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Item 3(e) of the agenda

Update of the Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries
Chapter 5: Transfer Pricing Issues

Note by the Secretariat

Summary

This chapter responds to that need and highlights some of the transfer pricing issues arising in the extractive industries. The chapter draws on materials that have been published in other forums, including the Platform for Cooperation on Tax (the Platform) reflecting enhanced collaboration between the International Monetary Fund (IMF) Organization for Economic Cooperation and Development (OECD), the United Nations and the World Bank Group (WBG) for the benefit of developing countries. Reference can be made to the Platform's Toolkit for Addressing Difficulties in Accessing Comparable Data for Transfer Pricing Analyses.

The present text is an update to the same topic part of the first version of the Handbook. The update was rendered necessary in part by the publication of a new update to the Transfer Pricing Manual, referenced throughout this text. The new text also seize upon new topics included in this Handbook update, particularly the chapter on Financial Transactions on which a couple of new practical cases are built.

The draft Chapter is presented for DISCUSSION and APPROVAL. The Subcommittee and the Secretariat are fully aware that in normal conditions the text would be presented twice to be approved. The text is in track mode to make it easier for the Committee to spot changes as compared to the previously published text.

Chapter 5

TRANSFER PRICING ISSUES

Executive summary

1. The first edition of the United Nations Practical Manual on Transfer Pricing for Developing Countries (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.[1]

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

(i) 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 United Nations Model Convention;

(ii) That it reflects the realities for developing countries, at their relevant stages of capacity development;

(iii) That special attention should be paid to the experience of developing countries; and

(iv) That it draws upon the work being done in other forums.

3. The 2017 Manual is organized into four parts:

(i) Part A relates to transfer pricing in a global environment;

(ii) Part B contains guidance on design principles and policy considerations;

(iii) Part C addresses practical implementation of a transfer pricing regime in developing countries; and

(iv) Part D contains country practices.

4. 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 transfer pricing documentation, audits and risk assessment, dispute avoidance and resolution and establishing transfer pricing capability in developing countries. Finally, the Manual provides an overview of certain country practices and perspectives on transfer pricing.

5. In the course of the work of the Extractive Industries Sub-com-mittee, a need was identified to develop a guidance document containing and analysing some examples on transfer

[1] The updated United Nations Manual on *Transfer Pricing for Developing Countries* is available at http://www.un.org/esa/ffd/wp-content/uploads/2017/04/Manual-TP-2017.pdf.

Commented [1]: Include link to the latest version of the manual.

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pricing issues in extractive industries, both relating to the production of oil and natural gas and relating to mining and minerals extraction.

6. This chapter responds to that need and highlights some of the transfer pricing issues arising in the extractive industries. The chapter draws on materials that have been published in other forums, including the Platform for Cooperation on Tax (the Platform) reflecting enhanced collaboration between the International Monetary Fund (IMF) Organization for Economic Cooperation and Development (OECD), the United Nations and the World Bank Group (WBG) for the benefit of developing countries. Reference can be made to the Platform's Toolkit for *Addressing Difficulties in Accessing Comparable Data for Transfer Pricing Analyses*.[2] The Toolkit includes a Supplementary Report on *Addressing the Information Gaps on Prices of Minerals Sold in an Intermediate Form* (the Supplementary Report). Reference can also be made to the WBG Extractive Industries work and materials[3] and the publication *Transfer Pricing in Mining with a Focus on Africa*.[4]

7. This chapter looks specifically at the value chain of mining and mineral extraction and of the production of oil and natural gas. Table VI.1 in the first part of the chapter 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.

8. Thereafter, the chapter 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 chapter 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 chapter and the Manual be consulted together.

Transfer pricing issues that may arise in the extractive industries

9. Transfer pricing issues in the extractive industries 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:

a~~i~~. Marketing / procurement companies or branches; and

b~~ii~~. Offshore hedging companies.

(ii) Fragmentation of transactions (i.e., where MNEs enter into convoluted structures involving the inter-positioning of multiple companies, generally in low-tax jurisdictions (splitting out of functions and risks) to divide profits);

[2] Available at https://www.oecd.org/tax/toolkit-on-comparability-and-mineral-pricing.pdf.

[3] Available at http://www.worldbank.org/en/topic/extractiveindustries/overview.

[4] Pietro Guj et al., *Transfer pricing in mining with a focus on Africa: a reference guide for practitioners* (Washington, D.C., World Bank Group, Centre for Exploration Targeting, Minerals and Energy for Development Alliance, 2017). Available at http://documents.worldbank.org/curated/en/801771485941579048/pdf/112346-REVISED-Dated-Transfer-pricing-in-mining-with-a-focus-on-Africa-a-reference-guide-for-practitioners-Web.pdf.

(iii) Thin capitalization and other types of financial transactions that may lead to potentially deductible expenses or have other impact on tax base of taxpayers;

(iv) Intra-group charges (e.g., technical fees and management fees); and

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

10. Table VI.1 below presents the transfer pricing issues that might develop during the course of business for those engaged in the extractive industry. These issues arise in conjunction with the major stages in the life of an extractive industry activity.[5]

Table VI.1:
Transfer pricing issues in that may arise in the extractive industries

Stage	Industry	Why is it an issue?	How to deal with this?
A: Negotiation and bidding			
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 transfer pricing (TP) methods (Comparable Uncontrolled Price—CUP—or Cost Plus) to assure reasonability of the price. However, comparability may be a real issue. 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 but also consult Chapter VI Section D4 of the OECD TPG and paragraph 6.190 regarding hart to value intangibles . 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. Transfers of extraction rights might happen directly or indirectly by transferring the shares in the entity holding the rights. For discussion of the issues arising in the indirect transfers of the shares in the entity holding the rights, see Chapter 4 of this Extractive Industry Handbook and the dedicated Toolkit issued by Platform for Collaboration on Tax.[6]
3. Advisory, consultancy,	Mining Oil and Gas	The costs for services form part of the capital	First consider the benefit test to ensure that the services are chargeable (general reference is made to part B.4 ("Intra-group

[5] With respect to the transfer pricing issues listed in Table VI.1, reference is also made to the Toolkit for Transfer Pricing Risk Assessment in the African Mining Industry, https://www.igfmining.org/beps/resources/toolkit-for-transfer-pricing-risk-assessment-in-the-african-mining-industry/.

[6] PST: The Taxation of Offshore Indirect Transfers— A Toolkit; For details see https://www.tax-platform.org/sites/pct/files/publications/PCT_Toolkit_The_Taxation_of_Offshore_Indirect_Transfers.pdf

managerial and technical services from related parties		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 price for such services to allow for future deductibility in the form of carry-forward losses.	services") in the United Nations Practical Manual on Transfer Pricing for Developing Countries ("the Manual"). Consider the most appropriate TP method (CUP, Cost Plus or Transactional Net Margin Method — TNMM — based on cost). Focus on verifying how the components of the cost base were established. Reference is also made to Chapter VII Section D of the OECD TPG as regards to ~~t~~the simplified approach for low value adding services and the guidance provided by EUJTPF on low value adding services.[7] Additional mitigation of such practices may take place when withholding taxes apply under domestic laws and also where taxing rights are retained under the Double Tax Treaty (i.e., through the Technical Services article). 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. Charging and allocation of costs are discussed in the Manual, paragraphs B.4.3.5 to B.4.3.9, and allocation keys are discussed from B.4.56 to B.4.62. 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 markup for the service provider. There is a tension between the joint venture partners on the one hand, who do not allow a profit markup where on the other hand the jurisdiction of the service providers would like to see and sometimes even demand a markup. 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 part B6 of the Manual or alternatively this issue could be addressed through a bilateral advance pricing agreement (APA).

