Transfer Pricing in Zambia's Mining Industry:

The Intricacies of the Sixth Method

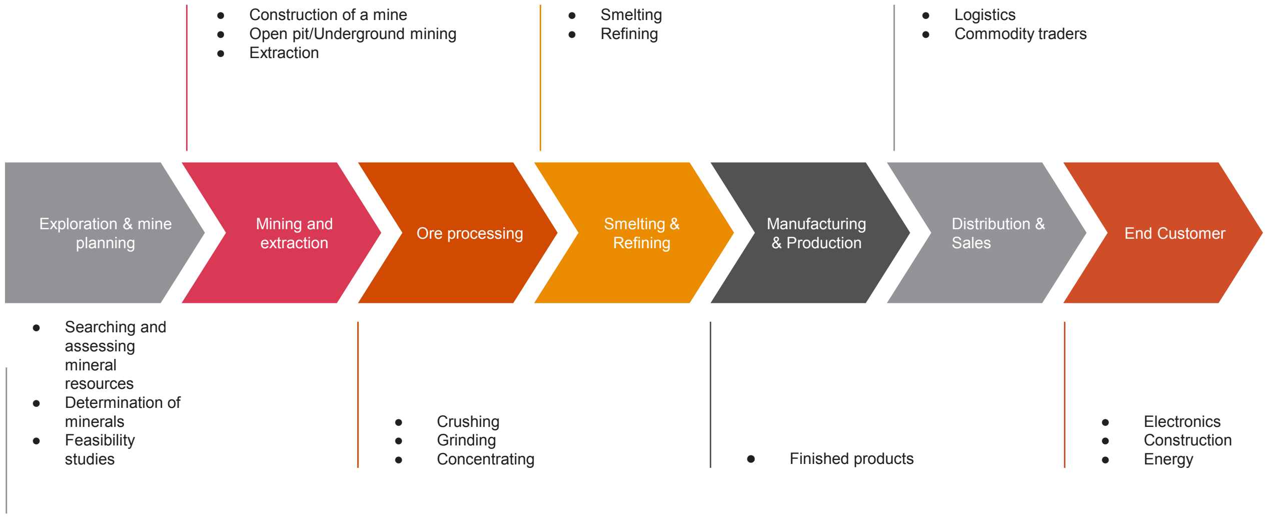
1. Introduction

Owing to the unique character of minerals as commodities, the area of transfer pricing in the mining sector is highly intricate. As multinational enterprises (MNEs) operate in a variety of jurisdictions, the price of such nonrenewable resources has a significant impact on fiscal revenues in resource-rich countries. This significance is seen in the implementation of the so-called "Sixth Method" in a number of jurisdictions, including Zambia. The Sixth Method is an alternative approach to transfer pricing aimed at ensuring a fair taxation environment for mineral transactions.

In order to grasp the transfer pricing considerations for mining companies, we first need to have a basic understanding of the mining industry. This understanding includes the mining value chain, typical structures of mining groups and common related party transactions.

2. Mining value chain

The mining value chain stretches from exploration to delivering commodities to the end customers, incorporating stages such as mining and extraction, ore processing, smelting and refining, sales and distribution.



Exploration: Defined by the Mines and Mineral Development Act, exploration involves searching for minerals and assessing potential deposits. Due to significant upfront costs without immediate revenue, entities often rely on inter-group loans for financing.

