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Transfer Pricing Issues in Extractive Industries

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Transfer Pricing Issues in Extractive Industries

1. Introduction

The first edition of the UN Practical Manual on Transfer Pricing for Developing Countries (hereafter: “the Manual”) was issued in 2013 in response to the need expressed by developing countries for clearer guidance on the policy and administrative aspects of applying transfer pricing analysis to some of the transactions of Multinational Enterprises (MNEs) commonly occurring in developing countries. The Manual was updated and revised in 2017. [*insert link to the latest Manual*]

The Manual is based on the work of the Subcommittee on Article 9 (Associated Enterprises) pursuant to a mandate with the following requirements:

- (a) That it reflects the operation of Article 9 of the United Nations Model Convention, and the Arm’s Length Principle embodied in it, and is consistent with relevant Commentaries of the U.N. Model;
- (b) That it reflects the realities for developing countries, at their relevant stages of capacity development;
- (c) That special attention should be paid to the experience of developing countries; and
- (d) That it draws upon the work being done in other fora.

The 2017 Manual is organized into four parts:

- Part A relates to transfer pricing in a global environment;
- Part B contains guidance on design principles and policy considerations;
- Part C addresses practical implementation of a transfer pricing regime in developing countries; and
- Part D contains country practices

The Manual does not address industry-specific issues, but serves to provide general guidance on technical aspects such as (i) the need for and how to conduct a comparability analysis; (ii) the respective available transfer pricing methods and how they operate; (iii) transfer

pricing issues particular to intra-group services; (iv) transfer pricing considerations for intangible property; (v) cost contribution arrangements; (vi) transfer pricing of business restructurings; and (vii) the general legal environment relating to domestic transfer pricing legislation. The Manual also provides guidance on administrative issues such as (viii) transfer pricing documentation, (ix) audits and risk assessment, (x) dispute avoidance and resolution and (xi) establishing transfer pricing capability in developing countries. Finally, the Manual provides an overview of certain country practices and perspectives on transfer pricing.

In the course of the work of the Extractive Industries subcommittee, a need was identified to develop a note containing and analyzing some examples on transfer pricing issues in extractive industries, both relating to the production of oil and natural gas and relating to mining and minerals extraction.

This guidance note responds to that need and highlights some of the transfer pricing issues arising in the extractive industries. The note draws on materials that have been published in other fora, including the Platform for Cooperation on Tax (hereafter: “the Platform”), reflecting enhanced collaboration between the IMF, OECD, UN and WBG for the benefit of developing countries. Reference can be made to the Discussion Draft published by the Platform on Addressing the Information Gaps on Prices of Minerals Sold in an Intermediate Form¹ and the Discussion Draft presenting A Toolkit for addressing Difficulties in Accessing Comparable data for Transfer Pricing Analyses.² Reference can also be made to the WBG’s Extractive Industries Transparency Initiative and materials³ and the publication *Transfer Pricing in Mining with a Focus on Africa*.⁴

¹ <https://www.oecd.org/tax/discussion-draft-addressing-the-information-gaps-on-prices-of-minerals-sold-in-an-intermediate-form.pdf>

² <https://www.oecd.org/tax/discussion-draft-a-toolkit-for-addressing-difficulties-in-accessing-comparables-data-for-transfer-pricing-analyses.pdf>

³ These are available at <http://www.worldbank.org/en/topic/extractiveindustries/overview>.

⁴ Guj, Pietro; Martin, Stephanie; Maybee, Bryan; Cawood, Frederick Thomas; Bocoum, Boubacar; Gosai, Nishana; Huibregtse, Steef. 2017. *Transfer pricing in mining with a focus on Africa : a reference guide for practitioners*. Washington, D.C. : World Bank Group.

This guidance note looks specifically at the value chain of mining and mineral extraction and of the production of oil and natural gas. Table 1 in the first part of the note identifies some of the transfer pricing issues that often arise in the extractive industries. The table is organized by reference to the various major stages in the extractive industry value chain. The table makes some general suggestions on methods and approaches that might be used in addressing the identified issues.

Thereafter, the guidance note provides several case examples, some of which result from discussions with tax inspectors working in developing countries. Taken together, the table and the examples provide useful background information for developing countries to utilize in addressing transfer pricing issues in extractive industries. The note does not aspire to provide comprehensive transfer pricing guidance for the extraction industries, but should provide a useful summary and checklist of some of the issues that commonly arise. It is recommended that this extractive industry guidance note and the Manual be consulted together.

2. Transfer pricing issues that may arise in the extractive industry; according to the (major) consecutive stages of the extractive industry value chain

Table 1

A: Negotiation and Bidding	Industry	Why is it an issue?	How to deal with this?
1. Acquisition of data from related parties	Mining Oil and Gas	Where the geological data is acquired from a related party, there is risk of overstatement of the acquisition cost (for deduction or depreciation).	Use traditional TP methods – CUP or Cost plus to assure reasonability of the transfer price. However, comparability may be a real issue. It should be noted that the transfer of (geological) data might occur directly or indirectly by transferring the shares in the entity holding the data.
2. Acquisition of extraction rights from related parties	Mining Oil and Gas	A difficulty at this stage may be the valuation of the likelihood of success. Transfer Pricing may be used as a technique to shift profit between parties in this early phase of the process.	Use of a valuation technique may be most appropriate. Comparability may be a real issue. Not applicable in countries where extractive rights are not granted to foreigners. In that case there is probably no cross border transfer pricing issue. It should be noted that the transfers of extraction rights might happen directly or indirectly by transferring the shares in the entity holding the rights.
3. Advisory, consultancy, managerial and technical services from related parties	Mining Oil and Gas	The costs for services form part of the capital expenditure that can be deducted against extraction income and a carry forward can be allowed if there is insufficient current income to offset the capital expenditure. In case the expenses from this stage may be deductible in the future, the company may be motivated to overstate the	First consider the benefit test to ensure that the services are chargeable (general reference is made to Chapter B4 Intra group services in the Manual). Consider the most appropriate TP method (CUP, Cost+ or TMNN based on cost). Focus on verifying how the components of the cost base were established. Additional mitigation of such practices may take place when withholding taxes apply under domestic laws and also where taxing rights are retained under

		<p>price for such services to allow for future deductibility in form of carry-forward losses.</p>	<p>the Double Tax Treaty (i.e. through the Technical Services article).</p> <p>Some countries may have reporting obligations for outbound payments of service fees, which can help identify expenses and which may help counter the overstating of expenses.</p> <p>Charging and allocation of costs are discussed in the Manual in chapter B.4.3.5- B 4.3.9 and allocation keys are discussed in B 4.56 to B 4.62.</p> <p>In the Oil and Gas industry, it has been a common and longstanding practice that services to projects, especially in the upstream life cycles, are provided at fees that ensure recovery of costs, without the inclusion of a profit margin or mark-up for the service provider. There is a tension between the joint venture partners on the one hand, who do not allow a profit mark-up where on the other hand the jurisdiction of the service providers would like to see a mark-up. Different authorities have different views as to whether this is at arm's length. Potentially this can be seen as a cost contribution arrangement. For more details see B6 of the Manual or alternatively this issue could be addressed through a bi-lateral APA.</p>
4. Performance guarantees	Mining Oil and Gas	<p>It is not uncommon for the host country that awards a license to a company to seek some form of guarantee from or through the parent company regarding the performance of the exploration and development contract.</p> <p>The transfer pricing question</p>	<p>For example, the India Model Production Sharing Contract provides for a full parent company guarantee, as well as a bank performance bond (for 7.5% of the contract obligations at various stages). Article 29.1 of India Model Production Sharing Contract reads: 29.1 Each of the Companies constituting the Contractor shall procure and deliver to the Government within thirty (30) days from the Effective Date</p>

		<p>here is whether contract-related guarantees require an arm's length charge. Financing guarantees clearly would.</p>	<p>of this Contract: (a) an irrevocable, unconditional bank guarantee from a reputed bank of good standing in India, acceptable to the Government, in favor of the Government, for the amount specified in Article 29.3 and valid for four (4) years, in a form provided at Appendix-G; (b) financial and performance guarantee in favor of the Government from a Parent Company acceptable to the Government, in the form and substance set out in Appendix-E1, or, where there is no such Parent Company, the financial and performance guarantee from the Company itself in the form and substance set out in Appendix-E2; (c) a legal opinion from its legal advisors, in a form satisfactory to the Government, to the effect that the aforesaid guarantees have been duly signed and delivered on behalf of the guarantors with due authority and is legally valid and enforceable and binding upon them; available at http://petroleum.nic.in/docs/rti/MPSC%20NELP-VIII.pdf.</p> <p>Nigeria has similar provisions requiring both parent company guarantees and a bank performance bond. See Production Sharing Contract between Nigerian National Petroleum Corporation and Gas Transmission and Power Limited, Energy 905 Suntera Limited, and Ideal Oil and Gas Limited covering Block 905 Anambra Basin (2007).⁵</p>
B: Exploration and Appraisal			
1. Transfer of exploration equipment	Mining	Transfer of new equipment from a related party may not	Look at the proper application of the transfer pricing methods. Consider the

⁵ Available at <http://www.sevenenergy.com/~media/Files/S/Seven-Energy/documents/opl-905-psc.pdf>

	Oil and Gas	<p>be at arm's length, especially with long lead equipment in a volatile world.</p> <p>Transfer of existing equipment at a price that is too high may result in a step up in base. Extra attention may be required when the sale is structured through an intermediary related entity with a favorable tax treatment.</p>	<p>application of group synergies (B5.2.28) and consider closer cooperation between Customs and review of customs valuation (B2.4.7.).</p> <p>This risk may be amplified if the jurisdiction has customs exemption for exploration equipment.</p> <p>The original contract should be reviewed considering the facts and circumstances that were available at the time of the signing of the contract.</p> <p>For Oil and Gas, the cost-only practices described in A.3. above and the required agreement of joint venture partners may reduce these risks for the country whose resources are being developed.</p>
2. Lease of exploration equipment	Mining Oil and Gas	<p>Potential overstatement of lease rental rates from either hiring from related parties or due to arrangements made by related parties.</p>	<p>Look at the proper application of the transfer pricing methods. Consider the application of group synergies (B5.2.28) and risk assessment (B2.3.2.23)</p> <p>The original contract should be reviewed considering the facts and circumstances that were available at the time of the signing of the contract.</p> <p>Reference is also made to the comment on the cost-only practices and the joint venture partners above in B.1.</p>
3. Exploration services – seismic, drilling, sampling and analyses	Mining Oil and Gas	<p>Related parties involvement in these activities may lead to overstatement of the value of these services, which creates high cost base for future depreciation.</p>	<p>See A2.</p> <p>Applicable tax treaties may have specific rules for the extractive industry, e.g. exploration permanent establishments (reference is made to the Guidance Note on permanent establishments in the extractive industries).</p> <p>Reference is also made to the comment on the cost-only practices and the joint</p>

			venture partners above in B.1
4. Administrative, managerial and technical services, and legal services from related parties	Mining Oil and Gas	Where the expenses from this stage may be deductible in the future, the company may be motivated to overstate the price for such services to allow for future deductibility in form of carry-forward losses	See A3.
5. Financing/ Guarantee/ Funding arrangements	Mining Oil and Gas	Level of possible interest payments which maybe deferred (initially interest free loan then later interest bearing) Unrelated parties may not be able to obtain a loan at this risky stage of the project.	This may (or may) not be a transfer pricing issue and may be addressed under domestic law. The transfer pricing issue would typically be the applicable interest rate or guarantee fee.
C: Development			
1. Sale/ lease of extraction rights – (Royalty payment/ sales value)	Mining Oil and Gas	Assignment of extractive rights to related company or outright transfer of extractive rights to related company can be at a high cost and it may be the case that the proceeds from the transfer of the extractive right may not be taxable in some jurisdictions	See A2. Please note that at this stage the value of the rights may have changed as you have more information on the success of the project. For example, there may be more certainty around the development plan and the extent of proven or probable reserves. Please note that farm in/farm out considerations may be relevant at this stage of the process. Reference is made to the Guidance Note on the Taxation of Indirect Asset Transfers (paragraph 5.13)
2. Purchase /lease of plant, equipment and machinery	Mining Oil and Gas	See B1 and B2.	See B1 and B2. Reference is also made to the comment on the cost-only practices and the joint venture partners above in B.1
3. Advisory, consultancy, managerial and technical services from related parties	Mining Oil and Gas	See B3.	See B3.
4. Financing/ Guarantee/ Funding	Mining	The interest rate or other conditions of the financing	See B4. Some countries may address this issue in their non-transfer pricing