[7] https://ec.europa.eu/taxation_customs/sites/taxation/files/docs/body/jtpf_020_rev3_2009.pdf

4. Performance guarantees	Mining Oil and Gas	It is not uncommon for the host country that awards a licence to a company to seek some form of guarantee from or through the parent company regarding the performance of the exploration and development contract. The transfer pricing question here is whether contract-related guarantees require an arm's length charge. Financing guarantees clearly would.	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 per cent of the contract obligations at various stages). Article 29.1 of the Contract states that "[e]ach 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 advisers, 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/sites/default/files/MPSC%20NELP-V.pdf.) 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). (Available at http://www.sevenenergy.com/~/media/Files/S/Seven-Energy/documents/opl-905-psc.pdf.)
B: Exploration and appraisal			
1. Transfer of exploration equipment	Mining Oil and Gas	Transfer of new equipment from a related party may not be at arm's length, especially with long lead equipment in a volatile world. Additional considerations may arise, where the new equipment is produced by a related party benefiting from special (tax) incentives. Transfer of existing equipment at a price that is too high may result in a step up in base, which may lead	Look at the proper application of the transfer pricing methods. Consider the application of group synergies (paragraphs B.5.2.28 of the Manual) and consider closer cooperation between customs and review of customs valuation (para. B.2.4.7.). This risk may be amplified if the jurisdiction has customs exemption for exploration equipment. The original contract should be reviewed considering the facts and circumstances that were available at the time of the signing of the contract. From a risk assessment perspective it may be worthwhile to inquire if any (tax)- incentives were available. If necessary, c~~C~~onsider using the mechanism of Exchange of Information to collect documents that are not available. ~~upon~~

		to excessive depreciation charges. Extra attention may be required when the sale is structured through an intermediary related entity with a favourable tax treatment.	~~request, where the taxpayer may not collaborate in making them available.~~ For oil and gas, the cost-only practices described in section A.3 of this table and the required agreement of joint venture partners may reduce these risks for the country whose resources are being developed but might require a buy-in of knowhow and IP which needs to be valued~~.~~
2. Lease of exploration equipment	Mining Oil and Gas	Overstatement of lease rental rates is possible, either because of hiring from related parties or arrangements made by related parties. Additional considerations may derive from the relevance of the particular provisions in domestic law and bilateral DTA, which may require application of withholding tax on the lease payments (i.e. Art 12 UN MTC).	Look at the proper application of the transfer pricing methods. Consider the application of group synergies (paragraphs B.5.2.28. of the Manual) and risk assessment (paragraphs B.2.3.2.23.). Challenges may arise in case of long-term contracts, which were concluded at the particular moment of economic cycle. The original contract should be reviewed considering the facts and circumstances that were available at the time of the signing of the contract. Reference is also made to the comment on the cost-only practices and the joint venture partners in section B.1 of this table.
3. Exploration services: seismic, drilling, sampling and analyses	Mining Oil and Gas	Related parties' involvement in these activities may lead to overstatement of the value of these services, which creates high cost base for future depreciation.	See section A.2 of this table. Applicable tax treaties may have specific rules for the extractive industry, e.g., exploration-related permanent establishments. Reference is made to the discussion in Chapter 3 on Permanent Establishments. Reference is also made to the comment on the cost-only practices and the joint venture partners in section B.1 of this table.
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 the form of carry-forward losses.	See section A.3 of this table.
5. Financing/ Guarantee/ Funding arrangements	Mining Oil and Gas	Level of possible interest payments which may be 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 section A.2 of this table. 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 discussion in Chapter 4 (Indirect Transfer of Assets).
2. Purchase/lease of plant, equipment and machinery	Mining Oil and Gas	See sections B.1 and B.2 of this table.	See sections B.1 and B.2 of this table. Reference is also made to the comment on the cost-only practices and the joint venture partners in section B.1.
3. Advisory, consultancy, managerial and technical services from related parties	Mining Oil and Gas	See section B.3 of this table.	See section B.3 of this table.
4.Financing/guarantee/ funding arrangements	Mining Oil and Gas	The interest rate or other conditions of the financing agreement could give rise to transfer pricing issues.	See section B.4 of this table. Some countries may address this issue in their non-transfer pricing rules. In this respect see, for example, Action 4 final report of the OECD BEPS Project, which was further elaborated with the focus on Mining Industry in the joint IGF-OECD Paper[8].
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 relates to whether the transaction is a bona fide sale or bona fide lease. In this respect, reference is made to the Manual, paragraphs. B.2.3.1.4–B.2.3.1.9. 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 sections B.1 and B.2 of this table.	See sections B.1 and B.2 of this table. Reference is also made to the comment on the cost-only practices and the joint venture partners above in B.1.
3. Advisory, consultancy,	Mining	See section A.3 of this table.	See section A.3 of this table.

[8] For details see: https://www.oecd.org/tax/beps/limiting-the-impact-of-excessive-interest-deductions-on-mining-revenue-oecd-igf.pdf

managerial and technical services from related parties	Oil and Gas	At this stage of the process, the MNE may be earning sales income and subsequently service fees may be charged calculated based on sales.	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 paragraphs B.4.4.19 of the Manual for examples of appropriate allocation keys.
4. Payments for use of intellectual property (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 part B.5 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 in section B.1 of this table. For use of IP in a CCA setting it will need to be considered if buy-in payments are required.
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, paragraph B.2.3.1.4 on delineation of the transaction. Developing countries should be aware of the fact that the OECD BEPS Action 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 be 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 in helping determine the arm's-length price in the sale between related parties. Reference is made to the Platform's Toolkit for Addressing Difficulties in Accessing Comparable Data for Transfer Pricing Analyses.[a] Especially its Supplementary Report, Addressing the Information Gaps on prices of Minerals Sold in an Intermediate Form (the "Supplementary Report").

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 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.	See section B.4 of this table. Reference can be made to the Transfer Pricing Guidance on Financial Transactions of the Inclusive Framework on BEPS: Actions 4, 8-10, which also contains ~~OECD~~ discussions on cash pooling and other relevant financial transactions.[9]
E. Processing (refining and smelting)			
1. Tolling fee for contract processing	Mining Oil and Gas	At issue is the appropriateness of the tolling fee where tolling is done by a related party to the 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 section E.6 of this table.
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~~ The 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 under-priced. Similarly, penalties	The price of the commodity is based on a reference price adjusted by items such as treatment charges, logistics, 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's Supplementary Report. 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 adjustments are arm's length. Therefore, industry know-how is crucial. Reference is made to the pricing practices paragraph of the Platform's Supplementary Report. As regards oil and 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

Commented [3]: Reference to the updated TP manual Chapter on financial transactions and add footnote with link to the TP manual.

[9] For details see: http://www.oecd.org/tax/beps/transfer-pricing-guidance-on-financial-transactions-inclusive-framework-on-beps-actions-4-8-10.htm

		for impurities in the concentrates may be overpriced. In the mining industry smelters sometimes enter into 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. In oil and 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. 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.	primary benchmarks that serve 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., American Petroleum Institute (API) gravity)[b] 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. To calculate the taxable income of oil and gas 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 oil and gas prices that best represent the market conditions. These reference 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 oil and gas 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 section A.3 of this table.	See section A.3 of this table.
4. Payments for use of IP	Mining Oil and Gas	See section D.4 of this table.	See section D.4 of this table.

