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# Toolkit for Transfer Pricing Risk Assessment in the African Mining Industry

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# About this toolkit

The African Tax Administration Forum (ATAF) and the German Federal Ministry for Economic Cooperation and Development (through the Gesellschaft für Internationale Zusammenarbeit), have developed this toolkit for African tax authorities seeking to assess transfer pricing risk in the mining industry. The purpose is to strengthen authorities' capacity to determine whether they should audit particular high-risk "related party transactions."

The toolkit employs a specific risk review approach, which focuses on particular transfer pricing issues that present a high risk to revenue (as distinct from a comprehensive risk review, which tax authorities use when they cannot detect where transfer pricing issues are likely to arise). A loss of even 1 percent of the value of these transactions is likely to be significant for developing country revenues. These issues are also very prevalent: many African tax authorities report corporate services, including procurement and management, as common causes of tax loss.

The four issues of focus are:

- 1 **Marketing arrangements.** A related company, for example a marketing hub, buys mineral products from the mine. The key issue is whether the mineral products are transferred to a fully fledged related party marketer that takes ownership of the product, performs value-adding functions and assumes entrepreneurial risk, or, more commonly, a hub that merely provides a support function.
- 2 **Intercompany debt.** A subsidiary receives debt from a parent or an affiliate company, often a corporate treasury located in a low-tax jurisdiction, to finance geological exploration or mine development. Debt generates interest payments, which are tax deductible. Most African countries currently limit the maximum amount of debt on which deductible interest payments are available, by way of a debt-to-equity ratio. However, the cost of related party debt (i.e., the interest rate) is difficult for tax authorities to price, leaving the tax base vulnerable to excessive interest deductions.
- 3 **Procurement services.** A company purchases mining goods and services on behalf of its subsidiary; the price charged to the subsidiary will include the direct cost, plus a "mark-up." Usually in such cases the cost base should be the cost of providing the service, not the value of the goods.
- 4 **Management services.** The subsidiary pays a fee to a related party in return for a range of administrative, technical and advisory services.

There are four phases in the transfer pricing compliance process: (1) case selection, (2) risk assessment, (3) audit and (4) dispute resolution. The toolkit focuses on stage 2, risk assessment. It assumes the tax authority has already selected cases and compiled a list of mining companies for risk assessment. Case selection is not yet a critical concern for tax authorities in African countries that host a small number of mining multinational enterprises (MNEs) that contribute most of government's revenue. However, case selection will grow in importance as the number of tax paying companies increases.

## STRUCTURE OF THE TOOLKIT

The toolkit is divided into four sections, mirroring the issues outlined above: marketing arrangements, intercompany debt, procurement services and management services.



Each section begins with an **information checklist** that details all the information a tax authority is likely to require to assess the risk of transfer mispricing in relation to a particular transaction. This includes information from the mining subsidiary, the foreign related party or parties, as well as relevant databases and publications (free and subscription based).



The information checklist is followed by a **step-by-step guide** to risk assessment which comprises a list of questions that tax authorities should consider when reviewing the transfer price for that transaction.



The guide is followed by a more **detailed explanation** of the related party transaction, including:

- An explanation of the transaction and the appropriate transfer pricing method(s)
- A detailed discussion of key factors likely to determine the transfer price
- Financial data gathered from uncontrolled and controlled transactions in the mining sector

**Note: The financial data included in this toolkit DO NOT constitute “comparable data.” Do not use it as basis for transfer pricing adjustments.** The data is merely intended as an indication of industry practice; there may be additional divergences across the industry due to a range of factors including, but not limited to, country context, commodity type and business size. Tax authorities should subscribe to commercial searchable electronic databases to extract comparable data, which can be adjusted for country context.

## HOW TO USE THIS TOOLKIT

The toolkit is designed to be applied in the context of national tax legislation, with reference to other authoritative documents such as the World Bank sourcebook *Transfer Pricing in Mining with a Focus on Africa: A Reference Guide for Practitioners* (below referred to as the “World Bank sourcebook”), the OECD’s Transfer Pricing Guidelines for Multinational Enterprises, the OECD base erosion and profit shifting (BEPS) reports, and the United Nations’ Practical Manual on Transfer Pricing for Developing Countries. Specific references to these documents are highlighted throughout the toolkit and users are encouraged to familiarize themselves with the World Bank, OECD and U.N. guidance.

There may be significant variation in tax legislation, as well as economic and political differences, across jurisdictions. The toolkit cannot account for all the country-by-country differences that may affect transfer pricing risk assessment and outcomes. Consequently, tax authorities should use the toolkit as a guide and adjust for country difference where necessary.

Table 1. Transactions that present the most common transfer pricing risks along the mining value chain

Related party transaction	Acquisition and exploration	Development construction	Mining and concentration	Transport	Smelting/refining	Marketing and sales
<b>Marketing hub</b>						
Marketing services						H
Shipping and distribution services				H		M-H
Cargo insurance services				M		M
<b>Finance hub</b>						
Treasury services	M	H	L-M		L-M	
Financing services	L-M	H	L-M	L-M	L-M	H
<b>Insurance hub</b>						
Insurance brokerage services	L	L-M	L-M			
Captive insurance services	M-H	H	H	H	H	H
<b>Engineering, science and tech hub</b>						
EPC/EPCM contracts		H	L-M	M-L	L-M	
Technical and scientific services	H	M	M		M	
Patents and other IP	H	H	M-H		M-H	M
<b>Corporate services</b>						
HR, accounting, IT, legal, etc.	L-M	M-H	L-M	L-M	L-M	L-M

This matrix shows the stage along the mining value chain at which the related party transaction is most likely to occur. Risk is indicated using high (H), medium (M), and low (L), or an intermediary likelihood (e.g., L-M, or M-H). The boxes shaded in red represent high financial flows.

Source. Adapted from the World Bank Sourcebook, 37.

# Introduction

Transfer pricing is the mechanism for choosing prices to value transactions between related legal entities within the same multinational enterprise (MNE). These are referred to as “controlled” or “intra-group” transactions and may include the purchase or sale of goods or intangible assets, the provision of services, the provision of financing, cost allocation, or cost-sharing agreements. Transfer pricing is normal business practice, provided the terms and conditions (including the price) of the controlled transaction are comparable to the “arm’s length” terms and conditions at which the transaction would have taken place between unrelated parties. However, transfer pricing may become abusive or illegal when related parties seek to distort the price to reduce their overall tax bill. In these instances, the practice may be referred to as “transfer mispricing.”

According to the United Nations Economic Commission for Africa, Africa is losing approximately USD 50 billion per year in illicit financial flows. Transfer mispricing is one of the primary sources of these losses. The African Development Bank has suggested that extractive industries are largely behind the alleged tax leakage.<sup>1</sup> While transfer mispricing is no more prevalent in mining than it is in other sectors dominated by MNEs, tax avoidance by mining companies has an outsized impact on domestic resource mobilization in countries heavily reliant on mining revenues. The problem is particularly acute for resource-rich developing countries, given the importance of corporate income tax to total tax revenue.<sup>2</sup> Whether mineral prices go up or down, existing and future mining operations should contribute their full share to government budgets. Minerals are a non-renewable resource: any abusive erosion of the tax base by mining companies is a net loss for the country and its population.

## Background

A comprehensive and proactive transfer pricing compliance process is essential for African tax authorities, particularly given their limited audit resources. While the compliance process may be generic, many African tax authorities are still acquiring the sector-specific expertise to detect and mitigate transfer mispricing in the mining industry. Therefore, to determine whether a risk area has been manipulated, tax authorities require further guidance to distinguish between abusive versus standard industry practice.

1 United Nations High Level Panel of the Economic Commission for Africa, *Progress Report on the Illicit Financial Flows: Track it! Stop it! Get it!* (2014).

2 OECD Tax and Development Programme, *Part 2 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries* (OECD Publishing, 2014), 10-11.

There are too few recorded uncontrolled transactions taking place in Africa from which to derive comparable data to benchmark related party transactions. This is particularly true for the mining sector, given the limited number of independent companies. Tax authorities can use foreign comparable data, available from a range of commercial databases. However, such databases are costly and adjustments to foreign data can be resource and time-intensive. Consequently, tax authorities need additional sources of information, for example industry and business analyses, to equip them to enforce transfer pricing compliance in the mining sector. For guidance on how to adjust foreign comparable data for country and taxpayer conditions and risks, tax authorities should refer to a *toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses* published by the Platform for Tax Collaboration in June 2017.<sup>3</sup>

### Transfer pricing compliance initiatives

There are few global initiatives to specifically improve transfer pricing compliance in the mining sector. The OECD's *Draft Handbook on Transfer Pricing Risk Assessment* outlines the objectives and process of risk assessment and provides a number of high-level risk indicators. More recently, the OECD has produced guidance on mineral product pricing<sup>4</sup> to equip revenue authorities in developing countries to more accurately assess transfer pricing risks in related party mineral sales. The OECD also updated Chapter 2 of its *Transfer Pricing Guidelines*<sup>5</sup> to endorse the use of the comparable uncontrolled price (CUP) method for commodities that have a publicly quoted price. In 2017, the World Bank, in collaboration with the Minerals and Energy for Development Alliance (MEfDA), launched a sourcebook titled *Transfer Pricing in Mining with a Focus on Africa: A Reference Guide for Practitioners*, (hereinafter referred to as the World Bank sourcebook).<sup>6</sup> The World Bank sourcebook offers a detailed discussion of the types of transfer pricing risks likely to arise along the mining value chain, as well as a database of current mineral resources in Africa, including projected revenues and main cost components.

3 Platform for Collaboration on Tax, *A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses*, 2017, <http://www.oecd.org/tax/toolkit-on-comparability-and-mineral-pricing.pdf>

4 Platform for Collaboration on Tax, *A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses*, 2017, <http://www.oecd.org/tax/toolkit-on-comparability-and-mineral-pricing.pdf>

5 OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2010, <http://www.oecd.org/tax/transfer-pricing/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-20769717.htm>.

6 World Bank and Minerals and Energy for Development Alliance, *Transfer Pricing in Mining with a Focus on Africa—A Reference Guide for Practitioners*, (Washington, D.C.: World Bank, 2017).

## SOURCES OF INFORMATION FOR TRANSFER PRICING COMPLIANCE PROCESSES

Table 2 clarifies the type of information available to the tax authority at each phase of the compliance process. The sources of information can generally be broken down as follows:

- **Case selection** will be informed by tax returns, financial statements and publicly available information, e.g., press releases.
- **Risk assessment** may require additional high-level information from the taxpayer on related party functions and internal transfer pricing policy.
- **Audit** will require the tax authority to gather further information through observation, interviews and examination of conduct and contracts.

