

Zimbabwe Revenue Authority  
Transfer Pricing Practice Notes

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## Glossary

### **Arm's length principle**

An international standard which states that where conditions are made or imposed between two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

### **Arm's length range**

A range of figures that are acceptable for establishing whether the conditions of a controlled transaction are arm's length and that are derived either from applying the same transfer pricing method to multiple comparable data or from applying different transfer pricing methods.

### **Associated Persons**

Two persons are associated persons with respect to each other if they meet the conditions set out in section 2A of the Income Tax Act (Chapter 23:06)

### **Comparability Analysis**

A comparison of a controlled transaction with an uncontrolled transaction or transactions. Controlled and uncontrolled transactions are comparable if none of the differences between the transactions could materially affect the factor being examined in the methodology (e.g. price or margin), or if reasonably accurate adjustments can be made to eliminate the material effects of any such differences.

### **Comparable uncontrolled transaction**

A comparable uncontrolled transaction is a transaction between two independent parties that is comparable to the controlled transaction under examination. It can be either a comparable transaction between one party to the controlled transaction and an independent party (“internal comparable”) or between two independent parties, neither of which is a party to the controlled transaction (“external comparable”).

### **Comparable uncontrolled price (CUP) method**

A transfer pricing method that compares the price for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.

### **Compensating adjustment**

An adjustment in which the taxpayer reports a transfer price for tax purposes that is, in the taxpayer's opinion, an arm's length price for a controlled transaction, even though this price differs

from the amount actually charged between the associated enterprises. This adjustment would be made before the tax return is filed.

### **Contribution Analysis**

An analysis used in the profit split method under which the combined profits from controlled transactions are divided between the associated enterprises based upon the relative value of the functions performed (taking into account assets used and risks assumed) by each of the associated enterprises participating in those transactions, supplemented as much as possible by external market data that indicate how independent enterprises would have divided profits in similar circumstances

### **Controlled transactions**

Transactions between two persons that are associated persons with respect to each other.

### **Corresponding adjustment**

An adjustment to the tax liability of the associated person in a second tax jurisdiction made by the tax administration of that jurisdiction, corresponding to a primary adjustment made by the tax administration in a first tax jurisdiction, so that the allocation of profits by the two jurisdictions is consistent.

### **Cost contribution arrangement (CCA)**

A CCA is a framework agreed among persons to share the costs and risks of developing, producing, or obtaining assets, services, or rights, and to determine the nature and extent of the interests of each participant in the results of the activity of developing, producing, or obtaining those assets, services, or rights.

### **Cost plus mark-up**

A mark-up that is measured by reference to margins computed after the direct and indirect costs incurred by a supplier of property or services in a transaction.

### **Cost plus method**

A transfer pricing method using the costs incurred by the supplier of property (or services) in a controlled transaction. An appropriate cost plus mark-up is added to this cost, to make an appropriate profit in light of the functions performed (taking into account assets used and risks assumed) and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction

### **Direct – charge method**

A method of charging directly for specific intra-group services on a clearly identified basis.

## **Direct costs**

Costs that are incurred specifically for producing a product or rendering service, such as the cost of raw materials.

## **Double taxation treaty**

A treaty made between two countries agreeing on the tax treatment of residents of one country under the other country's tax system.

## **Economic double taxation**

"Economic double taxation" is where two different legal persons are taxed on the same income or other taxable item by more than one State.

This may occur, for example where two States take different views of the profits made in transactions between a subsidiary resident in one of the States in its transactions with a parent company in the other State, so that at least some part of the profits on the transaction are taxed in both States.

## **Functional analysis**

An analysis of the functions performed (taking into account assets used and risks assumed) by associated persons in controlled transactions and by independent persons in comparable uncontrolled transactions.

## **Gross profits**

The gross profits from a business transaction are the amount computed by deducting from the gross receipts of the transaction the allocable purchases or production costs of sales, with due adjustment for increases or decreases in inventory or stock-in-trade, but without taking account of other expenses.

## **Independent enterprises**

Two persons are independent persons with respect to each other if they are not associated persons.

## **Indirect charge method**

A method of charging for intra-group services based upon cost allocation and apportionment methods.

## **Indirect costs**

Costs of producing a product or service, which, although closely related to the production process, may be common to several products or services (for example, the costs of repair department that services equipment used to produce different products).

**Intra-group service**

An activity (e.g. administrative, technical, financial, commercial, etc.) for which an independent persons would have been willing to pay or perform for itself.

**Intentional set-off**

A benefit provided by one associated person to another associated person within the group that is deliberately balanced to some degree by different benefits received from that person in return.

**Marketing intangible**

An intangible that is concerned with marketing activities, which aids in the commercial exploitation of a product or service and/or has an important promotional value for the product concerned. Depending on the context, marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers

**Multinational enterprise group (MNE group)**

A group of associated companies with business establishments in two or more countries.

**Multinational enterprise (MNE)**

A company that is part of an MNE group.

**Mutual agreement procedure**

A means through which tax administrations consult to resolve disputes regarding the application of double tax conventions. This procedure described and authorised by Article 25 in Zimbabwe's Double Tax Agreements, can be used to eliminate double taxation that could arise from a transfer pricing adjustment.

**Net profit indicator**

The ratio of net profit to an appropriate base (e.g. costs, sales, assets). The transactional net margin method relies on a comparison of an appropriate net profit indicator for the controlled transaction with the same net profit indicator in comparable uncontrolled transactions.

**“On call” services**

Services provided by a parent company or a group service centre, which are available at any time for members of an MNE group.

## **Primary adjustments**

An adjustment that a tax administration in a first jurisdiction makes to a company's taxable profits as a result of applying the arm's length principle to transactions involving an associated person in a second tax jurisdiction.

## **Profit potential**

The expected future profits. In some cases it may encompass losses. The notion of “profit potential” is often used for valuation purposes, in the determination of an arm’s length compensation for a transfer of intangibles or of an ongoing concern, or in the determination of an arm’s length indemnification for the termination or substantial renegotiation of existing arrangements, once it is found that such compensation or indemnification would have taken place between independent parties in comparable circumstances.

## **Profit split method**

A transactional profit method that identifies the combined profit to be split for the associated persons from a controlled transaction (or controlled transactions that it is appropriate to aggregate under the principles of the Thirty-fifth Schedule) and then splits those profits between the associated persons based upon an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm’s length.

## **Resale price margin**

A margin representing the amount out of which a reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. Resale price method

A transfer pricing method based on the price at which a product that has been purchased from an associated person is resold to an independent person. The resale price is reduced by the resale price margin. What is left after subtracting the resale price margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. custom duties), as an arm’s length price of the original transfer of property between the associated persons.

## **Residual analysis**

An analysis used in the profit split method, which divides the combined profit from the controlled transactions under examination in two stages. In the first stage, each participant is allocated sufficient profit to provide it with a basic return appropriate for the type of transactions in which it is engaged. Ordinarily this basic return would be determined by reference to the market returns achieved for similar types of transactions by independent persons. Thus, the basic return would generally not account for the return that would be generated by any unique and valuable assets possessed by the participants. In the second stage, any residual profit (or loss) remaining after the first stage division would be allocated among the parties based on an analysis of the facts and circumstances that might indicate how this residual would have been divided between independent persons.

**Shareholder activity**

An activity which is performed by a member of an MNE group (usually the parent company or a regional holding company) solely because of its ownership interest in one or more other group members, i.e. in its capacity as shareholder.

**Tested party**

The participants in a controlled transaction that is the party by reference to whom a particular transfer pricing method is applied.

**Uncontrolled transactions**

A transfer pricing term for transactions between persons that are independent persons (that is, that are not "associated persons") with respect to each other.



## 1 Introduction

- (1) These Practice Notes layout the Commissioner's-interpretation of Zimbabwe legislation and regulations relating to transfer pricing.
- (2) The Practice Notes are not intended to be a prescriptive or an exhaustive discussion of all potential transfer pricing issues that might arise in the course of business but provide Practice Notes and procedures that should be followed in determining the arm's length conditions for controlled transactions within the context of the Zimbabwe business environment.
- (3) Section 98B as read with the 35<sup>th</sup> Schedule to the Income Tax Act (Cap 23:06) (The Act) broadly adopts the internationally accepted "Arm's Length Principle" for the purposes of determining the income and associated expenditure for transactions between associated persons. Accordingly, these Practice Notes have been drafted in a manner broadly consistent with the Arm's Length Principle as laid out in Article 9 of the ATAF, OECD and UN Model Tax Conventions on Income and Capital; and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.
- (4) The ATAF Practice Notes, OECD Transfer Pricing Guidelines and UN Practical Manual on Transfer Pricing are relevant sources of interpretation for purposes of The Act and these Practice Notes. Where there is inconsistency between these Practice Notes and The ATAF Practice Notes, OECD Transfer Pricing Guidelines and UN Practical Manual on Transfer Pricing, these Practice Notes, together with the relevant legislation and regulations enshrined in Zimbabwe's law, shall prevail.
- (5) These Practice Notes are meant for guidance only and do not in any way purport to replace the Tax Act. Where there is inconsistency between these Practice Notes and The Act the latter shall prevail to the extent of the inconsistency.
- (6) Where a treaty is in force between the jurisdictions of the parties to a controlled transaction, the provisions of that treaty will prevail over the The Act.

### **Fundamental Features of the Transfer Pricing Practice Notes**

- (1) The Zimbabwe transfer pricing rules apply the 'arm's length principle' to controlled transactions. This means that the results of a controlled transaction should be consistent with the results that would have been realised in a comparable transaction between independent persons dealing under comparable conditions.
- (2) The Income Tax Act [chapter 23:06] require that taxable income of a person is calculated on the basis that the arm's length principle is applied in relation to all controlled transactions.
- (3) In cases where the conditions of a controlled transaction are not in accordance with the arm's length principle, then the taxpayer must make the appropriate adjustments to ensure

that the taxable income of the person is calculated in accordance with the arm's length principle.

- (4) Where a calculation of taxable income is not in accordance with the arm's length principle, and the result is that the measure of taxable income is understated, or a measure of taxable loss is overstated this will constitute an incorrect Income Tax Return and the Commissioner shall make the necessary adjustment to calculate the taxable income in a manner consistent with the arm's length principle. **Interest and penalties may also be eligible in respect of the adjustment.**
- (5) The arm's length principle requires careful delineation of the actual transaction between the associated persons by analysing the contractual relations between the parties in combination with the conduct of the parties to the controlled transaction. It is then necessary to compare the conditions and the economically relevant circumstances of the controlled transaction as accurately delineated with the conditions and the economically relevant circumstances of comparable transactions between independent persons. This is then used to select the most appropriate transfer pricing method to determine the arm's length price.
- (6) Taxpayers that are within the scope of the rules are required to provide information about their transfer pricing in an Annual Return on Transfer Pricing that constitutes part of the Income Tax Return and must be submitted to the Zimbabwe Revenue Authority with the Income Tax Return. In addition, taxpayers within the scope of the rules are required to keep documentation to demonstrate that their measure of taxable income accords with the arm's length principle. **This documentation must be in place at the time that the Income Tax return is filed and must be submitted to the Zimbabwe Revenue Authority within 7 days of a written request being issued by the Commissioner.**
- (7) Taxpayers that do not maintain the required documentation, or that file a measure of taxable income that is not in accordance with the arm's length principle, may be subject to penalties.

## 2 Scope of the rules

- (1) The Act applies to controlled transactions, which includes:
  - (i) A transaction between a person resident in Zimbabwe and an associated person; and
  - (ii) A transaction between two associated persons not resident in Zimbabwe where the transaction is in relation to a Permanent Establishment in Zimbabwe of one of the two associated persons.

In this context, a transaction includes one or more transactions, an operation or a scheme.

