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Tax Appeal Tribunal Delivers Judgement in maiden Transfer Pricing case in Nigeria

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The Tax Appeal Tribunal (TAT or "the Tribunal") sitting in Lagos recently delivered judgement in the case between Prime Plastichem Nigeria Limited (PPNL or "the Appellant") and the Federal Inland Revenue Service (FIRS or "the Respondent") on Transfer Pricing (TP). This is significant as it was the first TP judgement delivered in Nigeria since inception of the TP Regulations in 2012.

PPNL is a private limited liability company engaged in trading of imported plastics and petrochemicals in Nigeria. During 2013 and 2014 financial years (FYs), PPNL entered into a related party transaction with Vinmar Overseas Limited (VOL) for the supply of petrochemical products.

PPNL adopted the Comparable Uncontrolled Price (CUP) TP method to test whether the terms of the transaction with VOL for 2013 FY were at arm's length. In 2014 FY, PPNL changed the testing method to Transactional Net Margin Method (TNMM) using Operating Margin (OM) as the Profit Level Indicator (PLI). This, according to PPNL, was due to lack of information required for applying CUP. While the FIRS agreed with the change, it opted for Gross Profit Margin (GPM) as the most appropriate PLI, albeit for the two years. This led to an additional assessment of ₦1.7 billion.

TAT ruled in favour of the FIRS on all the issues raised by PPNL. A review of the issues tabled before the TAT by the Appellant shows that the Appellant based its case largely on the powers of the FIRS to make the adjustment. On the other hand, the FIRS based its response on core TP technical position to support the approach adopted. We have summarized below, the issues raised in the appeal and the pronouncement of the Tribunal in each instance.

Issues for determination

Issue 1:

Whether the Appellant proved its case before the Tribunal to be entitled to the claims and reliefs sought against the Respondent

TAT's Ruling

TAT agreed with the FIRS that the Appellant did not provide satisfactory information to justify both its use of the CUP method and subsequent change in methodology.

KPMG's Comments

Based on FIRS' arguments, PPNL did not provide adequate and consistent information to enable it to establish that the transaction was consistent with the arm's length principle. The 2012 and 2018 Nigerian TP Regulations clearly state that the burden of proof of compliance with the arm's length principle is on the taxpayer. Furthermore, Regulation 9 of the 2012 Nigerian TP Regulations states that:

"The documentation retained by a connected taxable person shall be adequate to enable the Service verify that the controlled transaction is consistent with the arm's length principle."

As provided in the TP Regulations, it is important that taxpayers prepare detailed documentation on all related party transactions to justify decisions made, in accordance with the TP Regulations, the Organisation for Economic Cooperation and Development (OECD) Guidelines and the United Nations (UN) TP Manual. This is necessary to ensure that in the event of a TP dispute, taxpayers are able to successfully defend the arm's length nature of their related party transactions and counter any argument raised by the tax authority. This should also enable taxpayers to defend the method adopted as the most appropriate to analyze their related party transactions.

Issue 2:

Whether the Respondent's action in benchmarking the Appellant's TP transaction with the TNMM for 2013 and 2014 FYs was valid and in accordance with the Transfer Pricing Regulations 2012 and the OECD/UN Guidelines.

TAT's Ruling

The TAT held that the Appellant did not provide sufficient documentation to satisfactorily explain its use of different TP methods in 2013 and 2014 FYs. The Appellant had selected the CUP as the most appropriate method in 2013 FY and the TNMM in 2014 FY. Essentially, the TAT agreed with the position of the FIRS that the Appellant had failed to discharge its burden of proof concerning the selection of TP methods for the relevant years.

Furthermore, the TAT held that consistency in the application of methods from year to year is very important and fundamental.

KPMG's Comments

Best practices concerning selection of TP methodology involves a process that starts with a consideration of the respective strengths and weaknesses of the various TP methods, followed by a detailed Function, Asset and Risk (FAR) analysis. The FAR analysis enables the taxpayer to accurately characterize the related party transaction. Accurate characterization of a controlled transaction will enable the taxpayer to select an appropriate TP method for analyzing the controlled transaction. Finally, the taxpayer is expected to consider the availability of information required to apply the method as well as the degree of comparability between the controlled and uncontrolled transactions.

