

NESTLE ZIMBABWE (PVT) LTD
versus
ZIMBABWE REVENUE AUTHORITY

SPECIAL COURT FOR INCOME TAX APPEALS
MAFUSIRE J
HARARE, 19 March 2024

Date of judgment: 11 June 2024

Assessors: Mr C. Maredza & Ms G. Kangai

Income tax appeal

M. Tshuma, for the appellant
S. Bhebhe, for the respondent

MAFUSIRE J

- [1] Paraphrased, s 15 of the Income Tax Act [*Chapter 23:06*] [*“the Act”*] grants traders the right to deduct from their income such expenses and losses, not of a capital nature, as are incurred by them for the purposes of trade or in the production of income.
- [2] This appeal is about deductions made by the appellant [*“Nestle”*] in the tax years 2014 to 2018 which the respondent [*“ZRA”*] disallowed. Nestle argues that ZRA wrongly disallowed the deductions as the expenses had been genuinely incurred in the production of its income and therefore legitimately deducted. On the other hand, ZRA insists that the expenses fell outside the range of permissible deductions. That generally is the outline of the dispute. Now the detail.
- [3] Nestle is a Zimbabwean company. But it is part of a global conglomeration that includes Nestle SA, Societe Des Produits Nestle SA and Nestec SA, all of them registered in Switzerland. It is wholly owned by Nestle SA. It is in the business of, among others, the manufacture, processing and distribution of milk, instant drinks and culinary products on licence from Nestle SA. ZRA is a statutory body and a central collector of Government revenue.

- [4] The licence arrangement within the Nestle group is governed by a comprehensive agreement called the Global Licensing Agreement [*“the GLA”*]. In terms of it, and very briefly, Nestle acquires exclusive rights for the manufacture, processing, packaging, marketing and distribution of the Nestle products. In return, Nestle pays licence fees, called royalties, of 5% on the net sales, reduced to 2% by the Reserve Bank of Zimbabwe [*“RBZ”*] as the exchange control authority.
- [5] In very general terms, the business model of the Nestle group at the relevant period, was such that services or functions that could be performed more optimally or efficiently by one entity in one region would be shared with the other entities elsewhere in return for this or that type of fees. More details on this emerge later in this judgment.
- [6] According to ZRA, it carried out an audit for those tax years in question. The audit was triggered by the fact that for those years, Nestle had been persistently reporting income tax losses. Upon investigation, ZRA concluded that Nestle was claiming expenses most of which had not been incurred in the production of any income. According to ZRA, there had been a flagrant violation of s 15(2)(a) of the Act by Nestle.
- [7] Following the audit, ZRA submitted fresh or adjusted assessments to Nestle. These showed a tax shortfall of \$15 998 442-22 for the tax years in question, inclusive of a penalty at 40%. The principal amount of the shortfall was \$11 427 458-73. Nestle objected. ZIMRA overruled the objection. Nestle then appealed to this court in terms of s 65 of the Act.
- [8] In terms of Para 13 of the Twelfth Schedule to the Act, if any facts are in dispute, *viva voce* evidence can be led. In the present case, only one witness testified. Her name was Betty Waithera Ngare [*“Ngare”*]. At the relevant time she was an advocate of the High Court of Kenya with a Masters degree in law. She was the Regional Tax Manager with Nestle global for 13 years. Her evidence was largely to explain the business model of the Nestle group in terms of the GLA. Particular aspects of her evidence as may be relevant to particular aspects of the dispute will be related to at the appropriate time.

