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TAX APPEAL TRIBUNAL- TRANSFER PRICING JUDGMENT

INTRODUCTION

On 19 February 2020, the Nigerian Tax Appeal Tribunal (the "**Tribunal**"), sitting in Lagos delivered its first ever judgement on a transfer pricing (**TP**) dispute under Nigeria's Income Tax (Transfer Pricing) Regulations No 1, 2012 (**TP Regulations**) in the tax appeal filed by Prime Plastichem Nigeria Limited (the "**Appellant**") against the Federal Inland Revenue Service (the "**FIRS**" or "**Respondent**").

In its judgment, the Tribunal upheld the Respondent's TP assessment of about $4.8 million against the Appellant.

Background of the Case

Prime Plastichem Nigeria Limited, the Appellant in the case, is a company registered in Nigeria which purchases industrial plastics and petrochemicals from its related supplier, Vinmar Overseas Limited (**VOL**) and distributes to its customers.

The Appellant filed its TP Documentation for the 2013 and 2014 financial years in respect of the transactions with VOL. In the 2013 Financial Year, the Appellant applied the Comparable Uncontrolled Price (**CUP**) Method [1] in determining whether or not its purchase price meets the Arm's Length Price (**ALP**) requirements [2]. However, in the 2014 Financial Year, the Appellant applied the Transactional Net Margin Method (**TNMM**) [3] to determine the ALP using the Operating Margin as the most appropriate Profit Level Indicator (**PLI**) for the transaction.

The Position of the FIRS

Upon review of the Appellant's TP documentation, the Federal Inland Revenue Service as the Respondent in the case was of the view that the Appellant had wrongly applied the CUP Method in determining the ALP in 2013, the reason being that the comparable data for 2013 did not meet the comparability requirements provided for by the TP Regulations. The Respondent also argued that although the Appellant had used the TNMM in the 2014 Financial Year, it had wrongly used its Operating Margin as

1 The CUP Method is used to ensure transactions between related companies are comparable in price to those conducted with unrelated organizations. - <https://www.valentiam.com/newsandinsights/comparable-uncontrolled-price> accessed online on 28 May 2020

2 The "arm's-length principle" in transfer pricing states that the amount charged by one related party to another for a given product or service must be the same as if the parties were not related. For a transaction, an arm's-length price is therefore what the price of that transaction would be on the open market. - <https://transferpricingasia.com/what-is-tp/arms-length/> accessed online on 28 May 2020

3 The transactional net margin method examines a net profit indicator that a taxpayer realises from a controlled transaction with the net profit earned in comparable uncontrolled transaction. - < https://www.oecd.org/ctp/transfer-pricing/45765701.pdf> accessed online on 28 May 2020

its PLI, and argued that the Appellant should have used its Gross Profit Margin [4] in determining its ALP in 2013 and 2014 seeing as this was the most appropriate PLI for the assessment of the arm's length condition in both years.

The Respondent therefore made TP adjustments to the relevant Financial Years and raised an additional tax assessment of over N1,738,481,875.33 (One Billion, Seven Hundred and Thirty Eight Million, Four Hundred and Eighty-One Thousand, Eight Hundred and Seventy- Five Naira, Thirty Three kobo) on the Appellant, and this tax assessment was upheld by the Federal Inland Revenue Service's Decision Review Panel (**FIRS DRP**).

The Appeal

The Appellant was dissatisfied with the decision of the FIRS DRP and went ahead to file an appeal at the Tribunal challenging the imposition of the additional tax assessments.

The summary of the issues before the Tribunal was whether the Respondent's action in benchmarking the Appellant's TP transaction with the TNMM for the 2013 and 2014 Financial Years was valid and in accordance with the TP Regulations and the Organization for Economic and Development/United Nations Transfer Pricing Guidelines 2010 (**OECD/UN Guidelines**), and whether applicable interest and penalties could be imposed by the Respondent based on the additional assessment. The Tribunal also determined the issue of whether the FIRS DRP which upheld the Respondent's position had been properly constituted in line with the provisions of the TP Regulations, OECD and United Nation's Guidelines.