5. Transportation	Mining Oil and Gas	The calculation of prices of transportation is generally based on comparables and Incoterms are relevant in this industry. The question is whether the Incoterms are appropriately applied within related party transactions. 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 payments (penalties, fees) are at arm's length.	Comparability factors need to be checked. Double check if the risks allocated to a related party can be managed and controlled by that party. The original contract should be reviewed considering the facts and circumstances that were available at the time of the signing of the contract.
6. Transfer pricing where different tax regimes are applicable	Mining Oil and Gas	The risk of profit shifting may arise in case there are different tax regimes available in a country. The processing and refining activities are often subject to lower tax rates than the extractive tax regimes. 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).	Reference is made to the United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries and to the issue of safe harbors, discussed in the Manual at B.8.8. It should be considered whether domestic laws even allow transfer pricing rules to apply in domestic transactions 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 also apply for the intra-company transaction, between the ring-fencing regimes.
F: Sales and marketing			
1. Marketing hubs	Mining Oil and Gas	The issue is to determine whether a related marketing hub is remunerated at arm's length, considering there are several remuneration models available. A company may be paid commissions under an off-take agreement that it has with producer. The commission needs to be	This can vary and therefore arrangements must be properly investigated. It is 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 percentage of sales. Consider whether the FAR of the marketing entity are in fact analogous to a typical distributor or whether they are rather routine support services. Consider also the value-add of the marketing entity to the

Commented [4]: Edit to reference and include in footnote the marketing Hub section/example of the TP manual please.

		reviewed as to whether the fee is at arm's length.	commodity product and the potential impact that may have on the arm's-length remuneration for the transaction. Reference is also made to the Manual, para. B.2.3.1.4. on delineation of the transaction. Access to information on the actual activities of the marketing entity will be critical for such analysis. This reinforces the point on obligations of taxpayer to obtain and provide the relevant information as well as the effective rules on information requests and/or Exchange of Information upon request.
2. Hedging gains and losses	Mining Oil and Gas	There is an issue when related party is the buyer of the commodity and is also the one doing the hedging for the producer.	It needs to be determined who manages and controls the risks whether the hedging gains and losses are allocated at arm's length. Issues to consider are whether hindsight is being used or if 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.	Various types of payment terms may be introduced in related party situations, which may potentially lead to (significant) adjustments to the transaction value. These adjustments may need to be carefully analysed both from the perspective of their nature and also their quantum. 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, while some of the general considerations related to the appropriate treatment of financial transactions referred to above remain relevant. 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 section E.5 of this table.	See section E.5 of this table.
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 the commodity, not only the income tax revenue but also revenue in the 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	Use of traditional TP Methods—CUP Method. Also see the Manual, at B.3.4.2. 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.

		time the long-term contract is executed.	
6. Abusive structures	Mining Oil and Gas	There are structures where an intermediary service provider is interposed to purchase the commodity, often below the market price, and sell it to independent parties at a profit. 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.	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 transactions of parties who do not fall within the definition of associated enterprises under domestic law. For example, Tanzania has a definition of related party/associate worded as follows: "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" [c] Where reference prices have been introduced, assure that they apply to all transactions—related party transactions and unrelated party transactions. An alternative approach could be introducing and applying controlled foreign corporation rules (CFC rules) or to have legislation which allows for a review of a series of consecutive transactions. ~~Reference is also made to Chapter 6 on the Tax Treatment of Decommissioning.~~
G. Decommissioning			
1. Decom-missioning services	Mining Oil and Gas	The price for decommissioning services provided by related parties may be overstated.	See section A.3 of this table. Reference is also made to Chapter 6 on the Tax Treatment of Decommissioning.

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 still be 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.	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. Reference is also made to the comment on the cost-only practices and the joint venture partners in section B.1 of this table.

[a] Available at https://www.oecd.org/tax/toolkit-on-comparability-and-mineral-pricing.pdf.

[b] 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.

[c] Tanzania, Income Tax Act, S. 3(d).

Generic case examples

11. 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 and gas industry.

Example 1: Marketing hub

Facts

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

13. 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

14. 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

15. 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.

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

17. 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 relevant provisions in the domestic law~~business profits article of the relevant tax treaty~~, in order to compensate Company B commensurate with the activities it performs.

See also table VI.1, section F.1, above.

Example 2: Information challenges

Facts

18. 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, their functional profile 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

19. 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

20. In many cases, there might not be an agreement for the exchange of information (EOI) or a 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 Country-by-Country (CbC) report requirements under the OECD Base Erosion and Profit Shifting (BEPS) Action 13 regarding transfer pricing documentation, it may receive access to relevant foreign information. For further guidance on effective implementation of TP Documentation requirements, see PCT Toolkit dealing with this matter.[10]

21. Without these international instruments in place, the tax authorities need to make sure domestic law clearly allows for the request of such information and the 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 Resale Price or Cost Plus Methods (see paragraph B.8.7. of the Manual) or taxation on a 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

[10] For details see: https://www.tax-platform.org/sites/pct/files/publications/PCT_Toolkit_TP_Documentation.pdf

22. 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.

23. 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

24. 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 as follows:

- Company A did not request any services from Company C;n
- ~~N~~o meetings were held to review the services requested and supposedly received from Company C;
- n~~N~~o records were provided of the respective services to Company A; and
- Company A arguably performed these services themselves internally (i.e., the services may be duplicative).

Considerations

25. 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 Plus 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 paragraphs 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.

26. 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.

Value chain for mining and minerals extraction

27. 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.[11] The transformation of minerals from the exploitation phase to the eventual trade, marketing and sale thereof typically follows a series of consecutive steps:

[11] Reference can be made to IMF, OECD, UN and WBG, "Supplementary Report—Addressing the Information Gaps on Prices of Minerals Sold in an Intermediate Form", in *The Platform for Cooperation on Tax*, which was released as part of the *Platform's Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses* (June 2017). The Supplementary Report provides guidance on identifying the types of mine and production methods. Available at http://www.oecd.org/tax/toolkit-on-comparability-and-mineral-pricing.pdf.

(i) Acquisition of the mining rights and exploration;
(ii) Construction and mine development;
(iii) Mining, processing and concentration;
(iv) Transportation;
(v) Smelting and refining; and
(vi) Trade, marketing and sales.

Functions

28. 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;[12] and

(d) Marketing and trading of commodity products, which may or may not include shipping and distribution.

29. 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 MNE.