arrangements	Oil and Gas	agreement could give rise to transfer pricing issues.	rules. In this respect see for example Action 4 final report of the OECD BEPS Project.
D: Production/ Extraction stage			
1. Lease of Concession rights – (Royalty payment)	Mining	Concession owner leases the right to exploit to a related company in exchange for remuneration.	There may be a difference between the tax treatment of a sale or a lease. This in itself is not a transfer pricing issue but regards whether the transaction is a bona fide sale or bona fide lease. In this respect reference is made to the Manual B2.3.1.4-B2.3.1.9. The transfer pricing issue regards whether the sale price or the lease payments qualify as arm's length (comparability analysis process).
2. Payments for purchase or lease of extractive equipment	Mining Oil and Gas	See B1 and B2	See B1 and B2 Reference is also made to the comment on the cost-only practices and the joint venture partners above in B.1
3. Advisory, consultancy, managerial and technical services from related parties	Mining Oil and Gas	See A3 At this stage of the process the MNE may be earning sales income and subsequently service fees may be charged calculated based on sales.	See A3 A service fee calculated as a percentage of sales may not be appropriate as it may overcompensate the costs. Typically payment for services would be calculated by reference to the cost of the actual services provided. This may require an allocation of group costs among operating entities based on allocation keys. For purpose of the allocation of a pool of costs an appropriate allocations key should be used. Reference is made to paragraph B.4.4.19 of the Manual for examples of appropriate allocation keys.
4. Payments for use of IP	Mining Oil and Gas	At the production stage the use of technology provided by related parties is important. Calculating the appropriate transfer price may be a challenge.	Reference is made to chapter B5 of the Manual as it contains a comprehensive elaboration on this issue. Reference is also made to the comment on the cost-only practices and the joint

			venture partners above in B.1
5. Mining sub-contracting services and special regimes (where tax rates for mining services and production operations are significantly different)	Mining	In cases where there is a lower tax rate for mining services and mining operation compared to the local corporate tax rate, profit shifting through transfer pricing/mispricing may offer even more benefits.	This may be a case of shifting profits between different tax regimes within country. Use traditional TP methods – CUP or Cost plus to assure reasonability of the transfer price of the services provided. However, comparability may be a real issue.
6. Contract Mining services	Mining	In cases where mining services are outsourced to a related offshore entity that purportedly is carrying far more risk, income may be shifted offshore.	In this case a proper functional analysis is required to properly delineate transaction and risk allocation. See the Manual at B.2.3.1.4 on delineation of the transaction. Developing countries should be aware of the fact that the OECD BEPS Action items 8-10 also affect mining and extraction industries and that transfer pricing can be used to shift income and tax base offshore to low-tax jurisdictions. In these scenarios it is recommended that the step-analysis listed in the Manual at B.2.3.1.4 and the risk analysis in the Manual at B.2.3.223 b considered.
7. Sale of raw minerals and adjustments	Mining	An ore can contain various minerals at this unrefined phase, making it difficult to determine the price.	Considering the actual characteristics of the mineral is important to help determine the arm's length price in the sale between related parties. Reference is made to the Platform for Collaboration on Tax discussion note, addressing the information gaps on prices of Minerals sold in an intermediate form.
8. Interest income/Interest expenses	Mining Oil and Gas	Both the interest income and interest expense need to be priced at arm's length. The fact that a company is highly capitalized and at this stage of the extraction process may be cash rich, it may	See B4. Reference can be made to the OECD discussions on Cash pooling.

		prefer to issue a loan to a related party over making a dividend distribution. It's debated in some jurisdictions whether this is a transfer pricing issue or not.	
E. Processing (Refining and Smelting)			
1. Tolling fee for contract processing	Mining Oil and Gas	In issue is the appropriateness of the tolling fee where tolling is done by a related party to concentrate producer. There is a risk that the fee may not be at arm's length. In cases where mining services are outsourced to a related offshore entity purportedly carrying far more risk, income may be shifted offshore.	See E6.
2. Adjustments to the reference price. (Treatment charge, refining charges, penalties and price participation clause)	Mining Oil and Gas	Payments for the concentrates are often based on Reference Pricing. Through treatment charges, refining charges and other payments can be used to shift profits where the parties involved in the process implementing these charges are related parties if they are not priced at arm's length. In the mining industry, credits for recoverable metals (e.g. precious metals in a copper or cobalt concentrate) may be underpriced. Similarly, penalties for impurities in the concentrates may be overpriced. In the mining industry smelters sometimes enter into	It should be noted that the price of the commodity is based on a Reference Price adjusted by items such as treatment charges, refining charges, credits for recoverable metals or penalties for impurities. Such adjustments are often calculated by reference to industry averages and a transfer pricing issue can arise if a company departs arbitrarily from the industry practice. Reference is made to the Platform for collaboration on Tax, addressing the information gaps on prices of Minerals sold in an intermediate form. In the situation of the price participation agreement in the mining industry, if the smelter is a related party, it needs to be determined whether any price

		<p>a price participation agreement where the price of the commodity is adjusted based on the fluctuation of the market price of the commodity. They may receive an additional fee or get an additional charge.</p> <p>In Oil & Gas, the acquisition and sale of crude oil and natural gas (LNG) from Upstream producers to the Midstream and Downstream sector may be to related or third parties. Normally, these transactions are priced “at index”, which means that such transactions are based upon market prices, generally referring the price of a barrel of crude oil to oil benchmarks.</p> <p>It needs to be considered whether the right benchmark is used and if the price used for the intercompany transaction may need to be adjusted depending on crude density (e.g. API gravity), location, sulphur content or other factors different from the referenced index.</p>	<p>adjustments are arm’s length. Therefore, industry knowhow is crucial. Reference is made to the pricing practices paragraph of the Platform for Collaboration on Tax, addressing the information gaps on prices of Minerals sold in an intermediate form.</p> <p>As regards Oil & Gas, many different oil benchmarks exist, with each one representing crude oil from a particular part of the globe, however, most of them are referred to one of three primary benchmarks that serves as a reference price for buyers and sellers of crude oil: the West Texas Intermediate (WTI), Brent Blend and Dubai/Oman. Depending on the type of crude oil, these benchmarks are generally adjusted depending on crude density (e.g. API gravity)⁶, location or other factors different from the referenced index. These benchmark prices are published by reliable international organizations as Platts, Oil Price Information Service (OPIS), Argus or the New York Mercantile Exchange (NYMEX) and widely used by the public and private sector.</p> <p>To calculate the taxable income of O&G companies, most producing countries have set tax reference prices (also known as norm prices) for given time periods. These reference prices are established by the government (e.g. a Petroleum Council) or the National Oil Company (NOC) in order to provide O&G prices that best represent the market conditions. These reference</p>
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⁶ API stands for the American Petroleum Institute, which is the major United States trade association for the oil and natural gas industry. The API gravity is used to classify oils as light, medium, heavy, or extra heavy.

			prices are normally determined from the assessment of the crude oil international benchmarks mentioned above (e.g. Platt's market indicators) generally adjusted to the specific gravity API of the actual crude produced, resulting a valid comparable for O&G transactions performed in the country. In some countries, the body in charge of setting the reference prices takes also into account the market indicators presented by the companies operating in their jurisdiction (based on price quotations from official publications and their own observations).
3. Advisory, consultancy, managerial and technical services from related parties	Mining Oil and Gas	See A3	See A3
4. Payments for use of IP	Mining Oil and Gas	See D4	See D4
5. Transportation	Mining Oil and Gas	<p>The calculation of prices of transportation is generally based on comparables and Incoterms are relevant in this industry. Question is whether the Incoterms are appropriately applied within related party transactions.</p> <p>In the oil and gas industry long term commitments are common and present risks if short-term conditions change. In the event payments are made between related parties based on changed conditions or transportation risks materializing, it should be determined whether these</p>	<p>Comparability factors need to be checked. Double check if the risks allocated to a related party can be managed and controlled by that party.</p> <p>The original contract should be reviewed considering the facts and circumstances that were available at the time of the signing of the contract.</p>

		payments (penalties, fees) are at arm's length.	
6. Transfer Pricing where different tax regimes are applicable.	Mining Oil and Gas	<p>The risk of profit shifting may arise in case there are different tax regimes available in a country.</p> <p>The processing and refining activities are often subject to lower tax rates than the extractive tax regimes.</p> <p>Considering domestic law, a transfer pricing analysis may be required, also when one company shifts value between two different tax regimes. (i.e. net-back calculations)</p>	<p>Reference is made to the UN Handbook Protecting the Tax Base of Developing Countries and to the issue of safe harbors, discussed in the Manual at B.8.8.</p> <p>It should be considered whether domestic laws allow transfer pricing rules even to apply on domestic transaction or where in the case of the same enterprise, the activity takes place within the same legal entity, but with a different tax regime, the transfer pricing rules should apply also for the intra-company transaction, between the ring-fencing regimes.</p>
F: Sales and Marketing			
1. Marketing hubs	Mining Oil and Gas	<p>The issue is to determine whether a related marketing hub is remunerated at arm's length, considering there are several remuneration models available.</p> <p>A company may be paid commissions under an off-take agreement that it has with producer. The commission needs to be reviewed as to whether the fee is at arm's length.</p>	<p>This can vary and therefore arrangements must be properly investigated. Important to consider the delineation of the transaction and from that, the basis for payments for sales/marketing and their relationship to value creation in the industry. For instance, it is commonly argued that a marketing hub is analogous to a "distributor" of goods and hence should be rewarded by way of a % of sales. Consider whether the FAR of the marketing entity are in fact analogous to a typical distributor. Consider also the value-add of the marketing entity to the commodity product and the potential impact that may have on the arm's length remuneration for the transaction.</p> <p>Reference is also made to the Manual paragraph B.2.3.1.4. on delineation of the transaction.</p>
2. Hedging gains and	Mining	A related party is the buyer of	It needs to be determined whether the

losses	Oil and Gas	the commodity and is also the one doing the hedging for the Producer	hedging gains and losses are allocated at arm's length. Issues to consider whether hindsight is being used or whether the hedge is asymmetric. Some countries under domestic laws have a regime in place that separates hedging gains and losses from extractive activities.
3. Payment terms such as credit interest on advance payments	Mining Oil and Gas	Determination of arm's length prices should take into account the relevant payment terms.	Payments made before or after the time when an unrelated party would have made payment may need to be adjusted for the time value of money. Consideration could be given to whether the payment terms have an inappropriate impact on the fiscal take (e.g.royalties).
4. Transportation	Mining Oil and Gas	See E5	See E5
5. Sales price of commodities	Mining Oil and Gas	The key risk is undervaluation of the commodity value in sales to related parties. By undervaluing the price of commodity, the income tax revenue but also revenue in form of Royalties and other mineral taxes (Additional Profit Tax, Mining Taxes) can be significantly reduced. Reference pricing may be used for spot sales. Long-term customers generally pay a premium above the quoted reference price at the time the long term contract is executed.	Use of traditional TP Methods – CUP Method. Also see UN Manual B3.4.2. Some countries use reference prices, replacing the transaction value with a reference price. Some countries may allow the reference price to be reasonably adjusted to reflect the specifics of the mineral. Pricing must be properly evaluated before it can be said that the reference price is the answer.
6. Abusive structures	Mining Oil and Gas	There are structures where an intermediary service provider is interposed to purchase the commodity often below the	Tax abuse provisions may be needed to tackle this issue or it should be considered whether the transfer pricing rules could be applied also to