In its appeal, the Appellant argued as follows:

i. that the CUP Method was the most appropriate TP method to use in 2013 and its change from the use of the CUP Method to TNMM in 2014 was only as a result of the lack of comparable data in 2014;

4 Gross Profit is essentially calculated as gross profit divided by operating revenue.

ii. that the Respondent did not provide a basis for rejecting the CUP method for 2013 and was therefore bound to accept the CUP as applied by the company;

iii. that the use of the Gross Profit Margin as PLI by the Respondent was wrong and unsupported by precedent or prevailing practice;

iv. that the DRP had not been properly constituted as the FIRS did not issue any formal notification in this regard thus, denying the Company of its right to fair hearing under the law;

iv. in relation to the interests and penalties on the additional assessment imposed by the Respondent, the Appellant argued that the said interests and penalties should not apply because it had filed its Companies Income Tax returns as and when due; and

v. in relation to the interests and penalties on the additional assessment imposed by the Respondent, the Appellant argued that the said interests and penalties should not apply because it had filed its Companies Income Tax returns as and when due; and

vi. that the Respondent could not challenge its TP position because it had prepared the TP documentation in line with the law and provided all the information requested by the Respondent.

The Respondent disagreed with the Appellant arguing that it did not provide reliable and sufficient information to prove that the CUP Method was the most appropriate method to use in the 2013 Financial Year. It is also argued that the Appellant had provided inconsistent information about the activities of VOL which makes the comparable transactions involving VOL an unreliable benchmark thereby failing to discharge the legal burden of proof required to establish its claims and reliefs in the appeal as required by section 131 and 1332 of the Evidence Act.

The Decision of the Tribunal

The Tribunal agreeing with the FIRS ruled in favour of the Respondent dismissing the appeal in its entirety. The Tribunal in reaching its decision relied heavily on the arguments of the Appellant and held that the TNMM was the appropriate benchmarking method for TP in this case. The Tribunal stated that the claim made by the Appellant had no legal basis and stated that:

> *"Since the Appellant was unable to provide to the Respondent reliable information that satisfactorily explained its use of CUP method for 2014 assessment year, the Respondent has no choice but to jettison the CUP method used and adopt the TNMM for 2014 and 2015 assessment years respectively. The Respondent justified its rejection of CUP method because its decision was in accordance with the TP Regulations and also in consonance with the provisions canvassed by the OECD in its transfer pricing guidelines. This fact is alluded to by the testimony of the Appellant Witness who admitted in the course of his evidence before this Tribunal that the use of CUP methods requires reliable data. the Tribunal agrees with the submission of the Respondent that the Appellant has not proved its case to the satisfaction of this Tribunal to enable it to be entitled to the claims and reliefs sought against the Respondent in this appeal."*

The Tribunal also upheld the Appellant's application of the Gross Profit Margin as the appropriate PLI for the said transactions. It stated that:

> *"By the provisions of paragraph 5(2) of the TP Regulations, availability of reliable information is a necessary condition for a transfer pricing method to be considered most appropriate. So, the Respondent's rejection of CUP was in consonance with the provisions of the TP Regulations and that the rejection is also in consonance with the provisions canvassed by the OECD in its transfer pricing guidelines. Consistency in the application of benchmarking method from year to year is also very important and fundamental. (Par. 29.4 of the OECD TP Guidelines.)"*

As regards the Appellant's application of interest and penalties on the Respondent, the Tribunal held that the Appellant has the power to disregard the TP method adopted by a taxpayer under the TP Regulations and to also impose penalties enshrined in the relevant tax law for failure to file their returns and pay the taxes when due. According to the Tribunal:

