NRGI Reader
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Natural Resource Governance Institute

Transfer Pricing in the Mining Sector

Preventing Loss of Income Tax Revenue

"Ensure competent tax administration and implement tax avoidance rules"

— Natural Resource Charter, Precept 4

KEY MESSAGES

- Transfer pricing is a business practice that consists of setting a price for the purchase of a good or service between two "related parties" (e.g., subsidiary companies that are owned or controlled by the same parent company).
- Transfer pricing becomes abusive when the related parties distort the price of a transaction to reduce their taxable income. This is known as transfer mispricing.
- Multinational mining companies rely on complex webs of interrelated subsidiaries. Some of them are domiciled in low-tax and secrecy jurisdictions. These subsidiaries can sell minerals to each other at a discount or purchase goods, services and assets from each other at inflated prices in order to "transfer" profits to lower-tax jurisdictions from higher-tax ones.
- One way governments can address transfer mispricing is by passing laws that require companies to apply the "arm's length" principle: related parties price transactions as if they were transactions on an open market.
- There are five major transfer pricing methods based on the application of the arm's length principle. A sixth method overcomes the challenge of lack of comparable transactions by requiring taxpayers selling mineral products to benchmark the sale price to the publicly quoted prices of minerals or metals.
- Alternative tax policy rules—limiting interest deductions on related party loans, for example—help to protect the tax base and simplify implementation of transfer pricing rules.

WHAT IS TRANSFER PRICING AND WHY DOES IT MATTER?

The transfer price is the price of a transaction between two entities that are part of the same group of companies. For example, a South Africa-based company might sell mining equipment and machinery to its Ghana-based subsidiary. The price agreed is the "transfer price." The process for setting it is referred to as "transfer pricing." The difficulty in monitoring and taxing such transactions is that they do not take place on an open market. A commercial transaction between two independent companies in a competitive market should reflect the best option for both companies; two affiliated companies are more likely to make transactions in the best interest of their global parent corporation. It can be in the interest of the global corporation to make higher profits in

This reader is intended for use in conjunction with Precept 4 of the Natural Resource Charter.

lower-taxed jurisdictions and lower profits in higher-taxed ones, as a means of reducing its overall tax bill, as illustrated by figure 1.

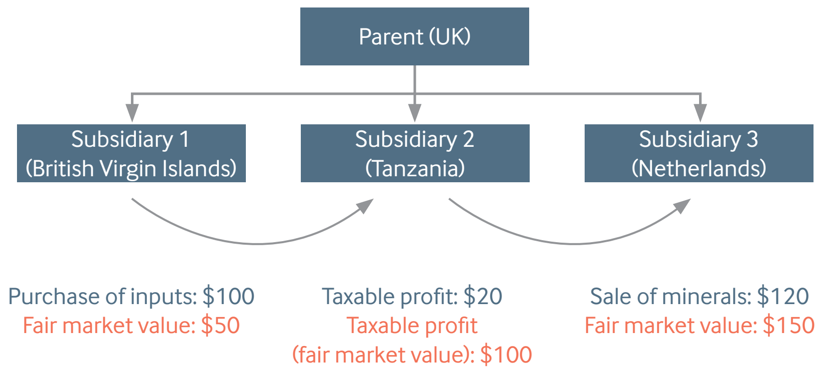

Figure 1. Illustration of transfer mispricing in the mining sector

While the corporations gain from such tax planning, there are winners and losers among the countries involved. Many governments of countries that have lost tax revenue as a result of "transfer mispricing" have created rules to regulate the practice.

Transfer pricing can limit income tax receipts, including in low- and middle-income countries. Developing countries depend twice as much on these receipts as developed economies, and African countries three times as much, as figure 2 shows. As developing countries try to increase funds available for social services and their national development agendas, limiting transfer mispricing is a key element of domestic resource mobilization.

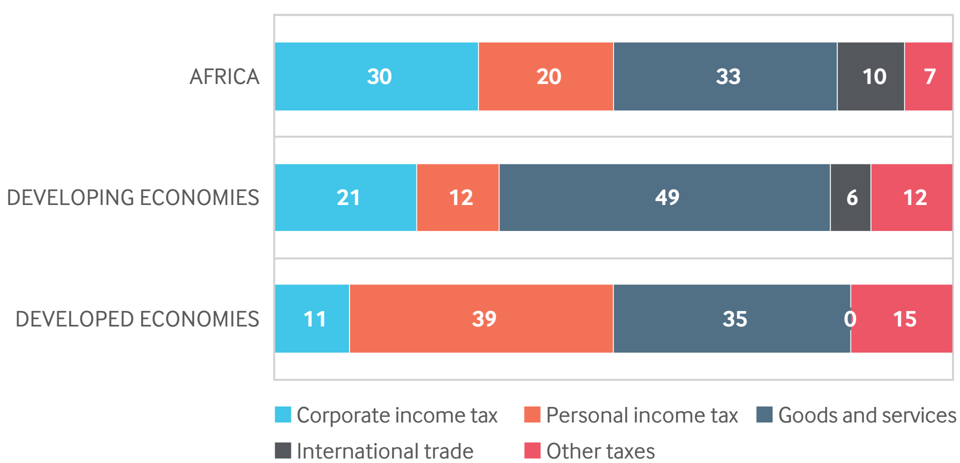

Figure 2. Composition of government tax revenue, by region (percentage)