- (2) A person is defined in section 2 of The Act
- (3) Two persons are considered to be associated where:

- (i) One person directly or indirectly controls the other, or
  - (ii) The same person or persons directly or indirectly control both persons.
- (4) A person controls another person where:
- (i) ownership, whether directly or indirectly, is more than 50% of the share capital of the other person, or
  - (ii) the person has the practical ability to control the business decisions of the other person.
- (5) In this context ‘directly or indirectly’ includes control through an intermediary or series of intermediaries. For example, if A owns 100% of the share capital of B, and B owns 51% of the share capital of C, then A indirectly controls C.
- (6) The rights or powers attributed to a person includes the rights or powers of any family member or partners. This means that, for the purposes of determining whether two persons are controlled persons, one person’s ownership of share capital, or a person’s practical ability to control another person, may be attributed to another person. For example, an individual A controls Company B; and A’s daughter controls Company C. In this case, A’s power to control Company B is attributed to A’s daughter. (And A’s daughter’s power to control Company C is attributed to A). This means that Companies B and C are controlled by the same person or persons, and thus are deemed associated persons.
- (7) The practical ability to control the business decisions of the person refers to the ability to direct business strategy and policy, and to direct the management of the business. Broadly, in the context of a company, this might be board-level decisions. For example, individual A holds no shares in Company B, but is appointed by the shareholders as a member of the Board of Directors of that Company, and, under the constitution of Company B, is able to make key Board decisions without the support of other directors. In this case, A can be said to have the practical ability to control the business decisions of the Company B, and would be deemed to control Company B.
- (8) On the other hand, a company, Company X, may enter into a distribution agreement with an uncontrolled company, Company Y, under which Company X purchases goods from Company Y, and sells those goods to third party customers. The agreement might specify the retail price of the goods to be sold to third parties by Company X. In this case, the arrangement is a commercial arrangement between uncontrolled parties, X and Y, and does not give Y the practical ability to control the business decisions of X. Similarly, where one person purchases or sells exclusively or almost exclusively to a single independent person, this does not, by itself, create an ability of the former person to control the business decisions of the latter.
- (9) A transaction includes any form or arrangement that involves the transfer of goods, or services, whether or not in written form, and whether or not a price is paid or payable. The term ‘goods or services’ includes, but is not limited to, the transfer of goods, services, intellectual property rights, intangibles, leases and financial transactions.

- (10) **The practices described in these Practice Notes should also be applied to the attribution of profit to a Permanent Establishment as defined in the Act or tax treaty.**

In such cases, the practices are applied as if the permanent establishment and other parts of a legal person are treated as separate enterprises. No deduction shall be allowed in respect of amounts, if any, paid or payable (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment

- (11) **The Act also applies to transactions between a person liable to tax in Zimbabwe (or operating through a Permanent Establishment in Zimbabwe and a person located in a beneficial tax regime, whether or not those persons are associated). Transactions involving low tax jurisdictions may be high risk from a transfer pricing perspective and have therefore been included in the scope of Zimbabwe’s transfer pricing rules.**

The Commissioner determines which jurisdictions are classified as beneficial tax regimes. The list of beneficial tax regimes, as determined by the Commissioner, will be published and updated on the Zimbabwe Revenue Authority’s website from time to time.

### **3 Principle of Comparability**

- (1) The authoritative statement of the arm’s length principle is found in paragraph 2 of the 35<sup>th</sup> Schedule to the Income Tax Act as read with Section 98B of The Act.

Section 98B provides that;

*“For the purposes of this section, where a person engages directly or indirectly in any transaction, operation or scheme (hereinafter referred to as “a controlled transaction ”), with an associated person, the amount of taxable income derived by a person that engages in that transaction shall be consistent with the arm's length principle, where the conditions of the controlled transaction do not differ from an uncontrolled transaction, that is to say, from the conditions that would have applied between independent persons, in comparable transactions carried out under comparable circumstances.”*

- (2) The application of the arm’s length principle is based on a comparison of the conditions in a controlled transaction (a transaction between two associated persons) with the conditions in a comparable uncontrolled transaction (a transaction between independent persons).

- (3) In this context, the term ‘conditions’ refers to the commercial or financial conditions of a transaction. Depending on the method employed, this condition will influence the price, gross margin or profit split. However, the term ‘conditions’ can also address whether, between independent persons, a transaction would not have taken place at all, or a different transaction would have taken place.

- (4) Comparable data may be drawn from uncontrolled transactions undertaken by either of the associated persons that conduct the transaction being tested (an ‘internal comparable’) or by two independent persons. For example, the resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions (“internal comparable”) or the resale price margin earned by one or more independent persons in comparable uncontrolled transactions (“external comparables”).
- (5) In order for such comparisons to be useful, the economically relevant characteristics of the controlled and uncontrolled transactions must be sufficiently comparable.
- (6) To be sufficiently comparable means that: -
- (a) There are no significant differences between the two conditions which could materially affect the financial indicator (e.g. price or margin) being examined under the appropriate transfer pricing method, or
  - (b) If such differences exist, a reasonably accurate comparability adjustment is made to the relevant financial indicator of the uncontrolled transaction in order to eliminate the effects of such differences on the comparison. If suitable adjustments cannot be made, then the transactions cannot be considered comparable.
- (7) When comparing a controlled transaction with a potentially comparable uncontrolled transaction, the factors that may be important when determining comparability include:
- The characteristics of the property, goods or services transferred;
  - The functions performed by the parties, taking into account assets used and the relative risks assumed by the parties to the controlled and uncontrolled transactions;
  - The contractual terms of the transaction;
  - The economic and market circumstances in which the transactions take place; and
  - The business strategies pursued by the associated parties or affiliates in relation to the transactions.
- (8) The extent to which each of the above factors is significant in establishing comparability depends upon the nature of the controlled transaction and the transfer pricing method adopted. For example, when the Comparable Uncontrolled Price method is used, the characteristics of the property, goods or services transferred will be as important as the other factors. Where other methods are employed, such characteristics may be less relevant.
- (9) In carrying out a comparability analysis, the factors in paragraph 7 are relevant in analyzing both the controlled transactions and the uncontrolled transactions.
- (10) It is recognised that information concerning comparables is often less than perfect. In some cases, information may be scarce or nonexistent; in other cases, there may be uncertainties about the reliability of comparables. The significance of such issues will vary

from case to case and depend both on the nature of the controlled transaction and the Transfer Pricing method adopted.

- (11) In the absence of information on uncontrolled transactions from the same geographic market as the controlled transaction, comparable uncontrolled transactions from other geographic markets may be accepted by the Commissioner. A determination of whether comparables from other geographic markets are reliable has to be made on a case-by-case basis, and by reference to the extent to which they satisfy the comparability factors and represent the most reliable choice of the method and tested party (if applicable). The expected impact of geographic differences and other factors on the price and profitability shall be assessed by the taxpayer and the Commissioner
- (12) The use of statistical techniques may be appropriate in cases where there are some uncertainties about the relative reliability of comparability data.
- (13) It is important that taxpayers and the Zimbabwe Revenue Authority both make efforts to identify the most reliable comparable data in each case, but it must also be borne in mind that perfectly reliable data is not always available, and that the use of less-than-perfect data may be inevitable, provided it is appropriate in the application of the chosen method and is likely to give rise to a sufficiently reliable indication of arm's length conditions.
- (14) The five comparability factors are discussed in more detail below.

**(a) The contractual terms of the transaction**

In arm's length transactions, the divergence of interests between the parties ensures (i) that contractual terms are concluded that reflect the interests of both the parties (ii) that the parties will ordinarily seek to hold each other to the terms of the contract, and (iii) that contractual terms will be ignored or modified generally, if it is in the interests of both parties. The same divergence of interests may not exist in the case of associated persons or any such divergence may be managed in ways facilitated by the controlled relationship and not solely or mainly through contractual agreements. It is therefore important to examine whether the conduct of the parties conforms to the terms of the contract. The terms of a transaction may also be found in communications between the parties other than a written contract. In cases where there is a divergence between the terms of an actual contract between controlled persons and the behaviour of the parties, then the latter should be used in determining arm's length conditions.

**(b) Functions undertaken**

The compensation for the transfer of property or services between two independent persons will usually reflect the functions that each person performs, taking into account the risks assumed and the assets used. In determining whether two transactions are comparable, the

functions and risks undertaken by the independent persons should be compared to those undertaken by the associated persons.

It can be assumed that the operation of the market in an ‘arm’s length’ context results in the highest profit potential being found in those persons that assume economically significant risks, and those that provide unique and valuable contributions (such as scarce capabilities or unique and valuable intangibles).

A practical way of evaluating functional comparability is to prepare a functional analysis. A functional analysis is a method of finding and organizing facts about a business' functions, assets (including intangible property) and risks in the transaction. It aims to determine how these are divided between the parties involved in the transaction under review. This identifies the nature and characteristics of the controlled transactions that have to be priced.

Usually in the open market, the assumption of increased risk will be compensated for by an increase in the expected return although the actual return may or may not increase depending on the degree to which the risks are actually realised. The risks assumed must therefore be taken into account in the functional analysis. In applying the transfer pricing rules, the reward for risk is based on the arm’s length principle, and must take into account how economically significant risk is allocated in contracts between persons, and which person in fact:

(i) bear the financial risk (upside or downside consequences of risk outcomes)

(ii) perform the relevant risk control functions and risk mitigation functions,

(iii) have the financial capacity to assume the risk.

For transfer pricing purposes, in cases where the contractual allocation of risk diverges from these factors, risk must be allocated to the person or persons that perform the relevant risk control and risk mitigation functions, and have the financial capacity to assume the risk.

If a person does not in fact control the financial risks associated with its funding activities, for tax purposes, it shall not be allocated the profits associated with those risks and will be entitled to no more than a risk-free return.

In cases where the person that performs the relevant risk control and risk mitigation functions does not have the financial capacity to assume the risk, the Commissioner shall determine what adjustments to the transaction are needed for the transaction to result in an arm’s length outcome.

### **(c) Characteristics of the property or services**

The following non-exhaustive list of features may be relevant in comparing two products:

(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

(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 knowhow),
- The duration and degree of protection, and
- The anticipated benefits from the use of the property.

The significance of the actual characteristics of a product or services being transferred in determining an arm's length price depends on the method applied in determining an arm's length price. For example, in applying the Comparable Uncontrolled Price (CUP) method, the precise characteristics of the goods or services will always be relevant. On the other hand, when the Transactional Net Margin method is applied, the functions and risks undertaken by the relevant entities are likely to be more important than the characteristics of the goods or services transferred.

#### **(d) Economic circumstances**

Arm's length prices and margins may vary across different markets even for transactions involving the same property, goods or services; therefore, comparability requires that the markets in which associated persons and persons conducting comparable transactions operate do not have differences that have a material effect on price or that appropriate adjustments can be made to eliminate those differences. As a first step, it is essential to identify the relevant market or markets taking account of available substitute goods or services. Economic circumstances that may be relevant to determining market comparability include the following:

- (a) The geographic location;
- (b) The size of the markets;
- (c) The extent of competition in the markets and the relative competitive positions of the buyers and sellers;
- (d) The availability (risk thereof) of substitute goods and services;
- (e) The levels of supply and demand in the market as a whole and in particular regions, if relevant;
- (f) Consumer purchasing power;
- (g) The nature and extent of government regulation of the market;
- (h) Costs of production, including the costs of land, labor, and capital;
- (i) Transport costs;
- (j) The level of the market (e.g. retail or wholesale); and
- (k) The date and time of transactions.

The facts and circumstances of the particular case will determine whether differences in economic circumstances have a material effect on price and whether reasonably accurate adjustments can be made to eliminate the effects of such differences.



### **(e) Business Strategies**

Business strategies must also be examined in determining comparability for transfer pricing purposes. Business strategies take into account the following:

- a) Innovation and new product development,
- b) Degree of diversification,
- c) Appetite for risk,
- d) Assessment of political stability,
- e) Input of existing and planned labor
- f) Market penetration strategies,
- g) Duration of arrangements, and
- h) Other factors bearing upon the daily conduct of business.

When evaluating whether a taxpayer was following a business strategy that temporarily decreased profits in return for higher expected long term profits, several factors should be considered. For example, it will be important to examine the conduct of the parties to determine if it is consistent with the purported business strategy. If, for example, a manufacturer charges its associated distributor a below-market price as part of a market penetration strategy, it would be expected that the cost savings to the distributor may be reflected in the price charged to the distributor's customers or in greater market penetration expenses incurred by the distributor. If neither of these actually occur, the purported business strategy, and the associated pricing, may be challenged.

Another factor to consider is whether the nature of the relationship between the parties to the controlled transaction would be consistent with the taxpayer bearing the costs of the business strategy. For example, in arm's length transactions, a company would generally not bear the costs of a market penetration strategy if it did not have a realistic expectation of benefiting from that strategy. Where a company has undertaken market development activities at its own risk and enhances the value of a product, for example, through a trademark or trade name, this situation should be reflected in the analysis of functions for the purposes of establishing comparability.

An additional consideration is whether there is a plausible expectation that following the business strategy will produce a return sufficient to justify its costs within a period of time that would be acceptable in an arm's length arrangement. It is recognised that a business strategy such as market penetration may fail, and the failure does not of itself allow the strategy to be ignored for transfer pricing purposes. However, if such an expected outcome was implausible at the time of the transaction, or if the business strategy is unsuccessful but nonetheless is continued beyond what an independent person would accept, the arm's length nature of the business strategy may be doubtful. Ultimately, the most important consideration is whether the strategy in question could plausibly be expected to prove profitable within the foreseeable future (while recognizing that the strategy might fail), and that a party operating at arm's length would have been prepared to sacrifice profitability for a similar period under such economic circumstances and competitive conditions.

