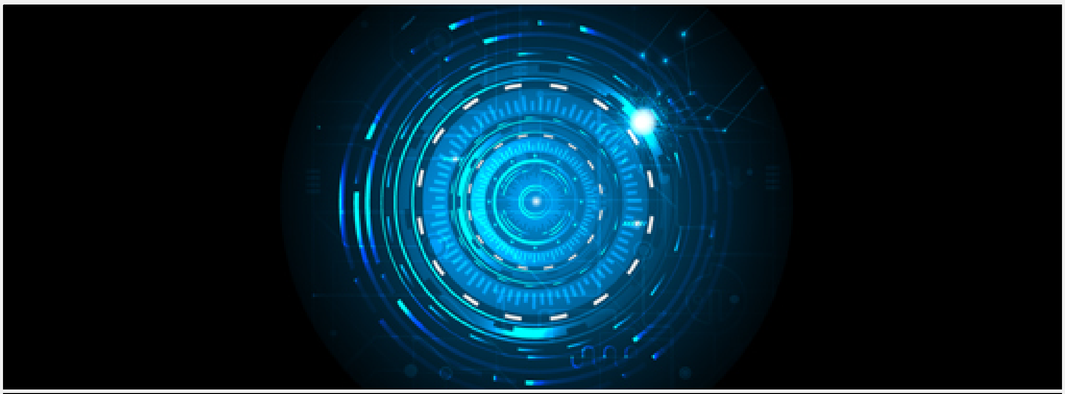

Zambia issues amended transfer pricing regulations

Global Transfer Pricing Alert 2018-014

Following extensive consultations with various stakeholders in 2017, the government of the Republic of Zambia has issued amended transfer pricing regulations through a government gazette dated 6 April 2018.

The issuance of these regulations -- Statutory Instrument No. 24 of 2018, the Income Tax (Transfer Pricing) (Amendment) Regulations, 2018 -- is in line with the global trend whereby various countries are taking legal steps to adopt the Organisation for Economic Co-operation and Development's (OECD's)'s base erosion and profit shifting (BEPS) final recommendations.

The amendment seeks to enhance the existing transfer pricing regulations, issued in 1999/2000, by providing detailed guidance on the application of the arm's length principle and Zambia's transfer pricing documentation requirements. The new regulations, read together with the Transfer Pricing (Regulations), 2000, are hereinafter referred to as the transfer pricing regulations.

Below is a summary of key provisions of the transfer pricing regulations.

Who is affected by the regulations?

The transfer pricing regulations apply to both domestic and cross-border transactions between associated persons. According to the Income Tax Act, two persons are associated if one person participates directly or indirectly in the management, control, or capital of the other or both of them.

The application of transfer pricing regulations to domestic transactions between associated persons within Zambia is not a unique development, as many countries in the region have adopted similar rules; however, most transfer pricing rules focus on cross-border transactions when the parties are located in different tax jurisdictions, thereby creating a potential for shifting profits from one country to the other. This development may impose a compliance burden on taxpayers even when there is no significant risk of erosion of the Zambian tax base.

Recognition of OECD guidelines and United Nations practical manual

The transfer pricing regulations recognize the application of the OECD transfer pricing guidelines and the *United Nations Practical Manual on Transfer Pricing for Developing Countries*. However, the regulations and the Zambian Income Tax Act (ITA) will prevail in case of any inconsistencies.

Determination of arm's length price

The transfer pricing regulations are largely consistent with the OECD guidelines/UN transfer pricing manual, and similarly provide five methods to be applied in the determination of the arm's length price in transactions between associated persons ("controlled transactions"). These methods are the traditional transaction methods -- the comparable uncontrolled price (CUP) method, the resale price method, and the cost plus method) -- and the transactional profit methods -- the transactional net margin method and the profit split method.

The transfer pricing regulations provide for the application of the most appropriate method, and allow taxpayers to apply to the Commissioner-General for approval of any other method, if the taxpayer can establish that none of the provided methods can reasonably be applied to the transaction.

Documentation requirements

Affected taxpayers should prepare contemporaneous documentation evidencing the arm's length nature of the controlled transactions for the relevant charge year. Documentation must be prepared on an annual basis, and maintained for six years. Documentation would be considered contemporaneous if it is in place by the due date of the annual income tax return, and should be submitted within 30 days upon request by the ZRA.