Source: UNCTAD 2015 analysis, based on ICTD government revenue dataset http://uncounted.org/wp-content/uploads/2015/03/unctad-draft-fig3.png

HOW DOES TRANSFER PRICING WORK IN THE MINING INDUSTRY?

Transfer mispricing happens in many sectors sensitive to developing countries, including pharmaceuticals, telecoms and extractive industries. Each sector has its own specificities when it comes to implementing transfer pricing rules, and this reader focuses on the mining sector. There are numerous possible transactions between affiliated companies in the mining industry value chain. They can be broadly grouped into two categories: (1) the sale of minerals and/or mineral rights to related parties; and (2) the purchase of various goods, services and assets from related parties. These transactions are common to most mining companies. The value of these transactions and potential tax revenue leakage vary greatly depending on the size and structure of the operation, commodity type and production processes. Other things being equal, large corporations tend to have more transactions between related parties and more complex financing structures than smaller companies.

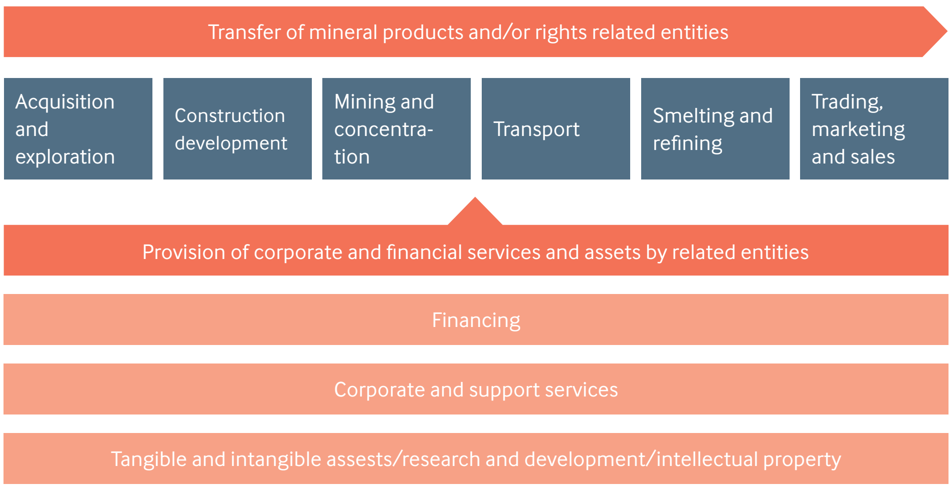

Figure 3. Possible transactions between affiliates along the mining value chain

Source: International Mining for Development Centre, 2014

Box 1. Examples of transactions between affiliated companies

In each case, the price could be manipulated to reduce taxable income in the country where the mine is located.

- Procurement of goods: A company purchases mining machinery on behalf of its subsidiary. The price charged includes the direct cost, plus a fee for service.
- Financing: The subsidiary receives a loan from its parent, usually to finance its exploration or development costs. This is another way for shareholders to provide capital to a mining project, but its accounting treatment is different from equity.
- Support services: The subsidiary pays a fee to a related party in return for a range of administrative, technical and advisory functions.
- Mineral sales: Minerals may be sold to a related company—a smelter, for example.

HOW CAN TRANSFER MISPRICING BE ADDRESSED?

Transfer pricing rules recommend the application of the "arm's length" principle when a company engages in a transaction with an affiliated company. This means that the transaction should reflect the market value of the goods or services exchanged: affiliated companies should trade with each other as if they were not affiliated. If the relevant transaction does not conform to the arm's length principle, transfer pricing rules give governments the legal right to adjust the price in the reported profits of the company.

"To address transfer mispricing, governments can put laws and regulations in place that define the arm's length principle and detail how it should be implemented."

To address transfer mispricing, governments can therefore put laws and regulations in place that define the arm's length principle and detail how it should be implemented. The OECD has proposed five major transfer pricing methods to apply the arm's length principle, and recommends that tax authorities ensure that companies use the method that is the most appropriate to each transaction with an affiliated party, given available data. Some of the five methods are based on comparing similar transactions between non-affiliated companies. Others compare the profit margins made by each subsidiary on a transaction. For detailed guidance, see the OECD guidelines (OECD 2010, 59-105).