## 4 Transfer Pricing Methods

- (1) The Income Tax Act [chapter 23:06] lists the methods set out below for the purposes of ascertaining the arm's length price of a controlled transaction.
- (2) The most appropriate method in a given case will depend on the facts and circumstances of the case and the extent and reliability of data on which to base a comparability analysis. It should always be the intention to select the method that produces the highest degree of comparability.
- (3) The choice of the most appropriate method should therefore be based on a practical weighting of the evidence, having regard to:
  - (a) The nature of the activities being examined,
  - (b) The availability, quality and reliability of the data,
  - (c) The nature and extent of any assumptions, and
  - (d) The degree of comparability that exists between the controlled and uncontrolled transactions where the difference would affect conditions in the arm's length dealings being examined.
- (4) (a) In practice, the application of the principles outlined in the paragraph above often results in the following steps in determining the most appropriate method:
  - i. In cases where, taking into account the comparability factors described in section 3 one or more reliable comparable prices are available, the comparable uncontrolled price method is used. As discussed in Section 6.1 below, it is often very difficult to identify a sufficiently reliable comparable uncontrolled price.
  - ii. In cases where a comparable uncontrolled price is unavailable, the next step is to consider whether a 'one-sided method' is available. A one-sided method refers to a cost-plus, resale-price or TNMM method applied to gross or net profit derived from functions undertaken by one of the parties to the transaction (the 'tested party'). Such a method may be available if one or more sufficiently reliable comparables are available for the function or functions undertaken by one of the parties to the transaction, taking into account the comparability factors described in section 3, and that sufficiently reliable information on the relevant financial indicator in the comparables is available.
  - iii. Where a one-sided method is appropriate, the tested party should be the party for which a) one or more sufficiently reliable comparables are available, and b) sufficiently reliable information on the relevant financial indicator in the comparables is available. Generally, it is less likely that a sufficiently reliable comparable will be available to test a return to a function that involves the use of a unique and valuable contribution, such as valuable unique intangibles, or a function that assumes economically significant risk.
  - iv. In cases where a one-sided method is not available, then a profit split method should be considered. This will often be most appropriate in cases where:

- a both parties to the transaction make unique and valuable contributions such as certain intangibles;
- b the business operations are highly integrated such that the contributions of the parties cannot be reliably evaluated in isolation from each other;
- c both parties share the assumption of economically significant risks or separately assume closely related risks

These factors are not mutually exclusive and may often be found together in a single case.

- (4) (b) It should be noted, however, that a profit split method will not normally be appropriate where one of the parties to the transaction is allocated neither significant risk nor valuable intangibles. In such a case a one-sided method is likely to be more appropriate. In cases where a transfer pricing analysis indicates that a one-sided method is most appropriate, a profit split method should not be used solely because reliable comparables cannot be found to apply it.
- (5) Notwithstanding the guidance in the paragraphs above, a different method may be applied by the taxpayer or the Commissioner provided the Commissioner is satisfied that:
  - i) None of the approved methods can be reasonably applied to determine arm's length conditions for the controlled transaction; and
  - ii) Such other method yields a result consistent with that which would be achieved by independent persons engaging in comparable uncontrolled transactions under comparable circumstances.

Where the taxpayer chooses to apply a different method, the taxpayer must state why the five transfer pricing methods in paragraph (7) below were regarded as less appropriate or non-workable in the circumstances in the case, and of the reasons why the selected other method was regarded as providing a price that applies the arm's length principle.

- (6) There is no requirement for a taxpayer to use more than one method when carrying out a transfer pricing analysis. However, a taxpayer may choose to employ a second (corroborative) method if it is considered that this is necessary in order to improve the reliability of the analysis. Other than in situation described in paragraph 5 above, there is no requirement that transfer pricing documentation includes a systematic analysis of why methods not used have been rejected.
- (7) The Income Tax Act [chapter 23:06] recognizes the standard transfer pricing methods below.
  - (a) The comparable uncontrolled price method (CUP method);
  - (b) The resale price method (RP method);
  - (c) The cost plus method (CP method);
  - (d) The transactional net margin method (TNMM); and
  - (e) The profit split method.

- (8) The Commissioner acknowledges that the suitability and reliability of a method will depend on the facts and circumstances of each case.
- (9) Application of a one-sided transfer pricing methodology (the resale price method, cost-plus method or transactional net margin method) requires the selection of a tested party — i.e. the party for which the relevant condition being examined, such as gross profit margin, is tested under the method. The tested party should be the party to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparable data can be found. Usually the tested party will be the one with the simplest functional profile.

For example, assume Company A, resident in Zimbabwe is a manufacturer of beverages. Company A owns valuable and in some cases unique assets (plant, equipment, trademarks, know-how) and assumes significant risk in carrying out its manufacturing functions. Company A sells its beverages to Company B, a routine distribution entity in Country X that assumes limited risks and owns no economically significant assets nor assumes any economically significant risks. As the more routine entity, Company B should in this case be the tested party. Assuming that reliable financial information and comparable data can be obtained, selecting Company B as the tested party should result in the most reliable application of the chosen transfer pricing method.

- (10) Where the most appropriate transfer pricing method in the circumstances of the case, determined following the guidance at paragraphs 4(a) and 4(b), above, is a one-sided method, financial information on the tested party is needed irrespective of whether the tested party is a domestic or foreign entity. In these circumstances, sufficient information is needed to be able to reliably apply the selected method to the foreign tested party and to enable a review by the Commissioner of the application of the method to the foreign tested party. This should, at a minimum, include an overview of the tested party's operations, a value chain and industry analysis and a functional analysis.

#### 4.1 Comparable Uncontrolled Price (CUP) Method

- (1) In applying the CUP method, a direct comparison is drawn between the price charged for a specific product or service in a controlled transaction and the price charged for a closely comparable product or service in an uncontrolled transaction in comparable circumstances. It therefore primarily focuses on the goods being transferred or service being rendered, but also takes into account broader business functions and economic circumstances.
- (2) The two transactions being compared will only be truly comparable if there are no differences between the two transactions that will have a material effect on the price, or if reasonably accurate adjustments can be made to eliminate the effect of differences that may materially affect the price.
- (3) It is important to keep in mind that two transactions will not be comparable merely because the product or service transferred is comparable. Regard should also be had to the effect on

price of broader business functions and economic circumstances other than just the product comparability. For example, a manufacturer of tinned fruit in Zimbabwe may sell a product to its own customers in Zimbabwe (such as wholesalers and larger retailers) and also to an uncontrolled distributor in Country B. Even if the product in both transactions are identical, a CUP method is unlikely to be applicable, unless reliable adjustments can be made. This is because there are likely to be differences between the two transactions that, at arm's length, would have a material effect on the price. These may include different risks (e.g. exchange risk); different costs involved (e.g. transport); differences in the level of market (i.e. selling to a distributor rather than wholesalers/retailers); differences between the Country B and Zimbabwe markets.

- (4) As another example, assume a taxpayer sells 1,000 tons of a product for \$80 per ton to a controlled person in its MNE group, and at the same time sells 500 tons of the same product for \$100 per ton to an independent person. This case requires an evaluation of whether the different volumes should result in an adjustment of the transfer price. The relevant market should be researched by analyzing transactions in similar products to determine typical volume discounts.

#### 4.2 Resale Price Method (RPM)

- (1) The resale price method begins with the price at which a product that has been purchased from an associated person is resold to an independent person.

This price (the resale price) is then reduced by an appropriate gross margin on this price (the "resale price margin") representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an arm's length gross margin. What is left after subtracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. customs duties), as an arm's length price for the original transfer of property between the associated person. This method is probably most useful where it is applied to distribution operations.

- (2) The 'arm's length gross margin is determined through a comparability analysis as described above.
- (3) In applying the resale price method, fewer adjustments are normally required for product comparability than under the CUP method. Minor product differences are less likely to have an effect on profit margins than on prices. For example, if a distributor performs the same functions (taking into account assets used and risks assumed) to sell toasters and blenders, it is likely to require the same profit margin, even though blenders are not comparable in price to toasters.
- (4) The resale price method is most appropriate where the reseller does not add substantial value to the product or does not use unique assets such as valuable unique intangibles.

- (5) As an example of the application of the resale price margin, assume that there are two distributors selling the same product in the same market under the same brand name. Distributor A offers a warranty; Distributor B offers none. Distributor A includes the costs associated with the warranty in its sales price, and so sells its product at a higher price resulting in a higher gross profit margin than if the costs of servicing the warranty were not taken into account. Distributor B, which does not offer the warranty, sells at a lower price. The two gross margins are not comparable until a reasonably accurate adjustment is made to account for the warranty difference.

#### 4.3 Cost Plus Method

- (1) The cost plus method requires estimation of an arm's length consideration, by adding an 'arm's length' mark-up to the costs incurred by the supplier of goods or services in a controlled transaction.
- (2) The level of mark-up is determined through a comparability analysis.
- (3) This method is often applied to manufacturers, or to service suppliers, which do not exploit valuable unique intangibles, or do not take extraordinary risk.
- (4) The costs included in a cost-plus analysis should be the direct and indirect costs incurred in supplying the relevant goods or services. Financial costs are not included. Care should be taken to ensure that the accounting measure of 'cost of goods sold' is consistent between the tested party and those selected as comparables. Where there is a significant discrepancy, adjustments should be made. If reliable adjustments cannot be made different comparables should be used. Care should also be taken to ensure that no significant controlled transaction costs are included in the cost-base for the method, such costs may distort the analysis.
- (5) As an example, B Co a subsidiary company in Zimbabwe specialises in the production of product **X** for A Co, a related foreign company under a contract manufacturing arrangement. Under the arrangement A Co provides B Co with the technical know-how used in the manufacturing of product **X** and B Co manufactures to the order of A Co. B Co is also an independent contract manufacturer of product **Y** in Zimbabwe. It sells the products to an independent distributor in country. In this case, it is provided with technical know-how by the distributor in country, and it manufactures to the order of the distributor under the same terms and conditions that it does for A Co.

The comparability analysis shows that sales to the independent distributor are uncontrolled transactions, which can be used as a comparable for the sales to the controlled person. In the former, the subsidiary charges a price which represents an average mark-up of 10 per cent of direct and indirect costs of production. Assume the subsidiary incurred direct and

indirect costs of [Currency]100 in producing one unit, the arm's length cost plus markup on the same costs would be [Currency] 10 (i.e., [Currency] 100 x 10%).

As a second example, Company X, resident in Zimbabwe, is a manufacturer of beverages. It sells this product to its foreign subsidiary Y. Company X earns a 10 per cent gross profit mark-up with respect to its manufacturing operation.

Companies M, N, and O are independent domestic manufacturers of beverages and all resident in Zimbabwe. Companies M, N and O perform comparable functions to Company X, and sell to independent foreign purchasers. They earn gross profit mark-ups with respect to their manufacturing operations that range from 5 to 6%, which is considered to be an arm's length range (a concept discussed below).

Company X accounts for supervisory, general and administrative costs as operating expenses, and thus those costs are not reflected in cost of goods sold. The gross profit mark-ups of Companies M, N and O, however, reflect supervisory, general and administrative costs as part of costs of goods sold. If the cost plus method is used, the gross profit mark-ups of Companies M, N and O must be adjusted to provide accounting consistency.

#### 4.4 [Transactional Net Margin Method \(TNMM\)](#)

- (1) The transactional net margin method examines the net profit margin relative to an appropriate base such as sales, costs or assets that a person realises from a controlled transaction or transactions that it is appropriate to aggregate. This is compared with the result achieved by independent persons on a comparable transaction(s). The use of net profit indicators can potentially introduce a greater element of volatility into the determination of transfer prices for two reasons. First, net profit indicators can be influenced by some factors that do not have an effect (or have a less substantial or direct effect) on gross margins and prices, because of the potential for variation of operating expenses across enterprises. Second, net profit indicators can be influenced by some of the same factors, such as competitive position, that can influence price and gross margins, but the effect of these factors may not be as readily eliminated.
- (2) The focus is initially on examining the net margin relative to an appropriate base. The relative usefulness of the various profitability ratios depends largely on the facts of the case and the extent of reliable data being available for the person and any comparables.

For example, in testing the return to a manufacturing operation that sells goods to associated persons, a net margin ratio may be relative to total costs (including raw material costs) or to assets used in production. In other cases, for example where raw materials are purchased from associated persons, the ratio may be relative to 'processing costs' only (i.e. costs other than raw materials) or, where more appropriate, to labour costs only.

For a manufacturing operation that purchases raw materials from a controlled person, and sells directly to independent persons, a net margin relative to sales may be available.

For a distribution operation, a net margin relative to sales will often be appropriate, but, under some circumstances, a net margin relative to internal costs may be appropriate.

- (3) Under the Transactional Net Margin Method (TNMM), margins are calculated after operating expenses but before interest and taxation.
- (4) As an example, Distributor A, a company based in Zimbabwe, purchases food products from a controlled person in a foreign country and distributes those goods to independent customers. Its accounts show a net return of 0.8%.