Table 2. Sources of information for transfer pricing compliance processes

	Phase 1 (case selection)	Phase 2 (risk assessment)	Phase 3 (audit)
<b>Type of information available</b>	<p>For Phase 1, tax authorities will generally draw information from tax returns, financial statements and publicly available information.</p> <ul style="list-style-type: none"> <li>• Local mine: tax files; related party information schedules; customs data; past cases</li> <li>• Service hub: no data generally available at the start of a case; data may be available in the risk assessment or audit phases</li> <li>• Parent company: publicly available information e.g., annual returns, SEC filings.</li> <li>• Industry analysis: comparative quantitative analysis of the business' profitability against peers and past performance, taking into account its apparent functions</li> </ul>	<p>Phase 2 may involve initial queries for further information from the approved list of taxpayers from Phase 1.</p> <ul style="list-style-type: none"> <li>• Fact-gathering for high-level functional analysis (i.e., what functions are performed, why, and by whom (no need for interviews))</li> <li>• Taxpayer's transfer pricing documentation</li> <li>• Information on transfer pricing controls, e.g., are they robust, properly documented, up to date and delivering the "right" results?</li> </ul> <p>Phase 2 may also involve gathering information on broadly similar mines (ideally independent) and their profitability, and on similar mineral products being sold in the market for broadly similar volumes and to similar destinations.</p>	<p>Audit evidence is obtained from the taxpayers and related parties via:</p> <ul style="list-style-type: none"> <li>• observation of mining operations and staff interviews/questionnaires</li> <li>• examination of contracts/conduct of parties</li> <li>• foreign data retrieved from country-by-country reports (CbCR) and Transfer Pricing Master File</li> </ul> <p>Types of evidence might include:</p> <ul style="list-style-type: none"> <li>• copies of contracts between parties</li> <li>• information from interviews with key commercial personnel to record and verify roles, including management of economically significant risks</li> <li>• organizational charts</li> <li>• segmented financial statements</li> <li>• information from a tour of the premises to understand domestic operations</li> </ul>
<b>Output</b>	<p>Candidates should be ranked in order of tax risk.</p> <p>Quantitative risk filters may include:</p> <ul style="list-style-type: none"> <li>• Sales revenue</li> <li>• Earnings before income tax (EBIT)</li> <li>• Accounting profit</li> <li>• Losses</li> <li>• Tax paid</li> </ul>	<p>Prioritized ranking of MNEs and their subsidiaries that should be further investigated, as well as the identification of potential transfer pricing issues and the controlled transactions involved.</p> <p>Ranking should be based on the risk adjusted value i.e., likelihood that transfer mispricing has occurred (low, medium, high risk) multiplied by the value of the related party transaction.</p>	<p>Amend transfer price to the arm's length price if needed, OR close the case if the price/profit is within the arm's length range.</p>



For a tax authority to decide whether a case should proceed to audit, it must first determine whether there is a material transfer pricing risk in Phase 2, the risk assessment stage. In some cases, particularly where significant revenue depends on the taxpayer and/or sector, determining risk may require primary evidence from the taxpayer, which would normally be collected in Phase 3, the audit stage.

Requests for additional information or documentation in Phase 2 should be based on the relevant circumstances. With additional information demands, tax authorities are more likely to identify all material transfer pricing risks for audit and less likely to waste limited time and resources on an unnecessary investigation. The more material the sector or taxpayer, the more assurance required as to whether the risk is significant. However, there are potential costs to this approach: a data deluge can overwhelm tax authorities, audit selection strategy is revealed and subsequently gamed by taxpayers, and an additional compliance burden is imposed on taxpayers.

Even with additional information from taxpayers, tax authorities should not aim to make a tax adjustment during Phase 2. When the tax authority's position is that an adjustment may be required, it must first conduct an audit (Phase 3), provide the taxpayer with the audit assessment and allow the taxpayer a reasonable opportunity to respond before reaching a conclusion. In Phase 2, tax authorities should only request information to gain reasonable assurance as to whether a material risk exists.

The information checklist for each transaction type distinguishes between information generally requested in Phase 2 and Phase 3. It is up to tax authorities to decide at which stage of the compliance process they will request particular information and documentation from the taxpayer. This may vary from case to case depending on a range of factors including, but not limited to, risk to revenue, the quality of the taxpayer's transfer pricing documentation, the relationship with the taxpayer and its compliance history, accessibility to information from other tax jurisdictions and the complexity of the transfer pricing issue.

### **Challenges to accessing tax information from offshore companies**

To understand how to determine transfer prices between related entities within a multinational mining group, and to identify potential mispricing, tax authorities may need information from foreign jurisdictions. For example, to assess whether a marketing commission is arm's length, the tax authority will need to obtain the third-party sales agreement from the marketing hub to compare against the terms and conditions of the mine offtake agreement.<sup>7</sup> For example, analysis may reveal that the risks stay with the mine, rather than transferring to the marketing hub as the offtake agreement suggests.

<sup>7</sup> An offtake agreement is an agreement between a mine and a buyer to purchase or sell a portion of the mine's future production.

Accessing information from parent companies and related entities offshore is a challenge for many African tax authorities. For more information see NRGi's report on *Preventing Base Erosion in Africa*.<sup>8</sup>

To overcome this challenge, African tax authorities should:

- 1 Join the OECD Convention on Mutual Administrative Assistance to participate in the automatic exchange of information (AEOI) between tax authorities.
- 2 Join the African Agreement on Mutual Assistance in Tax Matters (see Annex 1), which creates a legal basis from which African tax administrations can assist one another in tax collection and other matters.
- 3 Legislate to require taxpayers to maintain a master file that contains standardized information relevant for all MNE group members, and a local file that refers specifically to material transactions taking place in the local tax jurisdiction.
- 4 Legislate to assign the burden of proof in transfer pricing cases to the taxpayer, not the tax authority.

8 Alexandra Readead, *Preventing Tax Base Erosion in Africa: a Regional Study of Transfer Pricing Challenges in the Mining Sector*, Natural Resource Governance Institute (NRGI) (2016).

# Risk review of selected related party transactions

## TRANSACTION TYPE 1 MARKETING ARRANGEMENTS



### INFORMATION CHECKLIST FOR RISK ASSESSMENT

#### Local mine

- Transfer pricing documentation (analysis of functions, assets, risks)
- Type of mineral commodity or commodities being sold by the mine to the marketing hub, including stage of beneficiation
- Offtake agreement (key terms include: price, volume, payment terms, quotation period, quality)
- Production reports
- Royalty returns (i.e., company's calculation of mineral royalties payable for the period)
- Tax return (specifically sales revenue and related allowable deductions e.g., shipping and insurance)

#### Related party marketing hub

- Location and organizational structure of the hub including number and location of employees

#### *Additional information*

The following would generally be collected during an audit, but the tax authority may choose to request this information during Phase 2 if it is necessary to determine materiality.

- Balance sheet and detailed income statement of the hub (in particular, the effective sales commission)
- Customer list (growth or change in the customer list may be evidence of a marketing hub adding value)
- Pricing policy for different mineral product lines
- Agreements with independent marketers (may provide information on internal comparables)
- Evidence of analysis by the hub of key market dynamics (e.g., drivers, restraints, and opportunities)
- Evidence of marketing surveys, product brochures, specification sheets

## Commercial databases and publications for initial comparability review

These sources do not provide insight into the marketing commission, but are useful for reviewing the base mineral price when applying the CUP method. To benchmark the commission, the tax authority should look at publicly available information on offtake arrangements, or data from commercial databases. The list is not exhaustive.

### *Subscription publications and services*

- Platts. Energy and metals information including price assessments and indices. Platts publishes the Mineral Valuation Service, which compares price information for the sale of common iron ore products.
- The Steel Index. Offers reference prices for iron ore fines imported into China, price differentials for iron and impurities, and estimates of freight cost, to allow the “cost and freight” (CFR) price to be adjusted back to the “free-on-board” (FOB) price. The FOB price only includes transportation of goods to the main shipping point, whereas the CFR price includes transportation all the way to the destination port.
- Metal Bulletin Research. Comprehensive database on base metal, coal, iron and related alloying minerals, minor metals and industrials. Includes information about related mining companies.
- Bauxite Price Index and Harbor Aluminum
- United States Geological Survey
- Baltic Exchange. Bulk freight rates.

### *Free publications*

- London Bullion Market Association (LBMA). Publishes the daily AM and PM London fix spot gold prices
- *Wall Street Journal*. Same as above but data can be exported to MS Excel, CSV, XML, JSON.
- London Metals Exchange. Free data service providing daily prices; historical data available for purchase.
- Index Mundi. Monthly data with some lag time.

### *Further guidance*

- OECD, Addressing the Information Gaps on Prices of Minerals Sold in Intermediate Form (2017).
- World Bank sourcebook, sections 2.2.2.6; 4.4.2; 4.2.2.2
- ATO practical compliance guideline for transfer pricing issues related to centralized operating models involving procurement, marketing, sales and distribution functions.



## STEP-BY-STEP GUIDE TO REVIEWING THE TRANSFER PRICING ARRANGEMENT

### Step 1. Identify hub organizational structure and key personnel

Where is the marketing hub located?

- Is the marketing hub located in a jurisdiction that offers low or zero tax treatment of trading functions?

How is the marketing hub organized?

- How many employees are in the hub?
- Do employees' academic and professional qualifications demonstrate sales, customer relations, and marketing experience and expertise?
- How does this compare with the capabilities of the marketing staff in the local mining entity?

### Step 2. Initial functional review of hub

#### Step(a). Market dynamics

Are there transparent price indexes for the commodity being marketed? A marketer can negotiate premiums and discounts for any commodity, depending on market conditions. However, it will be harder for a hub to influence the price of commodities for which there are transparent price indexes, potentially reducing the need for marketing expertise.

Opportunity to influence sale price:

Low	Medium	High
<b>Refined base/precious metals</b> Gold, copper, lead, zinc, nickel, cobalt, tin, aluminum, platinum and silver	<b>Physical concentrates</b> Copper silver, zinc silver, lead silver, zinc lead, cobalt nickel	<b>Non-metallic industrial minerals</b> Barite, fluorite, graphite, industrial diamonds, beryl
<b>Bulk commodities</b> Iron ore, coking and steam coal, manganese ore and phosphate rock	<b>Metallurgical products and specialty metals</b> Blister copper, nickel matte, alumina, doré	<b>Gemstones</b> Refined diamonds and other gems
<b>Metallurgical products and specialty metals</b> Alumina and doré	<b>Gemstones</b> Industrial diamonds	


Table 3. Opportunity to influence sale price

Source: Adapted from the World Bank Sourcebook, 37.

*Step (b). Efforts to maximize the sale price*

What efforts have been made by the marketing hub to maximize the sale price? The relative weighting of these activities is generally consistent across commodities, but there may be some variation. For example, logistics may be more important for bulk commodities.

Some of the activities of marketing hubs (ranking by officials from the South African Revenue Service)	Importance of activity to achieving the realized sale price
Negotiating sales contracts and terms	
Managing supply	
Customer relationships	
Managing contracts	
Market development and relations	
Market analysis	
Sales and price forecasting	
Invoicing	
Logistics	
Financing	



*Step (c). Risk*

Has the marketer sold the product FOB to the customer?

- E.g., the marketer instantly sells the mineral product to the customer after purchasing it from the mining entity (a procedure known as “flash title”).

Is the inventory (mineral product) recorded on the hub’s balance sheet?

- No inventory may justify re-characterization of the hub to a limited distributor (lower remuneration).

Can the hub declare force majeure in the event of a supply problem, thereby freeing itself from the sales contract?

According to the offtake agreement, is the marketing hub, or mine, financially responsible for failure to comply with customers’ quality specifications?

Does the hub have long-term relationships with existing customers, processes for vetting new customers, and credit checks?

The marketing hub may manage other risks (e.g., freight, market and credit) generally of lower significance. The tax authority should consider these other risks when reviewing the transaction.

### **Step 3. Initial comparability review—do the results appear to be within the arm’s length range?**

#### *Profits relative to the hub’s operating costs*

Is the compensation received by the marketing hub proportional to its operating costs?