		<p>market price and sell it to independent parties at a profit.</p> <p>This profit may then be made available to the principal, who instructed the agent to carry out the transactions for a commission fee. Most countries' transfer pricing rules seem to not apply in this situation.</p>	<p>transactions of parties who do not fall within the definition of associated enterprises under domestic law.</p> <p>For example one developing country has a definition of related party/associate worded as follows: <i>“in any case not covered by paragraphs (a) to (c), such that one may reasonably be expected to act, other than as employee, in accordance with the intentions of the other”</i></p> <p>Where reference prices have been introduced, assure that they apply to all transactions – related party transactions and unrelated party transactions.</p> <p>An alternative approach could be introducing and applying CFC rules or to have legislation which allows for a review of a series of consecutive transactions.</p>
Decommissioning			Reference is also made to the Guidance Note on the Tax treatment of Decommissioning in the Extractive Industry.
1. Decommissioning services	Mining Oil and Gas	The price for decommissioning services provided by related parties may be overstated.	See A3.
2. Sale or transfer of equipment	Mining Oil and Gas	The equipment and infrastructure developed or purchased during the different stages of the project may be still functioning even though fully depreciated and having zero or close to zero value. The company may seek to sell or transfer this property close to the scrap or nominal value, rather than market price.	<p>Use traditional TP Methods – CUP or alternative valuation – It should be considered whether alternative valuations can be used as an indicator for the arm's length price.</p> <p>Reference is also made to the comment on the cost-only practices and the joint venture partners above in B.1</p>

2.1 Generic Case Examples

The following case examples are generic in nature for the extractive industry, meaning that the same facts and circumstances may arise in the extraction of ore and in the oil & gas industry.

Example 1: Marketing Hub

Facts

Parent company A established marketing entity B in a low tax jurisdiction. Company B is described by the taxpayer as fully-fledged marketing/distribution company responsible for servicing demand for a specific commodity and growing the business for the entire MNE Group.

The operations are staffed by a very limited number of management and administrative employees. Company B maintains that its operations perform a strategic and vital role, are fully risk taking (entrepreneurial risk) by buying and selling the refined product and performs value added functions that warrant a high return.

Findings

After examining the activities and functions performed by Company B, a tax audit reveals that Company B actually provides management and marketing support services rather than being a full risk marketing/distribution company as purported. The functions actually performed only warrant a routine return.

Considerations

Fundamental to these findings is the fact that customers consisted of a number of long-term customers that were procured decades before by Parent company A, and that no additional customers were established and no other value is being created by Company B. All subsequent activities performed by Company B are of a management and marketing support nature.

The accounting flow of the transaction was different from the physical movement of the refined mineral.

As a result of the above determination, the profits attributed to Company B are not in line with the actual activities and need to be adjusted and reduced by applying the business profits article of the relevant tax treaty, in order to compensate Company B commensurate with the activities it performs.

See also: Table 1, F 1.

Example 2: Information challenges

Facts

Company A is engaged in mining activities and being audited by the tax authorities in Country A, where the mining activities take place. The tax authorities of Country A wish to review the company's transfer pricing practices. Part of the audit questions by the Country A tax inspector include information regarding Company A's foreign related parties (taxpayer identification numbers etc.) In response to the latter question, Company A informs the local tax inspector that the requested foreign information is unobtainable by the domestic tax authorities and confidential.

Findings

When pressed further as to why Company A believes that the foreign information does not have to be submitted, Company A mentions that because the obligation to provide that information is not explicitly included as required in domestic law, there is no legal requirement for Company A to submit that information.

Considerations

In many cases there might not be an agreement for the exchange of information (EOI) or treaty for the avoidance of double taxation in place between Country A and the respective jurisdictions where Company A's related parties are located. Alternatively, if Country A participates in the

CBC documentation requirements under the OECD BEPS Action item 13 regarding transfer pricing documentation, it may get access to relevant foreign information.

Without these international instruments in place, the tax authorities need to make sure domestic law clearly allows for the request of such information and obligation of taxpayers to provide such information. Tax authorities may also consider having rules in place that allow for presumptive taxation, where competitor information may be treated as indicative using a resale price or cost plus method (see for paragraph B.8.7. of the Manual) or taxation on gross basis if domestic companies cannot disclose information on payments made to related parties that under domestic law would otherwise qualify as deductible expenses.

Example 3: Management services

Facts

Company A conducts mining activities in a developing country and receives management services from related Company C, which is located in a low tax jurisdiction. Company C charges its services out to the entire Mining Group, including Company A.

The tax authorities of Country A audit Company A as regards its related party transactions, in particular as regards the (price for) services rendered by Company C to Company A.

Findings

During the audit of Company A by the tax authorities of Country A, the management of Company A is being interviewed, and after a benefit test is applied for the services from Company C by the tax authorities of Country A, they conclude:

- that Company A did not request any services from Company C;
- that no meetings were held to review the services requested and supposedly received from Company C;
- that no records were provided of the respective services to Company A;

- that Company A arguably performed these services internally themselves, i.e. the services may be duplicative.

Considerations

To determine the arm's length nature of such charges, first the benefit test should be applied to ensure that the services are chargeable. Next, the most appropriate TP method (CUP, Cost+ or TMNN based on cost) ought to be considered, while focusing on verifying how the components of the cost base were established. To the extent the service charge consists of allocated costs, the allocation key for charging the costs needs to be reviewed. See also chapter B.4.3.5- B 4.3.9 of the manual. A service fee calculated as a percentage of sales may not be appropriate as it may overcompensate the costs. Typically payment for services would be calculated by reference to the cost of the actual services provided. This may require an allocation of group costs among operating entities based on allocation keys.

For purpose of the allocation of a pool of costs an appropriate allocations key should be used. Reference is made to paragraph B.4.4.19 of the Manual for examples of appropriate allocation keys.

3. Value Chain of Mining and Minerals Extraction

The value chain of mining and minerals extraction depends on the specific mineral commodity involved and the type of mining needed to extract the mineral depending on whether the mineral is available above ground or underground.⁷ The transformation of minerals from the exploitation phase to the eventual trade, marketing and sale thereof typically follows a series of consecutive steps:

- I. Acquisition and exploration;
- II. Construction and mine development;
- III. Mining, Processing and Concentration;
- IV. Transportation;
- V. Smelting and refining;
- VI. Trade, marketing and sales

3.1. Functions

To undertake mining activities companies will generally be designed to perform the following relevant functions:

- A. Exploration for minerals;
- B. Research and Development related to exploration and to provide related technical assistance services;
- C. Financing of activities;⁸
- D. Marketing and trading of commodity products, which may or may not include shipping and distribution.

Usual functions, like headquarter functions, insurance, and other services (such as those related to information technology and human resource management) will also be performed by (some of the) separate entities of a Multinational Enterprise (MNE).

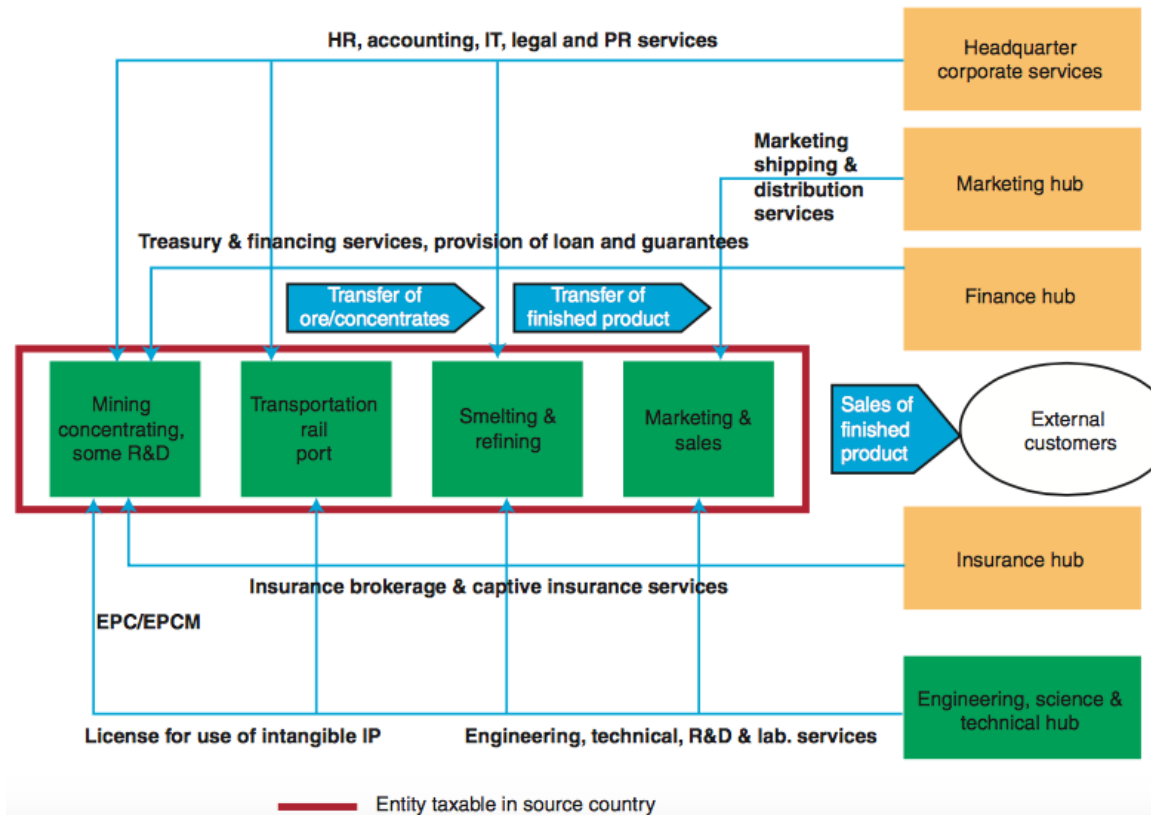
Figure 1⁹

⁷ Reference can be made to the Platform Discussion Draft on Addressing the information Gaps on Prices of Minerals Sold in an Intermediate Form which provides guidance on identifying the type of mine and production methods.

⁸ Reference can be made to the Platform Discussion Draft on Addressing the information Gaps on Prices of Minerals Sold in an Intermediate Form which provides guidance on financing arrangements affecting transacted product prices.

⁹ Guj, Pietro; Martin, Stephanie; Maybee, Bryan; Cawood, Frederick Thomas; Bocoum, Boubacar; Gosai, Nishana; Huibregtse, Steef. 2017. *Transfer pricing in mining with a focus on Africa : a*

Figure 2: Diagram showing a fully vertically integrated mining operation, outlined in red, and its possible relationship with related service provider hubs (Modified from TPA's Mining Handbook)



It should be noted that countries that grant licenses for mining and extraction of minerals usually have a requirement that different activities performed by the mining company are treated as separate taxable objects and as separate taxpayers. They are ring-fenced, which means that for tax purposes the income and expenses and tax base of the activities are determined separately for separate projects (horizontal ring-fencing) or that different types of activities (e.g. extraction; processing; etc.) are treated differently from other type of activities (vertical ring-fencing). The legal form in which the mining or

extraction activities are performed in the host country is more often that of a local subsidiary/corporate body, rather than through a branch of a foreign company. The shares of the local entity may or may not be partially owned by the local authorities.

To perform a transfer pricing analysis of companies engaged in mining and extraction, tax authorities need to get a thorough understanding of the functions performed, the assets used and risks borne by the respective MNE entities involved. For more details on conducting a functional analysis, reference can be made to paragraph B.2.3.2.7. on functional analysis of Chapter B.2. Comparability Analysis in the Manual.