> *"Paragraph 4(2) of the TP Regulations provides that "where a connected taxable person fails to comply with the provisions of this regulation, the Service shall make adjustments where necessary if it considers that the conditions imposed by connected taxable persons in a controlled transactions are not in accordance or consistent with the arm's length principle". Furthermore, Section 55 of the Companies Income Tax Act talks about the requirement of every company to file self-assessment returns with the FIRS while section 32 of the FIRS Act 2007 prescribes penalties for failure to pay tax within the periods prescribe under the relevant tax laws. The import of all of these provisions is that the FIRS has the power to disregard the TP method adopted by the taxpayer, so long as this is done with due regard to Paragraph 5(2) of the TP regulations and impose penalties enshrined in the relevant tax laws on the Appellant for failure to file their returns and pay the relevant taxes as at when due".*

With respect to the FIRS DRP, the Tribunal stated that it was evident that the FIRS DRP had been set up, and the understanding of the law under paragraph 14(3) of the TP Regulations is that a taxpayer may file an appeal to the FIRS DRP within 30 (thirty) days of receipt of its assessment. The Tribunal stated that:

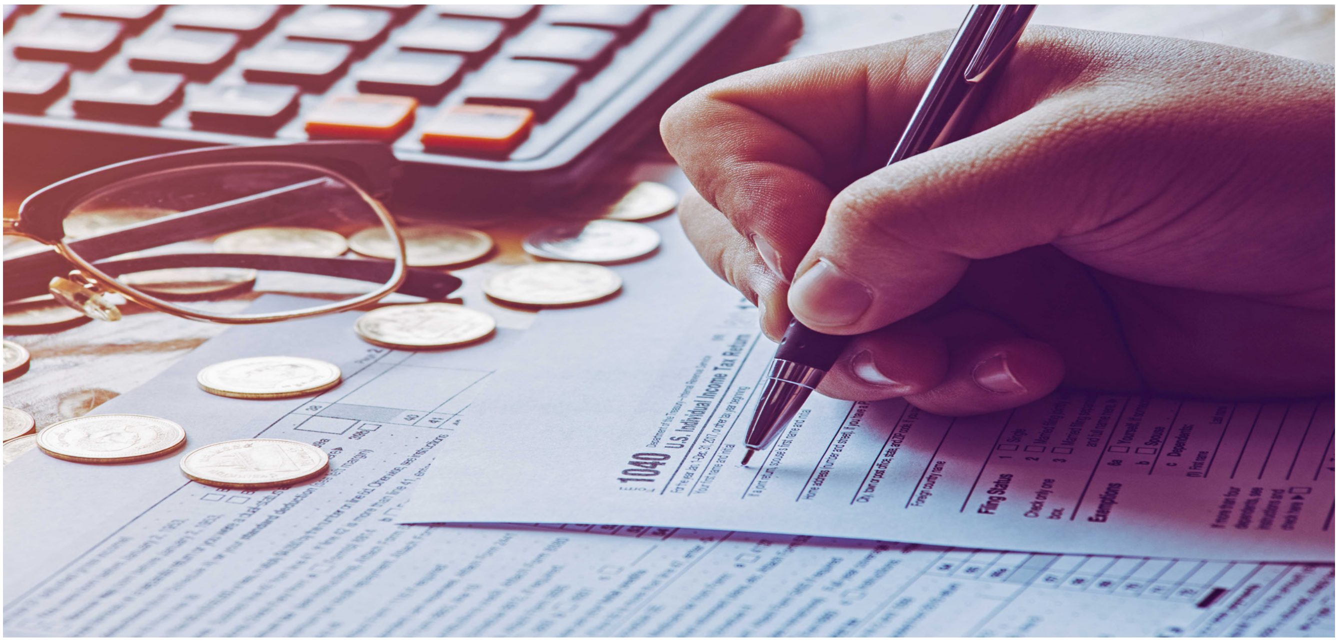
> *"Paragraph 14(1) of the TP Regulations 2012 mandates the FIRS to set up a Decision Review Panel for the purposes of resolving any dispute or controversy arising from the application of the provisions of this Regulations. The contemplation of the law as stated in Paragraph 14(3) of the TP Regulation is that the Taxpayer may within 30 days of the receipt of the assessment on the adjustment carried out under Paragraph 4(2) of the TP Regulation refer the assessment to the Panel."*