- Operating costs include rent, salaries and depreciation of hub assets.

Threshold indicator: is hub profit more than 100 percent mark-up of hub costs?

- This is the threshold set by the Australian Tax Office.<sup>9</sup> A return equal to, or less than 100 percent is low risk; above this, taxpayers may be subject to enquiry.

#### *Commission on sales (NB: the data below is not arm’s length data but a snapshot of industry practice)*

- The commission will depend on the commodity, the value and volume of sales, as well as the marketing hub’s actual functions, assets and risks, and those of the asserted comparable entities.
- Commission rates on base metals and bulk commodities range from 2 percent to 6 percent. Even where the commission rate is on the lower side of the range, the profitability of the hub may reflect a non-arm’s length outcome, hence the need to check the actual return on operating costs.
- For industrial minerals, gemstones, and some concentrates, the commission may be higher due to the technical complexity of meeting the market demand for quality.

### **Step 4. Presentation of findings and closing**

**Output.** Tax authorities should create:

- A list of which mining multinationals require further investigation, ranked according to the risk of transfer mispricing (probability of occurrence multiplied by the value of the fiscal impact)
- A detailed list of potential transfer pricing issues and the controlled transactions involved

The result will be a pool of potential audit cases.

<sup>9</sup> Australian Taxation Office, *ATO compliance approach to transfer pricing issues related to centralised operating models involving procurement, marketing, sales and distribution functions*, Australian Government (2017).



## GUIDE TO RISK ASSESSMENT

In the mining sector, the term “marketing” often describes the process of negotiating, selling and delivering minerals, as well as the functions that support those activities. It is common for mining subsidiaries to relocate marketing, sales and distribution functions to centralized operating models (“hubs”). Related party marketing hubs are generally located in low tax jurisdictions, for example Switzerland. An important reason for this choice is to take advantage of tax planning opportunities. However, in some cases, for example Singapore, the location also puts the marketer closer to customers, trading centers and shipping/warehousing facilities. Related party marketing hubs usually charge a fee or receive a discount on the price of commodities purchased or sold in return for their activities and the risks they assume.

Related party marketing hubs will usually characterize themselves as offtakers. This means that in addition to taking responsibility for all marketing functions and risks, the hub also takes title to the goods and sells it to its own customers. Hubs will usually commit to purchasing a significant proportion of the mine’s production (often 100 percent) under long-term offtake agreements. In controlled transactions, mining companies often argue that offtake arrangements give the producer greater certainty in their revenues, as the volume, price and credit risk are borne by the hub, and this justifies paying a higher commission. Tax authorities should carefully examine such assertions and test them by comparing the terms of the offtake agreement with those of third-party supply contracts, as well as comparable independent marketing arrangements, to understand the extent and bearer of each risk.

### 1.1 Transfer pricing methods

The OECD has revised chapter two of the Transfer Pricing Guidelines to state that under the CUP method, the arm’s length price for commodity transactions may be determined by reference to comparable uncontrolled transactions, and by reference to comparable uncontrolled arrangements represented by the quoted price.<sup>10</sup> The revised guidelines provide for adjustments to the quoted price if the physical features and quality of the commodity diverge, or to account for marketing fees paid to a related party marketer, as long as the taxpayer justifies the adjustment. Marketing fees are not always deducted from the sale price; they may be a separate (related party) charge. In both situations, tax authorities will need to check if the fee complies with the arm’s length principle, in which case two transfer pricing methods may be relevant:

- Marketing offtakers generally use the CUP method to determine their commission rate. Tax authorities should refer to publicly available information on third-party offtake arrangements, third party agency arrangements, as well as data from transfer pricing databases such as Bureau Van Dijk’s Amadeus, or Thomson Reuters’ ONESOURCE.

<sup>10</sup> Countries seeking to legislate the CUP method for commodity transactions should refer to the ATAF model transfer pricing legislation, sections 5, 6, or 7, depending on which option the country prefers.



- In some cases, the marketing commission may appear comparatively low, yet the return on the cost of performing the marketing function is significantly above what third-party marketers would generate in such a case. A more reliable transfer pricing method is the Transaction Net Margin Method, which tests whether the profit accrued by the hub is a reasonable return on its operating costs. According to the ATO's practical compliance guidance on offshore marketing hubs,<sup>11</sup> a reasonable mark-up on a hub's costs is less than or equal to 100 percent. Anything above presents a transfer pricing risk.

It is unlikely that most African tax authorities will be able to access the marketing hub's detailed financial reporting in order comprehensively review the return on operating costs during the risk assessment phase. However, the hub's income statement, combined with industry analysis and information from transfer pricing databases, should provide tax authorities with useful information of how the hub's profit outcomes compare with those of the rest of the industry, and whether there is a material risk of transfer mispricing.

## 1.2 Reviewing pricing factors

To determine the appropriate transfer price for a marketing arrangement, tax authorities should consider the specific legal form of the hub, as well as its functions, the risks it manages, and assets it uses.

### *Underlying substance*

To determine whether the hub has real underlying substance, tax authorities should consider the following:

- Is there evidence of specific marketing expertise and decision-making occurring at the hub?
- What mineral product is the hub marketing, and is there scope to influence the sale price?
- What efforts have been made to maximize the sale price and secure customers?

To answer these questions, tax authorities should investigate the marketing hub, as well as any marketing staff retained by the local mine, to enable a comparison of functions, skills and expertise.

<sup>11</sup> See footnote 9.

a) Evidence of marketing expertise and decision-making power

	Marketing hub	Local mine
<b>Expertise</b>	<ol style="list-style-type: none"> <li>1. How many people does the marketing hub employ?</li> <li>2. What are their academic/professional qualifications?</li> <li>3. What are their key performance indicators or job descriptions?</li> <li>4. What is the remuneration structure for marketing employees?</li> <li>5. Did the parent company know who their potential customers were before investing in the mine?</li> </ol>	<p>Apply Questions 1, 2, 3, and 4</p> <ol style="list-style-type: none"> <li>6. How often do local mine staff travel to the marketing hub and/or to where customers are located?</li> </ol>
<b>Decision-making power</b>	<ol style="list-style-type: none"> <li>7. Does the hub have the authority to submit the company to a supply contract? (Tax auditors should interview senior employees where possible.)</li> </ol>	<p>Apply Question 6</p>

Practitioner insights

- It may be the case that most hub staff deal with finance and lack the appropriate profile to deal with customers and marketing arrangements. Local marketing staff at the mine, however, may include geologists, and “value-in-use” specialists to determine the price of a mineral product for specific buying and selling scenarios.
- If travel schedules reveal frequent visits by local marketing staff to the hub, or to customers, this may suggest that local marketing staff have a better understanding of the product being sold and customer specifications than their global counterparts.

b) Opportunity to influence the sale price

A marketer can negotiate premiums and discounts for any commodity, but has less margin for commodities traded into terminals or stock markets and indexed on a transparent exchange. Consequently, the degree of marketing expertise required to negotiate and conclude contracts with customers will depend on the type of mineral product.

Low	Medium	High
<p><b>Refined base/precious metals</b> Gold, copper, lead, zinc, nickel, cobalt, tin, aluminum, platinum and silver</p> <p><b>Bulk commodities</b> Iron ore, coking and steam coal, manganese ore and phosphate rock</p> <p><b>Metallurgical products and specialty metals</b> Alumina and doré</p>	<p><b>Physical concentrates</b> Copper silver, zinc silver, lead silver, zinc lead, cobalt nickel</p> <p><b>Metallurgical products and specialty metals</b> Blister copper, nickel matte, alumina, doré</p> <p><b>Gemstones</b> Industrial diamonds</p>	<p><b>Non-metallic industrial minerals</b> Barite, fluorite, graphite, industrial diamonds, beryl</p> <p><b>Gemstones</b> Refined diamonds and other gems</p>

Table 3. Opportunity to influence sale price

Source: Adapted from the World Bank Sourcebook, 37.

c) Efforts made by the marketing hub to maximize the sale price

If it is possible to influence the price, the next question is, has the hub performed marketing activities to maximize the sale price?

Activities	Evidence	Importance to the realized sale price
Negotiating sales contracts and terms	<ul style="list-style-type: none"> <li>Spot trading and short-term sales are likely to secure a higher sale price than long-term supply deals; these types of arrangements are also evidence of entrepreneurial risk-taking.</li> </ul>	
Managing supply	<ul style="list-style-type: none"> <li>Offtake agreement with the mine</li> <li>Efforts to source third-party supply where mine supply is interrupted</li> <li>Communication with customer where there is a shortfall</li> </ul>	
Customer relationships	<ul style="list-style-type: none"> <li>Sales and marketing strategy</li> <li>Day-to-day contact with customers</li> <li>Dealing with customer complaints</li> <li>Organizing industry events</li> <li>Developing new customer relationships/growing the base</li> </ul>	
Management of contracts	<ul style="list-style-type: none"> <li>Spot sales are likely to require more management than long-term sales agreements</li> <li>Discussions with customers about specific requirements e.g., volumes per week or per month</li> </ul>	
Market development and relations	<ul style="list-style-type: none"> <li>Analysis of market trends</li> <li>Research into potential customers</li> <li>Samples sent to customers</li> </ul>	
Market analysis	<ul style="list-style-type: none"> <li>Sales data across commodities</li> <li>Information from customers</li> <li>Industry sources</li> </ul>	
Sales and price forecasting	<ul style="list-style-type: none"> <li>Analysis of historic trends</li> <li>Production forecasts provided by the mine</li> </ul>	
Invoicing	<ul style="list-style-type: none"> <li>Final invoices</li> </ul>	
Financing	<ul style="list-style-type: none"> <li>Local country accounts, budgets and forecasts</li> <li>Analysis of credit worthiness of customers</li> </ul>	

Table 4. Evidence and importance of marketing activities

**Dark blue** activities contribute the most to the final sale price. As the blue becomes lighter the relative contribution of each activity decreases. Functions such as invoicing and finance create less value. To warrant higher profitability, the hub would need to demonstrate that it is taking risks to get greater rewards.

Source: Interviews with international tax specialists at the South African Revenue Service

Tax authorities should look at how the hub responds to a downturn in commodity prices. If the hub can do something different from what it normally does to maximize sale volumes to minimize unitary production costs, (i.e., demonstrates entrepreneurship), it may be able to justify making higher profits. Conversely, a hub that routinely makes extraordinary profits is suspicious. Cost-conscious mining corporations would not let a marketing hub make abnormally high returns on an ongoing basis. Doing so may indicate an intention to shift profit to avoid tax.

*Legal form: ownership of mineral product*

A fully-fledged marketing offtaker that takes legal possession of the product upon or after export and on-sells it may be entitled to a higher commission. By taking legal possession of the product at the point of export, the marketing hub assumes legal title, potentially exposing it to price risk and the possibility that customers default on payment. However, where a hub has back-to-back agreements and/or engages in instantaneous sales, legal title may constitute “flash title,” in which case the hub takes less risk, which should be reflected in the pricing of the controlled transaction.

The tax authority should consider the following questions:

- How is risk and ownership transferred within the MNE?
- How has the product moved from the mine to the end customer?
- Does the marketing hub's balance sheet record the inventory?
- Does the hub manage and control the economically significant risks?
- Does the hub have the financial capacity to bear risk?