The form within which a fully vertically integrated mining operation is conducted may be fairly straightforward, but the allocation of functions, assets and risks relevant to operate in the mining and mineral extractive industry within an MNE may be diverse. To get a better understanding of the step-by-step process pursuant to which copper, iron ore, thermal coal and gold are mined, reference is made to the Platform Discussion Draft on Addressing the information Gaps on Prices of Minerals Sold in an Intermediate Form.

An MNE is likely to obtain services and products both from related parties and unrelated suppliers. Getting a proper understanding of whether parties with which the MNE conducts business are associated and therefore subject to the arm's length standard of Article 9 (Associated Enterprises) of the UN Model Convention, may present a challenge. Furthermore, through location of functions in the supply chain outside of the country where extraction takes place, MNEs may be able to allocate profits abroad.

3.2. Assets

Assets that can be considered and used by the MNE operating in mining and extractives are listed in the table below. For more details on the importance of assets within an MNE for transfer pricing purposes, reference can be made to paragraph B2.3.2.17. of Chapter B.2. Comparability Analysis, in the Manual.

Table 2¹⁰**Table 3:** Typical assets of a mining company

Exploration Discovery	Mine Development and Construction	Mining Exploitation	Beneficiation, Smelting and Refining	Trading, Marketing and Sales
Exploration and mining licenses and rights, (I)	Engineering design (I)	Exploitation techniques (I)	Beneficiation processes (I)	Customer lists and relationships(I)
Access and surface rights (I)	Engineering machinery (T)	Exploitation plant and equipment and infrastructure (T)	Beneficiation plant and equipment (T)	Marketing and distribution activities (I+T)
Drilling rights (I)	Engineering, procurement and project management know-how (I)	Logistics management and infrastructure (I+T)	Logistics management and infrastructure (I+T)	Logistics management and infrastructure (I+T)
Exploration and laboratory equipment and machinery (T)	Construction, drilling and excavation plant and equipment (T)	Transportation plant and equipment and infrastructure (T)	IP relative to the smelting/refining processes and protocols (I)	Shipping and warehousing (T)

¹⁰ Pietro Guj, Stephanie Martin and Alexandra Readhead, summary briefing note to handbook Transfer Pricing in Mining with a focus on Africa. Summary briefing note published by WBG, Centre for exploration Targeting and Deutsche Zusammenarbeit- German Cooperation.

Topographical surveys (I)	Construction camp and logistic infrastructure (T)	Value of mineral resources and reserves included in price of acquisition of mining rights from a third party (not by means of discovery) (I)	Smelting and refining plant and equipment (T)	Product stocks (T)
Geological surveys (I)	Mine development (T)	Broken ore stockpiles and inventory (T)	Ore, concentrate and metal stockpiles and inventories (T)	Marketing know-how (I)
Geochemical surveys (I)				Trading software/platforms (I)
Geophysical surveys (I)				Specialized aspects of supply chain management (I)
Transport, communication and camp facilities (T)				Product innovation processes (I)
Exploration techniques and know-how (I)				Distribution rights (I)

(continued)

Table 3: Continued

Exploration Discovery	Mine Development and Construction	Mining Exploitation	Beneficiation, Smelting and Refining	Trading, Marketing and Sales
IP related to remote sensing and GIS techniques and related databases (I)				Pricing negotiations know-how for unusual commodities (I)
IP related to negotiation, contract structuring and management of joint ventures (I)	IP related to negotiation, contract structuring and management of joint ventures (I)			

I = Intangible asset, T = Tangible asset, I + T = Intangible and tangible assets

3.3. Risks

Some of the relevant risks that an MNE operating in mining and extractive industry may incur can be external or internal and are summarized in the below table.

For more details on the importance of risks within an MNE for transfer pricing purposes, reference can be made to paragraph B2.3.2.22. and onward, of Chapter B.2. Comparability Analysis in the Manual.

Table 3¹¹

¹¹ See footnote 8.

Table 4: Risks typically encountered by a mining company (Source: TPA Global).

Risks	Acquisition/ Exploration	Mining	Ore Processing	Trade	Marketing/Sales
Exogeneous					
Market risk	—	x	x	X	X
Currency/foreign exchange risk	X	X	x	x	x
Social/political sovereign/ legal risk	X	X	x	—	—
Natural disaster risk	X	X	x	—	—
Environmental risk	X	X	x	—	—
Endogenous					
Exploration risk	X	—	—	—	—
Operating risk	x	x	x	x	x
Processing risk	—	X	X	—	—
Capacity underutilization and availability risk	—	x	x	x	—
Transportation risk	—	X	X	X	X
Inventory risk	—	X	X	X	X
Product liability risk	—	X	X	X	X
Credit risk	—	X	X	X	X

— = Limited risk, x = Moderate risk, X = High risk

3.4. Transfer Pricing Issues

Transfer pricing issues in the extractives industry that in particular may affect developing countries include:

(i) Fragmentation of the supply chain and ability to locate functions in order to allocate profits to:

- Offshore Marketing / procurement companies or branches
- Offshore hedging companies

(ii) Thin Capitalization;

(iii) Intra-Group Charges (e.g. technical fees and management fees);

(iv) Transactions involving fragmentation i.e. where MNEs enter in convoluted structures involving the inter-positioning of multiple companies, generally in tax havens/low tax jurisdictions (splitting out of functions and risks) to divide profits;

(v) Taxpayers using offshore marketing companies to divide profits arguing that they are securing demand through customer relationships, smart contracting and high quality services as key to placing product in the market and to overall value creation.

3.5. Mining-specific case examples and issues encountered

Following is a compilation and series of case examples regarding issues and facts encountered in practice with respect to mining and mineral extractive industries.

Example 1: Export of low value minerals to an intermediary distribution company

Facts

Physical commodities are shipped directly from the Mining Company to the third party customer. However, the invoice flow is from the Mining Company to an intermediary group Distribution Company C located in a low tax jurisdiction and then on towards the third party customer.

The transfer price between the Mining Company and intermediary Distribution Company C is determined with reference to an index price or reference price for the commodity less a distribution/marketing margin for the functions performed by the intermediary group Distribution Company C.

In this scenario there are two pricing issues to evaluate:

1) The point in time the reference price is determined compared to when it is calculated in an arm's length situation;

2) Whether the distribution/marketing margin is at arm's length.

The CUP method may be appropriate for the purposes of determining whether the reference price (number 1 above) applied in the transfer pricing between mining company and intermediary Distribution

Company C is at arm's length. However, for the purpose of the distribution/marketing margin (number 2 above) the CUP method may not be appropriate if the intermediary Distribution Company C performs substantial marketing/distribution functions.

Findings

It was found that despite the fact that the sale of the commodity is on a back-to-back FOB/ CIF (“flash title”) basis from the Mining Company to the intermediary Distribution Company C to the end customer, the pricing between the parties in the supply chain are determined at different points in time. Production sale price from Mining Company to related party intermediary Distribution Company C was determined at the Index price of the month prior to shipment, while the related party intermediary sales price to end customer is determined at the Index price at the month of shipment, i.e. later in time.

Considerations

The difficulty faced in this scenario is to get documentation / benchmarking data that can assist in the evaluation whether, in a back to back (“flash title”) sales transaction, the producer’s sale price (at index price prior to shipment) is at arm’s length.

For more information on pricing practices, also consult the Platform Discussion Draft on Addressing the information Gaps on Prices of Minerals Sold in an Intermediate Form.

Example 2: Coal Group marketing activities

Facts

The Coal group is involved in the mining, production and distribution of coal. The entities within the group perform research, development, marketing, sales, shipping and distribution of coal.

Coal Company is tax-resident of a developing country. The company owns several mines and is involved in the exploration, development and mining of coal. The coal that is produced by Coal Company is used for

electricity generation and more than 90% of Coal Company's revenue relates to coal that is exported.

Marketing Company is incorporated under the laws of a low tax jurisdiction. Marketing Company entered into a distribution agreement with Coal Company for all coal produced by Coal Company that is suitable for export.

According to a legal agreement between Coal Company and Marketing Company, Marketing Company is responsible for sourcing customers, contract negotiations, delivery of coal to end customers and exploiting the market for coal. It also bears inventory, credit, quality, price, foreign exchange and delivery risk. As consideration for the functions and risks borne Marketing Company earned a gross margin of 7 per cent. Marketing Company is described as a fully-fledged distributor.

The key value drivers in this industry are considered to be:

- Ability to blend different coal qualities to match customer requirements;
- Coal specifications, for example the higher the caloric value and lower the impurities, the higher the expected price per tonne;
- Prompt delivery to end customers; and
- Freight rates.

Marketing Company does not have any technical sales personnel. Coal Company is responsible for blending coal according to customer specifications. Customers inform Marketing Company of their need for blending and it passes the request to Coal Company to do the actual blending. Marketing Company does not hold inventory and takes flash title to the goods. At Marketing Company's request, Coal Company can liaise directly with the end customer to organize delivery of coal.

The market has changed drastically over the years. There has been a change in the grade of coal required by customers due to economic downturn, environmental laws, availability of substitutes and increased number of sellers in the market. This has put pressure on coal suppliers

to come up with innovative ways to retain their position in the market. The expertise of Coal Company's technical team is required to evaluate the changes to coal specifications and ensure that the group achieves high margins.

Marketing Company has 4 employees. Based on the documentation reviewed and interviews conducted, only 2 of these employees are responsible for marketing the coal. Marketing Company entered into an agreement with Advisory Company, a related party marketing agent, located in the same country as Marketing Company. According to this agreement Marketing Company outsourced all of its marketing functions to Advisory Company as it did not have the necessary skills and resources to fully market the coal bought from Coal Company. For the service it provides, Advisory Company receives a commission of 3 per cent on all sales by Marketing Company to third parties. A resale price method was used in determining a margin of 7 per cent for Marketing Company.

Findings

The Revenue Authority in Country A is of the view that 7 per cent is excessive and Marketing Company should have been classified as a limited risk distributor. According to the benchmarking study performed by the Revenue Authority in County A, comparable entities earn gross margins of between 2 and 4 per cent.

Considerations

From the background presented above, the following should be considered:

- (a) What factors influence the sale of coal? Get an understanding of the coal industry and the economic environment in which the taxpayer is operating.¹²
- (b) The terms of the distribution agreements: Are they comparable to third party distribution agreements? If they are not this forms a basis for a transfer pricing adjustment.

¹² Please note that the Platform Discussion Draft on Addressing the information Gaps on Prices of Minerals sold in an Intermediate includes an extensive example explaining thermal coal mining, markets and trading, pricing and contractual arrangements.

- (c) Obtain a clear structure of the group and an understanding of the supply chain. Understand the transactional flow of invoices and physical flow of goods.
- (d) The above step should be followed by delineating the actual transaction and allocating functions, assets and risks to each company in the supply chain. Does the conduct of parties differ from the legal agreement?
- (e) Who manages the risk and has the financial capacity to bear the risk? Which entity in the supply chain is ultimately liable to third parties? It is important to understand where value adding activities are conducted and managed as this is where economic functions should be allocated.
- (f) Review internal comparables, and if they exist, consider whether reasonable adjustments can be made.
- (g) What is the appropriate transfer pricing method to select? Does external data exist? If it does, perform a benchmarking study where comparable entities are identified.

Example 3: Price fluctuations and Intermediary sales of Uranium

Facts

Company A operates a uranium mine in developing Country A. Upon extraction, Company A sells the mined uranium to a related Swiss marketing entity at an output kg price that reflects the long-term commodity price, which price is agreed to in the related party distribution agreement.

Because of external developments, the uranium price decreased to 30% of the price agreed between the related mining company and its intermediary sales company.

Findings

Upon audit, the tax authorities question the use of the long-term commodity price between related parties, as it does not seem to consider who carries the risk of loss when commodity prices fluctuate

and – in this case- drop. There is no benchmark made available to help substantiate the income allocation between the related parties,

Considerations

In issue is whether the price set between the related parties qualifies as being at arm's length considering the facts and circumstances at the time the contract was entered into. Would independent parties have agreed an adjustment clause in case of changing market circumstances? What is the customary in the business? Tax authorities have to be careful using a hindsight analysis. Is the risk of loss (or gains) upon price fluctuations allocated to the party that can best handle and manage and control the risks in case of changing market conditions. For example, did any of the parties entered into hedging agreements to mitigate price fluctuations.