A comparability analysis shows that it is possible to find entities in Zimbabwe that carry out sufficiently comparable functions to A. Reliable financial data available on those comparable entities is available only at the net profit level. Accordingly, it is decided to employ a TNMM method, with A as the tested party, and using net profit to sales as the applicable profit level indicator. By means of a database search, 14 Zimbabwe entities are found that conduct functions that are comparable to those performed by A. It is decided that a statistical approach (described below) is appropriate in these circumstances, utilizing an ‘interquartile range’. A financial analysis of those entities reveals a range of net margins (by reference to sale) of 0.5% to 5.5%, with an inter-quartile range of 3.5% to 4.2%. The reported profit falls outside the interquartile range, and the profit of A must be adjusted, for tax purposes, to the [median of /most appropriate point in] the range.

- (5) The table below illustrates possible ‘profit level indicators (PLIs)’ available under the TNMM method. It is important to note, that each case must be considered according to its specific facts and circumstances, and that the illustrations in the table below may not always be the most appropriate. It should be noted also that the TNMM is unlikely to be an appropriate method to test the net return of an entity that exploits valuable unique intangibles or assumes extraordinary risk.

<b>Tested party</b>	<b>Potential PLI</b>
Manufacturer – selling to associated person	Net profit/Full costs Or Net profit/ Assets used (a)
Manufacturer – selling to independent persons, with controlled transaction costs	Net profit/Sales revenue
Manufacturer – raw materials purchased from controlled person, and sales to controlled persons	Net profit/Assets used Or Net profit/Process (non-raw material) costs Or Net profit/Wage cost (b)
Service provider	Net profit/Full costs
Distribution	Net profit/Sales Or Net profit/Operating costs (excluding cost of goods sold) (c)



## Notes:

- (a) Net profit/Assets used will most likely be appropriate in a capital-intensive business
- (b) Net profit/Wage cost will most likely be appropriate in a labour-intensive business
- (c) Referred to as the 'Berry Ratio', which may be appropriate in a business where a positive relationship between operating costs and net profit can be expected.

In all cases above it is assumed that TNMM is the most appropriate method, and that the appropriate party/function is being tested. This will always be a matter to be determined in view of a comparability analysis.

### 4.5 The Transactional Profit Split Method

- (1) The transactional profit split method seeks to establish arm's length outcomes or test reported outcomes for controlled transactions in order to approximate the results that would have been achieved between independent enterprises engaging in a comparable transaction or transactions.
- (2) The first step in the profit split method is to identify the profits to be split from the controlled transactions- the relevant profits - and then splits them between the associated persons on an economically valid basis that approximates the division of profits that would have been agreed at arm's length.
- (3) As is the case with all transfer pricing methods the aim is to ensure that profits of the associated parties are aligned with the value of their contributions and the compensation that would have been agreed in comparable transactions between independent enterprises for those contributions.
- (4) The transactional profit split method is particularly useful when the compensation to the associated persons can be more reliably valued by reference to the relative shares of their contributions to the profits arising in relation to the transactions than by a more direct estimation of the value of those contributions.
- (5) Where a transactional profit split method is determined to be the most appropriate method it should generally also apply in the same way regardless of whether the transaction(s) result in a relevant profit or a loss.
- (6) The accurate delineation of the actual transaction will be important in determining whether a transactional profit split is potentially applicable. This process should have regard to the commercial and financial relations between the associated persons, including an analysis of what each party to the transaction does, and the context in which the controlled transactions take place. That is, the accurate delineation of a transaction requires a two-sided analysis (or a multi-sided analysis of the contributions of more than two associated persons, where necessary) irrespective of which transfer pricing method is ultimately found to be the most appropriate
- (7) The existence of unique and valuable contributions by each party to the controlled transaction is perhaps the clearest indicator that a transactional profit split may be appropriate. The context of the transaction, including the industry in which it occurs and the factors affecting business performance in that sector can be particularly relevant to evaluating the contributions of the parties and whether such contributions are unique and

valuable. Depending on the facts of the case, other indicators that the transactional profit split may be the most appropriate method could include a high level of integration in the business operations to which the transactions relate and /or the shared assumption of economically significant risks (or the separate assumption of closely related economically significant risks) by the parties to the transactions.

- (8) Contributions (for instance functions performed, or assets used or contributed) will be “unique and valuable” in cases where (i) they are not comparable to contributions made by uncontrolled parties in comparable circumstances, and (ii) they represent a key source of actual or potential economic benefits in the business operations. The two factors are often linked: comparables for such contributions are seldom found because they are a key source of economic advantage.
- (9) Although most MNE groups are integrated to some extent, a particularly high degree of integration in certain business operations is an indicator for the consideration of the transactional profit split method. A high degree of integration means that the way in which one party to the transaction performs functions, uses assets and assumes risks is interlinked with, and cannot reliably be evaluated in isolation from, the way in which another party to the transaction performs functions, uses assets and assumes risks
- (10) A transactional profit split may be found to be the most appropriate method where, according to the accurately delineated transaction, each party to the controlled transaction shares the assumption of one or more of the economically significant risks in relation to that transaction
- (11) A transactional profit split may also be found to be the most appropriate method where, according to the accurately delineated transaction, the various economically significant risks in relation to the transaction are separately assumed by the parties, but those risks are so closely inter-related and/or correlated that the playing out of the risks of each party cannot reliably be isolated
- (12) Two alternative approaches to the profit split method are outlined in the OECD Guidelines: -

**(a) Contribution Profit Split Analysis**

Under a contribution analysis the relevant profits, which are the total profits from the controlled transactions under examination, would be divided between the associated persons based upon a reasonable approximation of the division of profits that independent person would have achieved from engaging in comparable transactions. This division can be supported by comparables data where available. In the absence thereof, it is often based on the relative value of the functions performed by each of the associated persons participating in the controlled transactions, taking account of their assets used and risks assumed.

It can be difficult to determine the relative value of the contribution that each of the associated persons make to the relevant profits, and the approach will often depend on the facts and circumstances of each case. The determination might be made by comparing the nature and degree of each party’s contribution of differing types and assigning a percentage based upon the economic analysis and external market data.

The measurement of each party's contribution may be made in many ways, but it is important that the measurement chosen makes sense in the context of the specific transaction. In general term the measurement chosen should reflect the respective parties' contribution to value – whether by means of ownership of unique value-adding attributes (e.g. intangibles) or by the assuming (including management) of economically significant risks.

**(b) Residual Profit Split Analysis**

Where the contributions of the parties are such that some can be reliably valued by reference to a one-sided method and benchmarked using comparables, while others cannot, the application of a residual analysis may be appropriate. A residual analysis divides the relevant profits from the controlled transactions under examination into two categories. In the first category are profits attributable to contributions which can be reliably benchmarked: typically, less complex contributions for which reliable comparables can be found. Ordinarily this initial remuneration would be determined by applying one of the traditional transaction methods or a transactional net margin method to identify the remuneration of comparable transactions between independent enterprises. Thus, it would generally not account for the return that would be generated by a second category of contributions which may be unique and valuable, and/or are attributable to a high level of integration or the shared assumption of economically significant risks.

For example, a distributor may carry out basic distribution functions such as sales, warehousing and distribution for an associated manufacturer. It may be that that comparable data is available for this function. The distributor may also have a right to a return from valuable intangibles such as trade marks (for which a comparable return is not available). In this case, the first step would be to determine the return to the distributor for carrying out the basic functions, by reference to third party comparables. The return (if any) from intangibles would then be determined in a second step (described below).

The residual profit remaining after the first step will typically be allocated among the parties based on the relative value of the second category of contributions of the parties in the same way as in the application of the contribution analysis outlined above. In the example above, the return to the distributor would take into account its right to a return from intangibles. At the same time, the residual return to the manufacturer would take into account any economically significant risks it assumes and any unique valuable contributions it makes.

Facts and circumstances that could influence the profit allocation in the second stage include the same factors relevant to a contribution profit split analysis described above.

In practice, the assessment of relative contribution may, of necessity, need to be a somewhat subjective measure, based on the facts and circumstances of each case.

#### 4.6 Summary of Methods

The table below summarises the main features of the methods described above and when they may be suitable to apply.

<b>METHOD</b>	<b>FINANCIAL INDICATOR EMPLOYED</b>	<b>POSSIBLE SUITABILITY</b>
<b>Comparable Uncontrolled Price</b>	Price	Financial transactions Transactions involving commodities Property rents
<b>Resale Price Method</b>	Resale margin (gross profit)	Distribution
<b>Cost-Plus Method</b>	Mark-up on direct and indirect costs of supply	Manufacturing and service provision where comparable data (at gross profit level) is available for the functions conducted by one of the parties to the transaction.
<b>Transactional Net Margin Method</b>	Net profit ratio to: <ul style="list-style-type: none"> <li>- Full costs</li> <li>- Sales</li> <li>- Assets</li> </ul>	Manufacturing, distribution or service provision where comparable data (at net profit level) is available for the functions conducted by one of the parties to the transaction
<b>Transactional Profit Split (Contribution Method)</b>	% split of combined profit	Manufacturing, distribution, service provision where both parties perform non-routine functions for which comparable cannot be identified.
<b>Transactional Profit Split (Residual Method)</b>	Step 1 – as for RPM, C+, TNMM Step 2 – as for contribution method	Manufacturing, distribution, service provision where both parties perform non-routine functions for which comparable cannot be identified.

## 5 Application of Methods in Special Circumstances

### 5.1 Transactions involving Commodities

Legislation and Practice Notes are under consideration

### 5.2 Transactions involving the transfer of rights of intangibles

- (1) Section [98B as read with paragraph 9 of the 35<sup>th</sup> schedule highlights considerations for determining the transfer price of controlled transactions involving the transfer of rights in an intangible,

### 5.3 Transactions involving the acquisition of a new or used asset from an associated person.

Legislation and Practice Notes are under consideration

### 5.4 Transactions involving the provision of low value-added services between associated persons

Legislation and Practice Notes are under consideration

### 5.5 Recognition of actual transactions

- 5.5.1 The transfer pricing methods described above will normally be applied to the actual controlled transaction as conducted by the taxpayer.

- 5.5.2 In arrangements between associated persons, it is possible that the actual transaction conducted by the taxpayer departs from the contractual terms between the controlled persons. In such cases, the transfer pricing method must be applied to the actual transaction. For example, the contractual terms between a manufacturer and a distributor might specify that the distributor bears risks associated with product warranties, but, in fact, that risk is borne by the manufacturer. In such a case, the transfer pricing method should be applied to the actual transaction in which the manufacturer bears the risk.

- 5.5.3 In arrangements between controlled persons, it is possible also that the substance of a transaction departs from the way the transaction has been contractually structured. The discussion on the allocation of risk in Section 3(b) makes it clear that where the contractual allocation of risk diverges from the performance of the relevant risk control and risk mitigation functions or the financial capacity to assume the risk, then risk must be reallocated, and the transfer pricing method will be applied to the substance of the transaction recognising the reallocated risk. Similarly, the discussion on intangibles in section 6.1 recognises that the rights of controlled persons to a share in the return derived from the intangible may depart from the contractual arrangements. In such cases the transfer pricing method must be applied to the substance of the transaction that recognises the reallocated rights to share in the return derived from an intangible.

- 5.5.4 There are some circumstances in which the actual transaction conducted by the taxpayer may be disregarded by the Commissioner- General. In some cases, the arm's length position would be as if the transaction had not occurred at all as outlined in Regulation 11(1). In other cases, if appropriate, the actual transaction might be replaced by an alternative transaction, and the transfer pricing methods applied to that transaction. This treatment will only be relevant where the actual transaction conducted between associated persons, viewed in its totality, differs from that which would have been adopted by independent persons behaving in a commercially rational manner in comparable circumstances, thereby preventing determination of a price that would be acceptable to both of the parties. An example of such a transaction would be one that damages the profit potential of the two parties combined (on a pre-tax basis), or one which one of the two parties would not have been willing to enter into on a commercially rational basis.
- 5.5.5 It should be noted that, when a transaction is subject to examination, the Commissioner will recognise the transaction as conducted and structured by the taxpayer, and as determined by any contracts between associated persons, unless there is a divergence between contractual and actual behavior (as discussed in paragraph (2) above), or a divergence between the substance of the transaction and the contractual terms (as discussed in paragraph (3)), or the provisions of paragraph (4) above apply.

## **6 Application of the arm's length principle in specific circumstances**

This section illustrates the application of the arm's length principle in a number of specific circumstances.