There are instances where more than one TP method may be considered appropriate in analyzing a controlled transaction after following the TP method selection procedure. In such instances, the OECD Guidelines and UN TP Manual recommend the selection of the Most Appropriate Method (MAM) based on the information obtained from the selection procedure. However, the chosen TP method is generally expected to be applied consistently by the taxpayer.

While the taxpayer is expected to apply the chosen TP method consistently, the TP method may be changed if there are any changes in the facts of the controlled transaction, functions of the entities involved or availability of data in subsequent periods. It is, therefore, very important for taxpayers to select a TP method based on the recommended procedure, maintain clear and sufficient documentation of the selection procedure and provide records of any changes which occurred during the relevant period that necessitated the change in the TP method.

Issue 3:

Whether the Respondent's action of using the GPM as the PLI in the instant Transfer Pricing transaction is valid and in accordance with the TP Regulations, OECD and UN Guidelines.

TAT's Ruling

The TAT held that the TNMM with the GPM as a PLI was the most appropriate PLI in this instance based on OECD Guidelines as explained by the Respondent.

KPMG's Comment

Based on the rules on the application of the TP methods in the OECD Guidelines and the UN TP Manual, the TNMM seeks to test the net profit margin of a company relative to an appropriate base, e.g., costs, sales or assets. Gross profit level indicators should ideally be used when the selected TP method tests a company's performance at the gross profit level such as where a taxpayer selects the Resale Price Method (RPM) or the Cost-Plus Method (CPM). Regulation 18 of the Nigeria TP Regulations provides that the TP Regulations shall be applied in a manner consistent with the OECD Guidelines and UN TP Manual.

However, in complete contrast to the OECD Guidelines, the FIRS applied the TNMM using a gross profit level indicator, that is, the GPM. It is, therefore, clear that the FIRS was wrong in saying that the method applied to analyze the transaction was the TNMM, as the PLI (GPM) adopted is not consistent with the definition and application of the TNMM as described in the OECD Guidelines and the UN TP Manual. This is because the OECD Guidelines and UN TP Manual both recognize the GPM as the PLI to be applied when using the RPM.

Issue 4:

Whether the Appellant's failure to file their returns within the prescribed period required by the extant tax laws validates the penalty and interest imposed by the Respondent vis-à-vis the provisions of paragraph 4(2) of the TP Regulations 2012, Section 55 of the Companies Income Tax Act, Cap. C21 LFN, 2004 (CITA) and Section 32 of the Federal Inland Revenue Service (Establishment) Act 2007 (FIRSEA).

TAT's Ruling

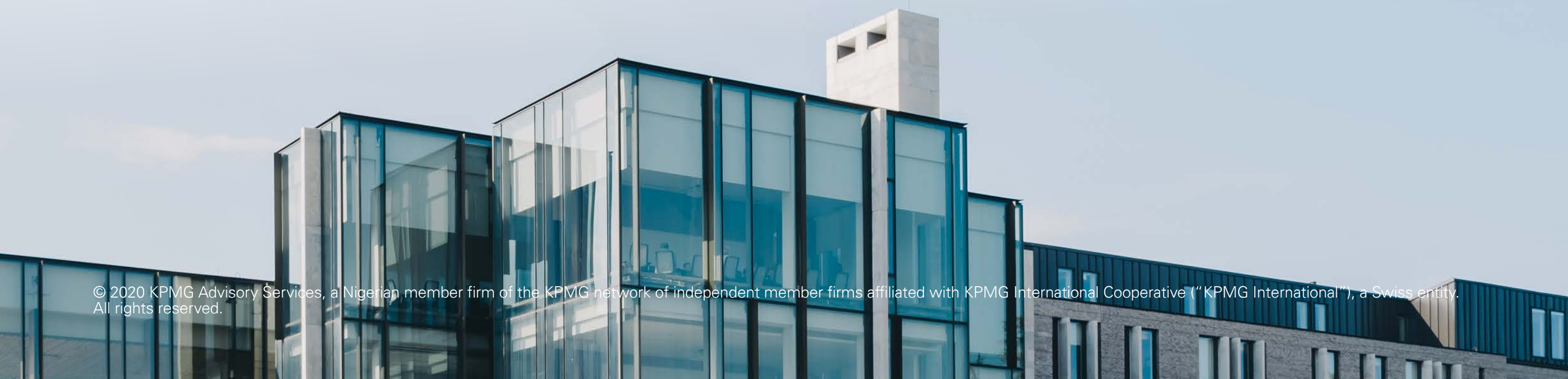
TAT held that the FIRS was right to disregard the TP method used by the Appellant and upheld the imposition of penalty and interest based on the Appellant's failure to file its returns and pay the relevant taxes as and when due.