To analyze these facts, it is important to consider the market environment. For example, in this particular industry, if there is an undersupply of smelting services, a price participation agreement may be appropriate.

Example 4: Market off-taker function

Facts

Company B is located in Country B, a low tax jurisdiction. Pursuant to an off-take agreement with related Company A in developing Country A, Company B is obliged to buy 100% of the coal produced by Company A.

The off-take agreement between Company A and Company B does not include a guarantee on price. The pricing will be based on current market prices minus a discount reflecting the risk assumed by Company B for the (100%) off-take obligation. Company B takes flash title to the coal it off-takes from Company A and therefore does not carry inventory risk.

Findings

The tax authorities of Country A challenge the discount to the market price that Company B receives when buying coal from Company A, as Company A is in a position to adjust its production based on market supply and demand conditions.

The mining group takes the position that the discount ought to be higher than independent full-fledged distributors to reflect the risk it takes in the off-take agreement.

Considerations:

The tax authorities should review whether the market off-taker (Company B) really assumed these additional market risks, in particular considering that Company A adjusts its production based on the market conditions. Furthermore the pricing is based on the current market price and volume risk is managed by Company A, now that the mining company adjusts its output to reflect supply conditions in the market.

Example 5: Buying and Selling of Iron

Facts

The taxpayer is resident in a developing country that has a relatively low corporate tax rate, and is engaged in the business of buying and selling raw materials (iron). The taxpayer has an associated Headquarters company in Europe and a direct Parent company, which is a holding company in the Middle East.

The taxpayer buys iron from associated enterprises in South America and sells the Iron to associated enterprises in Asia and the United States. About 80% of the buying and selling of ore is being conducted in Asia. Getting information on the technicalities of this particular business has proven to be very difficult.

The taxpayer reports a mark-up of 0,5% on cost on its intercompany buy-sell transactions. A comparison of companies that operate more or less in the same line of business shows margins between 10-15%.

Research also showed that the country of source of the iron provides a 6-year tax holiday.

Additional challenges encountered in this case regarded getting information on the margins obtained with buying and selling that specific iron.

Findings

Even though the corporate tax rate in the developing country where the taxpayer is operating its buy-sell activities is 15%, which is lower than the tax rates in many other countries, the MNE of which the taxpayer is a part, would have a benefit in leaving taxable profit at the source of the location where the iron originates. This case scenario shows that a corporate tax rate of 15% does not necessarily mean no transfer pricing irregularities will take place.

Example 6: Intercompany financing

Facts

The taxpayer is engaged in the exploration of minerals and mining. The Parent company/Headquarter company is located in a developing country, with a US Holding company and two Africa-based mining and operation companies.

The Parent company has issued loans to its African subsidiaries, which carry no interest remuneration for the Parent company.

On the other hand, the Parent company borrows funds denominated in USD from associated enterprises for which it pays a LIBOR + 2,5% interest rate.

Furthermore, the developing country-based Parent company pays a technical assistance fee to the two Africa-based mining and operation companies, based on the respective companies' salary cost, consulting costs, moving expenses of employees and for providing technical services. The technical assistance fee is at a cost plus 1-5% level.

Considering the absence of interest income yet the incurrence of interest costs and technical assistance fee costs, the developing country-based Parent company consistently operates at a loss.

The African mining company enjoys a tax holiday and other companies in the same industry normally report a cost +4%.

Findings

This case example presents the difficulty of associated enterprises reporting ongoing losses, and the fact that it is a challenge to obtain data on intercompany financing activities and the conditions of intercompany financing.

The developing country in issue has signed the Agreement on Mutual Administrative Assistance in tax matters, but collecting relevant information from overseas remains very time-consuming, in particular as transactions tend to be spread out over several jurisdictions.

Example 7: Copper JV

Facts

A copper mine in Country M is owned and operated by a joint venture company, JV, organized under the laws of Country M. 45 percent of the equity interests in JV are owned 45 percent by Company A, a Country X subsidiary of a large mining conglomerate based in Country Y. 40 percent of the equity interests in JV are owned by Company B, a Country X subsidiary of another large mining conglomerate that is based in Country Z. The remaining 15 percent of the equity interests in JV are owned by Company C, an entity wholly owned by the government of Country M.

JV has entered into service agreements with Companies A, B and C pursuant to which JV agrees to pay an annual fee equal to 5 percent of its revenues to Companies A, B and C as compensation for any technical services that may be required to support the operation of JV from time

to time. Under the agreements, the service fee payments are to be divided among the three recipients of the payments in proportion to the equity interests of Companies A, B and C in JV. Country M imposes a 10 percent withholding tax on dividends but has a treaty arrangement with Country X that provides that service fees are not subject to withholding tax.

The Country M tax authorities audit the services arrangements between JV and Companies A, B, and C. They learn that Companies A and B each provide occasional services of a technical nature to JV. The services are provided by a combination of employees of Companies A and B and employees of their respective parent companies. The amount and nature of the services provided varies substantially from year to year, but the tax authorities are told that JV has no available information regarding the costs incurred by Companies A and B in providing the services and that no specific invoices for particular services are provided. Instead there is merely a single annual invoice for the 5 percent of revenue payment. The Country M tax authorities learn further that Company C has never provided services of any kind to JV.

Analysis

The first step in the conducting a transfer pricing analysis of the relationships between Companies A, B, and C and JV is to accurately delineate the transactions. In doing so, the Country M tax authorities determine that there is a service arrangement between Company A and Company B and JV. However, the amount and nature of services provided cannot be determined based on the available information. The Country M tax authorities determine that no services arrangement actually exists between Company C and JV.

Since there is no evidence of the type and amount of services provided, the Country M tax authorities determine that without further information they are unable to determine whether the actual services provided by Companies A and B satisfy the requirements of the benefits test described in paragraph B.4.10. of the Manual. They therefore conclude that, unless further information regarding the nature of the

specific services is provided that no deduction should be allowed for the 5 percent fee and that it should be properly characterized as a distribution of profits to the holders of equity interests in JV.

Example 8: Sale and Leaseback of Equipment

Facts

Five years ago, Mining Company in Country G acquired a fleet of dump trucks to transport the ore it mined from the mine site to its nearby beneficiation plant. In accordance with Country G's accelerated depreciation provisions, Mining Company depreciated the capital costs of the trucks over five years. At the end of the 5-year period, Mining Company sells the fleet of trucks to Equipment Company, an associated enterprise of Mining Company, located in Country X, a low-tax jurisdiction. The sales price received by Mining Company from Equipment Company is equal to the written down value of the trucks. Immediately after the sale, Mining Company enters into a 5-year operating lease with equipment Company to lease back the fleet of trucks. Mining Company pays an arm's length rent to Equipment Company for the use of the trucks.

Findings

Mining Company has recorded depreciation deductions against the acquisition costs of the fleet of trucks. The sale of the fleet at their written-down value means that Mining Company records no capital gains upon the transfer of the asset. Under the lease arrangement, Mining Company can record deductible rent payments for the use of the same fleet of trucks it owned earlier and depreciated.

Considerations

The hiring or acquisition of equipment can be problematic. Here, Mining Company has mining equipment. It depreciates the asset and then sells it to related party Equipment Company in Country B. Country B records it as a new asset as opposed to a second hand asset and it is re-depreciated all over again in Country B. This form of tax planning may in

itself not be a transfer pricing issue but regards whether the transaction is a bona fide sale or bona fide lease. In this respect reference is made to the Manual B2.3.1.4-B2.3.1.9. It should be considered for transfer pricing purposes whether the sale value is inflated (if so there will be a recoupment in Country A). Also, the customs value may be under-declared to avoid high tariffs (the shipping value is not always checked against the sale value) and this creates room for arbitrage and generates tax benefits.

4. Value Chain of Production of Oil and Natural Gas¹³

The oil and gas exploration business is a high-risk global industry but when particular projects are successful the reward is potentially very high. In most countries, governments own the subsurface oil and gas. Rather than trying to extract these natural resources themselves, governments see value in bringing in specialized O&G companies to take on those activities. The main reason for this is to balance risks and rewards. Exploration and Production contracts (E&P) describe the rights and responsibilities of the investor and also entail the share of production and or revenues that have to be paid to the government. These contracts usually come in the form of either Concessions or Production Sharing Contracts.

E&P contracts reflect a fine balance between International Oil Companies (IOCs) and Developing Country Governments' their aspirations and expectations. In collaboration with natural resource owners, IOCs are prepared to accept numerous risks associated a project, such as (1) exploration risk (i.e., whether oil and gas reserves can be found in commercial quantities), (2) development risk (i.e., the technical risks associated with the physical investment needed to produce and transport production to market, (3) economic risks (the upfront capital outlays required prior to production and the ongoing operating costs of the project), and market risks (the price and

¹³ For more information, see: Silvana Tordo, World Bank Working Paper 218, National Oil Companies and Value Creation: Study and Results. <http://go.worldbank.org/UOQSWUQ6P0>

supply/demand risks over a very long project life).¹⁴ In return the IOC's expect (a) a fair risk/reward relationship; (b) a fair rate of return on capital; (c) as much certainty as governments can provide with respect to fiscal and legal terms. Content of the contracts can vary depending on the prevailing energy prices, demand for hydrocarbons and availability of funds for investments.

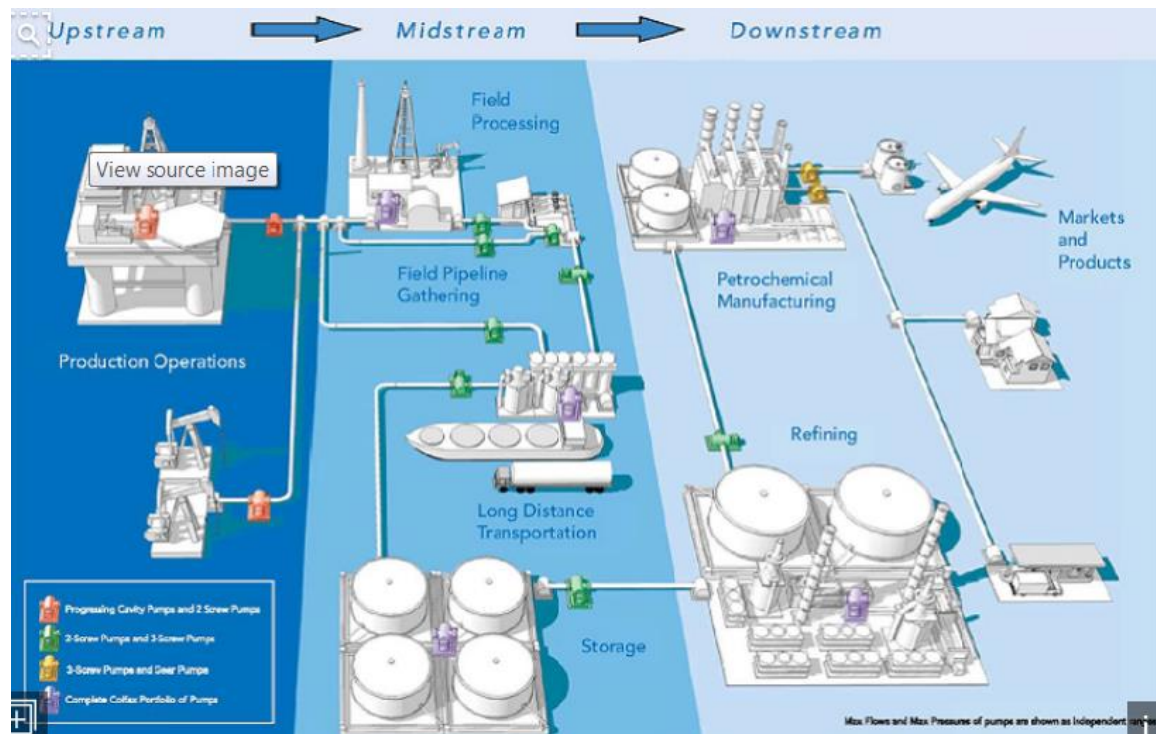
4.1. Upstream, Midstream and Downstream activities

The value chain of production of oil and natural gas commences with identifying suitable areas to conduct exploration for oil and/or gas, and continues with "upstream" activities, consisting of exploration, development and production of crude oil and natural gas (this may include oilfield related activities such as seismic surveys, well drilling and equipment supply or engineering). Like Mining, the Oil and Gas industry requires significant up-front capital investments, but the upstream activity, i.e. the exploration risk in the oil and gas industry tends to be more risky than in the mining industry.