- [9] It is now the task to look at the dispute between the parties in regards to those types of expenses as had been claimed by Nestle and disallowed by ZRA and render our decision.
- [a] *Royalties in respect of products manufactured by other affiliates*
- [10] ZRA disallowed royalties in respect of products manufacture by other Nestle affiliates on the basis that it was they, not Nestle, which had manufactured the products on licence from Nestle SA, and that Nestle had merely imported them for sale. As such, ZRA argued, this was not an expenditure incurred by Nestle in the production of its income.
- [11] ZRA further argued that royalties by nature are paid by the person who exploits the intangible asset by manufacturing the goods, and not by a purchaser of finished products, and that it was simply because of the ‘related party’ relationship existing within the Nestle group that an ‘arm’s length arrangement’ could not subsist. ZRA’s argument was that the GLA relied upon by Nestle was in conflict with the anti-avoidance or income splitting provisions of s 98 and s 98A of the Act respectively.
- [12] On the other hand, Nestle argued that the GLA is not such a tax avoidance scheme, or an income splitting arrangement as envisaged by s 98 and s 98A of the Act respectively, but rather a standard, legitimate and international business arrangement which is sometimes referred to as the ‘end product royalty agreement’.
- [13] Our decision on this point is arrived at in this way. Clause 25.1 of the GLA grants a licensee, in this case Nestle, the right to arrange for any of the Nestle products, or components or ingredients thereof, to be manufactured by it or by one or more of the affiliates. In return, the licensee, in terms of cl 32, pays a license fee of 5% on the net sales of the products sold under any of the trademarks. This was what was reduced to 2% by the RBZ.
- [14] It is common cause that the licence fee envisaged in cl 2 of the GLA is the royalty. A royalty is defined in Para 1[1] of the Nineteenth Schedule to the Act as any amount

payable as a consideration for the use of, among other things, any work whatsoever in which a copyright or trade mark exists.

- [15] ZRA's argument that Nestle did not exploit the intangible asset of the licensor and should therefore bear the royalty costs cannot succeed. The purpose of the GLA is for an affiliate like Nestle, to secure exclusive access to licences for the manufacture, processing, control, packaging, marketing, distribution and selling of the products [*underlining for emphasis*]. Thus, Nestle may itself manufacture. But it may also arrange manufacture by any of the affiliates and then merely import the finished products for sale. Clause 25 of the GLA provides:

“LICENSEE shall have the right to arrange for any of the Products or components or ingredients thereof to be manufactured by one or more of its affiliate companies ...”

- [16] What it means is that Nestle may exploit the intangible asset through the hand of an affiliate. Nestle does not accrue an economic benefit in merely manufacturing the products. The economic benefit accrues on the sale to customers. In terms of cl 2 of the GLA, the contract manufacturer cannot sell or distribute the products in Nestle's territory, Zimbabwe. Ngare testified that Nestle's local factory has a limited capacity. It manufactures only three of the Nestle products, namely *Cremora*, *Everyday Milk* and *Cerevita*. The Nestle group has 400 factories worldwide.
- [17] A licensee is exempt from paying royalties on products imported from affiliates in respect of which the licence fee has been paid. In the present case, Ngare testified that no licence fees had been paid by the contract manufacturers. She also testified that they had provided ZRA with a schedule of the licence fees, the calculations and the bank proof of payments by Nestle. However, despite that ZRA had still proceeded to disallow this expenditure item.
- [18] In terms of s 98 of the Act, and in paraphrase, a 'tax avoidance transaction or scheme' is one which is entered into, or carried out with the effect of avoiding or postponing or reducing a tax liability in circumstances in which such a transaction or scheme would

not normally be entered into, or the rights or obligations created thereby would not normally be created between persons dealing at arms' length and the avoidance or postponement or reduction of the tax liability was the *sole* purpose, or one of the main purposes of the transaction or scheme [*emphasis added*].

