Transfer pricing challenges in extractive industries

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1. TRANSFER PRICING PRINCIPLES

The basic concept of transfer pricing (TP)

- *Arm's length* principle
- Despite criticism, let us suppose that the principle is correct: market price-related transactions do not distort the tax base
- But finding/agreeing on that market price is often not easy
- Varying interpretation of the principle and its rules - extractive industries are a good example

What does Base Erosion and Profit Shifting (BEPS) explain?

- Minor section on commodities in a TP report
- The comparable uncontrolled price method (“CUP” method) -- one of the 5 methods established by the OECD -- is generally appropriate
- Price quoted on stock exchanges, an adequate benchmark
  (ratifies common practice)
- Permissible to use shipment date to determine the date of a controlled transaction
- Satisfies grain exporters
  - measure to counter contract post-dating abuses
- Grey areas – target of aggressive planning (or arbitrary acts)

More to be done

- But leaves another aspect unresolved: CUP should be the preferred method, unless another is rigorously justified
- It would avoid planning with the cost plus method
- Even the shipment day is somewhat loose
- It (rightly) supports the possibility of price adjustments, but is not very prescriptive

  (depends on facts and circumstances)

2. ISSUES WITH APPLYING THE ARM'S LENGTH PRINCIPLE

Vulnerable related transactions

- Sale of the product
- Acquisitions (goods and services)
- Financing
- Intangibles
- Disposal of the asset / concession

3. SALES PRICE

Sales

- Sales to another subsidiary, often in a tax haven
- How to ascertain that the price is consistent with the arm's length price (ALP)?
- In accordance with CUP: current market price for a similar (e.g., London Metal Exchange - LME) transaction
- But this market price typically does not apply directly to the good sold to the tax haven – there are remunerated activities between the pithead / point of delivery and end-client, including those (supposedly) carried out by the intermediary in the tax haven.
- It is necessary to define the initial benchmark price and discounts for intermediary activities (inside and outside the haven)

Which benchmark price?

- The spot price, futures? Which stock exchange? Specialized publications, official sources...Term of contracts...; averages, dates ... Principle: do as independent actors do ...

Adjustments to the price

- On account of quality, quantity ... (margin as safe harbor?)

Adjustment for place of delivery:

- Net-back pricing, domestic-international transportation, storage, pit or wellhead-point of delivery
- Difficulty: e.g. vertical integration in domestic transportation due to market flaw
- Monopoly situations, price in theory the result of non-competitive bilateral negotiations, but contracts imperfect, possibility of hold-up, uncertainty, obstacle to private investment, no feasible market price.
- In the absence of integration, industry subject to regulation
- Should transfer pricing follow the same rationale?
- Price that assigns greater profit to a more heavily taxed activity?

Adjustment due to processing:

- E.g., from mineral to metal (refining)
  - (N.B. If refining is not done locally, there is no source and no withholding)

Intermediation quota

- Explicit discount: % of price to third party. e.g., fee for placing/selling output
- Implicit discount, "blind" triangulation
  - Is the service really provided?
  - How to demonstrate that? Signing of contracts not enough

❑ What can be done? "Tested party" is the intermediary (simplest function)

- Burden of proof, proving market margin
- Formal obligation to document in order to deduct

Hedging

Hedging with a subsidiary?

- Hedging with a related party raises the question of whether risk is being diversified
- The fate of the subsidiary may not be unrelated to that of the group
- Is this a case in which the arm's length principle fails?
- Protective measures:

  - the subsidiary's line of business is extractive, not financial

  - losses due to certificate hedging (*coberturas cedulares*)

  - commercial rationality test

Representation agency

- If the intermediary is a broker, then the entire transaction is controlled and must be reported as such
- In transactions with an agent or commission agent, only the fee is subject to TP
- But only one contract with the final customer

recognized for the principal (including end-price)

4. PURCHASES

Consolidated purchases

- Acquisitions of the group concentrated in one subsidiary (in a tax haven)
- Could be justified under certain conditions – purchase of specialized equipment
- Or to improve the terms of a contract
- But intermediary's profit should be its own efficiency – not a margin over the market prices obtained by each of the subsidiaries (better with BEPS)

Acquisition of used assets

- Subsidiaries commonly acquire assets from related enterprises that have been fully depreciated
- Value them at market price – possibility: original invoice (from third party) less depreciation already written off

5. SERVICES

Financial

- Mining projects are often financed with a lot of debt and little equity
- Anti-abuse measures more effective than TP
- Over-indebtedness forces re-classification
- Several thin capitalization models
- But these are circumvented by using alternative financing arrangements

Administrative expenses (examples)

- Pro-rata deduction of parent company's expenses
  - Identify comparable market-based service

- Management expenses
  - Difference from shareholders' activity

- Technical assistance
  - Should not be duplicated with payment of assets, for example.

Conclusions

- Each of the factors referred to poses a challenge for the application of TP
- And they are not the only factors; there is a whole list, but:

Especially important are the following:

- Intra-group hedging (*coberturas internas al grupo*)
- The marketing function following first sale
- Replacing the comparable price methodology

Finally ....

- Is there a joint approach in the region for dealing with these situations?