So-called "midstream" activities in this industry include those related to the necessary infrastructure and storage to be able to refine the oil and process the gas. Processed products are subsequently distributed towards wholesale and retail, which part of the business is referenced as consisting of "downstream" activities. This includes the transport of the product via pipelines or oil tankers, refining and wholesale and or retail sales. Midstream activities are often included in the downstream processes, however.

The figure below presents an overview of the respective upstream to downstream activities.

¹⁴ A more complete discussion of risks, including references, can be found in the Overview Note at p.____.



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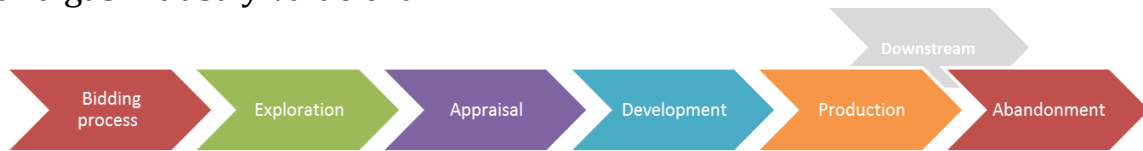
The functions performed, assets used and risk exposure of companies engaged in the oil and gas industry will differ depending on the type of contract that the company has entered into with the host country where the oil and gas reserves are located:

I. In a Concessionary system, the oil company, as licensee, obtains a lease for a fixed period of time from the government and is responsible for all investment in and generally owns all exploration output and production equipment subject to making royalty, tax, and other license payments to the government;

II. Under a Production-Sharing contract, the production and reserves in the ground usually are owned by the State (or the national oil companies) with which the company has contracted, whereas the company (fully) funds the development of the oil and gas production. Part of the produced oil and gas serves as reimbursement for the company's investments and part of the produced oil and gas will be shared between the State and the contracting company;

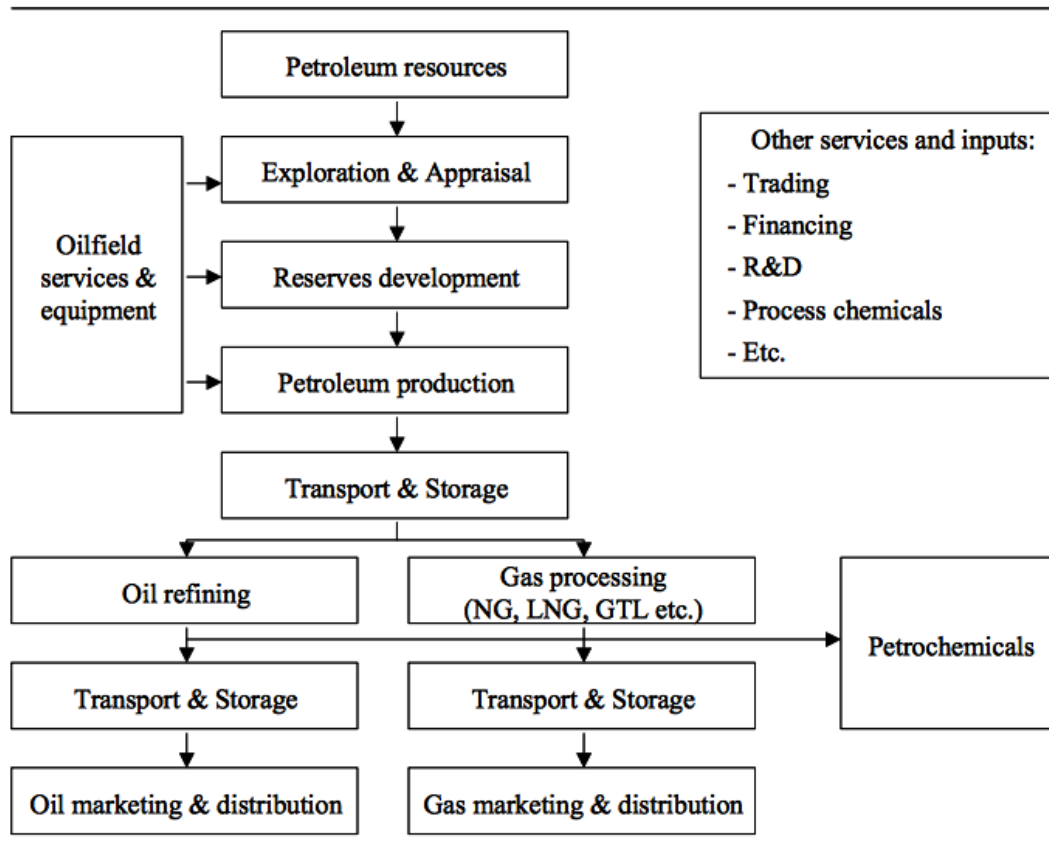
III. Under a Service Contract, the contracting company is usually paid a service fee for providing the service of producing oil and gas on behalf of the host State. The contracting company usually provides all capital associated with exploration and development without any claim to ownership of reserves or production. However, part of the sales revenue of the oil and gas will be applied to reimburse the contractor's costs and pay its service fee.

The figure below provides for a generic overview of the upstream oil and gas industry value chain:



Below, is a more detailed overview.¹⁵

¹⁵ See: Silvana Tordo, World Bank Working Paper 218, National Oil Companies and Value Creation: Study and Results. <http://go.worldbank.org/UOQSWUQ6P0>

Figure 1: Petroleum value chain

Source: Author

The valuation of crude has been a bone of contention in the past, when many IOCs traded the produced crude with their downstream organizations often at low transfer prices. Host governments in the producing countries assumed that the price was kept artificially low to reduce upstream taxation and therefore they introduced a posted price or a tax reference price. As there are now clear indices on international crude prices, this hand-off point to downstream business can be benchmarked.

4.2. Industry-specific Issues

Due to its nature, the Oil and Gas Industry presents specific transfer pricing issues. Some of these industry-specific aspects are shared with the mining and extractives industry and are identified in Table 1 listing

consecutive phases that extraction of minerals may involve. Other O&G industry issues that may be relevant from a transfer pricing perspectives include:

- A. Central Operating Model;
- B. Financing cost;
- C. Intra-Group guarantees;
- D. Cost Sharing;
- E. Group Synergies;
- F. Charging at cost;
- G. Ring fencing

To the extent possible, these issues are listed/identified in Table 1 listing the consecutive phases that extraction of minerals may involve.

4.3. Oil & Gas Industry –specific case examples and issues encountered

Following is a compilation and series of real life case examples regarding issues and facts encountered in practice with respect to the O&G industry.

Example 1: Oil acquired from related companies

Facts

Fuel Company is engaged in the blending and refining of crude oil to produce fuel that is sold to consumers in Country A. Imported crude oil is a very important element required for the production of fuel sold by Fuel Company.

Fuel Company purchases crude oil from its wholly owned subsidiary, Shipping Company, which is incorporated in and tax resident of Country B. Shipping Company purchases crude oil from Sourcing Company, incorporated and tax resident of Country C (a low tax jurisdiction).

Sourcing Company acquires crude oil from unrelated third parties in Countries D and E.

Shipping Company and Sourcing Company are both wholly owned subsidiaries of Fuel Company.

Findings

Upon review of the facts and intercompany agreements, it becomes clear that Sourcing Company has long-term contracts for the purchase of crude oil from unrelated parties in Countries D and E. Sourcing Company sells the crude oil to the related Shipping Company on a free-on-board (“FOB”) basis. Shipping Company is responsible for all freight and related activities and sells the crude oil to related Fuel Company on a cost, insurance and freight (“CIF”) basis. Crude oil is loaded at the ports in Countries D and E and delivered in Country A at the port near Fuel Company’s facilities.

In the past Fuel Company used to acquire crude oil directly from third parties in Countries D and E.

Considerations

As Sourcing Company is resident in and operates from a low tax jurisdiction, there is an inherent risk that the group profits may be diverted to that jurisdiction with the effect of reducing the tax liability of the group and eroding the tax base of the Fuel company.

It is assumed that the price paid by Sourcing Company to the unrelated third parties for the purchases of crude oil is a market price. Should the terms and conditions of the contracts between Sourcing Company and Shipping Company, and between Shipping Company and Fuel Company not reflect terms and conditions that would have been agreed upon in a contract between independent unrelated parties (non arm’s length) Fuel Company could end up paying an inflated price for the purchase of crude oil from the related Shipping Company.

The result is that the tax base of the country in which Fuel Company is resident is eroded by the inflated price paid for the crude oil purchases. Controlled foreign company rules could be applied to tax the profits made by Sourcing and Shipping companies as a result of mispricing of

the transactions between Sourcing Company and Shipping Company as well as between Shipping Company and Fuel Company.

As Sourcing Company and Shipping Company are subsidiaries of Fuel Company they are controlled companies and should be within the scope of domestic CFC rules, if those are in place. If applicable CFC rules cover situations where goods are purchased from third parties located in third countries for on-sale to the resident country then the profits arising from those transactions could be imputed to Fuel Company and included in the taxable income of Fuel Company. These diversionary rules would tax the full profit of the CFC from the diversionary activities performed by the CFC.

Example 2: Structure and operations of a company in the Petroleum Industry, which could lead to practical transfer pricing issues

Background

The petroleum industry includes the global processes of exploration, extraction, refining, transporting (often by oil tankers and pipelines), and marketing of petroleum products. Petroleum (oil) is also the raw material for many chemical products, including pharmaceuticals, solvents, fertilizers, pesticides, synthetic fragrances, and plastics.

Structure

The Company (“The Company”) is in the Petroleum Industry and one of the major players involved in upstream as well as in downstream activities. The Company is incorporated in Country A, but headquartered in Country B. The Company does not carry out any operational activities, but has a Board that oversees the activities of the Group. The business model is that of a vertically integrated company that provides significant economies of scale and barriers to entry, each business seeks to be a self-supporting unit without subsidies from other parts of the company.

The Group is comprised of four Holding Companies for different regions, Operating Companies for each country and Service Companies providing shared services to the operating companies. The upstream business tends to be more centralized with much of the technical and financial direction coming from the central offices in Country D.

Currently nearly all of the operations in various businesses are much more directly managed from Country D. The “autonomy” of the local structures has been removed, with a more global approach being created.

Upstream Business

The Company’s upstream activities relate to worldwide exploration activities for crude oil and natural gas. Due to the lengthy time period (of up to 5 years) and the expensive nature of this exercise, exploration activities are commonly conducted in partnerships with various role players including the governments of the countries in which the exploration activities are being carried on. Exploration activities are taking place on land and sea and are usually conducted on an outsourced basis to independent third parties that specialize in this field. Expenses relating to exploration activities are allocated to existing production upstream companies in the explored territory.

Exploration

A subsidiary of the Company called “Explore 1” is based in Country C (a low-tax jurisdiction). Explore 1 is responsible for coordinating the various types of exploration activities on land and sea. Explore 1 is further responsible for the tenders for exploration blocks and also manages the interaction with the relevant government departments of the effected countries.

