STRENGTHENING EXTRACTIVE SECTOR MANAGEMENT IN MONGOLIA

Base Erosion Profit Shifting (B.E.P.S) - an Overview

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Selected Topics

1. Excessive interest deductions
2. Abusive transfer pricing
3. Undervaluation of mineral exports
4. Indirect transfer of mining asset
5. Inadequate ring-fencing

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Definition – Transfer Pricing

- Transfer pricing (TP) is the process of determining the price for goods, services, or property sold between related parties within an MNE.
- For example, if a mining subsidiary sells mineral products to a parent company, the price paid for those goods to the subsidiary is called the transfer price.
- TP is a normal business accounting practice. However, some MNEs may use TP as an opportunity to shift profit to low tax jurisdictions to minimise their tax bill in the country hosting the mining operations.

Definition – Transfer Mis-Pricing

Mispricing is considered abusive and therefore referred to as "transfer mispricing." In the mining sector transfer mispricing is generally due to:

- underpricing of outbound transfer of mineral products to related parties, and
- overpricing of inbound (and underpricing of outbound) transfer of goods and services from related parties including marketing and financial services, corporate and support services, tangible and intangible assets, especially proprietary know-how, intellectual property (IP) and research and development (R&D).

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Topics

- International tax context for transfer pricing.
- Transfer pricing and the arm's length standard.
- Issues and challenges for governments and taxpayers in transfer pricing.
- A host country tax minimization example - challenges for tax authorities
- Government responses to transfer pricing challenges.

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Why is this a problem ?

- Taxpayers use transfer pricing to shift income to achieve lower taxes and higher after-tax returns. Governments have authority to adjust related party transfer prices.
- Inconsistent treatment by countries may result in
  - "Double" taxation of income.
  - Double non-taxation of income.
- OECD historically concerned with double taxation; extractive industry host country problem is non-taxation.

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Residence and Source

- “Source Country” = Country that is the source of the income (i.e., where the income is earned)
- “Residence Country” = Country where the owner of the income resides.
- Each country can be a both a source country and a residence country. Some countries are used solely as a intermediary country, i.e., for a holding company.
- Most developing countries are capital importing host countries and have predominantly source country tax interests.

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Controlled Business

- For tax purposes, transfer pricing refers to what is charged for transfers of value between commonly controlled businesses.
- Commonly controlled businesses also are thought of as “related” but common control is broader than common ownership.
- Most countries’ domestic laws accord tax authorities broad authority to adjust related party transfer pricing to the arm’s length standard.

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OECD Transfer Pricing Guidelines

- Approach of the Guidelines is to test controlled transactions (between associated persons) by reference to comparable uncontrolled transactions.
- Comparable means that differences in the conditions of uncontrolled transactions from the controlled transactions would not materially affect the amount determined or adjustments could be made to account for the differences.

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Mining supply chain

- The mining supply chain consists of a series of interconnected activities including operations, logistics and marketing functions.
- MNEs may introduce complex international structures when setting up their structure for investment in a mining venture, or following a restructure of pre-existing arrangements in order optimize their business.
- The result is a fragmentation of the supply chain, which may lead to profits being shifted from the host country where mining activities are undertaken.

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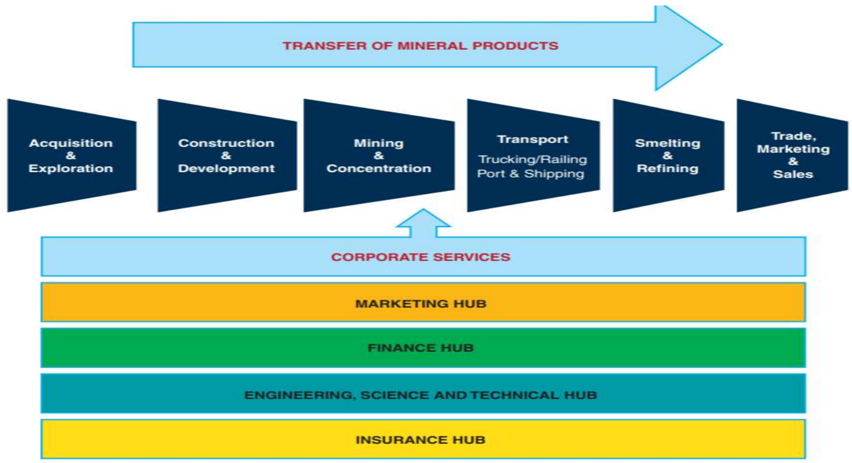
Mining cycle value-adding chain



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Business optimization

- Processes tend to consolidate most of an MNE’s specialized intangible assets and nonroutine, value-adding capabilities into centralised service centres or hubs or subsidiaries located abroad, often in low tax jurisdictions.
- As a consequence the tax base of the host country is eroded and profits are shifted to the lower tax jurisdictions, thus reducing the total tax paid by the MNE at the consolidated level.