### **6.1 Intangibles**

In the transfer pricing context, an intangible refers to something which is not a physical or financial asset, and which is capable of being owned or controlled for use in commercial activities and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances. An important attribute of many intangibles is a denial or restriction on the ability of persons who do not own or control it to exploit it. For example, a patent or a copyright may not legally be exploited by anyone other than the 'owner' (usually the person in whose name it is registered) or a person to whom the right to exploit it has been granted by the owner (usually through a license agreement). An intangible will not always be enshrined in law. For example, a business may have know-how or a trade secret that is proprietary information but is not legally registered or protected. The know-how or trade secret may be information of a commercial, industrial or scientific nature arising from previous experience and represents knowledge that assists or improves a commercial activity. They may relate to manufacturing, marketing, research and development or any other commercial activity. The value of the trade secret or know-how is often dependent on the ability of the party to preserve its confidentiality, which may be done through for example employment contracts, economic and technological barriers or other means.

- 6.1.1 An intangible will be significant for transfer pricing only if it creates value. For example, a person (including a licensee) who owns or controls an intangible may exploit it by charging a higher price for goods or services, or by selling a higher volume of goods or services. Another example is a manufacturer that has developed manufacturing know-how may be able to make more profit than competitors because it is able to produce goods at a lower price due to the use of that know-how.
- 6.1.2 When considering an intangible, a fundamental issue to consider is which persons have a right to share in the value it creates. This may include more than one person. The starting point in considering this should be the contractual and legal arrangements, recognizing that, at arm's length, value in an intangible may be recognised by one or more of the persons that are involved in the development, enhancement, maintenance, protection and exploitation of the intangible. Depending on the facts and circumstances of the case, this might include:
- a) Persons who carry out the development or enhancement of the intangible;
  - b) Persons who assume the risks involved in such development or enhancement, in particular those that manage and control the relevant risks, and in fact bear those risks;
  - c) Persons who assume the risks involved in exploiting the intangible, in particular those that manage and control those risks, and in fact bear them;
  - d) Persons that carry out maintenance and protection functions.
- 6.1.3 This analysis may inevitably be complex. For example, if a manufacturer is granted a right under a license to manufacture and sell a particular product under a valuable trademark, then consideration should be given to:
- a) The legal ownership of the trademark and the terms of the license agreement
  - b) Which persons developed the trademark
  - c) Which persons bore the financial risk of its development
  - d) Which persons in fact managed and controlled that risk
  - e) Which persons bear, and manage and control, the risks involved in the exploitation of the intangible
  - f) Which persons carry out the maintenance and protection of the trademark rights.
- 6.1.4 In the arm's length situation, it might be expected that the licensor would carry out the functions described at b), c), d) and f) above, as well as have legal ownership of the intangible. The activities described at e) may be carried out by the licensee, or, perhaps, jointly with the licensor. If the factual analysis shows this to be indeed the case, then the manufacturer may be entitled to a reward in line with arm's length comparable license agreements. If the factual analysis demonstrates otherwise, then a similar licensing agreement between independent persons may no longer provide a reliable comparable, and the right to share in the value in the intangible will depart from that resulting from a similar license agreement between independent persons.
- 6.1.5 The framework for analyzing transactions involving intangibles between associated persons requires taking the following steps:

- i. Identify the intangible used or transferred in the transaction with specificity and the specific economically significant risks associated with the development, enhancement, maintenance, protection and exploitation of the intangibles
- ii. Identify the full contractual arrangements with special emphasis on determining legal ownership of intangibles based on the terms and conditions of legal arrangements, including relevant registrations, licence agreements, other relevant contracts and other indicia of legal ownership and the contractual rights and obligations including contractual assumption of risks in the relations between the associated parties
- iii. Identify the parties performing the functions, using assets and managing risk relating to developing, enhancing, maintaining, protecting and exploiting the intangibles by means of the functional analysis and in particular which parties control any outsourced functions and control specific, economically significant risks;
- iv. Confirm the consistency between the terms of the relevant contractual arrangements and the conduct of the parties and determine whether the party assuming economically significant risks controls the risks and has the financial capacity to assume the risks relating to the development, enhancement, maintenance, protection and exploitation of the intangibles;
- v. Delineate the actual controlled transactions related to the development, enhancement, maintenance, protection and exploitation of intangibles considering the legal ownership of the intangibles, the other relevant contractual relations under relevant registrations and contracts, and the conduct of the parties, including their relevant contributions of functions, assets and risks.
- vi. Where possible determine arm's length prices for these transactions consistent with each party's contribution of functions performed, assets used, and risk assumed.

6.1.6 It should be noted that an entity that has legal ownership of an intangible, but carries out, or has carried out, no other functions, will not be entitled to any of the return derived from the exploitation of the intangible. Similarly, an entity that has provided funding to develop and enhance an intangible, but which has carried out no other function (including the control and management of the related risk) will not be entitled to any of the return derived from the exploitation of the intangible.

6.1.7 It is important that the determination of arm's length conditions for a controlled transaction involving licenses, such as that described in the example above, takes into account the perspectives of both the licensor and licensee. At arm's length, the licensor would consider the expected reward available if it were to grant a license to an uncontrolled party, or to directly exploit the intangible itself. The licensee would consider the benefit (in terms of increased profitability) that the license provides. A licensee at arm's length would not be willing to pay a royalty if the rights granted by the license provided no such benefit and would not be willing to pay a royalty that exceeded that benefit. In practice, if it established that an intangible does create value to a licensee, it might be expected that the benefit derived would be shared between the licensor and a licensee.



- 6.1.8 Once it has been determined which persons are entitled to share in the value of an intangible, an arm's length reward to each of those persons need to be established. The transfer pricing issues raised by intangibles can be complex, and each case must be considered based on its own facts and circumstances. However, a number of approaches are available.
- 6.1.9 In the case of a right to exploit an intangible under a license agreement, a royalty is often payable. It may be possible to find either an internal or an external comparable for a royalty (expressed as a rate) – using a Comparable Uncontrolled Price method. The unique nature of an intangible means, of course, that it is very unlikely that an exact external comparable is available, but the use of such an approach may assist in determining a reasonable range.
- 6.1.10 A transactional profit split method may also be used to determine an arm's length royalty rate. In such a case, the expected value created by the intangible needs to be determined, and the right of each person to a share in that expected value should be established (taking into account the factors described above). A royalty rate could then be determined which achieves an arm's length split of the value. This approach is illustrated in the example below.
- 6.1.11 As an example, assume that an owner of a valuable intangible (the licensor) grants a license to a manufacturer (the licensee) which gives the licensee the right to use the relevant intangible in manufacturing and selling a product in Country X. Assume, also, that, following a factual analysis, it is considered that the parties' actual conduct is in accordance with the terms of the license, and that the risks associated with creating and maintaining the intangible are properly allocated to the licensor. It should be assumed also that, other than the granting of the license, there are no further controlled transactions.
- 6.1.12 In such a case, the value of the intangible to the manufacturer may be estimated through testing its return for carrying out the actual manufacturing and sales functions, on the assumption that it does not exploit the intangible in question. This approach essentially assumes that the manufacturer's profit is made up of two elements – the return for carrying out the pure manufacture and sales functions; and the return from exploiting the intangible. A one-sided method (i.e. cost-plus, resale price or TNMM method) may be used to estimate the first of those elements (using comparables that carry out similar functions and that do not exploit a valuable intangible). Assuming there are no controlled transactions, other than the license of the intangible, the difference between that return and the manufacturer's actual profit can be assumed to be the return that is generated by the intangible (the 'residual profit').
- 6.1.13 The next step is to determine how that residual profit should be allocated between the licensor and licensee. In light of the factual analysis, an appropriate proportional share of the residual needs to be determined – in accordance with what might be expected at arm's length. As noted above, a person who owns an intangible but carries out no other functions will not be entitled to any of the residual profit arising from the value of that intangible. Similarly, an entity who funds the development of the intangible but carries out no other functions, will also not be entitled to any of the residual profit arising from the value of that intangible.

- 6.1.14 The final step might be to determine a royalty rate payable by the licensee to the licensor that provides the former with its appropriate split of the residual profit. The royalty rate might be fixed up-front, on the basis of forecasts; or it may be adjusted retrospectively (an ex-poste adjustment) in order to achieve an appropriate (arm's length) split of profit.
- 6.1.15 The example above illustrates the application of the transactional residual profit-split method, which is discussed in detail above. Of course, the split of profit used in such a method must reflect an analysis of the allocation of rights to share in the value of an intangible, in the light of all the facts and circumstances. For example, if it is established that, in fact, the manufacturer controlled and managed the development and any enhancement of the intangible and assumed (including the management and control) the associated risks, then it might be considered that 100% of the residual profit should remain with the manufacturer.
- 6.1.16 With regards to royalties it should be stressed that a royalty applies only where there has been a transfer of a right to exploit an intangible. In the example above, the manufacturer is granted a right to use the relevant manufacturing intangibles and the trademarks. A royalty should not be asserted in the case of a sale of a product that carries a trademark, or a product in which intangibles have been used in its manufacture – in such a case, there is no transfer of a right to commercially exploit an intangible. It is simply a sale of goods where the intangible is embedded in the product.
- 6.1.17 Lastly, the ownership of an intangible may be transferred between associated persons. In such cases, it will be necessary to establish an arm's length price for the intangible asset that has been transferred. This is a matter that may need the input of a valuation expert. A typical approach is to establish the value of an intangible by calculating its 'net present value' at the time of the transfer. This method estimates the current value of the stream of future income the intangible is forecast to generate.

## 6.2 Services

- 6.2.1 This section concerns the principles to apply in transactions involving the provision or receipt of services between a taxpayer and associated persons, particularly in the context of centralised services provided to MNE group members.
- 6.2.2 A service charge between a taxpayer and an associated person shall be considered consistent with the arm's length principle where:
- It is charged for a service that is actually rendered;
  - The service provides, or when rendered was expected to provide, the recipient with economic or commercial value to enhance its commercial position, and that economic or commercial benefit is not incidental or duplicative
  - It is charged for a service that an independent person in comparable circumstances would have been willing to pay for, if performed for it by an independent person, or would have performed in-house for itself; and
  - Its amount corresponds to that which would have been agreed between independent persons for comparable services in comparable circumstances

6.2.3 A service charge is generally not consistent with the arm's length principle where it is made solely because of the shareholder's ownership interest in one or more other group members. These are generally referred to as 'shareholder costs', being costs that are rendered as a consequence of or for the benefit of the shareholder rather than the subsidiary. Examples of shareholder costs include:

- Costs or activities relating to the juridical structure of the parent company of the first-mentioned person, such as meetings of shareholders of the parent, issuing of shares in the parent company, and costs of the parent company's supervisory board;
- Costs or activities relating to reporting requirements of the parent company of the first-mentioned person, such as preparing consolidated statutory accounts, auditing for the purposes of the consolidated accounts or preparing management accounts for the purposes of shareholder monitoring and evaluation; and
- Costs or activities related to raising funds for the acquisition of other entities or subsidiaries unless those participations are directly or indirectly acquired by the subsidiary and the acquisition benefits or is expected to benefit that subsidiary.

6.2.4 In general, no intra-group service should be found for activities undertaken by one group member that merely duplicate a service that another group member is performing for itself, or that is being performed for such other group member by a third party. Any consideration of possible duplication of services needs to identify the nature of the services in detail, and the reason why the company appears to be duplicating costs contrary to efficient practices. The fact that a company performs, for example, marketing services in-house and also is charged for marketing services from a group company does not of itself determine duplication, since marketing is a broad term covering many levels of activity.

6.2.5 A associated person should not be considered to receive an intra-group service when it obtains incidental benefits attributable solely to its being part of a larger concern, and not to any specific activity being performed. For example, no service would be received where an associated person by reason of its affiliation alone has a credit-rating higher than it would if it were unaffiliated, but an intra-group service would usually exist where the higher credit rating were due to a guarantee by another group member, or where the enterprise benefitted from deliberate concerted action involving global marketing and public relations campaigns. In this respect, passive association should be distinguished from active promotion of the MNE group's attributes that positively enhances the profit-making potential of particular members of the group.

6.2.6 Where it is possible to identify specific services provided by a taxpayer to an associated person, the determination whether the service charge is consistent with the arm's length principle shall be made for each specific service. Services performed to meet the specific needs of an associated person are referred to as specific benefit activities and a charge would normally be levied if the associated persons were dealing at arm's length. Some examples might be:

- The provision of assistance with a specific borrowing proposal of the entity;

- Assistance with planning and the raising of funds for an acquisition by a particular group member;
- The performance of certain accounting functions such as compliance with tax laws by a subsidiary;
- Training for employees of a particular entity provided by a controlled person.

6.2.7 Parent companies and regional headquarters companies typically undertake activities that are intended to benefit the group (or a geographical section of it) as a whole. Such activities may not be as readily identifiable with any particular entity as is the case with 'specific benefit activities' because the activities are undertaken primarily for the group as a whole or for particular groups of subsidiaries. The services that are centralised in a particular MNE group, and the extent of benefits conferred on members of the group, depend on factors such as the nature of its business, its organisational structure, and the degree of integration between its individual members. Typical examples of such activities are central co-ordination and control functions such as supervision of cash flows, management of foreign exchange and interest rate exposures and co-ordination of group finances, production, marketing and distribution.