Explore 1 on-charges all of its costs, with a 20% markup, per explored territory to the upstream production company of the relevant territory. The markup percentage is based on inherent risks the exploration company is taking in terms of the coordination activities and country risk issues.

The costs charged by Explore 1 have the potential of eroding the tax base of the resident country.

The allocation of the costs and the mark-up charged by the Explore 1 should probably be investigated by the tax authority of the Upstream Company for the following reasons:

- (i) Explore 1 is an entity operating from and resident of a low tax jurisdiction. This means there is an inherent risk that the group profits may be diverted to that jurisdiction with the effect of reducing the tax liability of the group and eroding the tax base of the production company. It is important to determine whether Explore 1 actually perform its functions and assume the risks it is said to perform.
- (ii) The allocation of costs should be investigated to ensure that the correct costs are allocated to the resident Upstream Company and not only to Upstream Companies already in operation with taxable revenue.
- (iii) The allocation of costs should further be investigated in terms of Capital vs Revenue depending on the resident country’s taxation rules on deductibility of startup capital expenditure.
- (iv) The high markup should be investigated, as Explore 1 is essentially a service company with coordinating activities. Explore 1 assumes no risks as all costs are essentially charged out.

Evaluation and Finance

Once a positive source is identified it is evaluated via geochemistry methods to quantify the nature of organic-rich rocks, which contain the precursors to hydrocarbons. After a hydrocarbon occurrence has been identified and appraised it is sent to a Finance 1 a subsidiary based in Country D. The finding is then evaluated using various factors, taking into account economic, political and geo political factors. This also means that the fiscal regime of the relevant country is evaluated (for example the government participation rights, deductibility of capital expenditures, ring fenced losses, fiscal stability agreements and royalty rates).

Finance 1 is responsible for the financing of the development phase or meeting any other capital requirements once in production phase. The development could either be financed through available group finance or external financing. The choice between internal and external financing is evaluated taking into consideration various factors. The factors include the overall expected return on the project, any participation rights of the relevant government and the fiscal regime of the country. Finance 1 then borrows the money either internally or externally and lends it out at a premium of 2% higher than the Group's internal rate of return of the previous year. This has the effect that any interest paid by the relevant companies in the Group is nearly always higher than the central bank rate of the specific country. The gearing of the Upstream Companies, due to intensive capital expenditure at the startup stage, is extremely high; usually at a 1 to 6 ratio of Equity to Debt. The premium compensates Finance 1 for both a return on monies lent and for the evaluation of the original project. The development phase to production can take up to three years.

The thin capitalization of the Operating Company and interest rate charged by Finance 1 results in eroding the tax base of the operational resident country. In terms of the borrowing and interest charged by Finance 1, the tax authority of the country where the Company is resident should probably investigate the following:

(i) The ratio of debt to equity of the resident Company. A company is said to be thinly capitalized when the level of its debt is much greater than its equity capital, i.e. when its gearing, or leverage, is very high.

Thin capitalization rules typically operate by means of one of two approaches by a revenue authority:

- Determining a maximum amount of debt in relation to which deductible interest payments are available; and
- Determining a maximum amount of interest that may be deducted by reference to the ratio of interest (paid or payable) to another variable.

Depending on the specific rules of the resident country the debt to equity ratios should be calculated and/or the interest rate charged by Finance 1 and the amount of interest paid.

Downstream Business

Downstream business relates to a number of different activities, in an integrated value chain, that collectively turn crude oil into a range of refined products. Products can include gasoline, diesel, heating oil, aviation fuel, marine fuel, liquefied natural gas, lubricants, bitumen, sulphur and liquefied petroleum gas. These products are moved and marketed around the world for domestic, industrial and transport use.

Crude purchases

Trading Company 1 in County C (a low tax jurisdiction) sells crude oil to Operational Companies with refineries situated worldwide. Trading Company 1 has several trading desks operated by specialists and is regarded as conducting a genuine business. Trading in Crude is of a high-risk nature due to the volumes traded per deal and the relative small margins per barrel. The trading system is largely computerized and equipped with interfaces with the operating companies.

The operating companies with a refinery located in various different countries would typically contact Trading Company 1 via the computerized interface for the relevant desired type and grade of crude. Each refinery has different requirements of crude grades and origin depending on the type and age of the refinery.

The trading subsidiary in country C would then enter into term supply contracts or spot purchases for crude based on the requirements of the refineries. These agreements could be made between The Company's

own upstream operational companies or independent third parties. The Trading Company then sells the crude to the operational companies.

The Trading Company also manages the logistics of the entire process and arranges transportation using either an external party or The Company's own shipping company, depending on the circumstances. The Trading Company charges a premium ranging from \$1 to \$5 for every barrel of crude oil sold to the operating companies for the logistics.

This premium charged by Trading Company 1 erodes the tax base of the operational companies in their resident countries. In terms of the premium charged by Trading Company 1, the tax authority of the Operational Company should probably investigate the following:

(i) The price per barrel paid should be compared to the relevant daily market related data of crude products depending on the origin of the crude. A premium is charged by Trading Company 1 per barrel of crude purchased by the operational Companies. As the average deal amounts to 350 000 barrels of crude, a substantial profit is made by Trading Company 1. Deviation to the daily-published prices should be investigated to determine the nature thereof.

Transport of crude

The Company's shipping arm is registered in country County B and owns several oil tankers able to transport crude or refined petroleum products in various volumes. Ship sharing is not uncommon when different petroleum companies share a ship to the same destination to attain a better rate. Cargos are bought based on CIF basis (Cost, Insurance & Freight) or on a FOB basis (Free On Board) at the loading port. In both cases risk and title of the oil passes from seller to buyer when the crude oil is loaded onto the ship. The CIF terms include the freight and insurance being provided by the seller and being included in the price, while the FOB terms only include the cost of the oil. The shipping company charges market related rates to the Trading Company or Operational Company depending on which Company is carrying the transport fees. Shipping rates are based on the internationally published rates for the petroleum industry.

In terms of the direct or on-charged transport costs, the following should probably be investigated by the tax authorities:

(i) the transport rates for moving crude and refining products by ship is published on a monthly basis. These rates should be compared to the transport costs carried ultimately by the Operational Company to ensure that the rate charged is comparable and arm's length.

Refinery and manufacturing

Manufacturing by local operating companies focuses on refinery and chemical plant operations making products such as gasoline, diesel, heating oil, aviation fuel, lubricants and bitumen. Crude purchases are usually paid within 30 days to the Trading Company. The refining of crude and manufacturing of lubricants is managed by the local operational company in conjunction with the regional holding company.

Purchases of finished product

Local operational companies that do not have refineries are not able to produce a specific petroleum product or lubricant, and make purchases from Trading Company 2 situated in County C (a low tax jurisdiction). Trading Company 2 will then source the relevant product on request from the operating company, either from the operational Companies situated in other countries or in certain instances from other petroleum companies. Depending on the product, origin and volume the group's shipping company may be used. Trading Company 2 would buy the relevant product and on-sell the product to the local company. The trading company adds a premium to the sales price, which fluctuates depending on the volume and type of product sold.

The premium charged by Trading Company 2 erodes the tax base of the operational resident country. In terms of the premium charged by Trading Company 2, the following should probably be investigated by the tax authority: The premium is based on the overall market price and then on-charged per barrel or litre purchased by the operational Companies. The calculation via units purchased has the effect that a substantial profit is made by the Trading Company. The premium price

should be compared to the relevant daily market related data of petroleum products.

Distribution

The operational companies own the refinery and lubricants factory and have a substantive network of storage tanks and distribution facilities. The product is sold directly to wholesalers or other oil companies depending on surpluses or country-by-country agreements. Depending on local legislation the operational company may own several service stations to which the refined product is directly delivered via their own fleet or independent contractors.

Distribution of surplus product

Previously, the Operational Company's internal marketing department made sales of surplus petroleum products to non-resident unrelated companies. This function has now been centralized through Trading Company 2 located in Country C (a low tax jurisdiction). The Operational Company informs Trading Company 2 of any surpluses after which the Trading Company secures buyers on a CIF basis. Trading Company 2 will then buy the surplus product and on-sell the product to independent third parties. Operational Company remains responsible for all relevant logistics and deliveries to the port and carries all risk up to the loading of the product to the arranged transport of the buyer. The Trading Company usually takes flash title of the product just before delivery when ownership passes to the buyer. The Trading Company carries the risk of bad debts. However, no bad debts have occurred in the last few years due to the extensive guarantees and securities before delivery. Operational Company charges a 5% commission on all purchases, which is relatively low, but is a substantial amount in relation to the volumes and ultimate price in a low gross profit industry.

The commission charged by the Trading Company erodes the tax base of the operational resident country. In terms of the commission charged by the Trading Company, the tax authorities should probably investigate the following:

(i) Whether the functions performed, the risks assumed and the assets used by the Trading Company warrant a commission of 5%.

The interposing of the Trading Company has synergy benefits in terms of the overall group perspective. However, the following should be looked at to determine if the amount paid can be considered to be at arms- length.

The Trading Company carries minimal risk for the product as they only receive a flash title. Its exposure to non-payment appears minimal. The Trading Company does perform functions regarding securing buyers. These appear to be have been built up by the operational companies themselves. The Trading Company has minimal assets in Country C, which consists of a few trading desks and a manager. In these circumstances a cost plus-basis charge by the Trading Company to the operational companies might be more representative of an arm's length price for services rendered to the operational companies than the 5% commission.

CCAs (cost contribution arrangements)

A global and regional cost sharing arrangement exists between the operational companies. The cost sharing arrangement allows for the equal sharing of risk, knowledge and expertise. Costs are allocated between the respective operational companies based on allocation keys, which range from full-time employees, computer devices to sales. Each operational company will share costs in the global pool, but costs would only be shared for the specific region in the case of regional pools. The operational companies in the group obtain services through the cost sharing agreement in the following areas.

- HR;
- Finance;
- Legal;
- IT; and
- Communications.

Pursuant to the cost sharing arrangement all costs for the year are invoiced to the operational companies as per the allocation keys. The CCA is tax resident in County E (a low tax jurisdiction) but operates on a non- profit basis. The allocation keys and apportionment of the costs are audited on a yearly basis by a large accounting firm. Due to the high

auditing costs, the accounting firm is requested to only provide an overview of the costs, and to issue a certificate to this effect to each operational company in the CCA together with an invoice for the yearly costs.

Considering the above facts related to the allocated CCA costs, the tax authority should probably investigate the operational company claiming the costs relating to the invoice from the CCA and check:

- (i) The actual benefit received and conduct a benefit analysis of the services received;
- (ii) The applicability of the allocation keys used;
- (iii) The reasonableness of the portion of costs carried by the operational company

Should these investigations indicate that the benefit does not support the cost allocated, the expense should not or only be partly allowed as a deduction against taxable income.

Example 3: Market Volatility issues

Facts

O&G company decided to lease drilling equipment from a related party for several years at a time when drilling equipment is scarcely available due to a high-demand market caused by high oil prices. The drilling equipment is to be used globally to realize activities in diverse countries where Exploration & Processing (E&P) campaigns are (expected) to be performed during such years.

In 2014 the oil prices dropped significantly.

A consequence of this unexpected drop in price is that drilling equipment becomes available in the market at very competitive fees, and considering the impact on profitability of high cost and reduced earnings several planned E&P projects are cancelled by O&G company.

Findings

The company that entered into the drilling equipment lease continues to pay a recurrent fee to the owner of the drilling equipment that was

previously hired, even if the drilling equipment is on stand-by and not currently used.

In issue is whether the price paid for the drilling equipment between related parties, consistent with the intercompany agreement which is not adjusted for current market prices, qualifies as being at arm's length.

Considerations

The price paid is a consequence of the contract entered into between parties and the fact that it is difficult to quantify the cost of the risk of not having the equipment available at the time a drilling campaign approaches its spud-date in a certain country against the cost of the risk of oil prices dropping.