- [19] In terms of s 98A of the Act, again paraphrased, 'income splitting' is where an individual attempts to split income with an associate by directly or indirectly transferring income or property to the associate who then receives or enjoys the income from that property, for the *sole* or main reason to lower their tax burden [*emphasis added*].
- [20] We are unable to agree with ZRA's argument as it pertains to anti-avoidance and income splitting provisions of the Act. In this instance, we start from back to front. Section 98A of the Act is manifestly inapplicable. It governs individuals, not companies. Section 2 of the Act defines an individual as a person other than a company. Furthermore, there is nothing to justify a conclusion that the GLA, which predates s 98A of the Act, was executed for the *sole* or *main* reason to lower tax burdens. Section 98A is a 2014 amendment. The GLA was executed in January of 2007. But more fundamentally, a scheme such as the Nestle GLA is not something peculiar to Nestle. It is a normal business arrangement amongst affiliates worldwide. It is not an income splitting device.
- [21] We also disagree that the GLA is a tax avoidance scheme as envisaged by s 98 of the Act. It is common and normal practice in commerce for sale-based royalties. Ngare testified that the Nestle group operates in 189 countries around the world with agreements identical to the GLA. This was not refuted. It is difficult to conclude that the GLA was executed to avoid or postpone or reduce a tax, let alone that this was the *sole* purpose or one of the *main* purposes of the agreement as envisaged by s 98 of the Act. This deduction was legitimate. ZRA should have allowed it.
- [b] *Management services*

- [22] In terms of a management services agreement between Nestle and one of the Nestle group affiliates, Nestle Equatorial African Region Limited [*NEARL*], whose objective was to streamline and avoid duplication of management services, support functions and the like, Nestle paid NEPZ a management fee. The management services envisaged under that agreement comprised common operational management services in the fields of, among others, general management, finance, accounting, reporting, procurement and human resources, depending on requirements from time to time. Payments for services would be made monthly in arrears upon invoices submitted.
- [23] ZRA disallowed expenses for management expenses on the basis that there had been an impermissible duplication of shared services which were, or could be carried out by Nestle's own local personnel. The services were in accounting, payroll, procurement, human resources and so on. ZRA's argument was that, *inter alia*, Nestle had adduced no evidence of services actually rendered and therefore of the expense actually incurred.
- [24] Ngare testified that multinationals operate in such a way as to reduce the overall cost of doing business. This is achieved by, among other things, avoiding the duplication of services. She said the services provided by NEARL included legal and back-office functions, payroll and accounting services. How it happened on the ground was that of the invoices received, Nestle would scan and send them to NEARL's offices in Ghana which then would do a compliance check. NEARL also did the banking. It ran the payroll. Ngare said such manner of operation frees up valuable time for production by the local entity.
- [25] The contentious issue on management service fees was that Nestle sought to rely on the fee cap by the RBZ of 2% on turnover as proof that the expense had been actually incurred. It was argued that it was not necessary that the service be actually rendered in order to establish that it had actually been incurred. On the other hand, ZRA argued that the RBZ fee cap of 2% could not, by itself, be proof that the service had actually been rendered and that the expense had actually been incurred.
- [26] Our analysis is this. The deductions that are allowable in terms of s 15[2] of the Act are for "... expenditure or losses to the extent to which they are incurred for the purposes

of trade or in the production of the income ...” A service charge between associates has to be consistent with the arm’s length principle of s 98 of the Act. In terms of Para 8 of the Thirty-Fifth Schedule to the Act such a service charge is so consistent where, *inter alia*, it is charged for a service that is actually rendered; the service rendered provides the recipient with economic or commercial value to enhance its commercial position, and it is charged for a service that an independent enterprise in comparable circumstances would have been willing to pay for [*underlining for emphasis*].

- [27] In *Port Elizabeth Electric Tramway Co v Commissioner for Inland Revenue* [1936] CPD 241 it was held that so long as the liability to pay had actually been incurred it could be deductible even though it may not have been actually paid in that tax year. In *CF [Pvt] Ltd v ZRA* HH 99-18 the High Court held that the principle derived from the cases from this jurisdiction and abroad is that the unconditional obligation to pay is incurred when the work has been done or the service has been rendered.
- [28] Nestle debates quite extensively the meaning of “expenses actually incurred”, drawing from case law here and abroad in order to prove that “actually incurred” does not mean that the expense must have been actually paid or discharged. With respect, that is not the crisp issue before the court. The crisp issue before the court was ZRA’s disallowance of the expenditure on the basis that it was not proved that the services for which the expenditure was claimed had been rendered or provided. It is a question of the onus resting on Nestle to prove that the service had actually been rendered and the necessary proof that had been submitted.
- [29] Ngare testified that the proof submitted to ZRA was in the form of e-mails, agendas and minutes of meetings, and so on. Apparently ZRA was not satisfied. That is understandable. It will be remembered that in terms of the management services agreement, among other things, payment is made upon production of invoices. We are satisfied that in the absence of cogent proof of the expenditure in question it is reasonable that ZRA was not satisfied. It was entitled to disallow the deduction. The RBZ fee cap of 2% could not be used as proof that the services in question had been rendered and therefore the obligation in respect thereof incurred.