The regulations exempt persons who are not members of a multinational enterprise and whose turnover does not exceed ZMK 20 million (approximately USD 2 million) in any charge year from the transfer pricing documentation requirement. However, taxpayers would still be required to comply with the arm's length principle on their associated-party transactions.

Comparability analysis

The regulations provide general and specific guidance on comparability analyses to be performed by the taxpayer with respect to controlled transactions. The concept of comparability analysis is used in the selection of the most appropriate transfer pricing method, as well as to arrive at an arm's length price or financial indicator (or range of prices or financial indicators) and thus plays a central role in the overall application of the arm's length principle. The regulations provide five comparability factors that require consideration with respect to a controlled transaction, as follows:

- **Characteristics of the property or services:** 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.

- **Functions undertaken, assets used, and risks assumed:** In transactions between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed). Therefore, in determining whether controlled and uncontrolled transactions or entities are comparable, a functional, assets, and risk analysis is necessary.

- **Contractual terms:** 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, assets, and risk analysis discussed above.

- **Economic circumstances:** Arm’s length prices may vary across different markets even for transactions involving the same property or services; therefore, achieving 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.

- **Business strategies:** Business strategies must also be examined in determining comparability for transfer pricing purposes. 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 labor 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.

In addition to the general guidance discussed above, the regulations stipulate specific comparability considerations for the following associated-party transactions:

- **Acquisition of assets:** When used or new assets are acquired from nonresident associated persons, the taxpayer will provide the invoice payment, proof of date of acquisition of the asset from an independent third party, and delivery note. When the asset is sold in state other than the state of purchase, or there is no third-party invoice, or the asset is built or assembled using different component of different invoices, a technical appraisal may be required.

- **Intragroup services:** The regulations stipulate that in justifying the arm's length nature of intragroup services, the taxpayer must demonstrate that the services were actually rendered and a benefit was conferred and/or the economic or commercial value enhanced the taxpayer's commercial position. Further, charges will be considered inconsistent with the arm's length principle if they relate to shareholder costs or activities, or are considered duplicative activities.

- **Low-value-adding services:** In line with the OECD guidelines, the regulations provide for a simplified approach to low-value-adding intragroup services, and consider the application of cost plus 5 percent mark-up as arm's length.

- **Intangible property:** Transactions involving the license, sale, or other transfer of intangible property should consider special factors of comparability, such as expected benefits of the intangible property, any geographical limitations on the exercise rights, exclusive or non-exclusive character of rights transferred, and the transferee's right to participate in further developments of the intangible property.

Taxpayers will be required to take the above into account when setting or reviewing their transfer pricing policies for their controlled transactions.

Arm's length range

The transfer pricing regulations provide for the use of the interquartile range when the results include a sizeable number of observations and the taxpayer has made reasonable efforts to exclude points of lesser degree of comparability. When a taxpayer's results fall outside the arm's length range, the ZRA's Commissioner-General may adjust the taxpayer's results to the median. However, the regulations are silent on whether a downward adjustment to the median may be allowed when the taxpayer's income from a transaction falls above the interquartile range of the full results of benchmarking studies.

Corresponding adjustments

To eliminate economic double taxation arising from transfer pricing adjustments made in the counterparty's jurisdiction with respect to a controlled transaction, the regulations allow taxpayers to apply for a corresponding adjustment.

Penalties

Noncompliance with the regulations may result in an offense and liability upon conviction to penalties specified under the Income Tax Act.

Conclusion

The release of the regulations is a positive step and provides taxpayers with clearer guidelines in discharging their transfer pricing obligations. The regulations also signal the ZRA's likelihood of more formal, rigorous, and perhaps more frequent transfer pricing audits. We are aware based ongoing transfer pricing audits that the ZRA, in addition to the taxpayer's local TP file, are requesting for additional information not covered by the Transfer Pricing Regulations such a country-by-country report (CbCR), and master file, using statutory powers vested in the Commissioner-General under the Income Tax Act. It is now more urgent for taxpayers to review their transfer pricing policies and put in place required contemporaneous transfer pricing documentation.

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