Information to request	Questions to consider
Offtake agreement and third-party agreements	<ol style="list-style-type: none"> <li>1. Are third-party sales instantaneous?</li> <li>2. Do the terms of the offtake agreement between the mine and the marketer, and the third-party sales agreement between the marketer and the customer vary (key terms: payment, price, quotation period,<sup>12</sup> volume, quality, penalties)?</li> <li>3. What does the variation in terms reveal about the risks assumed by the parties in the controlled transaction? E.g., if the offtake agreement allocates supply risk to the hub, but the third-party sales agreement allows it to invoke force majeure, there is limited real risk to the hub.</li> </ol>
Financial statements from hub	<ol style="list-style-type: none"> <li>4. Is the stock of goods included in the hub's inventory?</li> <li>5. Does the hub have the financial capacity to bear the risks that it is purported to bear?</li> <li>6. Where commodity or financial markets increase or decrease substantially, what is the evidence that the financial outcomes of those movements align with the allocation of risks under the arrangement?</li> </ol>
Bill of lading <sup>13</sup>	<ol style="list-style-type: none"> <li>7. Does the hub sell the product FOB or CIF?</li> </ol>

<sup>12</sup> Quotation period (QP) refers to the period across which metal index prices are averaged to give the final sale price.

<sup>13</sup> Terms of a contract between a shipper and a transportation company.

### Practitioner insights

- An instantaneous sale to third-party customers, once the hub takes possession of the product, suggests that the risk borne by the marketing hub is limited.
- Back-to-back sales arrangements with long-term customers suggest that the hub is exposed to very little real market risk (i.e., that demand for the product will fall).
- With the exception of precious metals, there is no right answer as to when the quotation period should fall, although it is usually one to three months, anchored to time of shipment or arrival. However, if the offtake agreement gives the hub the advantage of picking a date that suits it (i.e., the lowest price point), reducing the price received by the mine, one can infer that the hub assumes less price risk.
- If the hub takes legal title of the mineral product the balance sheet should record this. There is no stock holding risk with back-to-back agreements.
- The hub does not necessarily need the financial capacity to bear the full cost of the risk materializing; it just needs to be able to protect itself, for example through insurance.
- Mineral products can only be passed over the ship's rail (i.e., FOB) once at the port of shipment. If the mine sells the product FOB to the marketer, who then sells it FOB to the customer, there is no real intention to transfer risk to the hub. If the hub sells the product CIF, it retains some responsibility, for example insurance. However, this will depend on the commodity—some can change substantially on the high seas, making insurance critical, whereas others are unlikely to change.

### 1.3 Financial data

Following an assessment of function and risk, tax authorities should test the following indicators:

- **Mark-up on costs.** Can the profits of the hub be reconciled with profits of other similar independent entities, using several profit and loss indicators (e.g., sales, operating expenses and operating assets)?
- **Commission rate.** Is the remuneration the hub receives commensurate with commission rates observed in other similar associated entities, as well as in other similar independent entities?

According to multinational mining companies that have a related party marketing hub, a sales commission for base metals and bulk commodities will range between 2 percent and 6 percent. Six percent involves abnormal circumstances, for example, a distressed miner willing to pay a higher margin to liquidate mine products. Even the lower end of the range might be too high in some cases. In a marketing briefing to shareholders by BHP Billiton in 2007,<sup>14</sup> the company announced the decision to bring the marketing function in-house because it was paying too much (a 1-2 percent commission) to the independent agent to offload the product, and could perform the same function at a cheaper cost. (All the information above comprises industry analysis, not comparable data.)

Do not interpret financial information in tables 5 and 6 as comparable data, but as a snapshot of industry practice. The commission rate will depend on the taxpayer functions, risks and assets.

14 BHP Billiton, *Simplicity, Focus & Growth: Marketing Presentation to Analysts* (October 2, 2007)

When determining whether commission rates used by independent traders are comparable, tax authorities should consider all aspects of the marketing arrangement. For example, a trader might provide equity or debt finance to the mine, in addition to marketing services, resulting in a higher return. Authorities should also check the volumes being sold; traders may sell large volumes at a lower margin, which may not be comparable.

Table 5. Commission rate for independent trading houses

Independent trader	Commodity type	Functions of trading house	Revenue in 2013 (billions)	Remuneration
A	<ul style="list-style-type: none"> <li>Metals and minerals</li> <li>Energy products</li> <li>Agricultural products</li> </ul>	<ul style="list-style-type: none"> <li>Sources diversified commodities from third-party suppliers and from the company's own operations.</li> <li>Sells commodities, often with freight, insurance, financing and/or storage.</li> <li>Many customers constitute long-term commercial relationships.</li> </ul>	\$233	Gross margins of 2.7 percent to 5.2 percent on purchase and sale of third-party sourced commodities between 2008-2013.
B	<ul style="list-style-type: none"> <li>Coking coal, iron ore, ferro alloys, alumina/aluminum, steel and agricultural commodities</li> </ul>	<ul style="list-style-type: none"> <li>Undertakes all functions associated with distribution, including storage, logistics and shipping management.</li> <li>Provides a diverse range of financing solutions to its customers.</li> </ul>	\$98	Gross margins of 0.8 percent to 3.1 percent between 2007-2013. Average of 1.6 percent.
C	<ul style="list-style-type: none"> <li>Oil, ferrous and non-ferrous metals and coal</li> </ul>	<ul style="list-style-type: none"> <li>Operates all along the distribution chain: negotiating marketing offtake agreements, providing storage, processing and logistics.</li> </ul>	\$133	Gross margin for non-ferrous and bulk division was 2.3 percent in 2012 and 3.1 percent in 2013. Average of 2.7 percent.

Source: One source of data from an internal transfer pricing report used by a mining company to determine its marketing commission.

Table 6. Remuneration for integrated marketing offtakers

Marketing offtaker	Commodities sourced from African countries	Revenue in 2015 (billions)	Remuneration
D	Thermal coal, platinum and diamonds	\$20.46 billion	2-8 percent (gross sales)
E	Manganese, coal and aluminum	\$6.948 billion	2-6 percent (net sales)

Source: Interviews with mining MNEs

## TRANSACTION TYPE 2

### INTERCOMPANY DEBT



#### INFORMATION CHECKLIST FOR RISK ASSESSMENT

##### Local mine

- Description of the terms of the loan agreement
- Short company description; overview of financial figures and business plan
- Local entity treasury policy documents
- Description and application of the credit rating methodology deployed
- Comparability analysis (external and internal debt agreements with third parties)

##### *Additional information*

The following elements would generally be collected during audit, though the tax authority may choose to request this information during Phase 2 if it is necessary to determine materiality.

- Capital expenditure proposal (what the loan is intended for) and supporting analysis
- Evidence of any negotiations regarding the debt instrument's terms and conditions
- Transfer pricing benchmarking study

##### Parent/group level

- Group organizational management and company structure
- Treasury policy of the group

##### *Additional information*

- Group business strategy and financial accounts
- Group capital expenditure policy
- Group capital expenditure investment decision and supporting analysis
- Group financing decision on type and terms of debt instrument, and analysis supporting arm's length nature of terms and pricing, including any external comparability analysis

## Commercial databases and publications for initial comparability review

### *Commercial databases*

- LoanConnector (Thomson Reuters). Web-based loan information platform
  - Access to complete terms and conditions database, covering hundreds of thousands of loan and bond transactions from around the world
  - Includes access to DealScan which provides historical deal information on global loan markets
- Bloomberg
  - Information on credit ratings and interest rates (more than 300,000 companies worldwide)
- CUFTanalytics available through Bureau Van Dijk's TP Catalyst. Publicly filed credit agreements from the United States Securities and Exchange Commission. They add to this transactional data, the most current credit risk data (Standard & Poor (S&P)'s and Moody's Investor Services credit ratings and S&P's Creditscores).

### *Further guidance*

- Moody's Global Mining Industry Rating Methodology (2014)
- General Electric Capital Canada Inc. v. The Queen, 2009 Tax Court of Canada 563.
- Chevron Australia Holdings Pty Ltd v Commissioner of Taxation [2017] FCAFC 62 (21 April 2017)
- World Bank sourcebook, section 4.2.6





## STEP-BY-STEP GUIDE TO REVIEWING THE TRANSFER PRICING ARRANGEMENT

### Step 1. Review the interbank lending rate

Is the base interest rate the same as the interbank lending rate in the jurisdiction of the borrower?

- Check World Bank tabulation, or central bank website for interbank lending rate.
- The interbank rate will include the country risk premium (i.e., risk of investing in that country)

### Step 2. Review the loan terms and conditions

Several terms and conditions influence interest rates charged in third-party loans. The most significant include:

Loan duration

- Premium increases with duration. Arm's length duration may depend on construction timelines, market dynamics, and the particular subcontractors involved.

Currency of loan

- Usually the currency of the loan should be the same as the working currency of the borrower. Currencies more prone to devaluation will typically draw higher rates of interest.

Seniority of debt

- Higher subordination equals higher interest rates.

Additional collaterals or guarantees

- Loans with a guarantee should have a lower interest rate (may also carry a guarantee fee).

### Step 3. Review the subsidiary credit rating

Is the subsidiary's credit rating the same as the parent's rating?

- Assuming the subsidiary's rating is lower than that of its parent: is this justified when considering the relative importance of the subsidiary to the group, both historically and based on forecast results?
- Is the parent financially strong enough to bail the subsidiary out, and does it have a history of doing so?
- Is there implicit support from the parent, such that the subsidiary's credit risk is lowered?

Is the subsidiary's mineral/metal reserve of a high or low quality? (Factors to consider include grade, price, recovery rate, size, access and regulatory environment.) If the reserve position is strong, the credit quality is improved.

What are the subsidiary's debt levels (earnings before income tax (EBIT)/interest expense)? High debt levels increase financial risk and therefore credit risk.

Does the subsidiary have a steady level of income and EBITDA?<sup>15</sup> Companies with a larger revenue base will be better equipped to withstand different price and demand scenarios.

What is the subsidiary's EBIT margin? The more profitable the mine, the more likely its ability to service its debt obligations.

#### **Step 4. Presentation of findings and closing**

**Output.** Tax authorities should create:

- A list of which mining multinationals require further investigation. The risk of transfer mispricing (probability of occurrence multiplied by the value of the fiscal impact) should determine the companies' ranking on the list.
- A detailed list of potential transfer pricing issues and the controlled transactions involved.

The result will be a pool of potential audit cases.

<sup>15</sup> EBITDA refers to earnings before interest, tax, depreciation and amortization.



## GUIDE TO RISK ASSESSMENT

Mining requires significant up-front capital during construction and pre-production phases, and additional financing throughout the mine's life to maintain operations and fund expansions. For example, a typical large-scale copper mine with a daily throughput of 71,500 tons of copper requires \$2.3 billion in capital investment and \$900 million in annual operating expenses.<sup>16</sup> While parent companies can attract commercial lenders at the global level, this may be more difficult for mining subsidiaries based in Africa, primarily due to country risk. Consequently, many African mining subsidiaries rely on finance from their parent, and, because interest payments on debt can be deducted from taxable income, companies potentially have an incentive to increase the proportion of debt relative to equity, in particular for subsidiaries in higher-tax countries.