KPMG's comments

Section 55 of CITA and Section 32 of FIRSEA establish the FIRS' authority to impose penalties on companies that fail to self-assess and file their tax returns within 6 months of their year-end and to further impose penalties and charge interest for as long as the returns remain outstanding. But the TP Regulations does not specify any penalty where the FIRS makes an adjustment to the conditions imposed by connected taxable persons in controlled transactions. In addition, Section 22 of CITA which empowers the FIRS to adjust "artificial transactions" does not stipulate the imposition of penalties or interest where such adjustments are made.

However, the TAT, in its judgement in *Weatherford S.D.E.R.L vs the FIRS*, where the FIRS had imposed penalty and interest on additional CIT assessments originating from a tax audit, ruled that penalty and interest on additional assessments should only be applied when the assessment or demand notice becomes final and conclusive. This position is further buttressed by the TAT's judgement in *Tetra Pak West Africa Limited vs FIRS*.

Based on the above, the appropriateness of the TAT decision upholding the imposition of interest and penalty on tax liabilities arising from the FIRS varying the TP method adopted by a taxpayer is questionable.



Issue 5:

Whether the Defendant Decision Review Panel purportedly set up by the Respondent was in accordance with the TP Regulations.

TAT's Ruling

TAT held that the action to trigger the filing of the appeal is the receipt of Assessment on the Adjustment and not a formal notification from FIRS of the setting up of the Decision Review Panel (DRP or "the panel"). The TP Regulations, 2012 mandates the FIRS to set up a DRP for resolving any dispute or controversy arising from the application of the provisions of the Regulations. The FIRS' setting up of the DRP and subsequently inviting the taxpayer, is in line with the TP Regulations.

KPMG's comments

According to Regulation 14(1) of the TP Regulations (2012), the FIRS is empowered to set up a DRP to resolve any dispute or controversy arising from the application of the provisions of the TP Regulations. The DRP is responsible for hearing and addressing the issues raised by either the FIRS or the taxpayer. Regulation 14(3) stipulates a 30-day period within which the taxpayer may refer the adjustment received from the FIRS to the DRP. The DRP also reserves the right to issue a formal adjustment where a taxpayer fails to refer the adjustment to the Panel within thirty days of receipt of the adjustment.

It appears that there is a misconception about the role and *modus operandi* of the DRP. However, this has been made clearer in the 2018 TP Regulations which vests the FIRS with the sole power to refer a TP dispute to the DRP.

Conclusion

This landmark judgement by the TAT is indicative of the growth in the TP practice in Nigeria. The ruling also highlights the importance of maintaining robust TP documentation and the need for taxpayers to pay more attention to their TP affairs by ensuring availability of ample information to defend the arm's length nature of their related party transactions.

From a technical point of view, however, the outcome of the judgement may have been different if both the Appellant and the Respondent had made use of expert witnesses to clarify and further strengthen their arguments. It is common practice to use expert witnesses in court proceedings requiring technical knowledge. The use of expert witnesses would have provided a platform for an in-depth and technically sound judgement as their expertise would have provided clarity on certain key issues, such as the TP method selection procedure, the application of the method selected and the rationale behind a change in methodology. The TAT based its judgement on the information made available to it by the Appellant and the Respondent, which did not provide sufficient information for a more informed decision.

For further enquiries, please contact:
Wole Obayomi
NG-FMTAXEnquiries@ng.kpmg.com

home.kpmg/ng
home.kpmg/socialmedia