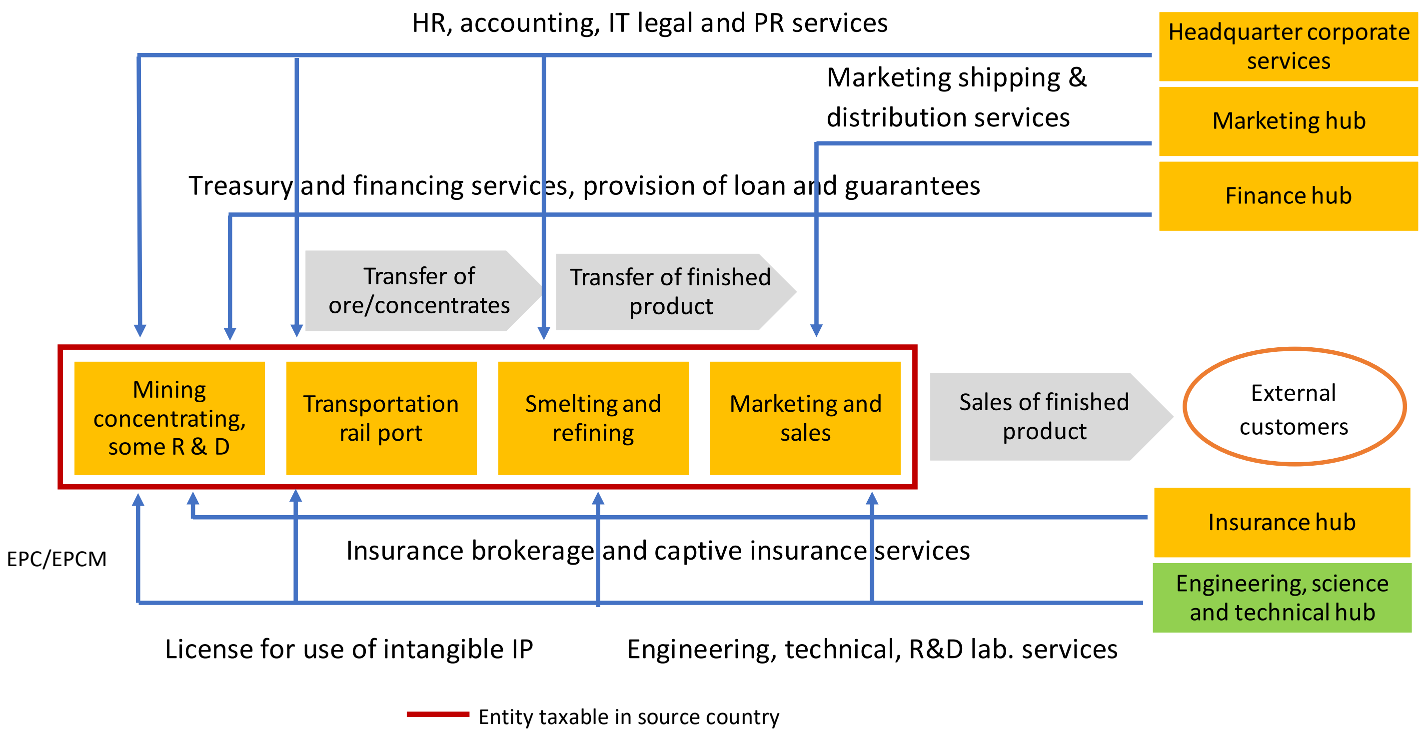
30. It should be noted that countries that grant licences for mining and extraction of minerals usually have a requirement that different activities performed by the mining company are treated as separate taxable objects and as separate taxpayers. They are ring-fenced, which means that for tax purposes 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 mineral 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.

31. To perform a transfer pricing analysis of companies engaged in mining and minerals 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 part B.2. (Comparability Analysis) in the Manual.

[12] Ibid. The document also provides guidance on financing arrangements affecting transacted product prices.

Figure V.1:[a]

Diagram of vertically integrated mining operation, including relationship with service provider hubs.[b]



a Pietro et al., *Transfer pricing in mining with a focus on Africa*

b Modified from the Transfer Pricing Handbook for the Mining Industry (Transfer Pricing Associates, 2012).

32. 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 for Collaboration on Tax Toolkit.[13]

33. A 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 United Nations 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.

Assets

34. Assets that can be considered and used by the MNE operating in mining and minerals extractive 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 in the Manual.

Table VI.2: [a]
Typical assets of a mining company

Exploration Discovery	**Mine Development and Construction**	**Mine 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	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)
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	Smelting and refining plant and equipment (T)	Product stocks (T)

[13] Available at https://www.oecd.org/tax/toolkit-on-comparability-and-mineral-pricing.pdf.

		(not by means of discovery) (I)		
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				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)
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				

[a] Pietro Guj, Stephanie Martin and Alexandra Readhead, *Transfer pricing in mining with a focus on Africa: a briefing note* (Washington, D.C., World Bank Group, German Cooperation Deutsche Zusammenarbeit, Centre for Exploration Targeting, 2017). Available at http://documents.worldbank.org/curated/en/213881485941701316/pdf/112344-REVISED-Transfer-pricing-in-mining-with-a-focus-on-Africa-a-briefing-note-Web.pdf .

Risks

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

36. 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 in part B.2. of the Manual.

Table IV.3:
Risks typically encountered by a mining company

Risks	**Acquisition /Exploration**	**Mining**	**Ore Processing**	**Trade**	**Marketing /Sales**

Exogenous					
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
Source: TPA Global					
— = Limited risk, x = Moderate risk, X = High risk					

Industry-related case examples

37. 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

38. 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.

39. 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.

40. In this scenario there are two pricing issues to evaluate:

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

(b) 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 (i) 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 (ii) above) the CUP Method may not be appropriate if the intermediary Distribution Company C performs substantial marketing/distribution functions. In that case, another method may be considered to determine the remuneration for the Distribution Company C, which will depend on facts and circumstances.

Findings

41. It was found that despite the fact that the sale of the commodity is on a back-to-back free-on-board (FOB)/cost, insurance and freight (CIF) (or "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. The 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

42. 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 Supplementary Report.

Example 2: Coal group marketing activities

Facts

43. 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.

44. Coal Company is a 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 per cent of Coal Company's revenue relates to coal that is exported.

45. 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.

46. 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.

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

Ability to blend different coal qualities to match customer requirements;

~~C~~coal specifications, for example the higher the caloric value and lower the impurities, the higher the expected price per ton;

~~P~~prompt delivery to end customers; and

~~F~~freight rates.

48. 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.

49. The market has changed drastically over the years. There has been a change in the grade of coal required by customers due to an 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.

50. Marketing Company has four employees. Based on the documentation reviewed and interviews conducted, only two 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

51. The Revenue Authority in Country A is of the view that seven~~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 two and four per cent.

Considerations

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

(a) What factors influence the sale of coal? Obtain an understanding of the coal industry and the economic environment in which the taxpayer is operating;[14]

(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;

[14] Please note that the *Platform's Supplementary Report* 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 (what are the roles and functional profiles of each of the companies – Coal Company, Marketing Company as well as the Advisory Company). 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; and

(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

53. 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 kilogram price that reflects the long-term commodity price, which is agreed to in the related party distribution agreement.

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

Findings

55. 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 (as in this case) drop. There is no benchmark made available to help substantiate the income allocation between the related parties.

Considerations

56. At 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 on an adjustment clause in case of changing market circumstances? What is the custom in the business? Tax authorities have to be careful in using a hindsight analysis. Is the risk of loss (or gains) upon price fluctuations allocated to the party that can best handle, manage and control the risks, when market conditions change? For example, did any of the parties enter into hedging agreements to mitigate price fluctuations?

57. To analyse 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

58. 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 per cent of the coal produced by Company A.

59. 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 per cent) off-take obligation. Company B takes flash title to the coal it off-takes from Company A and therefore does not carry inventory risk.

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Findings

60. 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.

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

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Considerations

62. 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

63. 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.

64. The taxpayer buys iron from associated enterprises in South America and sells the Iron to associated enterprises in Asia and the United States of America. About 80 per cent 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.

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65. The taxpayer reports a markup of 0.5 per cent 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 1~~0~~–1.5 per cent. Research also showed that the country of source of the iron provides a six-year tax holiday.

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

Findings

67. Even though the corporate tax rate in the developing country where the taxpayer is operating its buy-sell activities is 15 per cent, 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 per cent does not necessarily mean no transfer pricing irregularities will take place.

Example 6: Intercompany financing

Facts

68. The taxpayer is engaged in the exploration of minerals and mining.

69. The Parent company/Headquarter company is located in a developing country, with a US Holding company and two Africa-based mining and operation companies.

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

71. On the other hand, the Parent company borrows funds denominated in US dollars from associated enterprises for which it pays a London Interbank Offered Rate (LIBOR) plus 2.5 per cent interest rate.

72. 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 one-five per cent level.

73. 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.