In general, most centralised activities that are not solely for the benefit of the parent may provide a sufficiently non-incidental, non-duplicative benefit to the other associated persons to justify charging for the services. A charge is justified where the activity of the service centre benefits an associated person and takes the place of an activity the associated person would have been required to undertake itself or to have performed for it by a third party. Examples of such services include:

- Administrative services such as planning, accounting, auditing and legal;
- Financial services such as management of cash flows and solvency, managing working capital, deposits and liabilities, interest and currency exposures;
- Assistance in the fields of production, buying, distribution and marketing;
- A worldwide advertising campaign;
- Personnel services such as recruitment and training;
- Information technology services.

6.2.8 Where services are rendered by a taxpayer jointly to various associated persons and it is not possible to identify specific services provided to each of them, the total service charge shall be allocated among the associated persons that benefit or expect to benefit from the services according to reasonable allocation criteria. Allocation criteria shall be viewed as reasonable where they are based on a variable or variables that:

- Take into account the nature of the services, the circumstances under which they are provided, and the benefits obtained or that were expected to be obtained by the persons for which the services are intended;
- Relate exclusively to uncontrolled, rather than controlled, transactions; and
- Are capable of being measured in a reasonably reliable manner.

## 6.3 Business Restructures

- 6.3.1 For transfer pricing purposes, a business restructure although having no legal definition involves the reorganization or transfer of functions, assets or risks to an associated person. This section considers situations where such transfers occur between associated persons to implement changes in the group's existing business arrangements or operations. Common examples are product supply chain restructurings involving conversion of a distributor into a sales agency arrangement or of a manufacturer into a provider of manufacturing services. Business restructurings also commonly involve the transfer of the ownership of intangibles such as patents, trademarks and brand names.
- 6.3.2 Where a particular transaction is part of a broader agreement in respect of a business restructuring, determining the arm's length consideration for that transaction requires that all of the circumstances relevant to the agreement are taken into account in evaluating comparability with the consideration that might reasonably be expected under an agreement between independent persons dealing at arm's length.
- 6.3.3 Where possible and practicable, the arm's length consideration is determined by applying the most appropriate transfer pricing method using reliable comparable data relating to an agreement between independent persons dealing at arm's length for a comparable transaction in comparable circumstances.
- 6.3.4 Where there is insufficient reliable comparable data, the consideration that might reasonably be expected under an agreement between independent persons dealing at arm's length in comparable circumstances can be determined by considering the following indicators of arm's length behaviour and outcomes that might reasonably be expected to shape such an agreement:
- An arm's length outcome is one that makes business sense in the circumstances of all parties to the arrangement;
  - An independent person dealing at arm's length would seek to protect its own economic interest;
  - An independent person dealing at arm's length would compare the options realistically available and seek to maximise the overall value derived from its economic resources;
- 6.3.5 One option might be not to enter into a transaction because it does not make commercial sense to one of the parties to the arrangement. Where it is concluded from an examination of all relevant matters that the consideration for a transaction under the agreement in respect of a business restructuring is comparable with that which might reasonably be expected to be agreed between independent persons dealing at arm's length, then that consideration is regarded as satisfying the arm's length principle under the transfer pricing provisions.

- 6.3.6 In some cases, comparability with what might reasonably be expected to be agreed between independent persons dealing at arm's length should be achievable by adjusting the consideration payable or receivable by the taxpayer based upon the business restructuring arrangement, as agreed by the associated persons.
- 6.3.7 However, in some cases where it is not possible or practicable to achieve an arm's length outcome in this way, the [Zimbabwe Revenue Authority] may apply the transfer pricing provisions to adjust the consideration receivable or payable by the person by reference to an agreement that might reasonably be expected between independent parties dealing at arm's length in comparable circumstances.
- 6.3.8 In determining the arm's length price in relation to a business restructure transaction, the following steps should be undertaken:

Step 1: Consider the transactions between the associated persons in the context of the business:

- a. Identify the scope, type and value of the dealings with associated persons involved in the business restructuring
- b. Perform functional analyses of the pre and post-restructuring business activities affected by the business restructuring.
- c. Refer to any relevant contracts, including those entered into to implement the business restructuring (for example, contracts for the sale of property) and those evidencing the terms of the pre and post-restructuring arrangements for the business activities affected by the restructuring.
- d. Examine whether the contractual terms accord with the outcomes of the functional analyses and determine the true nature, terms and effects of the business restructuring.

Step 2: Select the most appropriate transfer pricing methodology or methodologies:

- e. Identify the available data that may establish an arm's length consideration for each of the dealings involved in the business restructuring and for the dealings in their entirety:
- f. Obtain any available data as to arrangements between independent persons dealing at arm's length in comparable circumstances;
- g. Depending upon the extent of such comparables data, obtain any other available data relevant to determining whether the pricing of the business restructuring makes commercial sense for the parties, having regard to what is in their best economic interests and the options realistically available to them at arm's length.
- h. Determine the most appropriate arm's length pricing methodology or methodologies based on the facts and circumstances of the particular case.

Step 3: Apply the most appropriate method and determine an arm's length outcome:

- i. Determine the consideration that might reasonably be expected under an agreement between independent persons dealing at arm's length in comparable circumstances.
- j. Perform a comparability analysis using any available data as to arrangements between independent persons dealing at arm's length in comparable circumstances.
- k. If this analysis is sufficiently reliable, use the outcomes to apply the most appropriate arm's length pricing method(s) to determine the amount(s) of arm's length consideration receivable or payable in connection with the business restructuring.
- l. If not, then use the functional and comparability analyses and any other relevant available data to examine whether the pricing of the business restructuring makes commercial sense for the associated persons, having regard to what is in their best economic interests and the options realistically available to them at arm's length.
- m. If the pricing of the business restructuring arrangement is considered to make commercial sense using this analysis, then this determines the amounts of arm's length consideration receivable or payable by the taxpayer under that arrangement.
- n. If the examination of these matters shows that the pricing of the business restructuring arrangement does not make commercial sense, then seek to achieve an arm's length outcome by a pricing adjustment by reference to the arrangement as entered into by the parties.
- o. If it is not possible or practicable to achieve an arm's length outcome in this way, then determine arm's length pricing using an arrangement that might reasonably be expected to exist between independent persons dealing at arm's length in comparable circumstances.

#### 6.4 Cost Contribution Arrangements

- 6.4.1 A cost contribution arrangement ('CCA') is a contractual arrangement among persons to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, tangible assets or services with the understanding that such intangibles, tangible assets or services are expected to create benefits for the individual businesses of each of the persons.
- 6.4.2 In practice, CCAs are normally entered into between associated persons, although arrangements between independent persons do exist.
- 6.4.3 A key feature of a CCA is the sharing of contributions in accordance with the arm's length principle at the time of entering into a CCA, each participant's proportionate share of the overall contributions to a CCA must be consistent with its proportionate share of the overall benefits expected to be received under the arrangement.

6.4.4 Two major types of CCA are most commonly encountered in practice. Each is fundamentally different in its commercial rationale and characteristics, particularly in respect of the relationship between cost, risk and benefit. These differences have significant implications for the application of the arm's length principle.

a. **Development CCAs:** Arrangements for developing, producing or obtaining assets or rights

CCAs most commonly relate to research and development activity performed for the joint benefit of the participants. A CCA might also relate to mining exploration and/or development undertaken jointly. Such activities typically involve a significant degree of risk of commercial failure and resulting financial loss. A commercial rationale of a CCA for such activities is to share or spread this risk. Another possible benefit is that a party is able to exploit a potentially profitable business opportunity that individually may not be a financially or commercially viable proposition. The participants to the CCA may contribute different assets, resources and expertise that together make the venture possible. When entering into the arrangement, any benefit from success of the venture is a future possibility or expectation that may accrue within an uncertain timeframe. Such CCAs contractually provide for each participant an ownership interest in any intangible or tangible assets resulting from the activities of the CCA or rights to use or exploit those intangible or tangible assets

b. **Service CCAs**

A CCA may relate to activities performed for the joint benefit of the participants that do not result in any property being produced or developed. For example, management and administrative services may be centralised by a MNE and undertaken by one group member for the benefit of it and others. Such activities involve little risk of commercial failure. Rather, the commercial rationale of a CCA for such activities is primarily to share, and thus create cost savings. The participants have a common need for the activities to be performed and the benefit of cost efficiencies from centralisation of functions is cost savings through non-duplication of infrastructure. Such a benefit is immediate or short term, being ordinarily realised in the period in which the service activities are performed. In this regard, the distinction between the expectation of benefit and the derivation of actual benefit from the activities may not be as significant as in other types of CCA.

- (1) Development CCAs may, in practice, be the most complex to apply the arm's length principle to. This section relates largely to development CCAs; however, the principles can apply to all types of CCA. Not all CCAs are simply one or other of the above types. A particular CCA may be a variation or hybrid of one or both of these types.
- (2) Where the CCA is a pure service arrangement, that is, the CCA does not result in any property being produced, developed or acquired, the guidance on intra-group services at paragraph 6.4 shall apply.



- (3) For the conditions of a CCA to satisfy the arm's length principle, the value of the participants contributions must be consistent with what independent persons would have agreed to contribute under comparable circumstances given their proportionate share of the total anticipated benefits they reasonably expect to derive from the arrangement.
- (4) In addressing this, regard should be given to the following matters, to the extent that each is relevant in a particular case:
- a. The arrangement should make business sense:
    - The terms and conditions of a CCA should be consistent with what would have been agreed between independent persons acting in their own economic interests, and reflect outcomes that make business sense in their particular circumstances; and
    - It should make business sense for each person, acting in its own economic interests, to enter into a CCA compared to other options realistically available to it.
  - b. The terms should accord with economic substance:
    - The terms agreed between the participants to a CCA should accord with the economic substance of the arrangement, as evidenced by the conduct of the participants and what persons dealing at arm's length would be expected to have agreed in similar circumstances.
  - c. The terms should be agreed up-front:
    - The terms of a CCA should be agreed prior to commencement of the CCA activity; and
    - The terms of a CCA should be arm's length judged by reference to circumstances known or reasonably foreseeable at the time of entry into the arrangement.
  - d. The participants should have a reasonable expectation of benefit:
    - A participant must have an interest in the results of the CCA activity; and
    - A participant should have a reasonable expectation of benefit from exploiting its interest in the results of the CCA activity.
  - e. Sharing of contributions should be consistent with sharing of expected benefits:
    - A participant's proportionate share of the overall contributions to the CCA should be consistent with its proportionate share of the overall expected benefits from the arrangement;
    - Cost contributions should be measured on an arm's length basis;
    - Expected benefits should be measured using reasonable estimates of revenues or cost savings from use of the results of the CCA activity; and
    - The sharing of contributions might appropriately be subject to review and prospective adjustment to account for changes in circumstances that result in changes to expected benefits.

- f. Entry, withdrawal and termination should be on arm's length terms:
    - Any transfer of a valuable interest in the results of the CCA activity as a result of a person's entry into or withdrawal from an active CCA, or upon termination of a CCA, should be on arm's length terms.
- (5) Generally, a CCA between controlled persons should meet the following conditions:
- a) The participants would include only persons expected to derive mutual and proportionate benefits from the CCA activity itself (and not just from performing part or all of that activity).
  - b) The arrangement would specify the nature and extent of each participant's interest in the results of the CCA activity as well as its expected respective share of benefits
  - c) No payment other than CCA contributions appropriate balancing payments and buy-in payments would be made for the particular interest or rights in intangibles, tangible assets or services obtained through the CCA.
  - d) The value of participants contributions would be determined in accordance with these Practice Notes and, where necessary, balancing payments should be made to ensure the proportionate shares of expected benefits from the arrangement.
  - e) The arrangement may specify provision for balancing payments and/or changes in the allocation of contributions prospectively after a reasonable period of time to reflect material changes in proportionate share of expected benefits among the participants.
  - f) Adjustments would be made necessary (including the possibility of buy-in and buy-out payments) upon the entrance or withdrawal of a participant and upon termination of the CCA.

## 6.5 Financial Transactions

It should be noted that the interest limitation rules as specified in section 16(1)(q) of the Act are applicable on all interest payments to associated persons whether the payments are at arm's length or not. The arm's length principle applies to financial arrangements to ensure that the conditions of a transaction between associated persons are consistent with those conditions that would have been made or imposed between independent persons dealing in comparable circumstances.