### 2.1 Limiting interest deductions

There are two ways that related party debt may contribute to profit shifting through thin capitalization:

- **The quantum of debt** (e.g., assuming the interest rate is 10 percent, a loan of \$100 will have an interest deduction of \$10, but if the loan amount increases to \$1,000, the deduction will be \$100)
- **The cost of debt** (e.g., assuming the loan is \$100, an interest rate of 10 percent will result in a deduction of \$10, but if the rate increases to 15 percent the deduction becomes \$15)

The most common legislative response to thin capitalization has been to limit the maximum level of debt on which interest payments are deductible, by way of a debt-to-equity ratio. However, there are ways for companies to circumvent this rule by converting debt to equity.<sup>17</sup> In addition, CSIMarkets data indicates that the average debt-to-equity ratio in the metal mining sector is 0.84 to 1, which suggests that the 3:1 ratio commonly used by African countries is far too generous for the mining sector.<sup>18</sup>

An interest limitation rule is another way to limit both the quantum and cost of debt. BEPS 2015 Action Item 4 recommends the following approach:

- **A fixed ratio rule (recommended approach).** This approach limits an entity's net deductions for interest and payments economically equivalent to interest to a percentage of its tax EBITDA. The recommended ratio is between 10 and 30 percent of tax EBITDA. This applies to intercompany debt as well as third-party debt.
- **A group ratio rule (optional).** This approach allows an entity with a net interest expense above the country's fixed ratio to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group.

<sup>16</sup> World Bank sourcebook, 263

<sup>17</sup> See for example Arthur Beesley, "Engie tax arrangements broke European tax law – EU Commission," *Financial Times*, 5 January 2017, accessed 8 March 2017, <https://www.ft.com/content/38779574-35a8-3b00-86ef-f6498186a3fa>.

<sup>18</sup> World Bank sourcebook, 68.

To simplify administration, and protect the tax base against excessive interest deductions, finance ministries should incorporate BEPS Action 4, specifically the fixed ratio rule, into domestic tax law. BEPS Action 4 should take legal priority ahead of transfer pricing rules, and be treated as a limit on the tax deductibility of interest payments. However, given that most African governments are yet to enact interest limitation rules, and, even when they do tax authorities may still choose to contest non-arm’s length interest rates, the next section will focus on applying the arm’s length principle to the cost of related party debt.

## 2.2 Transfer pricing method

The CUP method is typically applied to benchmark intercompany loans. The CUP method compares the cost of debt in a controlled transaction to the cost of debt in an uncontrolled transaction in comparable circumstances. A loan usually comprises three parts; to determine the overall interest rate, a CUP benchmark must be identified for each component.

Component	Calculation
Interest rate on the drawn amount (outstanding loan amount).	Currency interbank lending rate plus a margin e.g., US dollar London Interbank Offered Rate (USD LIBOR) plus 200 basis points (bps). <sup>19</sup>
Upfront fee for facilitating the loan—generally charged by a commercial bank in third-party transactions as a type of commission-based payment to set up and administer the loan facility.	Calculated on the loan amount (this is likely to be incorporated into the annual rate rather than charged as a separate upfront fee).
Interest rate on the undrawn but committed amount “commitment fee.”	Usually a percentage of the interest rate on the total loan amount.

## 2.3 Reviewing pricing factors

### *Verify the base interest rate*

The first step is to verify that the base interest rate is the same as the interest rate the central bank in the borrower’s jurisdiction charges to lend money to commercial banks. Examples of a base interest rate include the London Interbank Offered Rate (LIBOR), and the South African Interbank Offer Rate (SABOR).

Tax authorities can use the World Bank’s tabulation of the indicative bank lending rates to verify the base interest rate. Alternatively, the central bank should publish the interbank lending rate on its website.

A country’s interbank lending rate will automatically include the country risk premium, which is the additional risk associated with investing in an international company in that jurisdiction, rather than a domestic market. For example, in 2016, the interbank lending rates in the United States and Afghanistan were 3.5 percent and 15 percent respectively, the huge difference reflecting the level of risk associated with investing in Afghanistan.

<sup>19</sup> Basis point refers to one hundredth of one percentage point.

The base interest rate is the starting point for pricing a loan. It will then be adjusted to account for the following:

- The terms and conditions of the loan
- The credit or default risk of the borrower (measured through a credit rating process)
- Implicit and explicit guarantees

*Assess the terms and conditions of the loan*

Tax authorities should first consider whether the loan terms and conditions appear to be arm's length. If tax authorities determine that the terms and conditions are not arm's length, they should disallow some interest deductions to better reflect the arm's length position.

Some terms and conditions are more likely to affect the level of exposure to financial risk and the interest rate, including loan duration, seniority, collateral and guarantees, and financial and non-financial covenants. (See table 7.)

There are two key issues to consider when assessing the arm's length nature of loan terms and conditions. First, the terms and conditions should reflect the fact that the financing is debt. For example, the borrower should be under a clear obligation to repay (i.e., non-contingent, commercial terms), and generally the lender should not be taking on the risk of the project.<sup>20</sup> Second, if the composition of the parent company's funding and its intercompany lending arrangements are not broadly the same, it may indicate profit shifting. For example, if the parent issues senior debt to its creditor but provides subordinated debt to its subsidiaries, the tax administration should test the commercial rationality for such financial structuring. There may be some points of difference, for example the currency of the loan, but the intercompany loan must make commercial sense under the arm's length principle.

<sup>20</sup> This is not always the case with hybrid instruments. See BEPS Action 2, available at: <http://ow.ly/PeYi30cacW9>.

Loan term	Explanation	Arm's length standard
Loan duration	This is the repayment period.	The interest rate increases with duration. In the case of mining, the loan duration will depend on the production profile of the mine. Mining usually requires loans over several years, but this will depend on construction timelines, subcontractors, and market dynamics.
Seniority	A subordinated loan is paid after senior debt.	Higher subordination implies higher interest rates. It is unlikely that a subsidiary would accept subordinated debt if it increased their interest rate.
Guarantee	A contractual arrangement where one party (the guarantor) agrees to assume the debt obligation of the borrower if that borrower defaults. A guarantee can be limited or unlimited.	Additional collaterals or guarantees included in the financing transaction typically reduce the risk of default.
Currency of the loan	The currency in which the loan is denominated.	Typically, the loan currency should be the same as the working currency of the borrower. Currencies more prone to devaluations will typically draw higher rates of interest.
Financial and non-financial covenants	Conditions that require the borrower to fulfil certain requirements, or force the borrower to undertake certain actions.	Financial covenants are frequently ratios that the borrower is required to stay above or below: <ul style="list-style-type: none"> <li>• Net debt to EBITDA</li> <li>• Net debt to total capitalization</li> </ul> Non-financial covenants may include a limit on sale of assets, change of control provisions, or negative pledges. <sup>21</sup>

Table 7. Key loan terms and conditions

Terms	Explanation	Arm's length standard
Loan amount	Size of debt.	Size of the loan should correlate with its purpose and the ability of the subsidiary to repay it. (See 2.3.)
Loan type	What is the nature of the loan? (e.g., revolving, non-revolving, convertible bonds, corporate facility, non-recourse project finance.)	Long-term debt instruments that are refinanced on maturity are common amongst mining groups.
Date of loan agreement	Date the loan agreement is signed.	The date of a loan agreement is unlikely to raise a flag unless there has been a material change in the subsidiary's profit margin between the time when the credit risk spread was determined and the loan agreement executed.
Purpose of loan	The purpose of the loan may be to construct a mine or expand the mine and its operational capacity.	Loan drawdowns should match the commercial purpose of the loan. For example, if the purpose is construction, drawdowns should coincide with payments to subcontractors and other relevant expenses.
Fixed or variable/ floating rate	A floating or a variable interest rate refers to a loan that does not have a fixed rate of interest for the duration of the loan.	A commercial bank will generally use a floating rate to automatically reflect changes in market conditions and reduce their risk.

Table 8. Other loan characteristics

<sup>21</sup> A negative pledge ensures that other creditors do not obtain a preferred claim over the debtor's assets in the event of insolvency.

**The case of interest-free loans.** A mining subsidiary may receive an inbound interest free loan from its parent company. Such loans do not present a risk to the tax base, and tax authorities should focus audit resources on other related party issues.

*Assess the credit rating of the borrower*

Credit risk (i.e., the likelihood of default) is based on a combination of project and country risk. It is the primary reason that mining subsidiaries in Africa pay higher interest rates. In some cases, a parent company may overstate the credit risk associated with a subsidiary to push up the risk premium, and, as a result, the interest rate. This can have a huge impact on interest deductions. The difference between what a borrower with strong credit quality and a low or medium-rated borrower would pay in interest is significant, which, for a substantial transaction, could mean a major reduction in taxable income.

**The question of implicit support.** The credit rating of the borrowing entity can be determined either as a distinct and separate enterprise (i.e., on a “standalone” basis), or in the context of its membership in a larger group. In the context of a loan, “implicit support” means that the parent is likely to step in to support the subsidiary and meet its debt obligations in the event of financial difficulty. On this basis, implicit support may lead to a higher credit rating, lowering the interest rate charged to the subsidiary.

When considering whether to account for implicit support, credit rating agencies look at:

- the relationship between the parent company and the subsidiary
- the relative importance of the subsidiary to the group
- the financial strength of the parent to bail its subsidiary out
- the parent’s track record of supporting financially distressed subsidiaries

**What the courts have said about “implicit support”**

- GE Capital Canada case:
  - This case involved determining the validity of a Canadian subsidiary’s guarantee fee payment to a US parent. The court determined that implicit support from a parent company was an economic factor that needed to be taken into account in an arm’s length transfer pricing analysis and that the value implicit support provided to the subsidiary should not be charged for.
- Chevron Australia case (Federal Court Appeal):
  - Chevron borrowed \$2.5 billion at a 1.2 percent interest rate in the U.S., which it then lent to Chevron Australia at 9 percent. The court did not accept the proposition that the Australian subsidiary of Chevron should be allowed to claim interest expense, on the basis that its borrowings should be judged under transfer pricing rules as if it were a standalone company, separate from the rest of the Chevron Group.

More factors to consider in determining whether there is implicit support (S&P's Corporate Ratings Criteria):

- Domiciled in the same country
- Percentage ownership
- Common source of capital
- Significance of amount of investment
- Investment relative to amount of debt
- The track record of the parent company in similar circumstances
- Shared name

### **Guarantees**

Guarantees may come from the parent company or from an export credit agency (ECA).<sup>22</sup> An ECA guarantee may (1) cover things that a parental guarantee would not, (2) have backstop facilities in case called upon to guarantee (i.e., a person or entity that will pay off the company's loan if the ECA cannot) and (3) involve significant monitoring of the loan recipient. Parental guarantees on the other hand may not include backstop, monitoring or emergency facilities. Consequently, an ECA guarantee may not be an appropriate benchmark to use when pricing a parental guarantee into the final interest rate.

Beyond implicit support and guarantees, tax authorities should also consider the following factors:

### **Mineral/metal reserve**

Mining subsidiaries in possession of high quality assets will be in a better position to service intercompany debt. The parent company is likely to assess the quality of the mineral asset when making the investment decision. A review of the mineral asset should factor in:

- Grade
- Recovery rates
- Metal price assumptions and expected markers for production
- Return on investment
- Level of proven and probable reserves relative to resources
- Existing operation or greenfield
- Metallurgy
- Surface or underground
- Proximity to existing infrastructure
- Political, regulatory, environmental and permitting issues

<sup>22</sup> Relevant ECAs include: African Export-Import Bank (Afreximbank), Multilateral Investment Guarantee Agency (part of the World Bank) and the International Finance Corporation (part of the World Bank).