74. The African mining company enjoys a tax holiday and other companies in the same industry normally report a cost plus four per cent.

Findings

75. 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.

76. 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.

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Example 7: Copper JV

Facts

77. A copper mine in Country M is owned and operated by a joint venture company, JV, organized under the laws of Country M. 45 per cent of the equity interests in JV are owned 45 per cent by Company A, a Country X subsidiary of a large mining conglomerate based in Country Y. 40 per cent 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 per cent of the equity interests in JV are owned by Company C, an entity wholly owned by the Government of Country M.

78. JV has entered into service agreements with Companies A, B and C pursuant to which JV agrees to pay an annual fee equal to five per cent 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 per cent withholding tax on dividends but has a treaty arrangement with Country X that provides that service fees are not subject to withholding tax.

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79. 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 five per cent of revenue payment. The Country M tax authorities learn further that Company C has never provided services of any kind to JV.

Analysis

80. The first step in 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.

81. 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, no deduction should be allowed for the five per cent fee and that it should be properly characterized as a distribution of profits to the holders of equity interests in JV.

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Example 8: Sale and leaseback of equipment

Facts

82. 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 five-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.

83. Immediately after the sale, Mining Company enters into a five-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.

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Findings

84. 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

85. 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 considers whether the transaction is a bona fide sale or bona fide lease. In this respect, reference is made to paragraphs B2.3.1.4–B2.3.1.9 of the Manual. 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); this creates room for arbitrage and generates tax benefits.

Value chain for the production of oil and natural gas [15]

86. 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 oil and gas companies to take on those activities. The main reason for this is to balance risks and rewards. Exploration and Production (E&P) contracts 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.

87. 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 with a project, such as (i) exploration risks (i.e., whether oil and gas reserves can be found in commercial quantities); (ii) development risks (i.e., the technical risks associated with the physical investment needed to produce and transport production to market); (iii) economic risks (the upfront capital outlays required prior to production and the ongoing operating costs of the project); and (iv) market risks (the price and supply/demand risks over a very long project life).[16] In return, the IOCs expects (a) a fair risk/reward relationship; (b) a fair rate of return on capital; and (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.

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[15] For more information, see Silvana Tordo, Brandon S. Tracy and Noora Arfaa, “National Oil Companies and Value Creation: Study and Results”, in *World Bank Working Paper 218* (Washington, D.C., World Bank, 2011). Available at http://go.worldbank.org/UOQSWUQ6P0.

[16] A more complete discussion of risks, including references, can be found in Chapter 1 (Overview) of this Handbook.

Upstream, midstream and downstream activities

88. 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). As with mining, the oil and gas industry requires significant upfront capital investments, but the upstream activity (i.e., the exploration risk in the oil and gas industry) tends to be riskier than in the mining industry.

89. 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; this part of the business is described 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.

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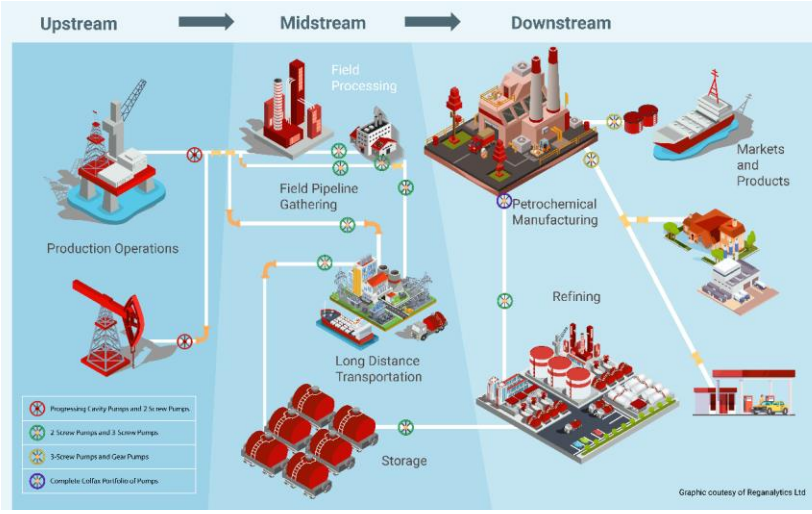
90. The figure below presents an overview of the respective upstream to downstream activities:

Figure V.2:
Upstream, midstream and downstream activities in the extractive industries



Source: Reganalytics Ltd

91. 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, as follows:

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(i) In a concessionary system, the oil company, as ~~licencee~~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 licence 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.

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

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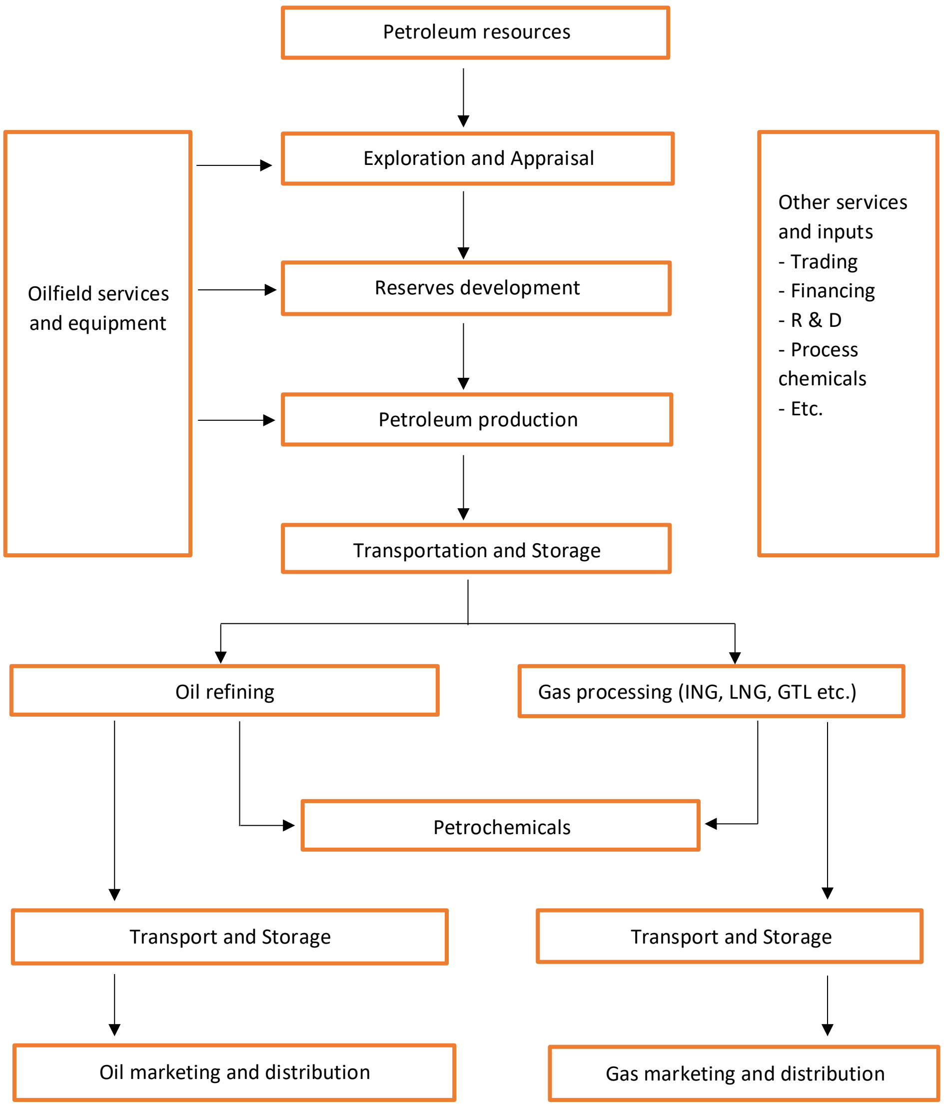
Figure V.3:
Upstream oil and gas industry value chain

Source: UN/DESA.