Tax authorities can assess whether the methods have been applied properly by taxpayers in setting transfer prices. They first conduct a risk assessment to identify the riskiest cases, and then launch specific transfer pricing audits. They might need additional information from taxpayers and from tax authorities in other jurisdictions. The relevant tax authority may make an adjustment to a transfer price if it is not at arm's length: this is called a "transfer pricing adjustment."

The transfer pricing methods mentioned above rely directly or indirectly on the government having data on comparable external transactions so as to determine a price at arm's length. This use of "comparable data" as a benchmark requires that the external transaction be sufficiently similar to the related party transaction: similar features of the traded product, contractual terms, and economic circumstances. In practice, finding comparable data up to that standard can be very challenging.

For revenue authorities in Africa, for instance, applying the arm's length principle can be extremely difficult because there is often a lack of comparable transactions. Parties frequently have to adapt comparable data from other contexts in OECD countries. This can often be time-consuming and expensive, and produces results that do not reflect the economic reality of companies operating in Africa. Access to information on related parties based in offshore jurisdictions is a further obstacle for many revenue authorities, preventing them from building a complete picture of global activities of companies.

"For revenue authorities in Africa, applying the arm's length principle can be extremely difficult because there is often a lack of comparable transactions."

In light of these implementation challenges, an additional transfer pricing method has emerged called "the sixth method." It is designed specifically to limit the risk of transfer mispricing in commodity transactions. It requires that taxpayers selling commodity products to related parties use the publicly quoted price of the traded goods on the date that the goods are shipped as a reference. This is particularly relevant for resource-rich economies when publicly quoted prices of minerals or metals are widely available (for example, through the London Metals Exchange, Platts and other indexes).

In addition to the sixth method, low-income countries are also beginning to explore other policy and procedural alternatives that try to avoid transfer pricing issues altogether. These alternatives may not follow the arm's length principle, but they can relieve tax administrations of time-consuming transfer pricing monitoring and audits. For example:

- Limiting the deduction of interest on loans from affiliated companies
- Separating the operational income of the mine from the income on financial products that set future prices of minerals ("hedging")
- Advance pricing agreements and "safe harbors," which define an appropriate pricing method for specific related party transactions in advance, for a number of years

WHAT STEPS CAN STAKEHOLDERS TAKE TO TACKLE TRANSFER MISPRICING?

While transfer mispricing is a complex problem, there are different steps that various stakeholders can take to address the issue, such as the measures described below. At the end of this document are questions that oversight actors such as Extractive Industries Transparency Initiative (EITI) secretariats, civil society organizations and parliamentarians can use to conduct an initial study of a government's approach to transfer mispricing risks.

	Stakeholder	Recommendation
1	National tax administration	Put in place detailed rules that enable revenue authorities to determine the tax value of intra-company transactions in a rigorous and consistent way, including by spelling out the procedures by which the system is to be administered.
2	National tax administration	Establish administrative structures that promote a concentration of well-trained, highly skilled officials sufficiently empowered to implement transfer pricing rules effectively.
3	Government: prime minister's office, ministry of finance, ministry of mines, tax administration; country EITI multi stakeholder group	Improve inter-agency coordination on mining revenue collection by clarifying division of audit responsibilities, encouraging joint audits and establishing overarching coordination mechanisms.
4	National tax administration; international partners	Equip revenue authorities with transfer pricing expertise and technical sector knowledge to identify and evaluate transfer pricing risks in the mining sector.
5	National tax administration; ministry of mines; international development partners and agencies	Take proactive steps to narrow the information gap, obtain more regular and precise information from mining companies and develop automatic exchange of information with other jurisdictions.
6	EITI country secretariat; civil society organizations, parliamentarians	Hold the political leadership accountable for implementation of transfer pricing rules in the mining sector.
7	National tax administration; ministries of finance, mines.	Examine the feasibility of adopting specific tax policy rules to limit the reliance on the arm's length principle and the difficulty of finding comparable transactions.

For a comprehensive overview of transfer pricing implementation challenges, see "Preventing Tax Base Erosion in Africa: a Regional Study on Transfer Pricing Challenges in the Mining Sector," NRGI, July 2016.