*Broad rating factors (adapted from Moody's global mining industry rating methodology)*

Mining groups may use various external credit rating methodologies to determine an appropriate internal rating for subsidiaries. Depending on the debtor and jurisdiction, weightings might need adjusting. Tax authorities should request that taxpayers provide documentary evidence of how they applied the rating method.

Factor	Weight	Why it matters	Indicators
Leverage and coverage	35 percent	Companies that maintain lower levels of debt will have greater flexibility to manage changes in economic and competitive conditions, and a better ability to reinvest in their business, either through organic growth or acquisitions.	<ul style="list-style-type: none"> <li>• EBIT/interest expense</li> <li>• Debt/EBITDA</li> <li>• Debt/total capital</li> </ul>
Scale	20 percent	Subsidiaries with a larger revenue base can weather price cycles, and have more levers to pull in the event of sustained market downturns.	<ul style="list-style-type: none"> <li>• Historical revenue and future revenue forecasts.</li> </ul>
Profitability and efficiency	15 percent	<p>Greater operating efficiency means that the mine will be more resilient during downturns.</p> <p>Higher return on tangible assets means better absorption of fixed costs, thus improving a company's ability to generate returns from its assets.</p>	<ul style="list-style-type: none"> <li>• EBIT margin: annual EBIT/annual revenue</li> <li>• Return on average tangible assets: EBIT/tangible assets</li> </ul>

Two other factors that credit rating agencies may use are **business profile** and **financial policy**. The first relates to exposure to volatility; diversifying the location of mining operations and the number of commodities can mitigate this. The second is based on the management and governing board's track record in financial risk, for example, if the company has previously adhered to its financial commitments. A parent company will have greater capacity to manage these risks than a subsidiary.

Examples of factors leading to increased risk:

- Fluctuating prices and demand for commodities
- Government review of mining concessions taking place
- Project company's mining title will expire prior to the final maturity of the loan
- Insecurity over the mining permit, buildings, plant and installations, mining products, shares of the borrower and onshore accounts
- Rules requiring repatriation of offtake proceeds
- Rules that require proceeds to be converted into local currency

## 2.4 Financial data

Project finance is one possible reference point for tax authorities when assessing the terms and conditions of intercompany loans. Project finance is the structured, long-term financing of the project based on its projected cash flows, provided by third parties such as commercial banks or other lending institutions. Thus, project finance arrangements may be one input to benchmark intercompany loans during the risk assessment phase.

The table below sets out the terms and conditions of select project finance deals in the mining sector in sub-Saharan Africa between 2006 and 2013. While this sample is not sufficiently large to be suitable for comparability purposes, there are some trends worth noting:

- Interest rates are reasonably consistent across the larger project financing loans, i.e., 75 percent of loans at \$88 million and above have an average interest rate of approximately LIBOR +4.2 percent.
- Shorter duration project financing loans may represent bridge financing or projects in financial distress, hence higher interest rates, e.g., the two-year loan to Sabodala at LIBOR +10 percent.
- Most of the project financing loans are rated LIBOR + 4 to 5 percent.

**Table 9. Select project financing loans to mine projects in sub-Saharan Africa**

The financial information in table 9 should not be interpreted as comparable data, but rather a snapshot of industry practice, which may be useful for risk assessment purposes.

Country	Mine project	Loan amount (millions)	Loan date	Loan duration	Terms and conditions	Interest rate
Tanzania	Bulyanhulu (Barrick)	\$142	2013	7 years	• Secured upon the project	LIBOR +2.5%
Liberia	New Liberty (Aureus Mining)	\$88	2013	6 years	• Charges over mine assets, shares, and holding companies • Aureus must fund equity contribution before first drawdown • Backed by South Africa ECA	LIBOR +4.3%
Senegal	Sabodala (Teranga Gold)	\$60	2012	2 years	• Fixed and floating charge • Gold forward sales contracts to manage commodity price risk	LIBOR +10%
Kenya	Kwale Mineral Sands	\$150	2011	8 years	• 6 years for \$80 million; 8years for remaining \$70 million • 4.5 percent pre-project completion; 4.0 percent post project completion • 2.5 percent upfront fee	LIBOR +4 to 4.5%
Zambia	Lumwana (Equinox)	\$220	2010	3 years	• Fixed and floating charge; • Financial guarantee from parent.	LIBOR +4%
Mali	Loulo (Randgold)	\$60	2007	4 years	• Gold forward sales contract to manage price risk.	LIBOR +1.4 to 1.6%
Burkina Faso	Youga (Etruscan Resources)	\$35	2006	7 years	• Quarterly payments over a three-year term commencing 2010.	LIBOR +5%

Source: Open Oil, Aleph Search Engine, <http://aleph.openoil.net>

## 2.5 Legislative provisions

See 2.1 Limiting interest deductions.

Another option for limiting interest deductions is:

- Legislating a fixed rate, i.e., LIBOR plus X percent. If the sample size in table 9 were bigger, there may be sufficient grounds to suggest that LIBOR plus 4 percent is a reasonable ceiling.

## TRANSACTION TYPE 3 PROCUREMENT SERVICES



### INFORMATION CHECKLIST FOR RISK ASSESSMENT

#### Local mine

- Procurement agreement with related party procurement hub
- Number of local procurement staff, duties, key performance indicators and remuneration
- Travel schedules of local procurement staff
- Transfer pricing analysis

#### *Additional information*

The following elements would generally be collected during audit, though the tax authority may choose to request this information during Phase 2 if it is necessary to determine materiality.

- Third-party supplier agreements
- Where the hub is part of a business restructure, the cost/benefit analysis of setting up the hub

#### Related party procurement hub

- Organizational structure of the procurement hub (number and key performance indicators of staff and location(s))
- Balance sheet and detailed income statement of hub (in particular, the effective sales commission generated by the hub and the margin applied). The tax authority should expect to see this in the transfer pricing analysis mentioned above.

#### *Additional information*

- Where the goods and services provided by the hub are sourced from a related party, details of the related party, including its location, business operations and margins
- Hub functional analysis, benchmarking studies, and market research
- Third-party supplier agreements (internal comparables)

#### Commercial databases and publications for initial comparability review

##### *Subscription publications*

- CostMine, produced by InfoMine. Includes information on mine equipment costs, transportation, smelting, labor, etc. (Price: one-year subscription, single user, PDF only: \$2,600.)
- EquipmentMine, produced by InfoMine. Includes information on mining equipment and parts, and mining company news releases. It also includes details for second hand equipment. (Price: \$25.00/month.)
- Mine Economics Data, produced by SNL Metals & Mining. Enables mine comparisons based on a wide range of production and cost parameters.

#### *Further guidance*

- World Bank sourcebook, section 4.2.4



## STEP-BY-STEP GUIDE TO REVIEWING THE TRANSFER PRICING ARRANGEMENT

### Step 1. Identify hub organizational structure and key personnel

Is there specialized procurement staff at the hub?

- Number of employees and their academic/professional qualifications
- Key performance indicators

To what extent do local procurement staff at the mine support the procurement hub?

- How often do local staff travel to the procurement hub and/or visit third-party suppliers?

### Step 2. Initial functional review

*Step (a). Has the procurement service been rendered?*

Is there evidence of procurement activities having been undertaken?

Procurement activity	Evidence	Importance of activity to the mark-up
Purchasing	<ul style="list-style-type: none"> <li>• Procurement requisitions by mine sites</li> <li>• Tender advertisements</li> <li>• Bid documents</li> <li>• Procurement analysis</li> </ul>	
Quality assurance	<ul style="list-style-type: none"> <li>• Efforts to resolve issues where goods and services do not meet the mine site's requirements</li> </ul>	
Receiving	<ul style="list-style-type: none"> <li>• Inventory</li> <li>• Delivery receipts</li> <li>• Examples of items returned to suppliers due to incorrect specifications or quantity</li> <li>• Service level agreement with freight</li> </ul>	
Invoicing	<ul style="list-style-type: none"> <li>• Invoices and receipts</li> </ul>	

Source: Interviews with tax officials at the South African Revenue Service

*Step (b). Has the procurement service created real value for the mine?*

Is the procurement function contributing to satisfying mining production delivery times as agreed in the mine offtake agreement?

- Is there a premium attached to delivery time in the mine offtake agreement?
- Are late penalties payable by the hub enforceable or actually enforced when default occurs?

Are the goods and/or services critical to the mine's operations?

Are the goods and/or services readily available in the market?

In the event that the goods and/or services critical to the mine's operations do not meet quality specifications, or are delayed, how does the hub mitigate the miner's business risk?

*Step (c). Has the procurement team created the value, or is it merely a result of group synergy?*

Value creation attributable solely to the procurement hub being part of a larger group may not warrant more than a low mark-up on costs, whereas group synergies arising from deliberate concerted group action may justify a higher mark-up, the rate of which will depend on functional and comparability analysis. (See para 1.157 and 1.162 of the revised OECD Transfer Pricing Guidelines.)

Were third party suppliers familiar with the company brand before the procurement hub was set up?

Does group negotiating power (e.g., volume) generate the discount?

### **Step 3. Initial comparability review—do the results appear to be within the arm's length range?**

Depending on the functions, risks, and assets of the procurement hub, the appropriate transfer price will include a mark-up on the cost of providing the service, or, in some limited circumstances, a mark-up on the value of the good or service procured.

Using the indicators below, tax authorities should compare the results of the mining subsidiary under assessment with similar mines operating in their country.

#### **Cost base of the procurement charge**

- Cost of providing the procurement service; or
- Value of the good and/ or service; or
- Total budgeted spend.

#### **Mark-up**

- Five percent is common.

### **Step 4: Presentation of findings and closing**

**Output.** Tax authorities should create:

- A list of the mining multinationals that require further investigation. This list should be ranked per the risk of transfer mispricing (probability of occurrence multiplied by the value of the fiscal impact).
- A detailed list of potential transfer pricing issues and the controlled transactions involved.

The result will be a pool of potential audit cases.



## GUIDE TO RISK ASSESSMENT

It is common for mining subsidiaries to use a procurement hub for the purchase and import of equipment, machinery and services required to develop and run the mine. However, some procurement support may continue to come from the mine site, and there may even be an explicit division of procurement responsibilities at global, regional and local levels.

### 3.1 Transfer pricing method

Procurement services are a common corporate service,<sup>23</sup> therefore a procurement hub would not expect to be a profit center for a mining group. Routine functions expect routine rates of return. The most appropriate method to calculate the transfer price for procurement hub services is the cost-plus method, which is the cost of providing the service (i.e., not the value of the goods and services procured), plus a mark-up. A mark-up of five percent is quite common.<sup>24</sup>

### 3.2 Reviewing pricing factors

The appropriate cost-plus mark-up will depend on:

- The underlying substance of the procurement hub
- Any evidence of value creation, derived from deliberate concerted group action rather than incidental benefit of group membership

#### *Underlying substance*

The first test is substance over form. To determine whether the hub possesses real substance, tax authorities should consider the following:

- Does a procurement hub exist, and does it possess real procurement expertise?
- Has the mine stopped performing the functions transferred to the procurement hub, or is there duplication?
- What risks does the procurement hub assume in the provision of the goods and services?
  - How is the miner protected from the provision of poor quality products or the late delivery of goods or services that are critical to its business operations?
  - To what extent does the procurement hub or its suppliers assume those risks?