- (1) In relation to financial arrangements, this requires a broad analysis of the conditions of the loan or other financial instrument to determine whether these conditions satisfy the arm's length principle.
- (2) The application of the arm's length principle requires a detailed analysis of all conditions of the arrangement, including but not limited to:
  - a. The quantum of debt
  - b. The quantum of interest costs
  - c. The nature and schedule of repayments of principal and interest

- d. The denominated currency of the arrangement and repayments
  - e. The rate of real or effective interest
  - f. Any security in respect of the arrangement
  - g. The level of subordination of the arrangement
  - h. The existence of any guarantees
  - i. The existence of a conduit arrangement
- (3) It also requires an analysis of the circumstances surrounding the arrangement, including but not limited to:
- a. The commercial purpose of the loan
  - b. The creditworthiness of the borrower
  - c. The ability of the borrower to obtain finance from a third party
  - d. The economic conditions (including capital markets) in the jurisdiction of the borrower and the lender
- (4) After consideration of these factors, the taxpayer should determine whether a transaction (with those conditions) would have been made at arm's length, and if so, what the arm's length consideration should be.
- (5) If it can be concluded that a transaction with such conditions would not have been made between independent persons dealing in comparable circumstances, the conditions of the transaction may be altered, and the arm's length consideration adjusted, to reflect what would have occurred between independent persons dealing in comparable circumstances.
- (6) The comparable uncontrolled pricing method will usually be the preferred method for determining the arm's length consideration in respect of a financial arrangement.

## 6.6 Hard to Value Intangibles

- (1) For the purposes of these Practice Notes, the term hard to value intangible ('HTVI') covers intangibles or rights in intangibles, which are transferred between associated persons but at the time of transfer there are:
  - a. No reliable comparables that exist; and
  - b. At the time of the transfer, the projection of future cash flows or income expected to be derived from the intangible or right, or the assumptions used in valuing the intangible or right, are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer.
- (2) Transactions involving the transfer of HTVIs may exhibit one or more of the following features:
  - a. The intangible is only partially developed at the time of the transfer
  - b. The intangible is not expected to be exploited commercially until several years after the transfer

- c. The intangible does not itself fall within the definition of HTVI but is integral to the development or enhancement of other intangibles that do fall within the definition of HTVI
  - d. The intangible is expected to be exploited in a manner that is novel at the time of the transfer and the absence of a track record of development or exploitation of similar intangibles makes projections highly uncertain
  - e. The intangible meeting the definition of HTVI has been transferred to an associated person for a lump sum payment
  - f. The intangible is either used in connection with or developed under a CCA or similar arrangements
- (3) In situations involving the transfer of HTVIs, the Zimbabwe Revenue Authority can consider ex post outcomes as presumptive evidence of the ex-ante pricing arrangements. However, the consideration of ex post evidence should be based on a determination that such evidence is necessary to be taken into account to assess the reliability of the information on which ex ante pricing has been based. Where the Zimbabwe Revenue Authority is able to confirm the reliability of the information on which ex ante pricing has been based, then adjustments based on ex post profit levels should not be made.
- (4) However, the approach described above, shall not be applied where at least one of the following applies:
- a. The taxpayer provides the Zimbabwe Revenue Authority with sufficient detail of:
    - i. The ex-ante projections used at the time of the transfer to determine the pricing arrangements, including detail of the appropriateness of accounting for risks and other reasonably foreseeable events, and their probability of occurrence; and
    - ii. Reliable evidence that any significant difference between the financial projections and the actual outcomes is due to a) unforeseeable developments or events occurring after the determination of the price that could not have anticipated by the associated persons at the time of the transaction or b) the playing out of the probability of occurrence of foreseeable outcomes and that these probability occurrences were not significantly overestimated or underestimated at the time of the transaction.
  - b. The transfer of the HTVI is covered by a bilateral or multilateral advance pricing arrangement in effect for the period in question.
  - c. Any significant difference between the financial projections and the actual outcomes does not have the effect of reducing or increasing the compensation for the HTVI by more than 10% of the compensation determined at the time of the transaction.

- d. A commercialization period of five years has passed following the year in which the HTVI first generated unrelated party revenues for the transferee and in which commercialization period, any significant difference between the financial projections and the actual outcomes was not greater than 20% of the projections for that period.

### *Example*

Company A, a resident of Country A, has patented a pharmaceutical compound. Company A has concluded pre-clinical tests for the compound and has successfully taken the compound through Phases I and II of the clinical trials. Company A transfers in Year 0 the patent rights to an affiliate, Company S, a resident of Country S. Company S will be responsible for the Phase III trials following the transfer. In order to determine the price for the patent on the partially developed drug, the parties made an estimation of expected income or cash flows that will be obtained upon exploitation of the drug once finalised over the remaining life of the patent. Assume the price so derived at the time of the transfer was 700 and that this was paid as a lump sum in Year 0.

In particular, the taxpayer assumed sales would not exceed 1,000 a year, and that commercialisation would not commence until Year 6. The discount rate was determined by referring to external data analysing the risk of failure for drugs in a similar therapeutic category at the same stage of development.

### *Scenario A*

Commercialisation in fact starts during Year 3 since the Phase III trials were completed earlier than projected. Sales in Years 3 and 4 correspond to sales that were projected, at the time of the transfer, to be achieved in Years 6 and 7. The taxpayer cannot demonstrate that its original valuation properly took into account the possibility that sales would arise in earlier periods and cannot demonstrate that such a development was unforeseeable.

The Zimbabwe Revenue Authority may use the presumptive evidence based on the ex post outcome to determine that the possibility of earlier sales should have been taken into account in the valuation. The taxpayer's original valuation is revised to include earlier sales resulting in a revised net present value of the drug in Year 0 of 1,000 instead of 700. Therefore, assume for the purposes of the example that the arm's length price anticipated in Year 0 should have been 1,000. Note that the value of 1,000 is not necessarily the net present value of the transferred rights based solely on the actual outcome.

In accordance with the approach to HTVI, the Zimbabwe Revenue Authority can make an adjustment to assess the additional profits of 300 in Year 0.

### *Scenario B*

The taxpayer's original valuation is revised to include earlier sales resulting in a revised net present value of the drug in Year 0 of 800 instead of 700. Therefore, assume for the

purposes of the example that the arm's length price anticipated in Year 0 should have been 800. Note that the value of 800 is not necessarily the net present value of the transferred rights based solely on the actual outcome.

In accordance with the approach to HTVI, an adjustment could be made to assess the additional profits of 100 in Year 0. However, in this example, the exemption applies since the adjustment to the compensation for the transfer is within 20% of the compensation determined at the time of the transaction.

Notwithstanding that the HTVI approach does not apply, an adjustment under other sections of these Practice Notes may be appropriate.

## **7 Arm's length range and statistical analyses**

- (1) A comparability analysis will not necessarily identify a single price or other financial indicator, and a range of prices or other financial indicators may result from the analysis.

The 'arm's length range' is applicable where the comparability analysis identifies a number of comparables (and associated financial indicators) that are all reliable, and equally reliable. In this case the full range of the relevant financial indicators is adopted. It is often the case that such a range contains relatively few comparables and the range is relatively small.

- (2) Where the application of the most appropriate method results in a number of financial indicators for which the degree of comparability of each to the relevant transaction between associated persons, and to each other, is uncertain, or the highest point in the range exceeds 25% of the lowest point in the range, a statistical approach should be used. Such an approach is most likely to be relevant in cases where a database search has been used in order to identify potential comparables.
- (3) Where such an approach is used, the interquartile range will be considered to be an arm's length range.
- (4) The interquartile range is a range of the appropriate financial indicator derived from the various comparables employed by the application of a transfer pricing method. For example, the application of a TNMM may identify 80 comparables and, for each of these comparables, a return on sales (operating profit/sales) is identified. This thus creates a 'full range' of 80 profit/sales ratios. If this range is listed from lowest to highest, the interquartile range represents the two middle quarters (in the case, the range of figures from the 20<sup>th</sup> highest to the 60<sup>th</sup> highest).
- (5) Where the relevant financial indicator resulting from a transaction between associated persons falls outside the arm's length range, then the taxable income of the taxpayer must be computed on the basis that the relevant indicator is the median of the arm's length range.

(6) Where such adjustments are necessary, they must be made by the taxpayer in order to calculate the amount of taxable income, included in the relevant tax return. If no such adjustment is made by the taxpayer, the Commissioner shall make such an adjustment.

(7) For the purposes of paragraphs above, a financial indicator is a price, resale margin, cost mark-up, net profit ratio or a split of profit.

## **8 Identifying and Using Data on Comparables**

(1) The Commissioner recognises that taxpayers often face difficulty in accessing reliable data for comparables, searches and benchmarking. This challenge is shared by taxpayers and tax authorities alike, and, although an issue in many regions of the world, is particularly acute in Africa, where publicly available data is scarce or non-existent.

(2) There are a number of potential sources of comparables.

(a) Some taxpayers may be able to identify internal comparables – that is, comparable data derived from a transaction between the taxpayer (or the related party counterpart to the transaction) and an independent party. The Commissioner encourages taxpayers to attempt to identify internal comparables where possible.

(b) Comparables may also be identified through research into business and industry pricing. Taxpayers will usually have an in-depth knowledge of the industry in which they operate, and that knowledge may be useful in determining arm's length conditions in transactions between independent persons. The Commissioner may consider reliable and relevant data and information derived from business and industry sources, as well as data derived from other publicly available sources.

(c) Many taxpayers rely on commercial searchable electronic databases to identify financial data on companies that conduct potentially comparable transactions to determine their transfer prices. Commercial databases are developed by private-sector providers and the information contained in them may be regional or global in reach. Information included in such databases is based on publicly available information, including company financial data submitted to government or stock exchange registers. In many countries, including many in Africa, information from the country might be very limited or non-existent. In such cases, a database might still be a useful source for identifying comparables, but it should be recognised that such data is likely to be drawn from other markets or other regions (i.e. 'foreign comparables').

The Commissioner will accept for consideration comparable data derived from a commercial database provided the search method and criteria are a) clear and made available to the Commissioner and b) they are appropriate to the transaction being tested.

- (d) Where comparables are difficult to identify, efforts to expand the breadth of a benchmarking search may be appropriate. This can be achieved by considering data:
- derived from products that differ (in varying degrees) to those which are the subject of the tested transaction, or
  - derived from sectors other than that of the tested transaction, or
  - derived from countries or regions outside that of the party being tested.

Where the scope of a benchmarking search is widened, it is important, to keep economically relevant differences between the comparables and the tested transaction or the tested party as small as possible. In addition, where the scope of a benchmarking search is expanded, it may be possible to make reliable comparability adjustments to compensate for those differences. It is recognised, however, that reliable comparability adjustments may be difficult to make.

- (3) It is important that taxpayers and the Zimbabwe Revenue Authority both make efforts to identify the most reliable comparable data in each case. It should also be kept in mind, however, that perfectly reliable data is not always available and that the use of less-than-perfect data may be inevitable. In some cases, an ideal amount of information is unavailable; in other cases, there may be uncertainties about the reliability of comparables. The significance of such issues will vary from case to case and depend both on the nature of the controlled transaction and the method adopted. These considerations mean that, while [Zimbabwe Revenue Authority] and taxpayers should always make best efforts to identify the most reliable comparables, they need also to recognise that data will often give no more than an indication of arm's length pricing rather than an exact measure.
- (4) It should be remembered that comparability data does not normally require data on actual prices. In practice the use of cost-plus, resale price method, TNMM and profit split methods require information concerning the profits derived by person conducting comparable transactions (expressed, for example, as a mark-up on costs or a return on revenue or on assets).
- (5) As discussed in Section 7 above, the use of statistical techniques may be appropriate in cases where there is a relatively large number of identified comparables, and, at the same time, uncertainties about their relative reliability. This is frequently the case where databases are used to identify comparable transactions and extract financial data deriving from them.
- (6) Data on comparables used to justify a taxpayer's transfer pricing should be derived from time periods as close as possible to the time that the transaction under examination is conducted. It is recognised that contemporaneous data may not always be available at the time of the transaction, or even when a comparability analysis is conducted, and that data derived from time periods prior to that being tested may be appropriate.
- (7) Multiple year data relating to comparables may be considered where it adds value to the transfer pricing analysis, to take into account, for example, of the effects on profits of product life cycles and short term economic conditions. Similarly, a multiple year average of the



relevant financial indicator may be used where it adds to the reliability of the data used for comparability purposes.

- (8) The Commissioner will thus consider data derived from prior years, and also consider multi-year data, provided that such data can be considered sufficiently and reasonably reliable in the context of the controlled transaction.
- (9) A review of a taxpayer's compliance with the transfer pricing rules, will be based primarily on information provided by the taxpayer itself. However, it should be remembered that the Commissioner when applying any method, may have more information available than a taxpayer has, or can through its own efforts have reasonable access to. The Commissioner does not intend to use publicly undisclosed information in an attempt to substitute an alternative measure of the arm's length amount. There are procedural problems in using such information, such as the likelihood that such information could not be provided to taxpayers whose transfer prices are under review or as evidence in court due to the secrecy provisions of the Act. The Commissioner will not rely on comparable financial information for the purposes of making an adjustment under the Income Tax Act if that information, in relation to the transactions, is not available to the taxpayer. However, the Commissioner may use that publicly undisclosed information in administering the transfer pricing rules for the purposes of risk assessment and case selection.