Below is a more detailed overview.[17]

[17] Silvana Tordo, Brandon S. Tracy and Noora Arfaa, "National Oil Companies and Value Creation: Study and Results" in *World Bank Working Paper 218* (Washington, D.C., World Bank, 2011). Available at http://go.worldbank.org/UOQSWUQ6P0.

Figure V.4:[a]
Petroleum value chain



[a] C. Wolf, *Does Ownership Matter* (2009)

94. The valuation of crude has been an area 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.

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Industry-related case examples

95. 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 VI.1, listing consecutive phases that extraction of minerals may involve. Other oil and gas industry issues that may be relevant from a transfer pricing perspective include:

- Central operating model;
- Financing cost;
- Intra-group guarantees;
- Cost sharing;
- Group synergies;
- Charging at cost; and
- Ring-fencing.

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

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97. Following is a compilation and series of real-life case examples regarding issues and facts encountered in practice with respect to the oil and gas industry.

Example 1: Oil acquired from related companies

Facts

98. 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 to produce fuel sold by Fuel Company.

99. 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).

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

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

Findings

102. 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 an FOB basis. Shipping Company is responsible for all freight and related activities and sells the crude oil to related Fuel Company on a 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

103. 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.

104. 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 (not at arm's length) Fuel Company could end up paying an inflated price for the purchase of crude oil from the related Shipping Company.

105. 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.

106. As Sourcing Company and Shipping Company are subsidiaries of Fuel Company, they are controlled companies and should be within the scope of domestic controlled foreign corporation (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" is in the Petroleum Industry and one of the major players involved in upstream as well as 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.~~

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Commented [OM5]: This example has been deleted. It is found to be very complex and some of its messages can be found in other examples.

~~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 five 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 happening. 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 this part to be reconsidered/redrafted to reflect real life practice perhaps?]~~

~~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 per cent 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 markup charged by Explore 1 should probably be investigated by the tax authority of the Upstream Company for the following reasons:~~

~~a. 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 performs its functions and assumes the risks it is said to perform.~~

~~b. 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.~~

~~c. The allocation of costs should further be investigated in terms of capital versus revenue, depending on the resident country's taxation rules on deductibility of start-up capital expenditure.~~

~~d. 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.] In addition, it is reported industry practice that in the O&G consortia arrangements, the partners in these arrangements commit to perform such activities at no-profit basis, which implies that also Zero mark-up may be relevant in some cases.~~

~~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 Finance 1, a subsidiary of the Company based in Country D. The finding is then evaluated using various factors, taking into account economic, political and geopolitical 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 the 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 various factors into consideration. 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 two per cent 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 start-up stage, is extremely high, usually at a one-to-six 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 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; or~~
- ~~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. See also Section B.5. and C.4. of the table.~~

~~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 Country 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 relatively 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:~~

> ~~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 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 a CIF or FOB basis 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 provided by the seller and 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:~~

> ~~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 Country 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). 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 five per cent 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:~~

~~Do the functions performed, the risks assumed and the assets used by the Trading Company warrant a commission of five per cent?~~

~~The interposing of the Trading Company has synergy benefits in terms of the overall group perspective. However, the following possibilities should be looked at to help determine if the amount paid can be considered to be at arm's 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 five per cent commission on sales.~~

~~*Cost contribution arrangements (CCAs)*~~

~~A global and regional cost contributionsharing arrangement on provision of services exists between the operational companies. The cost contributionsharing 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 contributionsharing agreement in the following areas:~~

~~Human resources;~~

~~Finance;~~

~~Legal;~~

~~Information technology; and~~

~~Communications.~~

~~Pursuant to the cost contributionsharing arrangement, all costs for the year are invoiced to the operational companies as per the allocation keys. The entity performing services under CCA is tax resident in Country 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; and~~

~~(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

107. Oil and Gas (O&G) Company decides 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 these years of high oil prices.

108. In 2014 the oil prices drop 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 the O&G Company.

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Findings

109. The O&G 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 standby and not currently in use.

110. At 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.

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Considerations

111. 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.

112. 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 and may request for price adjustments.

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113. To determine if the pricing applied is at arm's length, it is valid to consider all available information as well as the options realistically available to both of the parties to the transaction at the time the contract was concluded. 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 where unable to be invoiced to related parties due to inexistence of the service.

Example 4: Financing costs

Facts

114. 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 that may be deducted from the taxable tax base.

115. In the exploration phase it is usually not feasible to obtain loan financing given the exploration activities are capital intensive and 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.

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116. Because of the concession conditions, developing Country B disallows a portion of the interest costs incurred by oil and gas Operating Company while Country A includes the full interest in the tax base of oil and gas Parent Company resulting in double taxation.

Considerations

117. 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

118. MNE Group D ~~Company~~ consists of three taxpayer entities: Principal Company D, 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 D 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.

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

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

Findings

121. 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 1,000 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 1,000. Company 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 D's accounts will show total income of 250, consisting of 50 from Company B and 50 plus 150 from Company A. Principal Company D's costs of 200 (100 x 2) are paid to the service provider. Principal Company D's net income therefore is 50. The total Group taxable income ~~in Country M~~ is 800 + 50 = 850.

Considerations

122. These arrangements may lead to shifting of costs between ring-fenced blocks and effectively overriding the ring-fencing. 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.

123. Without the interposition of Principal Company D between Company A and Company B, and without making use of the success fee that Principal Company D 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.

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124. One can question whether the pricing between Company A and Company B and Principal Company D—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 D.

Example 6: Cost contribution~~sharing~~ arrangement

Facts

125. O&G Company has a development cost contribution~~sharing~~ arrangement in which all the operating entities participate. Under the cost sharing arrangement, 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 intellectual property (IP).

126. The O&G Company is rolling out a multi-year project to deploy a new information technology (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 one, the programme is rolled out in Countries A and B, but not yet in Countries C and D. Still the operating companies in Countries C and D need to bear their proportionately allocated costs under the cost sharing arrangement. In year two, the programme is rolled out also to Countries C and D.

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Findings

127. In year one, Country C and Country 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 receive a proportionate charge of the new IT system costs.

128. Under the cost sharing arrangements, 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.

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Considerations

129. Cost sharing arrangements generally consider anticipated benefits and not only current-year benefits (reference is made to the Manual, part B.6). A bona fide cost sharing arrangement requires consistent use of allocation keys among the participants. The applied allocation key should reflect a reasonable allocation of anticipated (future) benefits. Where countries would prefer cost sharing for services to 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

130. 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

131. The tax authority of the country where the related service company of the operator is located requires a markup on the services provided to the consortium.

132. The operator takes the position that the consortium agreement does not allow his associated service provider to charge a markup on its services. In case a markup on costs was to be charged due to commercial and legal arrangements, the consequences would include cost rejections by partners to the production sharing agreement and joint operating agreement and double taxation.