To answer these questions tax authorities should investigate the procurement hub, as well as procurement staff at the local mine, to compare functions, skills and expertise.

<sup>23</sup> OECD *Transfer Pricing Guidelines*, section 7.14.

<sup>24</sup> World Bank sourcebook (53).

	Procurement hub	Local mine
Expertise	1. How many staff does the procurement hub employ? 2. What are their academic/professional qualifications? 3. What are their key performance indicators, or job descriptions? 4. What is the remuneration structure for procurement staff?	Apply Questions 1,2, 3, and 4  5. How often do procurement staff from the local mine travel to the procurement hub, or visit offshore suppliers?

### Practitioner insights

- It may be the case that most employees in the procurement hub are accountants, or administrative staff, rather than procurement experts. This may undermine the hub’s claim that the presence of significant procurement expertise justifies a higher mark-up on services.
- If travel schedules show local procurement staff travelling frequently to the procurement hub, or to suppliers, this may indicate that the local team is in fact responsible for core negotiations with suppliers, meaning the procurement hub only has a support function.

Assuming the substance test is satisfied, the next question is: what activities is the procurement hub performing, and to what extent should these be remunerated?

Procurement activity	Evidence	Importance of activity to mark-up
Purchasing items	<ul style="list-style-type: none"> <li>• Procurement requisitions by mine sites</li> <li>• Tender advertisements</li> <li>• Bid documents</li> <li>• Procurement analysis</li> </ul>	
Quality assurance	<ul style="list-style-type: none"> <li>• Efforts to resolve issues where goods and services do not meet the mine site’s requirements.</li> </ul>	
Receiving items	<ul style="list-style-type: none"> <li>• Inventory</li> <li>• Delivery receipts</li> <li>• Examples of items returned to suppliers due to incorrect specifications/quantities</li> <li>• Service level agreement with freight forwarded</li> </ul>	
Invoicing and managing payment by mine sites	<ul style="list-style-type: none"> <li>• Invoices and receipts</li> </ul>	

Table 10. Evidence and importance of procurement hub activities

**Dark blue** activities are likely to add the most to the final mark-up. Relative importance decreases as the color blue becomes lighter. Functions such as invoicing and finance are of lower value.

*Specific value creation*

More sophisticated value adding procurement services may warrant a higher cost-plus mark-up, or, in limited circumstances, the CUP method expressed in terms of a commission rate based on the value of the service, or total procurement spend.

Special added value	Questions to consider	Arm's length standard
Good or service is critical to the mine	<ol style="list-style-type: none"> <li>1. Can the good or service be purchased on an open market?</li> <li>2. Is the good or service readily available in the market?</li> </ol>	<p>Goods and services critical to the mine will be of greater value, potentially justifying a higher mark-up.</p> <p>If the good or service can be easily sourced, the hub requires less effort and "know-how," which may mean a lower mark-up.</p>
Assisting in the output of the mine	<ol style="list-style-type: none"> <li>3. Did the procurement hub make the expected deliveries on time?</li> <li>4. Do third-party sales agreements stipulate a delivery time for the mineral product?</li> <li>5. Can the customer penalize the mine for late delivery?</li> </ol>	<p>There is a premium attached to delivery time particularly where the goods and services are critical to the mine meeting its obligations to customers.</p>

Table 11. Testing specific value creation

Further questions that relate to value-add:

- Does the procurement team bring suppliers and buyers together, or is it simply told what to buy?
- Did the hub procure the good/service from the same supplier as before, or has a new relationship been developed? This is relevant to time and effort, but also to security of supply.
- Was the price lower than what the mine could have achieved independently?
- Was the price generally available to everyone?
- Is there evidence that the subsidiary disputed the procurement charge?

*Group synergy*

According to BEPS Actions 8-10, it is necessary to distinguish between the incidental benefits of synergy derived from group membership (e.g., economies of scale), versus benefits which can be attributed to deliberate concerted group actions (e.g., consolidating purchasing activities). The former does not warrant separate compensation, whereas the latter may, in which case the benefits should generally be shared by group members in proportion to their contribution to the synergy.<sup>25</sup>

The OECD suggests that centralizing procurement to take advantage of volume discounts may be an example of deliberate concerted group action. However, the level of compensation will ultimately depend on whether the procurement hub has achieved a material, clearly identifiable structural advantage over other market participants in comparable transactions as a result of centralizing procurement.

<sup>25</sup> See para 1.157 and 1.162 of the revised OECD *Transfer Pricing Guidelines*.



Benefits from group membership	Questions to consider	Arm's length standard
Company name	<ol style="list-style-type: none"> <li>Were suppliers familiar with the company name before the procurement hub was established?</li> <li>Is there a benefit for the supplier in being associated with the company brand?</li> </ol>	If the company was widely known before the hub was established, any discounts will be derived from group membership, rather than a structural advantage arising from the group action to centralize purchasing. Well-known companies will get preferential rates from suppliers because suppliers want to be associated with the brand, not because of centralized purchasing.
Buying power	<ol style="list-style-type: none"> <li>Who negotiated the cost savings? Was it the procurement team or a staff member outside of the hub?</li> </ol>	If staff members outside the hub had pre-existing strategic relationships with suppliers, and they concluded the agreements, any cost savings should be considered an incidental benefit of group membership, with the hub receiving a lower mark-up.

Table 12. Testing the benefits of synergy

### 3.3. Financial data

Following an assessment of substance, value creation and group synergy, tax authorities should review whether the remuneration received by the procurement hub is commensurate with that observed in other comparable entities.

**Do not interpret the financial information in table 13 as comparable data, but rather a snapshot of industry practice amongst a small number of mining MNEs.** The appropriate procurement charge will depend on the particular jurisdiction, as well as a thorough review of the hub's functions, risks and assets.

Company	Mining business in Africa	Revenue in 2015 (billions)	Procurement charge
A	Thermal coal, platinum and diamonds	\$20 billion	7.5 percent of "budgeted spend" (i.e., the amount allocated to procurement spending for that year)
B	Manganese, coal and aluminum	\$7 billion	6 percent of value of goods (volumes up to \$1 million) or 1 percent of value for additional volume.
C	Mineral sands, uranium and iron ore	\$35 billion	1 to 3 percent of value of good and/or service depending on whether it is easily sourced.

Table 13. Procurement charge used by mining MNEs

Source: Interviews with mining MNEs

## TRANSACTION TYPE 4 MANAGEMENT SERVICES



### INFORMATION CHECKLIST FOR RISK ASSESSMENT

#### Local mine

- Management services agreement
- A description of the categories of management services provided:
  - the rationale for the provision of services within the MNE
  - a description of the (expected) benefits of each category of services
- Transfer pricing analysis including: (a) description of the selected allocation keys (i.e. the basis used to allocate costs to a subsidiary, for example, number of staff might be a basis for allocating charges for human resource services), (b) justification that these allocation keys produce outcomes that reasonably reflect the benefits received, and (c) confirmation of the mark-up applied.

#### Parent/group level

##### *Additional information*

The following elements would generally be collected during audit, though the tax authority may choose to request this information during Phase 2 if it is necessary to determine materiality.

- Calculations showing the distribution of costs amongst the group
- Calculations showing the application of the specified allocation key
- Third-party service agreements (internal comparables)

#### Commercial databases and publications for initial comparability review:

##### *Subscription databases*

- Bureau Van Dijk's TP Catalyst brings together private and public company financial data, making it possible to identify comparables for management service charges, although some adjustment may be required for country context.
- Thomson Reuters' ONESOURCE Transfer Pricing offers a similar service to TP Catalyst.

##### *Further guidance*

- World Bank sourcebook, section 4.2.3
- BEPS Actions 8-10, "Aligning Transfer Pricing Outcomes with Value Creation," see Low Value-Adding Intra-Group Services, 141–153.



## STEP-BY-STEP GUIDE TO REVIEWING THE TRANSFER PRICING ARRANGEMENT

### Step 1. Initial functional review

Is there *prima facie* evidence that the management service may have taken place?

Activity	<i>Prima facie</i> evidence that the service may have taken place
Accounting/auditing services	Timesheet of accounting/audit staff
Human resources	Number of employees/staff contracts
Legal services	Number of employees/staff contracts
Computer services	Number of PCs
Health and safety	Number of employees/staff contracts
Technical services (inclusive) <ul style="list-style-type: none"> <li>• Geology</li> <li>• Geotechnical and rock mechanics</li> <li>• Mine planning and feasibility study</li> <li>• Metallurgy</li> <li>• Use of heavy equipment</li> <li>• Water, energy and asset management</li> <li>• Environment related</li> </ul>	<ul style="list-style-type: none"> <li>• Reports</li> <li>• Workings specific to the project</li> <li>• Services agreement</li> <li>• Manuals</li> <li>• Software</li> <li>• Feasibility study</li> </ul>

Is the charge calculated on a direct or indirect basis?

- If direct, request the invoice assessing the arm's length nature of the reimbursement.

If indirect, is the allocation key appropriate?

- Check the total global cost for the service, and the percentage allocated to the subsidiary.

Activity	Allocation key
Accounting/auditing services	Time spent
Human resources	Headcount (number of staff at mine site)
Legal services	Time spent, or, if the legal matter is complex, the value of the dispute
Computer services	Number of users per software, or number of computers
Technical services	Time spent

Did the subsidiary benefit directly from the service?

- Did the service benefit the parent company only? If so, it is a “shareholder activity” and the parent should absorb the cost, not the local mine.
- Has the subsidiary's profit margin improved because of the service?
- Why did the subsidiary need the service? How did it relate to the subsidiary's business?
- Would the subsidiary have paid a third party to provide the service?

Does the service duplicate an activity already undertaken by the subsidiary?

**Step 2. Initial comparability review—do the results appear to be within the arm’s length range?**

Is the mark-up fair and reasonable, given the nature of the service and the risks assumed?

- no mark-up for simply passing on third party costs
- low mark-up for low-risk supporting services (e.g., budgeting, accounting and human resources)
- higher mark-ups where specialist “know-how” or expertise is involved (e.g., geological interpretations provided by a central engineering team)

Low-value adding services (mark-up of five percent or less)	Technical services (mark-up of five percent or more)
<ul style="list-style-type: none"> <li>• Corporate planning</li> <li>• Processing and managing of accounts</li> <li>• Accounting and auditing</li> <li>• Legal—general legal services</li> <li>• IT services</li> <li>• Internal and external communications</li> <li>• Human resource services</li> <li>• Administrative activities</li> </ul>	<ul style="list-style-type: none"> <li>• Geology</li> <li>• Geotechnical and rock engineering</li> <li>• Metallurgy</li> <li>• Use of heavy equipment</li> <li>• Water, energy and asset management</li> <li>• Environment related</li> <li>• Legal (may be considered technical if the matter is particularly complex)</li> </ul>

**Step 3. Presentation of findings and closing**

**Output.** Tax authorities should create:

- A list of which mining multinationals require further investigation. The risk of transfer mispricing (probability of occurrence multiplied by the value of the fiscal impact) should determine the companies’ ranking on the list.
- A detailed list of potential transfer pricing issues and the controlled transactions involved.

The result will be a pool of potential audit cases.



## GUIDE TO RISK ASSESSMENT

Mining subsidiaries can access a range of administrative and technical services from their parent company, or, in some cases, from a specially designated related party services company. In most instances, the parent or services company covers the cost of delivering these services, then charges it as management service fees to its subsidiaries.