## 9 Adjustments

- (1) In cases where the conditions of an actual transaction differ from arm's length conditions, an adjustment shall be made by either the Commissioner or by the taxpayer. Such adjustments are made either in the calculation of taxable income or to the price paid or payable in the controlled transaction. An adjustment to the price paid or payable can only be made by the taxpayer and not by the Commissioner. In the first case, the adjustment is reflected in the calculation of taxable income only. In the second case, the adjustment is reflected in the financial accounts, and thus ultimately in the calculation of taxable income.
- (2) Adjustments made by the Commissioner normally arise as a result of a tax audit. If, as a result of an audit, it is established that the conditions of a controlled transaction differ from the arm's length conditions, and, as a result, profit has been understated, or losses overstated, then the adjustment to the taxable income will be made. Such adjustment will be made, of course, to the measure of taxable income that would result if controlled transactions had been conducted in accordance with the arm's length principle.
- (3) Where taxpayers make adjustments themselves such adjustments may be either to the price paid or payable, or to the calculation of taxable income.
- (4) The first of these adjustments may take place at a time after a relevant transaction has taken place, but before the financial accounts are drawn up. This might be the result of a comparability analysis undertaken at the end of an accounting period.

- (5) As an example, take a distributor located in Zimbabwe that purchases goods from a foreign associated person for resale in Zimbabwe. At the beginning of the period, the purchase price may be set at a level that was expected to provide a 3% net profit return on sales, on the basis of forecasted sales volume, sales price and internal costs. At the end of the period the taxpayer's actual return on sales turned out to be only 1.5%. At that time, the taxpayer conducts a comparability analysis using the most up to date data available, which suggests that the arm's length return for its distribution activities is 3.5%. In order to comply with Zimbabwe's transfer pricing rules, the taxpayer may make a retrospective price adjustment. This might take the form of a repayment made by the associated person, or a credit note. This adjustment to the actual price will be reflected in the accounts, and thus the taxable income.
- (6) As an alternative, the taxpayer may make the relevant adjustment in the calculation of taxable income included in the annual tax return. The adjustment would be to the level of taxable income that would result if controlled transactions had been conducted in accordance with the arm's length principle. (That is, in the example above, a net return on sales of 3.5%).
- (7) In this case, Section 98B only allows an adjustment to be made only if it results in a higher level of taxable income, or a lower level of tax losses.

## **10 Transfer Pricing Documentation**

- 1) The Income Tax Act deals comprehensively with the books and records that every person liable to tax in Zimbabwe is required to maintain.
- 2) The records are required to be maintained in Zimbabwe and in the [English] language.
- 3) The Income Tax Act authorises the Commissioner to request, demand, and collect from any person within Zimbabwe, all information deemed necessary for the purposes of the Act.
- 4) The Income Tax Act requires all books and records to be maintained for a period of 6 years after the completion of the transaction, acts or operation to which they relate.
- 5) All the above provisions are also applicable to transfer pricing documentation. The purpose of this section of the Practice Notes is to cover the broad issues relating to the types and extent of documentation which taxpayers are required or advised to keep, to be able to demonstrate how their methods and prices satisfy the arm's length principle.
- 6) While Statutory Instrument 109 of 2019 provide the transfer pricing documentation and records required to be maintained by taxpayers, it is not possible to specify a comprehensive pre-defined set of documentation requirements that meet the requirements of all taxpayers and therefore the list is non-exhaustive. Appropriate documentation depends on each taxpayer's specific facts and circumstances.

- 7) The taxpayer's process of considering the transfer pricing documentation appropriate for tax purposes should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance. The Commissioner would expect taxpayers to have created, referred to and retained documentation in accordance with this principle.
- 8) In determining an arm's length price, a taxpayer would generally go through a process which will include a comparability analysis and information gathering on relevant comparables. This would be expected to point to an appropriate method under which the arm's length price would be determined. Once the appropriate method has been determined, the process becomes one of applying the relevant data to determine the arm's length process.
- 9) As a general rule, the Commissioner considers that taxpayers should contemporaneously document the process they have followed and their analysis in determining transfer prices, in their efforts to comply with the arm's length principle. This should include setting out in detail why those transfer prices are considered to be consistent with the arm's length principle.
- 10) The Commissioner will rely as much as possible on documentation that should be created in the ordinary course of business and in setting an arm's length transfer price.
- 11) Consistent with Statutory Instrument 109 of 2019, the regulations on transfer pricing documentation require persons to provide the Commissioner with high-level information regarding their global business operations and transfer pricing policies that is to be available to all relevant tax authorities.
- 12) It also requires that detailed transactional transfer pricing documentation be provided specific to each country, identifying material controlled transactions, the amounts involved in those transactions, and the company's analysis of the transfer pricing determinations they have made with regard to those transactions.
- 13) The Regulations stipulate that an Annual Return on Transfer Pricing must be submitted to the Zimbabwe Revenue Authority in conjunction with their income tax return. The Annual return on Transfer Pricing includes detailed disclosures on the nature and quantum of the taxpayer's controlled transactions.
- 14) Taken together, this documentation will require taxpayers to articulate consistent transfer pricing positions and will provide the Commissioner with important information to assess transfer pricing risks, make determinations about where audit resources can most effectively be deployed, and, in the event audits are called for, provide information to commence and focus audit inquiries.
- 15) The information should make it easier for the Commissioner to identify whether companies have engaged in transfer pricing that have the effect of artificially shifting substantial amounts of profit leading to a reduction in the taxpayer's taxable income.

The specific content of the various documents reflects an effort to balance the Zimbabwe Revenue Authority's information needs, concerns about inappropriate use of the information, and the compliance costs and burdens imposed on business.

## 11 Other Practical Considerations

Depending on the facts applicable to each individual case, the Commissioner intends to follow the general Practice Notes set out in this Practice Notes. The discussion below focuses on various practical issues that have not been addressed above.

### 11.1 Information in the possession of foreign Associated persons

- (1) Taxpayers sometimes claim that a non-resident parent dictates the transfer prices used by its subsidiaries, and that the latter does not reveal to the Zimbabwe taxpayer the basis for this pricing. In other cases, the taxpayer may explain that the transfer pricing is based on a transfer method that involves the benchmarking of a foreign controlled person, but that the details of this analysis is not available to the Zimbabwe taxpayer.
- (2) The Commissioner will not accept this type of argument for failure to provide necessary information or documentation to the Commissioner. If the Zimbabwe taxpayer does not have such information it cannot be certain that it has complied with the transfer pricing rules and has thus submitted a correct tax return. At the same time, the taxpayer will not be able to demonstrate to the Commissioner that its transfer pricing complies with the arm's length principle. The Commissioner considers it reasonable to expect taxpayers to obtain such information where necessary. The Commissioner will treat failure to make such information available to the Zimbabwe Revenue Authority when required to do so as a failure to keep adequate documentation, and the penalties articulated in Section 13 below will apply.
- (3) More specifically, Transfer Pricing Regulations s require that where the chosen method involves the application of a tested party that is foreign, the taxpayer must provide:
  - The financial information of the tested party; and

### 11.2 General anti-avoidance provisions

- (1) Taxpayers should be aware that the exercising of the discretion by the Commissioner as provided in Section 98 to the ITA and these Practice Notes will not limit or exclude the application of this section.

### 11.3 Corresponding adjustments

- (1) An adjustment to the measure of taxable income as a result of the application of the transfer pricing rules has the potential to create double taxation. In order to eliminate double taxation a 'corresponding adjustment' may be made.

- (2) Take, as an example, Taxpayer A, in Zimbabwe, which conducts transactions with an associated person, Taxpayer B, in Country X. Assume that the combined profit of Taxpayers A and B from the controlled transaction is \$1000, with \$400 recognised by Taxpayer A, and \$600 recognised by Taxpayer B. As a result of an audit of Taxpayer A by the [Zimbabwe Revenue Authority], an adjustment under the transfer pricing rules of \$50 is made to the taxable income of Taxpayer A. Without a corresponding adjustment, the total profit subject to tax will be \$1050 (made up of \$ 450 in Taxpayer A and \$600 in Taxpayer B), whereas the actual profit remains at \$1000. There will thus be double taxation of \$50.
  
- (3) Where the transfer pricing rules apply to adjust the measure of profit of a taxpayer in respect of a cross-border transaction, a corresponding adjustment may be available for the counterpart to the transaction in the other country. In the example above, double taxation may be eliminated if Taxpayer B makes a request to the foreign tax authority for a ‘corresponding adjustment’. If that request is accepted by the foreign tax authority, then it will reduce the taxable income for the relevant period by \$50.
  
- (4) Similarly, where an adjustment is made by a foreign tax authority to the conditions of transactions between a person resident in that country and an associated person in Zimbabwe, and this adjustment results in an increase in the taxable income of the foreign associated person, then the Commissioner will grant a corresponding adjustment in the tax computation of the Zimbabwe taxpayer if he considers it appropriate.
  
- (5) It should be noted that a corresponding adjustment in respect of both domestic and cross-border transactions will be considered only if Zimbabwe has a treaty with the relevant foreign jurisdiction that reflects an intention to provide for the relief of economic double taxation. In all such cases, the Commissioner will grant a corresponding adjustment in a taxpayer resident in Zimbabwe only after an examination of the consistency of that adjustment with the arm’s length principle, consulting as necessary with the competent authority of the other country. If the Commissioner takes the view that the adjustment to taxable income made by the foreign tax authority is not in accordance with the arm’s length principle, a corresponding adjustment will be denied, or only granted to the extent it accords with the arm’s length principle. In such cases, the Commissioner will discuss the issue with the competent authority of the foreign tax authority with a view to eliminating double taxation.
  
- (6) A request for consideration of a corresponding adjustment must include the information necessary for the Commissioner to examine the consistency of the adjustment made by the foreign tax authority with the arm’s length principle, including:
  - a. The name, registered address and, where applicable, trading name(s) of the associated person;
  
  - b. Evidence of the tax residence of the associated person;

- c. The year(s) in which the adjusted controlled transaction(s) took place;
- d. The amount of the requested corresponding adjustment and the amounts of the adjustment made by the foreign tax authority;
- e. Evidence of the adjustment made by the foreign tax authority and the basis for the adjustment, including details of comparability analysis relied upon and the transfer pricing method applied;
- f. Confirmation that the associated person will not, or is unable to, pursue any further recourse under the domestic law of the other country that may result in the adjustment made by the foreign tax authority of the other country being reduced or eliminated;
- g. Any other information that may be relevant for examining the consistency of the adjustment with the arm's length principle.

The request must be made within the applicable time period for making a request for the case to be resolved by way of agreement procedure under the applicable tax legislation. It must be made to: The competent Authority ZIMRA ZB Centre Cnr Nkwame Nkrumah Ave.

- Other information that is sufficient to be able to reliably apply the selected method to the foreign tested party and to enable a review by the Commissioner of the application of the method to the foreign tested party.

#### 11.4 [Acceptability of analyses prepared for a foreign tax authority.](#)

- (1) It would be expected that the same transfer pricing analysis would normally be applicable for the compliance purposes of both the domestic and foreign parties to a controlled transaction.
- (2) Most analyses under the accepted pricing methods focus directly on testing the return to one party to a transaction. In such cases, the return to the tested party is established and any residual profit or loss arising from the transaction lies with the counterparty to the transaction. The Commissioner would expect an arm's length price established through any of the methods described in this Note to result in a return for the Zimbabwe operations, commensurate with its economic contribution and risks assumed, whether or not the analysis has been carried out also for a foreign tax jurisdiction or tests the return to a foreign controlled person.
- (7) Double taxation may also arise from the application of the transfer pricing rules to purely domestic transactions between two Zimbabwe controlled persons. The Commissioner shall make an appropriate adjustment to the taxable income of the other party to the transaction unless otherwise provided by the Taxation Act.

## 12 Penalties Relating to Transfer Pricing

Where the taxpayer's income tax assessment is amended by the Commissioner in accordance with section 98B of The Act as read with the 35<sup>th</sup> schedule, the taxpayer is liable to a penalty (section 98B (2a) of The Act) as follows:

- a. In the event of fraud or evasion: 100 % of the tax shortfall amount
- b. Where contemporaneous transfer pricing documentation does not exist in relation to the transaction giving rise to the amended assessment, or does not comply with the Transfer Pricing Documentation Regulations 30 % of the tax shortfall amount.
- c. Where contemporaneous transfer pricing documentation exists in relation to the transaction giving rise to the amended assessment and complies with the requirements of Transfer Pricing Documentation Regulations 10 % of the tax shortfall amount