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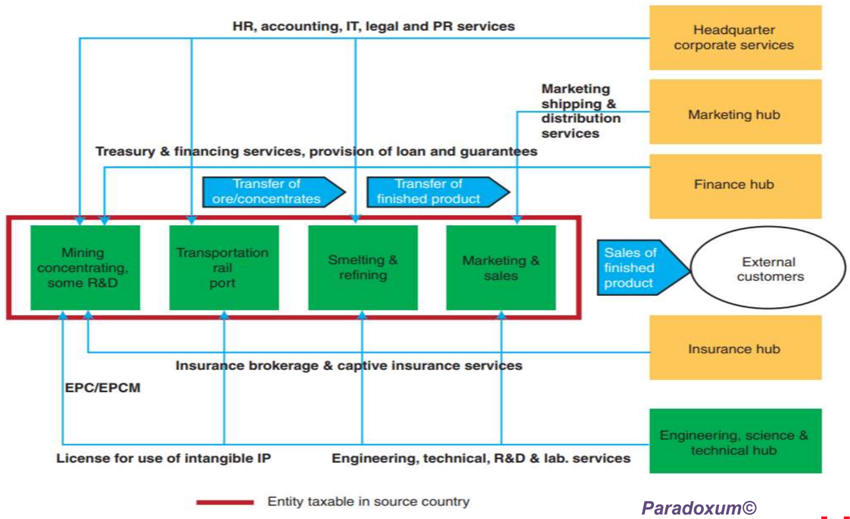
Mining Supply Chain



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Source: Transfer-pricing-in-mining – Briefing note WB

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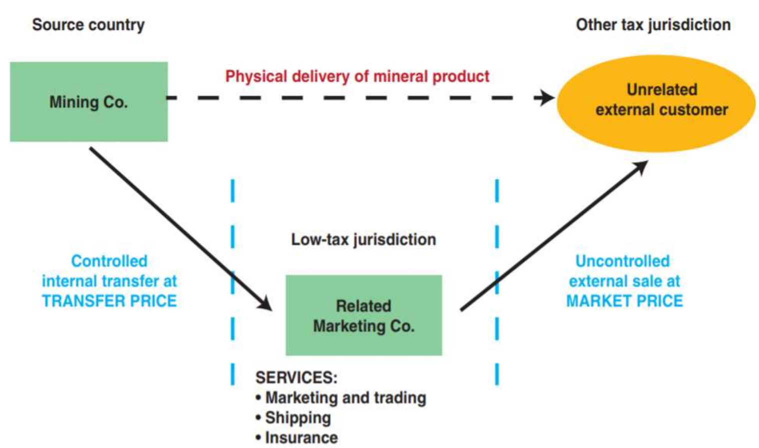
Triangular xfer / sale transaction



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Comparability

- Characteristics of the property or services transferred;
- Functions undertaken by each enterprise with respect to the transactions (taking into account assets used and risks assumed);
- Contractual terms of the transactions; and
- Economic circumstances in which the transactions take place and business strategies of the parties.

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Challenges of the Arm's Length methods

- The arm's length principle must be applied with care to avoid inappropriate outcomes:
  - Contractual arrangements should be scrutinized for realism in particular context.
  - Unless impossible, test suspicious transfer price using "two way" method that looks a results for both sides. Generally, this is a profit split, which requires information for associated parties.
  - Exchange of information may be used to obtain or confirm information for nonresident associated parties.
- Arm's length should mean results are arm's length, not just formal conditions.

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Taxpayers advantages

- Taxpayers are accorded broad freedom to contract and structure their business affairs.
- Taxpayers possess the relevant information ("information asymmetry").
- Taxpayers operate within and without the host country jurisdiction and make strategic use of jurisdictional limits on governments' legal authority and power
- Taxpayers have superior resources (legal, accounting and economic) and access to specialist resources.
- Taxpayers establish the structure, arrange the intercompany contracts, set the intercompany prices and control the information disclosure.
- The arm's length standard as implemented accords very broad latitude to taxpayers.

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Overcoming the taxpayer's information advantage

- Require identification of material related party transactions and their amounts on a tax return so that transfer pricing risk can be screened.
- Require transfer pricing documentation, including "see through" operating profit information allowing profit split analysis, to justify arm's length amount for related party transactions.
- Create incentives to adopt reasonable transfer pricing on returns and disincentives for aggressive transfer pricing.
  - Adopt penalties for failure to disclose related party transfer pricing and for inadequate documentation supporting transfer pricing
  - Adopt material penalties in cases of material transfer pricing adjustments, scaled to increase with relative size of adjustment
  - Extend penalties to preparers and advisors; taxpayers do not act alone

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Personnel development is critical

- Training of examiners and access to economists to identify unreasonable and to accept reasonable transfer pricing is essential for credibility.
- Corruption is disastrous; structure processes to minimize this risk.
- Losing good examiners to the private sector is not always a bad outcome if examiner has internalized importance of taxes to pay for public goods and encourages responsible taxpayer behavior.
- The World Bank / OECD and various institutions and countries support technical assistance in transfer pricing.