[c] *Shared services*

- [30] ZRA disallowed the amount Nestle paid to Nestle Central and West Africa's Nestle Business Services [NBS] allegedly for accounting and human resources functions on the basis that such functions are materially performed by Nestle's locally based personnel. In the course of its audit, ZIMRA held interviews with certain of Nestle's employees in accounts and human resources and came to the conclusion that their functions were substantially the same as those performed by NBS.
- [31] During her evidence, Ngare took the court through the agreement on shared services, the employee interviews, the relevant job descriptions, graphs, pictures and so on, and concluded that there was no such duplication of services as claimed by ZRA. She said the local functions were dissimilar to those rendered from abroad.
- [32] The whole of this appeal presents issues that dog the courts from time to time in ZRA's relations with multinationals. On the one hand ZRA is entitled to scrutinize and question intragroup business models that may appear to be mere tax evasion schemes. It has the statutory mandate to collect taxes and protect the fiscus from errant tax planning schemes. On the other hand, businesses are entitled to adopt models or concepts that offer the best advantage in the reduction of the cost of doing business for optimum profitability. The position is settled that the central revenue collector cannot assume an armchair position and decide for businesses how to run their operations: see *IAB Co v ZRA* HH 32-22, at p 12 of the cyclostyled judgment.
- [33] In the instant case, having scrutinised the relevant documents on the shared services, the results of the employee interviews and Ngare's evidence, we are satisfied that Nestle has proved on a balance of probabilities that there was no duplication of services in the expenses that were disallowed by ZRA. There are differences, admittedly marginal in some respects, between the functions of Nestle's local personnel and the services that it receives from its affiliates from abroad. But it is too sweeping a conclusion that the services rendered by Nestle's affiliates abroad were the same as those performed by its local personnel here. Consequently, ZRA's decision on this expenditure item should be set aside.

[d] *Research services*

[34] In terms of the management services agreement, Nestle also pays service costs which comprise, among others, direct or indirect expenses, charges, overheads and administration costs. ZRA disallowed expenses claimed by Nestle in relation to certain analytical quality tests conducted by an affiliate in a laboratory in Singapore under the rubric 'research services'.

[35] ZRA's basis for disallowing the deduction for such services was that Nestle could not pay royalties to the owner of the brand, Societie Des Produits Nestle SA, when it was its obligation to account for any research associated with food safety. Ngare testified that each of the Nestle group laboratories is equipped with specialised equipment. She said that any testing is referred to a laboratory with the appropriate equipment; that Nestle laboratory here does not have such capacity; that there had been no laboratory testing in years 2014, 2017 and 2018, and that no research fees had been claimed in respect of those years.

[36] Our findings are that the research or analytical fee was not paid to the owner of the brand but to an affiliate with the appropriate laboratory apparatus. An affiliate tests the products after the manufacture to ensure product compliance with specifications and standards as a guarantee for food safety. We are satisfied that such a cost is classically deductible in terms of s 15[2][a] of the Act in respect of the years in which it was claimed.

[e] *Zone services*

[37] Zone services related to the cost of goods allegedly imported by Nestle from related parties, for example raw materials. ZRA disallowed the expense on the basis that the value of such imports as claimed by Nestle exceeded the value of those imports as captured on its ASYCUDA platform. ZRA said the excess was unverified. Nestle

argued that a customs documentation such as ASYCUDA cannot be a reference point for confirming expenditure that had actually been incurred.