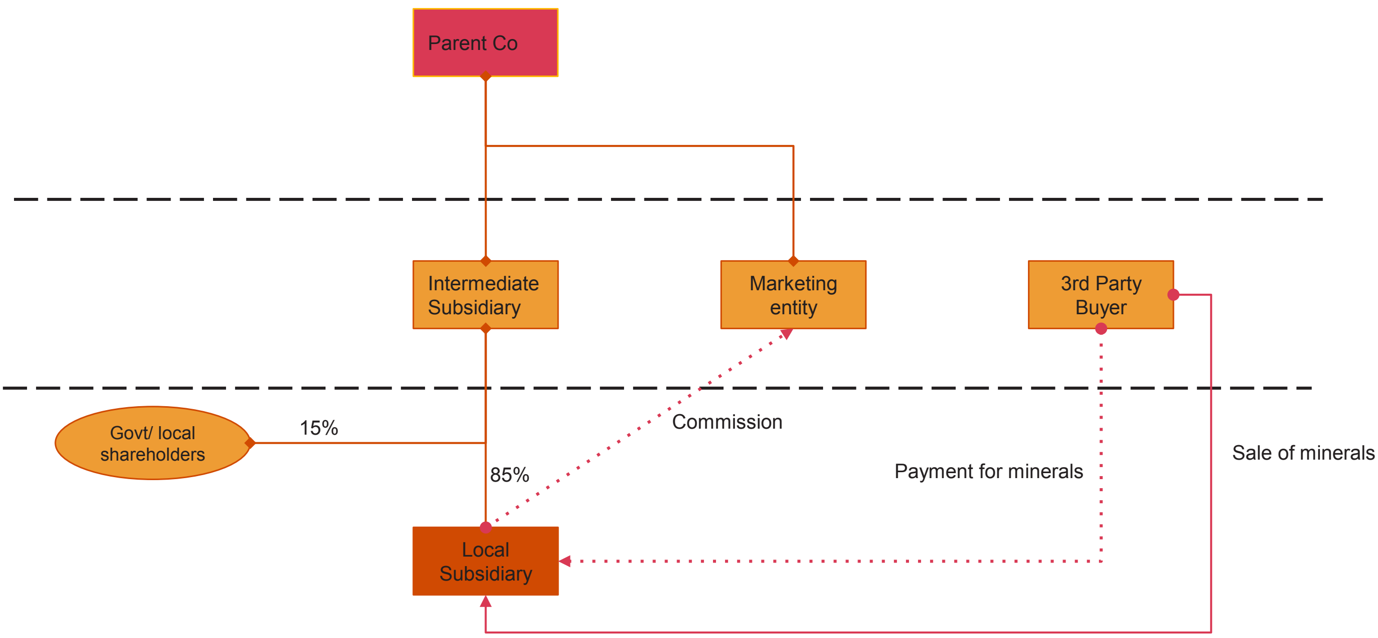
Mining: Post-discovery, the focus shifts to efficient and economic extraction. This phase includes a range of capital-intensive operations and intercompany transactions, from financing to procurement of specialised machinery and equipment.

Processing: This involves beneficiating minerals through various operations like crushing, grinding, smelting, and refining. Sharing of proprietary technologies among group entities may also occur here due to the phase's capital intensive nature.

Typical mining group structures

Mining MNEs are often hierarchical, with headquarters in capital-rich countries and holding companies in low-tax jurisdictions. Subsidiaries in resource-rich countries such as Zambia serve as the operational based, with marketing and financing hubs strategically located to leverage tax efficiencies.

A typical mining group structure is shown below:



4. Pricing of minerals among associated parties

Some revenue authorities have determined that the traditional transfer pricing methods may not adequately address the pricing of associated party mineral sales and purchases. As a result, they have instituted an alternative approach — commonly known as the "Sixth Method". This method is typically characterised by referencing international commodity prices, such as those listed on metal exchanges, to ascertain the arm's length price for mineral transactions. It is designed to counteract profit shifting and base erosion by anchoring the transfer price to publicly quoted prices, reducing the room for manipulation.

The Sixth Method was introduced in Zambia in 2008 and mandates using reference prices for associated parties mineral sales and purchases. The Income Tax Act provides that these reference prices may be adjusted for quality or grade premiums and discounts.

Essentially, this means that the starting point for pricing of mineral commodities between associated parties is the reference price which can then be adjusted to taking into account premiums and discounts on account of grade and quality.