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Considerations

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

134. Figure VI.5 below depicts how the at-cost restriction for services rendered by all consortium members is passed on to the operator or service company:

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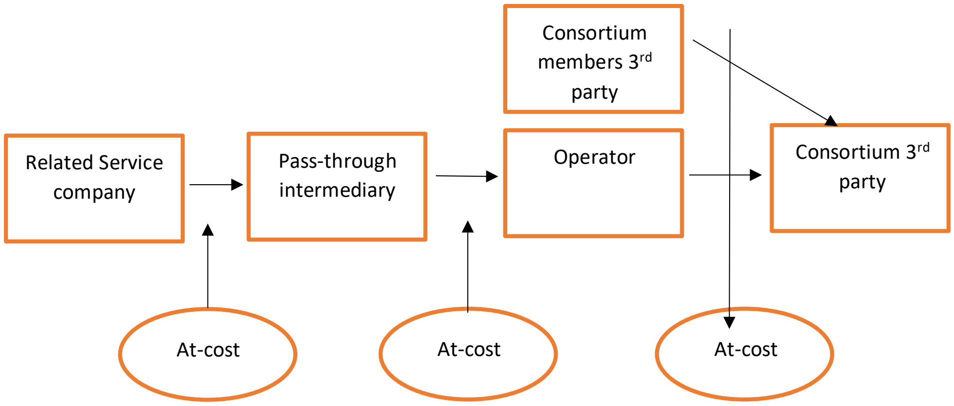
Figure V.5:
Flow of at-cost restrictions



Example 8: Performance guarantees and bonds

Facts

135. Country A awards an oil and gas exploration and development licence 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 licence, 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 licence contract throughout the contract life. Second, in addition to the parent company guarantee, Country A requires a more limited but third-party provided performance bond granted in favour of host Country A. Under this bank performance bond, an unrelated third party, Bank Z, guarantees 7.5 per cent of the total obligation value under the contract for the first four years of the agreement.[18]

Findings

136. Country A's tax authorities review the performance guarantee provided by Parent Company ~~X~~ Y and find that no charge has been made to its subsidiary, Company ~~Y~~X. 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~~ X 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

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

138. 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~~ Y'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~~Y. This 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.

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[18] See, for example, Article 29.1 of India Model Production Sharing Contract, as quoted in table 1 at A.4.: "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://www.dghindia.gov.in/assets/downloads/56ce986044a31ModelCBM.pdf. Also, see *Sharing Contract between Nigerian National Petroleum Corporation and (i) Gas Transmission and Power Limited, (ii) Energy 905 Suntera Limited and (iii) 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.

139. 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.[19] The basis for not charging a fee in these circumstances is that 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.[20]

Example 9: Transfer Pricing Issues of Loan Pricing

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The facts

140. MiningCo, HoldCo and FinCo are 100% subsidiaries of HeadCo. FinCo is the group's treasury company. HeadCo's rating is A+, the rating of the three subsidiaries is BBB. MiningCo is a mining company. On January 30, 2018 MiningCo signed a loan contract with HoldCo for an amount of EUR 200 million at a fixed rate of 12,5%. The aim of the loan is the purchase of a mining activity in MiningCo's country. The loan's maturity is 5 years. According to the contract, interest will not be paid annually but only at the request of HoldCo, based on MiningCo's financial performance. For the documentation of the loan following a request of information from tax authorities, MiningCo provided a transfer pricing study related to a loan of USD 800 million contracted by HoldCo with the internal bank of the group, FinCo. The maturity of this loan is 10 years (2017-2027). This study shows that HoldCo's cost of financing is 3.5%, i.e. an interest rate of 2.5% (the median interest rate from the comparability analysis) plus 1% of guarantee fee paid by HoldCo to the parent company, HeadCo. The credit risk premium applied on this loan, based

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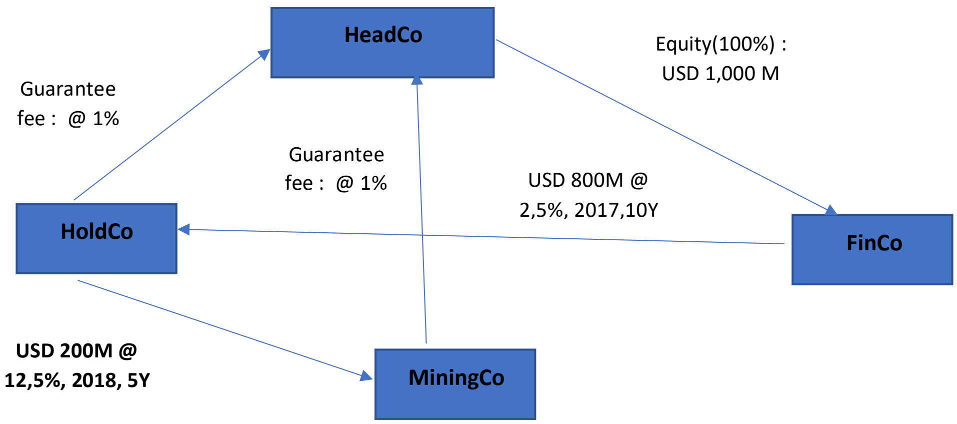
[19] See Shepherd and Wedderburn LLP, *Parent company guarantees and performance bonds* (2010): which notes that "(…) a parent company guarantee should be provided at no cost to the developer, whereas there will be [a] charge for [third party] performance bonds….". Available at http://www.shepwedd.co.uk/knowledge/parent-company-guarantees-and-performance-bonds.

[20] See the United Nations Manual on Transfer Pricing for Developing Countries and the OECD Transfer Pricing Guidelines regarding intra-group services and when a charge may be appropriate. The former provides:

> "B.4.2.13. Shareholder activities are activities undertaken to provide an economic benefit only to the shareholder company (ultimate parent company or any other shareholder such as an intermediary holding company, depending on the facts of the case) in its capacity of shareholder. Accordingly, the cost of shareholder activities should be borne exclusively by the shareholder. Shareholder activities performed by an associated enterprise on behalf of its parent company should be charged to the parent company on an arm's length basis."
>
> B.4.2.14. Shareholder activities may include the following:

- 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 subsidiary companies."

on MiningCo's rating (BBB) and the country risk, is 9%. Furthermore, following the contract, MiningCo has to pay an upfront fee of 2%.



141. In addition, within the framework of a group services agreement signed with the parent company HeadCo, MiningCo has to pay 1% guarantee fee. This guarantee is required by HoldCo, the lender, as a condition for accepting the loan application. Following this payment the total interest rate of this loan is 14.5%.

What is the concern?

142. This loan arrangement raises several questions for the tax authorities in MiningCo's country:

(i) The implied credit risk premium of 9% may not be arm's length. A credit risk premium is the interest rate charged by banks on loans to private sector customers minus the "risk free" treasury bill interest rate at which short-term government securities are issued or traded in the market. This risk premium should be checked against the risk premium in MiningCo's country. The transfer pricing analysis does not contain any additional evidence to support this particular loan instrument attracts additional risk at the time it was issued.

(ii) The guarantee granted by the parent company is a written explicit financial guarantee, however there is no evidence that MiningCo received a real

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economic benefit from entering into the financial guarantee. It does not appear MiningCo was able to access a larger amount of borrowing and/or at a reduced interest rate.

(iii) Consideration of parental support is an important element in assessing the arm's length nature of the interest rate. Undertaking an assessment of the strategic importance of MiningCo to HeadCo to understand if the subsidiary is considered in the core portfolio of key assets of HeadCo will assist in determining if the credit rating of BBB needs to be notched up due to implicit support provided by HeadCo. Global credit rating agencies publish information which can assist with determining an appropriate notching adjustment.[21]

(iv) The interest rate paid by HoldCo on the loan from FinCo is based on a benchmark of bonds whose principal amounts are significantly larger than the MiningCo loan and that have longer maturities. There is an issue of comparability. The amount and maturity have an impact on the risk and therefore on the risk premium. No adjustments have been made to account for these differences. The tax authority should seek to identify any other third part debt arrangements which may have been entered into by the HeadCo group in January 2018 as this loan may be traceable to the acquisition of MiningCo and assist with undertaking a pricing analysis.