[38] ASYCUDA stands for Automated Systems for Customs Data. It is an automated customs platform or programme for the compilation of accurate statistics on imports and exports. Ngara testified that for the relevant period, its erstwhile clearance agent, Allan, Wack and Shephard [Pvt] Ltd, had perpetrated a fraud on it regarding the value of its imports. This had given rise to a court case which had ended in favour of Nestle. Ngara said ZRA had been fully apprised of these developments.

[39] We are satisfied that in the absence of any better evidence on the point ZRA was entitled to rely on the ASYCUDA evidence to ascertain the value of Nestles' imports for the period in contention. It was a question of whether or not Nestle had discharged the onus resting on it. Therefore, the zonal expenses in excess of those reflecting on the ASYCUDA remained unverified and therefore not deductible.

[f] *Canteen meals*

[40] Nestle provides meals to both its factory and head office employees. The meals comprise lunch and teas. The employees are not allowed to bring their own food for the reason that Nestle being in a sensitive food manufacturing industry, there is a high risk of contamination from foreign food items. Ngara testified that head office employees might bring their own food to the office but that they would be provided with meals where they visited the factory. Meals are taken in the canteen factory. .

[41] ZRA disallowed the deduction on the basis that this was entertainment and therefore an expenditure not incurred for the purposes of trade or in the production of income within the meaning of s 15[2][a] of the Act.

[42] In terms of s 16[1][m] of the Act no deduction should be made in respect of any expenditure on entertainment. Entertainment is defined to mean hospitality in any form. In *IAB Co v ZRA* above, the High Court, *per* NDOU AJ, at p 19, allowed canteen meals as a deductible expense. It said:

“Accordingly, the meals are provided to employees in the interest of the appellant’s business. The canteen meals provided to employees cannot be classified as entertainment. The primary purpose of providing the meals is to ensure minimal business disruption and continuity given [that] the appellant operates continuously 24 hours a day and every day of the year. The expenditure is closely connected with the production of income and would be allowable under s 15[2][a] of the Act – *Port Elizabeth Electric Tramway Co. Ltd v CIR, supra*, and *ITC 81820 SATC 507.*” .”

[43] Nestle’s counsel argues that s 15[2] of the Act only refers to expenditure “incurred” and not expenditure “*necessarily* incurred” and that therefore it is immaterial whether or not an expenditure incurred is necessary as long as it is incurred in the production of income. This is more so, he concludes, given that the collector of taxes has no right to dictate to a taxpayer how they may run their business more efficiently.

[44] WILLIAMS J, in *Tweddle v Federal Commissioner of Taxation* [1942] 180 CLR 1, at 7 said:

“It is not suggested that it is the function of the income tax Acts or of those who administer them to dictate to taxpayers in what business they shall engage or how to run their business profitably or economically. The Act must operate upon the result of a taxpayer’s activities as it finds them. If a taxpayer is in fact engaged in two businesses, one profitable and the other showing a loss, the Commissioner is not entitled to say he must close down the unprofitable business and cut his losses even if it might be better in his own interests and although it certainly would be better in the interests of the Commissioner if he did so.”

[45] In similar vein, WATERMEYER JA, in the *Port Elizabeth Electric Tramway Co.* case above, said, at p 244:

“[T]he words of the statute are ‘actually incurred’ not ‘necessarily incurred.’ The use of the word ‘actually’ as contrasted with the word ‘necessarily’ may widen the field of deductible expenditure. For instance, one man may conduct his business inefficiently or extravagantly, actually incurring expenses which another man does not incur; such expenses therefore are not ‘necessary,’ but they are actually incurred and therefore deductible.”

[46] With respect, in this matter the argument of expenditure “actually incurred” or “necessarily incurred” misses the point. A deductible expense in terms of s 15[2][a] of the Act must, *inter alia*, be one incurred “...*for the purpose of trade or in the production of the income* ...” If an expenditure does not meet any one of the criteria in the legislation, for example if it is of a capital nature, then it is not deductible, irrespective of whether or not it was necessary.