5. The Interplay with International Guidelines

The introduction of the Sixth Method may seem at odds with the OECD guidelines, which traditionally emphasise comparability and transactional analysis. However, proponents argue that for commodities with an active and transparent market, the Sixth Method can serve as a practical solution that aligns with the arm's length principle. It may also reduce the administrative burden of conducting comparability analysis, which can be resource-intensive.

6. Balancing Interests and Maintaining Compliance

For MNEs operating in jurisdictions like Zambia that adopt the Sixth Method, compliance requires a careful balancing act. They must comply with both local regulations that may mandate this method while also maintaining consistency with international transfer pricing norms to mitigate the risk of double taxation. It is essential for these companies to engage in meticulous documentation and substantiation of their transfer pricing policies.

7. Challenges with the Sixth Method

The application of the sixth method, while straightforward in theory, comes with its own set of complexities. International quoted prices can be subject to significant fluctuations due to market volatility. Moreover, the method must account for the quality and grade of the commodity, transfer of ownership, transportation costs, insurance, financing and other logistical considerations. Another challenge is ensuring that the quoted price corresponds to the same point in the value chain as the controlled transaction.

Below we discuss some of such challenges as well as possible solutions.

Premium and discounts: Due to the lack of premiums and discounts in publicly available third-party agreements, precise adjustments for quality or grade can be challenging to make. While a leading benchmark for copper, for example, is the premium or discount announced by large copper producers such as Chile's state-owned Codelco, such figures can range significantly from what third parties actually agree on.

Transport charges: Taxpayers must calculate appropriate transportation costs to adjust the reference price that takes into consideration the parties' agreed-upon delivery terms as well as ultimate destinations that may differ from the delivery location of the referenced price. The taxpayer's inability to obtain actual third-party transportation charges to the reference price location, as well as fluctuation in transportation pricing, exacerbates the issue at hand.

Financing chargers: The Sixth Method, as implemented, also seems to ignore the possible financing charges adjustments to the reference price related to pre-financing before delivery.

Traders margins: Centralised trading and marketing hubs may obtain higher pricing, leading to disputes with revenue authorities over the need for margin adjustments to the reference price.

The Sixth Method's challenges, such as determining appropriate premiums or discounts and accounting for any necessary adjustments to the reference price, require a collaborative approach between revenue authorities and taxpayers. Solutions could include mutual agreement on the use of external pricing for benchmarking hypothetical transactions to justify reference price

adjustments. For example allowing taxpayers to use a benchmarked margin to adjust the reference price for trader compensation and marketing intangibles could minimise disputes. These solutions need open dialogue, transparency, and a willingness to adapt to the intricacies of mineral commodities trade, resulting in a more equitable and efficient tax system.

8. Navigating the Future

As global trends evolve, with more scrutiny on natural resource taxation, it is likely that the Sixth Method will remain a source of controversy and dispute between revenue authorities and taxpayers. Companies must remain flexible, adjusting their transfer pricing practices to the regulatory environments in which they operate. Concurrently, international collaboration and communication will be critical in aligning the Sixth Method with broader transfer pricing principles.

9. Conclusion

The Sixth Method in transfer pricing for minerals represents a unique solution to a specific challenge in the mining sector. While it offers certain benefits in terms of simplicity and objectivity, it also raises questions about compatibility with established international transfer pricing methods. As revenue authorities and MNEs grapple with these issues, the future of transfer pricing in the mining industry will undoubtedly be shaped by a continuous effort to balance the interests of revenue protection and the fair and consistent application of the arm's length principle.

When confronted with uncertainties regarding transfer pricing or disputes with the revenue authority, keep in mind that adopting a strategic approach can yield significant benefits. Should you need our assistance in ensuring that your transfer pricing policies and positions are not only compliant, but also tailored to your particular business requirements and circumstances, please do not

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