The Tribunal therefore held that the action to trigger filing of an appeal at the FIRS DRP is the receipt of the assessment and not a formal notification from the FIRS of the setting up of the FIRS DRP, and it is evident that FIRS set up the DRP and subsequently invited the Appellant.

The Tribunal's decision in this case reiterates the provision of paragraph 6 (10) of the TP Regulation which places the burden of proof of the arm's length nature of a controlled transaction [5] on the taxable person. In

5 The Income Tax (Transfer Pricing) Regulations 2012 defines "Controlled Transactions" to mean transactions between connected taxable persons, i.e. transactions between two enterprises that are associated enterprises with respect to each other.

this case, the Appellant failed to convince both the FIRS DRP and the Tribunal that its TP position satisfies the arm's length principle.[6]



Our View

Section 6(10) of the TP Regulations provides that *"the burden of proof that the conditions of the controlled transactions are consistent with the arm's length principle shall be that of the taxable person and the taxable person will be regarded as satisfying this burden of proof if it provides documentation consistent with this Regulation to support the consistency with the arm's length principle of the taxable profits derived from its controlled transactions."* This shows that the law places the burden of proof on the taxpayers to show that whatever transactions are carried out are done on an arm's length basis.

The decision made by the Tribunal appears to have been made based on the inability of the Appellant to provide reliable and sufficient information to prove its case as required by the TP Regulations. However, as this is a maiden case, it is unclear what standard of proof was relied on by the Tribunal in examining the information and argument presented by the Appellant. Furthermore, it seems that taxpayers must provide all required information that is correct, consistent and necessary to justify their TP choices, benchmark and prices, as according to the Tribunal, the Appellant failed to do so.

On the Respondent's arguments on whether different TP Methods can be applied in different years where facts are not substantially different, the Tribunal in agreeing with the Respondent relied on a non-existent paragraph 29.4 of the OECD/UN Guidelines stating that *"consistency in the application of benchmarking method from year to year is also very important and fundamental."* However erroneous the quotation was, the statement was supported by paragraph 6.1.3.3. of the United Nations Practical Manual on Transfer Pricing for Developing Countries 2013 (**UN TP Manual**) which provides that a change in TP method is typically required only if there are any changes in the facts of the transaction, functionalities of the parties to the transaction or availability of data.

6 Tax Appeal Tribunal's Judgement, "Transfer Pricing in Nigeria", < https://pwcnigeria.typepad.com/files/tat-ruling_tp-case-prime-plastichem-nig-ltd-v.-firs.pdf> accessed online on 28 May 2020

The Appellant argued that there was a change of TP Method due to the non-availability of data, while the Respondent relied on the fact that the functionalities of the parties to the transaction and the facts of the transaction had not changed. We believe that however valid, the Appellant did not make a persuasive argument to support its reason of the non-availability of data and convince the Tribunal.

Conclusion

Due to the fact that TP is a very risky area in taxation, it is advised that taxpayers should ensure that TP specialists and other personnel within their organization be involved in TP matters from the inception. This is to prevent incorrect representations from being made to the tax authorities by persons who may not have the knowledge in such matters.

Furthermore, it appears that the FIRS prefers to apply the Gross Profit Margin as the arm's length profit indicator when the transaction involves purchases from related parties for resale to third parties. Therefore, even where a taxpayer is convinced that a different PLI is more appropriate, it is safe to consider making use of the Gross Profit Margin as a secondary check during the TP documentation process.

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