[47] However, notwithstanding the foregoing, it is our considered view that ZRA should have allowed the deduction for canteen meals for factory workers. It is in Nestle's vital interest that the risk of product contamination be eliminated altogether or minimised. ZRA does not suggest that food production does not require that stringent conditions be observed. On the contrary, any food item is a sensitive product. Not only should high hygiene standards be observed, but also a manufacturer like Nestle should be expected to jealously guard and protect its brand by, among other measures, banning external food items from its premises. We hold that it was wrong for ZRA to classify the canteen meals for Nestle's factory workers as mere entertainment.

[48] It was not the issue before us, and therefore there was no debate on it, whether or not the factory employees could eat outside of the company canteen and if so, what effect that would have on production. On the facts and the issues placed before us, we rule that the canteen meals for Nestle's factory employees should be a deductible expense in terms of s 15[2][a] of the Act.

[50] We leave open the position whether meals for Nestle's head office staff are also a deductible expense as those for factory employees. The disallowance by ZRA was not on the basis that head office staff should have been treated differently. The case was neither presented nor argued on that premise. It was an issue that arose as a query by the court at the end of Ngare's evidence.

[g] *40% penalty*

[51] Section 46 of the Act imposes an obligation on a taxpayer to pay additional tax in the event of default or omission in certain respects, including, for instance, omitting from his / her returns an amount of tax that should have been included. Such additional tax is in fact a penalty. Its purpose is to punish the individual wrongdoer and to deter other prospective wrongdoers: *ITC 1351* [1982] 44 SATC 58 and *PL Mines v ZRA* 2015 [1] ZLR 708 [H]. ZRA is entitled to charge additional tax of up to 100% of the outstanding tax.

[52] In the present case, ZRA charged a 40% penalty. This was on the basis that Nestle was a repeat tax evader. It argued that it had previously disallowed management fees,

royalties and entertainment expenses in respect of the 2009 to 2013 tax years but that Nestle had refused or neglected to adjust its approach to these expenses.

- [53] The approach of the courts to the question of additional tax or penalty is to consider whether there has been a deliberate evasion, a careless or inadvertent omission or a misstatement by the taxpayer: see *PL Mines, supra*. No particular form of *mens rea* is required. All that the court has to consider objectively is whether an amount which ought to have been included was omitted, or whether an incorrect statement was rendered: *CIR v Di Ciccio* 1985 [3] SA 989 [T], 993E – G and *CIR v McNeil* 1959 [1] SA 481, 487E – G.
- [54] The question of deliberate evasion has to be looked at in context. Each case has to be determined on the basis of its peculiar facts. In the present case, we find that although there was a deliberateness on the part of Nestle, it was not to evade tax. Instead, it was to avoid paying a tax that it genuinely considered not to be due. It was to deduct expenditure items that it genuinely considered were lawfully deductible. It did not consider itself a repeat offender. In respect of the tax audits for the years 2009 to 2013, the information before us is that it had appealed successfully to the Supreme Court and had therefore been vindicated. Furthermore, ZRA's attempts to re-issue the same assessments had been nullified by the High Court.
- [55] ZRA's 40% penalty aforesaid has to be set aside in its entirety, not only because the basis of its imposition was incompetent as analysed above, but also that in the present proceedings, Nestle has achieved substantial success. Of the six expenditure items in contention, we have held that only two could not genuinely be claimed for deduction. Objectively, *no mens rea* can be said to have been established to attract the penalty in terms of s 46 of the Act. Whilst both the power to impose the penalty and the extent thereof are matters of discretion for ZRA, in the present case, factors attracting such a penalty being absent, the question of discretion falls away.
- [h] *Disposition*
- [56] The appeal is allowed in respect of:

- i/ the royalties relating to goods manufactured by other affiliates;
- ii/ shared services;
- iii/ research services;
- iv/ canteen meals, and
- v/ the 40% penalty.

[57] The appeal is dismissed in respect of:

- i/ management services, and
- ii/ zone services.

[58] There having been no outright success by either party. And in line with the rules of practice in regards to public interest litigation, each party shall bear their won costs.

11 June 2024



Gill, Godlonton & Gerrans, applicant's legal practitioners
Kantor & Immerman, respondent's legal practitioners