POTENTIAL ROLES OF DIFFERENT ACTORS IN TRANSFER PRICING REGULATION

Government institutions (executive branch)	• Ministry of finance: sets transfer pricing policy; develops transfer pricing laws and regulations. • Ministry of mines: may contribute to the development of transfer pricing policy, particularly if there is an issue relating to mining. • Revenue authority: administers transfer pricing rules; collects transfer pricing adjustments. • Mining regulator: administers mining laws, may be involved in transfer pricing assessments pertaining to non-tax revenues, and where cost audit information is required.
Parliament	• Parliament: tracks trends in mining revenue collection and questions revenue shortfalls; scrutinizes government audit reports and investigate government corruption, public tenders and revenue collection; initiate legislation with respect to transfer pricing, and tax avoidance.
Oversight actors	• Civil society organizations and media: monitor government implementation of transfer pricing rules. • EITI country secretariat: monitor high-level transfer pricing risk indicators such as profitability, transactions with related parties in low tax jurisdictions, and excessive debt and/or interest expense. • EITI country MSG: provides a platform to promote stronger measures against transfer mispricing.
International organizations	• OECD: develops international guidelines. OECD Guidelines are the international authority on common practices and methods in the area of transfer pricing. More than 100 countries refer to OECD Guidelines in their domestic laws. • United Nations: develops guidelines specific to developing countries. In 2013, the U.N. released a transfer pricing manual that tailors transfer pricing guidance to the circumstances, priorities and administrative capacity of non-OECD countries. • African Tax Administration Forum: enables cooperation between African revenue authorities on transfer pricing and other tax issues. It provides a platform to communicate domestic and regional tax concerns to international forums.

KEY TRANSFER PRICING TERMS

Arm's length principle

The U.N. defines the arm's length principle as "an international standard that compares the transfer price between related parties with the price of similar transactions carried out between independent parties at arm's length."

Advance pricing agreements and safe harbors

Advance pricing agreements (APAs) and safe harbors are simplification measures aimed at reducing the monitoring burden for revenue authorities, while protecting the tax base from transfer mispricing. They can be advantageous for both taxpayers and administrations, enhancing predictability of tax treatment, encouraging a free flow of information, preventing costly audits and enabling limited audit resources to be allocated to more material transfer pricing issues.

- An APA is a contract, usually for multiple years, between a taxpayer and at least one revenue authority, which agrees in advance how the transfer price will be set for a number of transactions between related parties. The revenue authority will not make any transfer pricing adjustments during the period of the agreement.
- A safe harbor is an administrative tool that applies to a defined category of transactions. It protects taxpayers from transfer pricing audits as long as the price of their related party transactions follows the pricing formula defined in the safe harbor rules by the tax authority.

Hedging

Hedging is a business practice that addresses volatility in many commodity markets. It consists of locking in a future selling price in order to plan commercial operations with predictability. A problem arises when companies engage in abusive hedging with related parties. They can use hedging contracts to set an artificially low sale price for their production and therefore record systematic hedging losses, which reduce taxable income in the producing country.

Thin capitalization

The OECD defines thin capitalization as "the situation in which a company is financed through a relatively high level of debt compared to equity." This presents a particular risk of profit shifting: the management may choose to finance its investment disproportionally through debt rather than equity as a means of avoiding corporate income tax as most countries allow companies to deduct interest expenses in calculating taxable income, including interest paid on debt owed to related parties.

QUESTIONS TO ASK

Oversight actors can use these questions to conduct a diagnostic of whether a government has taken the initial steps to address transfer pricing risks in the mining sector.

- Does the law define transfer pricing? Are taxpayers required to use the arm's length principle to determine the value of related party transactions? Do these rules apply to mining companies?
- Are there regulations that provide details on how mining companies should implement the transfer pricing legal provisions, including:
    - transfer pricing methodologies
    - guidance on comparability analysis (i.e., use of local and/or foreign comparable data)
    - transfer pricing documentation requirements and filing deadlines
    - how and when transfer pricing adjustments will be made by the revenue authority
    - how taxpayer disputes will be resolved
    - fines and penalties
    - (optionally) specific guidance on particular related party transactions.
- Are companies required to submit (as a part of their tax return or otherwise) an annual list of related-party transactions and an explanation of how these transactions were priced?
- Do regulations empower taxpayers to request advance pricing agreements? If not, why not?
- Is there sufficient interagency coordination on implementing transfer pricing rules? This could include encouraging joint audits and establishing coordination mechanisms such as an automatic system for sharing information relevant to transfer pricing between mining industry regulators and the revenue authority.
- Does the government have sufficiently skilled personnel and adequate systems and facilities to implement transfer pricing rules? This could include ensuring that the revenue authority has access to staff with transfer pricing expertise and technical sector expertise to identify and evaluate transfer pricing risks specific to the mining sector.
- Does the government have the facilities to independently verify company reporting on the quality and quantity of mineral sales?
- Have any of the following alternative tax policy rules been considered or adopted? If not, why?
    - Separate tax treatment of hedging income
    - Capping management fees between related parties
    - Capping interest deductions on foreign related party loans
    - Use of the sixth method for related party commodity transactions or use of publicly quoted prices to calculate the tax value of mineral sales

ADDITIONAL RESOURCES

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