The related party which invested in the long term lease arrangement in the drilling equipment still requests the agreed price whereas the related operating company is currently not able to use the drilling equipment, may request for price adjustments.

To determine if the pricing applied is arm's length, it is relevant to consider all available information. Well-prepared transfer pricing documentation that memorializes relevant economic conditions and other relevant facts contemporaneously may offer support and evidence of the business decision that will help clarify if the pricing is arm's length and may help allow the deductibility of costs from related entities in those cases or, if the case may be, the deductibility of non-recharged costs at the related entity level when such cost were unable to be invoiced to related parties due to inexistence of the service.

Example 4: Financing Costs

Facts

O&G Parent company is based in country A. O&G operating company develops a block in developing country B. The condition of the

concession to conduct E&P activities limits the amount of interest expense which may be deducted from the taxable tax base.

In the exploration phase it is usually not feasible to obtain loan financing given the exploration activities are capital intensive and are high risk. Once the project moved from the exploration stage into the development stage, O&G Parent company switched to project finance (Loans). Therefore Parent company issues an intercompany loan.

Because of the concession conditions, the developing country B disallows a portion of the interest costs incurred by O&G operating company while Country A includes the full interest in the tax base of O&G Parent company resulting in double taxation.

Considerations: In essence this is not a transfer pricing issue, but more a conflict between the concession agreement and the tax legislation of the Parent company. Transfer Pricing considerations would relate to determination of an arm's length interest rate or requalification of the loan into equity.

Example 5: Horizontal Ring Fencing

Facts

MNE Group D Company consists of 3 taxpayer entities: Principal Company, Company A and Company B. Company A and Company B are each special purpose vehicles whose sole business consists of the exploration and if successful, development and operation of Blocks A and B respectively. Principal Company acts as group coordinator in Country M. In this role, Principal Company contracts with an arm's length service provider to undertake exploratory drilling in blocks A and B. the fee for this service is 100 per block.

Assume that in the area of Blocks A and B and given the stage of exploration, it is anticipated that 50% of exploratory drilling will be successful such that it will lead to development of the block and production of oil.

Company A and Company B each initially pay a fee of 50 to Principal Company for the drilling work undertaken by the service provider. A further 150 is payable to Principal Company if the drilling is successful.

Findings

In this case example, it turns out that block A is successful and Block B is not. Furthermore, the oil produced by Block A results in 1000 of income. Company A's accounts will show an initial loss of 200 (the 50 initial fee and the 150 success fee) but this loss can be offset against its future income of 1000. A's net taxable income is therefore 800. Company B's accounts will show a loss of 50 (the initial fee). As Company B has no income and the ring fence does not allow Company B's loss to be transferred elsewhere, the 50 of costs are effectively stranded costs and can never be deducted against income. Principal Company's accounts will show total income of 250, consisting of 50 from Company B and (50 plus 150) from Company A. Principal Company's costs of 200 (100 x 2) are paid to the service provider. Principal Company's net income therefore is 50.

The total Group taxable income in Country M is $800 + 50 = 850$.

Considerations

These arrangements may lead to shifting of costs between ringfenced blocks and effectively overriding the ringfencing. If Company B makes a successful discovery, and receives its success fee, that fee constitutes costs of the successful block, which may be used to offset against future taxable income from that Block. Company B is facilitating the override of the ring fencing for Company A. It would be relevant to look for unrelated comparables.

Without the interposition of Principal Company between Company A and Company B, and without making use of the success fee that Principal Company demands, the accounts would show a different picture. Company A's accounts would show a tax loss of 100 (the service fee paid for exploratory drilling) which can be offset against its income

of 1000. Company A's net income would be 900. Company B's accounts would also show a tax loss of 100 (the service fee paid for exploratory drilling) but this amount would constitute stranded costs. The total group taxable income in Country M would therefore be 900.

One can question whether the pricing between Company A and Company B and Principal Company, and making use of a success fee is at arm's length, and it should be determined what an arm's length fee would be for the services rendered by Principal Company.

Example 6: Cost Sharing Agreement

Facts

O&G company has a cost sharing arrangement in which all the operating entities participate. Under the cost sharing agreement costs of rendering services as well as R&D development are shared among the participants on a projected benefit basis. The participating operating entities have access to all the developed technology and jointly own the IP.

The O&G company is rolling out a multi year project to deploy a new IT-system across the world. The cost of this project is included in the cost base of the cost sharing arrangement and is allocated based on PC count in the respective operating entities. In year 1 the program is rolled out in country A and B, but not yet in country C and D. Still the operating companies in country C and D need to bear their proportionately allocated costs under the cost sharing agreement. In year 2 the program is rolled out also to Country C and D.

Findings

In year 1 Country C and D treat the cost sharing as a cafeteria style arrangement, implying that the operating entities should only share the costs in which it has a current year benefit (cherry picking) and therefore not get a proportionate charge of the new IT-system costs.

Under the cost sharing agreements all participants are entitled to IP resulting from pooled R&D. Country C disallows the operating entity in

its country a deduction for the proportionate charge of the R&D activities as they do not see current benefits.

Considerations:

Cost sharing agreements generally consider anticipated benefits and not only current year benefits, reference is made to UN Manual, Chapter B.6. A bona fide cost sharing arrangements requires consistent use of allocation keys amongst the participants. The applied allocation key should reflect a reasonable allocation of anticipated (future) benefits. Where countries would prefer cost sharing for services over cost sharing for R&D, it should be considered that the latter may reduce future royalty discussions for IP used by the cost sharing participants operating in their countries.

Example 7: Intercompany charges at Cost

Facts

Under a production sharing agreement a consortium of three independent parties is established. From among the participating companies, an operator is appointed. The operator runs the project on behalf of the consortium and provides all technical and functional services, ensuring that costs and risks are shared with the consortium members. Pursuant to the consortium agreement, the operator is not allowed to benefit or be disadvantaged by its position, compared to the non-operating consortium members. As such the consortium agreement stipulates that the operator and its affiliates may not earn a profit from undertaking activities for the benefit of the consortium.

Findings

The tax authority of the country where the related service company of the operator is located, require a mark-up on the services provided to the consortium.

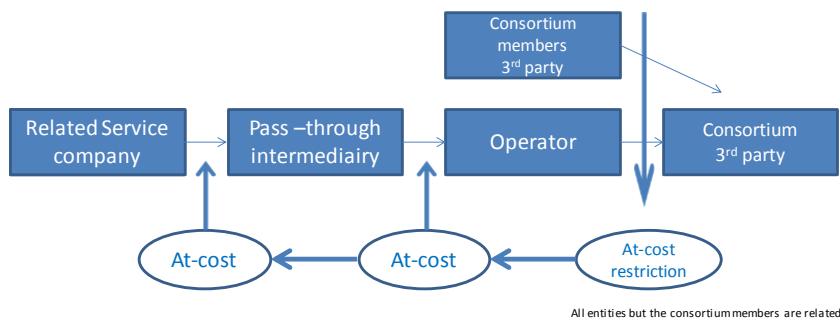
The Operator takes the position that the Consortium Agreement does not allow his associated service provider to charge a mark-up on its services. In case a mark-up on costs was to be charged, due to

commercial and legal arrangements, the consequences would include cost rejections by PSC and JOA partners and double taxation.

Considerations

The issue to be resolved is whether the consortium arrangement provides a comparable basis for asserting that charging at cost is appropriate.

The following figure depicts how the at-cost restriction for services rendered by all consortium members is passed on to the operator or service company.



Example 8: Performance Guarantees and Bonds

Facts

Country A awards an oil and gas exploration and development license to Operating Company X. Operating Company X is incorporated in developing Country A, and is a subsidiary of Company Y. Company Y is incorporated in Country B. Country A, as a condition for awarding the license, requires two types of guarantees with respect to Company X's obligations. First, Country A insists that parent Company Y guarantee in full the obligations Company X has agreed to under the license contract throughout the contract life. Second, in addition to the parent company guarantee, Country A requires a more limited, but a third party provided, performance bond granted in favor of host Country A. Under this bank performance bond, an unrelated third party, Bank Z,

guarantees 7.5% of the total obligation value under the contract for the first 4 years of the agreement.¹⁶

Findings

Country A's tax authorities review the performance guarantee provided by parent Company X and find that no charge has been made to its subsidiary, Company Y. They further note that in the case of the performance bond provided by independent Bank Z, a fee has in fact been charged. After further researching the bank guarantee, it is determined that the capitalization of Company A is sufficient to satisfy the coverage requirements of the bank for its level of exposure, but if the exposures were materially higher, Bank Z would not issue the performance bond without additional capital or further protections.

Considerations

The issue involved is whether the parent Company X should charge a fee for providing its performance guarantee for Company Y's obligations and, if so, how should the appropriate level of the fee be determined.

One approach to be explored is whether the third party Bank Z's fee for its guarantee can be used as a comparable to determine what an arm's length fee for Company X's guarantee should be. In evaluating this, a key difference can be observed, i.e., that the level and timeframe for Bank Z's exposure is far different from that of Company X. This

¹⁶ See for example, Article 29.1 of India Model Production Sharing Contract quoted in Table 1 at A.4. reads: 29.1 Each of the Companies constituting the Contractor shall procure and deliver to the Government within thirty (30) days from the Effective Date of this Contract: (a) an irrevocable, unconditional bank guarantee from a reputed bank of good standing in India, acceptable to the Government, in favour of the Government, for the amount specified in Article 29.3 and valid for four (4) years, in a form provided at Appendix-G; (b) financial and performance guarantee in favour of the Government from a Parent Company acceptable to the Government, in the form and substance set out in Appendix-E1, or, where there is no such Parent Company, the financial and performance guarantee from the Company itself in the form and substance set out in Appendix-E2; (c) a legal opinion from its legal advisors, in a form satisfactory to the Government, to the effect that the aforesaid guarantees have been duly signed and delivered on behalf of the guarantors with due authority and is legally valid and enforceable and binding upon them; available at <http://petroleum.nic.in/docs/rti/MPSC%20NELP-VIII.pdf>

[See also the](#) Production Sharing Contract between Nigerian National Petroleum Corporation and Gas Transmission and Power Limited, Energy 905 Suntera Limited, and Ideal Oil and Gas Limited covering Block 905 Anambra Basin (2007); available at <http://www.sevenenergy.com/~media/Files/S/Seven-Energy/documents/opl-905-psc.pdf>

difference is clearly material, and the tax authorities will need to assess whether some type of “multiplier” to that fee can be made. They will also need to consider what additional protections a third party bank would seek.

An additional consideration could be a finding that for related party contract guarantees, such as the parent company guarantee in the example, prevailing practice is that there is generally no charge to the in-country affiliate for a parent company guarantee.¹⁷ The basis for not charging a fee in these circumstances is the guarantee is often viewed as a requirement for the affiliate (and indirectly, the parent) to qualify for the contract and is thus just as much a benefit to the parent as to the affiliate. Alternatively, the parent guarantee is often viewed as simply the equivalent of an agreement to further capitalize the subsidiary if needed to meet its obligations, and generally not something for which a fee is charged.¹⁸

¹⁷ See “Parent company guarantees and performance bonds”, Shepherd and Wedderburn (2010) noting “...a parent company guarantee should be provided at no cost to the developer, whereas there will be [a] charge for [third party] performance bonds...”; available at <http://www.shepwedd.co.uk/knowledge/parent-company-guarantees-and-performance-bonds>

¹⁸ See OECD and UN Transfer Pricing Manuals regarding intra-group services and when a charge may be appropriate. UN Manual Intra-Group Services paragraph 22 provides: “Shareholder activities are activities that are carried out by or on behalf of a parent company [or any shareholder] and relate to the parent company’s role as the ultimate shareholder of the MNE group. These activities may be carried out by the parent company or on its behalf. Shareholder activities include: ... • the activities of the parent company for raising funds used to acquire share capital in subsidiary companies; and • the activities of the parent company to protect its capital investment in a subsidiary companies.”