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Business or Tax

- Despite arguments that
- business considerations prevail, tax exploitation opportunities feature strongly, for example through:
- tax rate arbitration between jurisdictions with different tax rates;
- specific tax concessions provided in certain countries (i.e., The Netherlands, Singapore and Luxembourg);
- availability of tax losses to offset profits;
- opportunities to reduce the rates of withholding tax (WHT) payable by MNE entities taking advantage of DTA networks (i.e., ‘treaty shopping’)

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Arm's-length principle (ALP)'

Five methods which can be used to apply the ALP, including:

1. the comparable uncontrolled price (CUP) method,
2. the resale price method,
3. the cost plus method,
4. the transactional net margin method (TNMM), and
5. the transactional profit split method.

Some developing nations also make use of the so called 'sixth method' involving mandatory use of publicly quoted prices for commodities on their shipment date to a related party

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Five methods

Example: A sells minerals to B, a related party, who sells the same minerals on to C, a third party. B is the "tested party" (the party which is the point of reference for comparison of the controlled transaction with the uncontrolled transaction).

We must determine the transfer price for the transaction between A and B.

1. The comparable uncontrolled price (CUP) method directly compares the price in a controlled transaction with the price in an uncontrolled transaction in comparable circumstances.
   - *In the example, the transfer price between A and B is the price received in a sale between two unrelated parties in similar circumstances, taking into account factors such as contractual terms, quality, transportation and insurance.*

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Five methods

2. The resale price method (RSP) is based on the difference between the price at which a service or product is purchased in a controlled transaction and the price at which the same service or product is sold on to a third party.
   - *In the example, B sells minerals to C for USD 100. Based on the gross profit margin earned by third parties in comparable circumstances B earns USD 20, or 20 percent of the sale price. The transfer price is USD 80, i.e., the resale price of USD 100 minus the arm's length gross profit margin of USD 20.*

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Five methods

3. The cost plus method (CPM) identifies the costs incurred by the supplier of goods or services in a controlled transaction and then adds an arm's length mark-up to that cost base.
   - *In the example, B sells the minerals to C, on behalf of A. The direct cost to B of performing this service for A is USD 10 (e.g., to cover staff time and administration). Based on the arm's length mark-up earned by third parties in comparable circumstances, B earns 10 percent of the costs incurred in providing the service to A, or USD 1. The transfer price received by A is USD 89, i.e., the sale price to C, USD 100 (method 2) minus the USD 11 compensation to B.*

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Five methods

4. The transactional net margin method (TNMM) compares the net profit margin that a related party earns from a controlled transaction with the net profit margin earned by a third party on a comparable uncontrolled transaction. The net profit margin is measured relative to an appropriate indicator (i.e., the cost of providing the service, the sales generated, or the assets used).
   - *In the example, comparable companies have a net profit margin of 20 percent relative to operating costs. This means that if B earns USD 20 gross profit /tonne (method,\2) the arm's length net profit margin is USD 4. The transfer price is then defined as the price that allows B to make a USD 4 net profit margin.*

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Five methods

5. The profit split method (PSM) divides the combined profit earned by related parties from the same transaction according to the relative contribution of each party to the transaction. The transfer price is then defined as the price that splits the profit between parties according to the agreed relative contributions.
   - *In the example, B advises A on market conditions and identifies potential customers, in which case its contribution to the combined gross profit from the sale to C is low, resulting in limited compensation to B, and a higher transfer price to A. Alternatively, B may take legal title of the mineral products, selling to its own customers, in which case B's compensation is higher, reducing the transfer price to A.*

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More on the Five methods

- The use of single example for all methods is only illustrative; in practice different methods are applied to different types of transactions.
- For example, CUP is adapted to straightforward sales of commonly traded commodities;
- RSP or CPM may be alternatively applied in the case of marketing hubs, depending on the sophistication of the services provided by the hub.
- They are also used in cases where companies have dedicated subsidiaries in charge of procurement of goods and services. TNMM and PSM are more adapted for cases when several affiliated companies contribute significantly to the total income of a business.
- According to OECD guidance, authorities should ensure that enterprises use the method that is the most appropriate to each controlled transaction, given the data available.

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Need for regulation

To strengthen administration of transfer pricing rules, regulations should address the following:

- transfer pricing methodologies
- guidance on comparability analysis (i.e., use of local and/or foreign comparable data)
- transfer pricing documentation requirements and filing deadlines
- how and when transfer pricing adjustments will be made by the revenue authority
- how taxpayer disputes will be resolved
- fines and penalties
- optionally: specific guidance on particular related party transactions

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Common Weaknesses & Challenges

- Definition of non–arm's length transactions is too narrow. Association may be poorly defined.
- Definition may not capture transactions with a non-associate that form part of a wider agreement involving an associate.
- Rules do not oblige taxpayers to report transactions with associates at arm's length prices for tax purposes.

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Common Weaknesses & Challenges

- Burden of the proof: which merely permitted the tax authority to substitute arm's length prices if transactions between associates were priced in a way that reduced tax.
- This leaves taxpayers free to misprice such transactions with impunity and puts the onus on the tax authority to detect such mispricing and determine the arm's length prices to be substituted. Incompatible with self-assessment principles.
- Transfer pricing rules may not apply to domestic transactions (a problem if extractive industries are taxed differently from other domestic businesses).

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