Technical services provide specialized support to the specific mining operation. They should not be confused with research and development activities, which are not covered in this toolkit.

Administrative services may include:	Technical services may include:
<ul style="list-style-type: none"> <li>• Corporate planning</li> <li>• Budgetary control</li> <li>• Accounting</li> <li>• Auditing</li> <li>• Legal</li> <li>• Computer services</li> <li>• Human resource services</li> <li>• Health and safety</li> </ul>	<ul style="list-style-type: none"> <li>• Geology</li> <li>• Geotechnical and rock engineering</li> <li>• Metallurgy</li> <li>• Use of heavy equipment</li> <li>• Water, energy and asset management</li> <li>• Environmental management</li> </ul>

### 4.1 Transfer pricing methods

The **cost-plus method** will often be the most appropriate transfer pricing method for management services, particularly for administrative functions. The cost-plus method identifies the costs incurred by the supplier of services in a controlled transaction, and then adds an arm's length mark-up to that cost base.

Technical services may be critical to local mining operations, and may therefore be charged according to the **CUP method** expressed as a commission on the value of the service. However, tax authorities should only allow this if they can identify an appropriate CUP in the African context.

### 4.2 Reviewing pricing factors

In reviewing management service charges, tax authorities should consider the following:

- Any direct charges
- The cost basis—particularly relevant for more expensive technical services
- Use of allocation key
- Whether the mark-up, or commission rate is arm's length. In the case of low value-adding intra-group services, the mark-up should not exceed five percent.<sup>26</sup>

BEPS Actions 8-10 defines low value-adding intra-group services as those which are of a supportive nature, are not part of the core business of the MNE group, do not require or create unique and valuable intangibles, and do not involve risk.

<sup>26</sup> OECD BEPS Actions 8-10, D.2.4 (158).

*Has the service been rendered?*

Establishing whether an intra-group service has been effectively rendered requires more than proof that the service was provided. It requires proof that the service created economic or commercial value for the recipient, such that it has enhanced or maintained its business position.

Activity	Evidence
Accounting/auditing services	Timesheet/intercompany service agreement
Human resources	Timesheet/intercompany service agreement
Legal services	Timesheet/intercompany service agreement
Computer services	Timesheet/intercompany service agreement
Health and safety	Timesheet/intercompany service agreement
Technical services (inclusive) <ul style="list-style-type: none"> <li>• Geology</li> <li>• Geotechnical and rock mechanics</li> <li>• Mine planning and feasibility study</li> <li>• Metallurgy</li> <li>• Use of heavy equipment</li> <li>• Water, energy and asset management</li> <li>• Environment related</li> </ul>	<ul style="list-style-type: none"> <li>• Reports</li> <li>• Timesheet</li> <li>• Activities specific to the project</li> <li>• Services agreements</li> <li>• Manuals</li> <li>• Software</li> <li>• Feasibility study</li> </ul>

Table 14. *Prima facie* evidence that the service may have taken place

**Benefits test**

There must be concrete evidence that the subsidiary actually benefited, or reasonably expected to benefit, from the service. In the absence of such evidence, tax authorities should disregard the services and disallow the cost deduction.

**Test:** has the specific service led to a material improvement in the mine’s profitability?

**Box 1. The benefits test**

The parent company installs a new computer system for the subsidiary and charges a 7 percent mark-up on the value of the computer system. To prove that a service was rendered, the taxpayer must demonstrate why they wanted to install the new computer system, and explain the expected benefit. For example, was it expected to reduce staff costs by enabling more efficient stock monitoring? The evidence provided should be of the decision-making process at the time. The expected benefit should be for the subsidiary’s business operation, not the parent company. For example, if the expected benefit is for the computer system to assist in the preparation of consolidated accounts, the charge would be deemed a shareholder cost, and disallowed.

Further questions:

- Why did the subsidiary need the service? How did the service relate to the subsidiary’s business?
- Would a subsidiary have been willing to pay a third party to provide the service?

### **Shareholder activities**

In some cases, management services benefit the group as a whole. The charge is justified only if the service was of immediate benefit to the local mining operation. If the service benefits only the parent company, it is a “shareholder activity,” and the parent should absorb the cost, not the local mine.

Examples of shareholder activities (see BEPS Actions 8-10):

- a) Costs of activities relating to the legal structure of the parent company:
  - meetings of shareholders of the parent
  - issuing of shares in the parent company
  - costs of the board
- b) Costs relating to reporting requirements of parent company including the consolidation of reports
- c) Costs of raising funds for the acquisition of new interests, and managing investor relations
- d) Costs relating to compliance of the parent company with relevant tax laws

### **Duplication of services**

The service provided by the parent company, or a dedicated services company, should not already be provided by the subsidiary itself. However, the provision of management services at both the group and subsidiary level does not necessarily constitute duplication. For example, there may be a temporary overlap of services when a group is reorganizing to centralize its management functions, though the overlap should be time bound and justified.

#### *Is the cost of the service arm’s length?*

Technical services may include significant “know-how” and expertise, making them more costly than administrative management services. Individual experts, on short- to medium-term secondments to the mine, provide the majority of technical services as the need for specialized services arises. These arrangements are generally structured on a commission basis that may range as a percentage of the total capital cost of the project, depending on the extent of the services provided, and the general demand for them in the market at the time.

A contract for technical services may specify the following:

- hourly or daily rates for the professional services of various members of the project team, with different levels of seniority for the various components of the project
- overheads as a fixed percentage of the hourly or daily rates
- a fixed amount representing the contractor’s profit margin

For further information on how to evaluate technical consulting fees and charges, tax authorities should refer to the guidelines<sup>27</sup> of the Consultants Society of the Australasian Institute of Mining and Metallurgy (AusIMM) and various other professional engineering groups.

For generic management services such as human resources, IT and legal, there may be domestic comparables available, making the cost of administrative services easier for tax authorities to verify.

*Is the charge arm’s length?*

Once the tax authority has verified that a management service was rendered, and that the cost base is appropriate, it should determine whether the amount of the charge complies with the arm’s length principle.

**1 Direct charge method**

In the direct charge method, related parties charge each other directly for specific services. These charges are easy to track: an affiliate performs a service to meet an identified need of the subsidiary.

**2 Indirect charge (most commonly used)**

Indirect charge methods include cost allocation, and apportionment of global expenses. The allocation key should depend on the nature and usage of the particular service, for example, manpower, tonnage and revenue.

*Is the allocation key appropriate?*

Management services will attract a modest mark-up compared with other inter-company services. This is because they are largely supportive in nature, involving limited technical expertise or risk. But, while the mark-up is limited, taxpayers may use the allocation key as an opportunity to inflate the basis for the fee, hence the need for tax authorities to be particularly vigilant when it comes to assessing the appropriateness of the allocation key. Tax authorities should be mindful of the use of “turnover” as an allocation key, as very few management services are likely to contribute directly to an increase in sales.

Activity	Allocation key
Accounting/auditing services	Time spent
Human resources	Headcount (number of staff at mine site)
Legal services	Time spent, or if the legal matter is complex, the value of the dispute
Computer services	Number of users per software or number of computers
Technical services	Time spent

Table 15. Allocation keys

27 Consultants Society of the Australasian Institute of Mining and Metallurgy (AusIMM), *Setting Consulting Rates*, (2013)



Assuming the allocation key is appropriate, tax authorities should request the subsidiary to provide the total global cost for a particular management service, and the percentage allocated to that subsidiary, in order to check that the subsidiary is not overburdened. This information may be difficult to obtain, as it will be held in a foreign jurisdiction.

**Is the mark-up appropriate?**

The mark-up is likely to vary depending on the type of management service, but it should be fair and reasonable in relation to the nature of the service and the risks assumed. For example:

- No mark-up for simply on-charging third party costs
- Minimal mark-ups for low risk supporting services (e.g., budgeting, accounting and human resources)
- Higher mark-ups where specialist “know-how” or expertise is involved (e.g. geological interpretations provided by a central engineering team)

BEPS Action 8-10 suggests a mark-up of five percent as a simplified rule for low value-adding intercompany services. This is an elective approach, requiring domestic legislation.

Low-value adding (mark-up of five percent or less)	Technical services (mark-up of five percent or more)
<ul style="list-style-type: none"> <li>• Corporate planning</li> <li>• Processing and managing of accounts</li> <li>• Accounting and auditing</li> <li>• Legal—general legal services</li> <li>• IT services</li> <li>• Internal and external communications</li> <li>• Human resource services</li> <li>• Administrative activities</li> </ul>	<ul style="list-style-type: none"> <li>• Geology</li> <li>• Geotechnical and rock engineering</li> <li>• Metallurgy</li> <li>• Use of heavy equipment</li> <li>• Water, energy and asset management</li> <li>• Environment related</li> <li>• Legal (may be considered technical if the matter is particularly complex)</li> </ul>

Table 16. Distinguishing between low-value adding and technical management services in the mining industry

Further questions:

- Is the cost calculated each year?
  - Fixed fees are bad practice. The value of management services should change because companies are becoming more cost-efficient.
- Is it a cost that is only charged to a specific mine? This may be appropriate for technical services focused on only one mine, but is not common for other low value-adding services.

### 4.3 Financial data

Following an assessment of whether the management service was rendered, and the charging method appropriate, tax authorities should consider whether the mark-up is commensurate with that observed in other comparable entities.

**Do not interpret the financial information in table 17 as comparable data, but rather a snapshot of industry practice amongst a small number of mining MNEs.**

The appropriate management service fee will depend on the particular facts and circumstances of the case and requires a thorough review of the functions, risks and assets of the parties to the transaction.

Company	Business	Revenue in 2015 (billions)	Mark-up
A	Thermal coal, platinum and diamonds	\$20 billion	7.5 percent
B	Manganese, coal, and aluminum	\$7 billion	5 percent to 10 percent (depends on service)
C	Mineral sands, uranium, and iron ore	\$35 billion	5 percent

Table 17. Mark-up on management services by integrated mining companies

Source: Interviews with mining MNEs

#### Legislative provisions

##### Simplified method to determine the mark-up on low value-adding intra-group services.<sup>28</sup>

Many countries have indicated that excessive charges for intra-group management services constitute their primary BEPS challenge.<sup>29</sup> Subsidiaries paying for services they do not receive, or being overcharged, fuel this view. Consequently, countries may be reluctant to legislate a fixed mark-up, which could be subject to abuse by companies. While such concerns are valid, the threshold is intended to apply to low-value services, meaning those that present limited risk to government revenue. Consequently, ease of administration may be considered an appropriate trade-off against accuracy.

Therefore, tax authorities should consider limiting the mark-up on low value-adding intra-group services to five percent of the relevant cost. The same mark-up should be applied to all low value-adding services irrespective of the category of service.

Important caveats:

- Taxpayers should only be allowed to apply the simplified approach to services that fall within the definition of low value-adding.
- Tax authorities should set a threshold beyond which taxpayers are no longer eligible to apply the simplified approach to low value-adding services. For example, if the proportion of intra-group services to total costs gets too high. In such cases the tax authority could disallow the simplified approach, and require a full functional analysis and comparability analysis including the application of the benefits test to specific service charges.

<sup>28</sup> OECD (2015) BEPS Actions 8-10 available at <http://www.oecd-ilibrary.org/error/authentication/2315351e.pdf>

<sup>29</sup> OECD (2015) BEPS Actions 8-10, 142

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