(v) An upfront fee is a fee paid to a lender by a borrower as consideration for making a new loan to reflect specific types of costs or activities that may be related to the origination of the loan. Those costs/activities may not have been present in this case.

(vi) Interest will be paid at the request of HoldCo based on MiningCo's financial performance. First, this clause could indicate that in substance, it is not really a loan but a contribution of equity, as the remuneration is similar to a dividend.[22] The tax authority should review the local countries debt/equity rules as there may be legal ground to deny interest deductions where the amount is deemed to be equity under the local country tax rules. Second, with this clause, HoldCo can only request the payment of interest when MiningCo has generated profits which ultimately delays collection of tax to a later date.

(vii) Determining the commercial purpose of the basis of interest payments would be important. E.g. it is not uncommon for payments of interest to be

[21] The fact that the MiningCo is one of the core entities of the MNE Group may have the practical effect that the credit rating may be significantly higher or even the same as the credit rating of the MNE Group.

[22] Such characteristics of the financial instrument could lead to the conclusions that the loan should be accurately delineated as equity, rather than being treated and priced as a loan. Furthermore, such characteristics may be also leading to the outcome that the recipient's jurisdiction will treat the income paid under this instrument also as dividend and this could lead to double non-taxation due to the "deduction/non-inclusion" effect. The rules and provisions recommended under G20/OECD BEPS Action 2 addressing the Hybrid mismatches could be of relevance in this case.

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deferred until there is positive cash flow to repay debts, otherwise additional debt would be required make repayments. However as HoldCo can control to some degree when interest is paid, if the local country tax rules allow interest deductions only when payments are made, rather than when interest accrues, then it may be possible to circumvent the interest limitation rule if it is based on an EBITDA test (refer to the Financial Transactions Chapter further information)"

Example 10: Currency Hedge

Facts

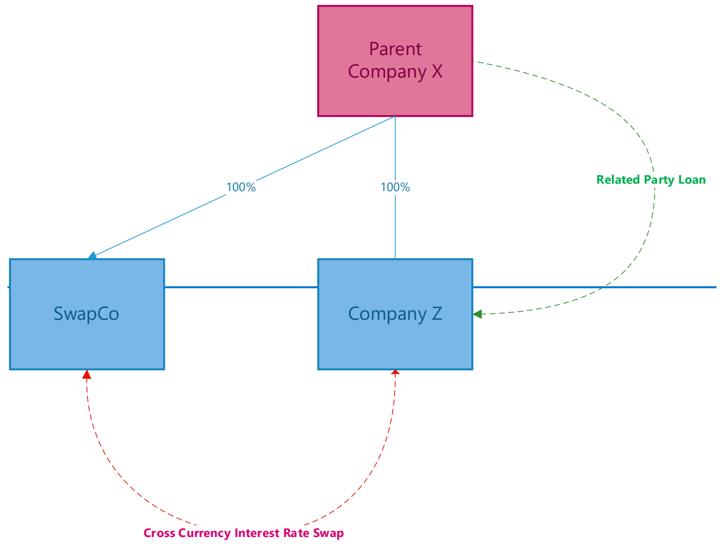
143. Extractive Parent Company X is a large multinational company based in Country A and operates in several countries around the world. Like most extractive companies, Parent Company X has a functional currency of US dollars.

144. Subsidiary Company Z is a subsidiary company of Parent Company X that operates in Country B. It is one of several production entities within the Company X MNE group. Company Z is producing extractive materials and is selling the material to an unrelated third party buyer. Company Z is paid by the unrelated third party buyer in US Dollars. Company Z has an accounting functional currency of US Dollars and has elected under the domestic tax regime of Country B to have tax functional currency of US Dollars.

145. Company Z is also undertaking significant expansion in its operations which requires large capital expenditure investment and a moderate short term increase in operating expenses. The capital expenditure comes from a third party supplier and is paid for in US Dollars. The operating expenses are mostly denominated in the local currency of Country B, however, a small proportion of specialised consultants and engineers are paid in foreign currencies such as US Dollars and Euros.

146. Company Z requires additional financing to fund the expansion of the operations and is provided a related party loan from Parent Company X. The loan is priced on arm's length terms and is denominated in US Dollars.

147. Company Z is of the view that because most of its operating expenses are in a local currency, it requires funding in the local currency of Country B. Company Z enters into a cross currency interest rate swap (CCIRS) with a related party SwapCo, which swaps the US Dollar loan into the domestic currency.



Financial outcomes

The cash consequences of the CCIRS operates in three ways:

1. The initial principal is exchanged from US Dollars into Country B's local currency

2. Periodic interest payments are exchanged so that Company Z pays in local currency

3. At the swap contract maturity, the principal will be re-exchanged

4. The total borrowing cost of the financing is the interest expense *plus* the hedging expenses

Tax outcomes

Subject to laws of Country B:

1. There is a tax deduction for the interest accrued

2. There is withholding tax on the interest payment to a related party foreign resident

3. There is a crystallised tax gain or loss on the periodic interest payments, depending on the difference between the swap obligations and the *actual* spot exchange rate at the time the interest payments are made.

4. There is generally no withholding tax on the swap payments

5. There is a crystallised tax gain or loss at maturity when the principal is re-exchanged, depending on the amount agreed under the CCIRS and the *actual* spot exchange rate at the CCIRS maturity.

Considerations

1. What type of foreign exchange (FX) risk is Company Z seeking to manage?

In this example, Company Z faces a general operational FX risk as it generates income in US Dollars but incurs operational costs in another currency (Country B local currency). This is not uncommon in the extractive sector as commodities are almost exclusively sold on a US Dollar basis but most of the resources are located outside of the United States.

As part of its economic FX risk, Company Z purported to include its financing costs, thereby requiring a CCIRS.

2. What are the options realistically available for Company Z to manage its FX risk?

Foreign exchange risk is managed typically through natural hedging or hedging with financial instruments.

Natural hedging refers to operational changes that mitigate or eliminate FX risk without the use of financial instruments. Alternatively, a MNE may choose to use financial instruments that are negotiated privately or through a public exchange to mitigate the FX exposures.

3. Were the actions taken by Company Z economically rationale given the options realistically available?

Company Z earns income on a US Dollar basis and therefore had a natural hedge against a US Dollar borrowing.

In the absence of a CCIRS, there is a transactional FX exposure if the funding arising from the loan is needed to pay for operational needs. By entering into a CCIRS to swap the US Dollar loan into the local Country B currency, Company Z is able to mitigate any translational FX risk with operational expenses.

However, a loan denominated in the local currency has created new FX exposures:

i) to service the interest on the loan, Company Z will need to exchange its US Dollar income into the local currency. This creates a translation risk every time the periodic payments are due on the CCIRS

ii) There is a significant FX exposure once the CCIRS matures, when Company Z will be required to re-exchange the principle in local currency

iii) Company Z will need to exchange the local currency loan into US Dollar again if the loan funding is required to pay for capital expenditure

iv) From the MNE group's perspective, unless SwapCo entered into a back-to-back arrangement with a third party, the FX risk the CCIRS purports to mitigate remains within the group and is unhedged.

In this example, the additional FX risk created by the CCIRS is likely to exceed the risks its purports to mitigate and the commercial rationale to enter into a hedging arrangement is questionable.

4. Is the transaction priced on an arm's length basis?

Asymmetrical hedging arrangements are a transfer pricing risk and need to be benchmarked against publically traded derivatives to determine whether they are priced on an arm's length basis.