Case Study
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Transfer Pricing in the Mining Sector in Zambia

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EXECUTIVE SUMMARY

Zambia's vast copper reserves have been the primary driver of its impressive economic growth, enabling the country to regain its status as a lower-middle-income country in 2011. According to a report by the International Council of Mining and Metals (ICMM), copper mining accounts for over 80 percent of export earnings in Zambia, contributing at least 12 percent of gross domestic product (GDP) and 30 percent of total tax revenue.[1] Despite the large and positive impact of mining on government revenue, international NGOs and academics have raised concerns that Zambia may be losing up to US $500 million per year due to illicit transfers by mining companies. Former vice-president of Zambia, Guy Scott, suggested that this figure might be as high as US $2 billion per year. The government has initiated an appropriate policy response to the problem of transfer pricing in the mining sector, however further efforts are required to ensure effective implementation.

Transfer pricing is the mechanism by which prices are chosen to value transactions between related legal entities within the same multinational enterprise (MNE). These are referred to as "controlled transactions" and may include the purchase and sale of goods or intangible assets, the provision of services, the provision of financing, cost allocation, and cost sharing agreements. As long as the price that is set matches the "arm's length" price at which a transaction would have taken place between unrelated parties, this is not problematic. However, transfer pricing may become abusive or illegal when related parties seek to distort the price as a means of reducing their overall tax bill. In these instances the practice may be referred to as "transfer mispricing."

This case study investigates the barriers to implementation of transfer pricing rules in the mining sector in Zambia. It forms part of a series of five country case studies including Ghana, Guinea, Sierra Leone and Tanzania. The result of this study is a number of recommendations that aim to provide guidance on practical steps to strengthen enforcement of transfer pricing rules in the mining sector. The recommendations can be broadly grouped into four categories: transfer pricing legal framework, administrative arrangements, knowledge and skills, and information.

1 International Council of Mining and Metals, and the Chamber of Mines Zambia. *Enhancing Mining's Contribution to the Zambian Economy and Society* (2014), 6.

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Overview of recommendations

		Recommendation	Responsibility
Legal framework	1	Fast track the approval of the transfer pricing regulations to ensure that Zambia has a well-established legal framework to pursue transfer pricing cases.	Ministry of Finance
	2	Explore complementary tax avoidance measures such as capping management fees and limiting the deduction of related party payments as a percentage of total income. These additional measures will help safeguard the tax base and reduce the transfer pricing monitoring burden.	Ministry of Finance
Administrative arrangements	3	Maintain the current approach of embedding transfer pricing specialists within the mining and non-mining audit teams, rather than moving to a stand-alone transfer pricing unit. Ultimately, a hybrid approach may be most appropriate: expanding the network of embedded transfer pricing specialists, who report to a small transfer pricing team that provides technical support, consolidates learning, develops tools, and facilitates capacity building.	Zambia Revenue Authority (ZRA)
	4	Establish a formal coordination mechanism for the sharing of mining information and expertise.	Ministry of Finance Ministry of Mines (MMMD) and ZRA
	5	Strengthen the coordination function of the Zambia Extractive Industries Transparency Initiative (ZEITI), bringing together government, companies, and civil society on a regular basis, to improve information sharing, and build mutual respect and trust.	ZEITI Secretariat Head of state
Transfer Pricing information	6	Clarify roles and responsibilities with respect to the collection of information in the mining sector. There should be agreement on who is collecting what information, from whom, by when, and how the various government institutions plan to share the data.	MMMD and ZRA
	7	Harmonize the Mineral Value Chain Monitoring Project and the Mineral Production Monitoring Support Project to prevent parallel reporting systems, and conflicting production and export figures from becoming further entrenched.	MMMD and ZRA
	8	Expand current reporting requirements for mining companies to include information on expenditure.	MMMD
Knowledge and skills	9	Key officials from the MMMD should be selected for training on transfer pricing and other tax avoidance mechanisms. While the ZRA is the primary institution responsible for enforcing transfer pricing rules, given the role that the MMMD is expected to play in gathering and evaluating production data, it would be valuable for key officials to have some knowledge of transfer pricing, particularly as it relates to mining.	Government of the Republic of Zambia (GRZ) and international partners

TRANSFER PRICING LEGAL FRAMEWORK

Status of transfer pricing rules

Considerable progress has been made to establish transfer pricing capability in the Zambia Revenue Authority (ZRA), despite the fact that transfer pricing regulations are yet to be finalized.[2] The regulations were drafted by the ZRA and Ministry of Finance in 2012, with support from the OECD. However since then, the regulations have been held up at the Ministry of Justice due to a dismissal of state lawyers following a strike in 2014. The regulations are expected to be published in 2016. It was not possible to review the regulations in their draft form, however, according to ZRA officials, the regulations are broadly in accordance with OECD guidelines, although some detailed and complex elements have been left out. The draft regulations require taxpayers to follow the transfer pricing methods in order of priority, and where they are unable to adhere to this order they must provide adequate justification.[3]

According to ZRA officials, the main feature of the transfer pricing regulation is the documentation requirements which have been presented as a manual for taxpayers. The significance afforded to transfer pricing documentation reflects the challenges that the ZRA has experienced in implementing anti-tax avoidance provisions to date. When the ZRA has requested information, taxpayers have often not understood what is required, or referred the ZRA to their corporate headquarters. Subsequently, the ZRA concludes that taxpayers are obstructive. Setting clear expectations is a way of limiting the potential for such standoffs. The regulations will clarify what transfer pricing documents taxpayers are expected to keep at their premises in Zambia, how often the documents must be updated, and when they are must be submitted. This should make the transfer pricing audit process more efficient and consistent.

That taxpayers are not legally obligated to keep transfer pricing documentation has been a major obstacle to implementation of the arm's length principle in Zambia. This has been resolved in the draft transfer pricing regulations, which should be passed in 2016.

Until the transfer pricing regulations are formally introduced in 2016, the ZRA continues to rely on Section 97a of the Income Tax Act (ITA) of 2006 as the legal basis to adjust non-arm's length transactions. Section 97 was amended in 2014 to bring the language in line with international standards and to empower the finance ministry to develop transfer pricing regulations. In particular, Section 97 specifies the documentation to be kept by taxpayers and the penalties for non-compliance. The amendment established the legal basis for the ministry to draft the transfer pricing regulations that will be introduced in 2016. Currently, there are no specific penalties for TP, instead the standard penalties in the ITA are applied.[4] The new Mines and Minerals Development Act (MMDA) of 2015 includes penalties relating to preparation of documentation, however they are relatively general. The specific penalty provisions in the draft mining regulations are not strong enough, creating an opportunity to debate which specific penalties apply to mineral production reporting.

Despite the lack of transfer pricing regulations, the ZRA has established a team of four transfer pricing specialists in the Large Taxpayers Office (LTO), and provided basic training to all ZRA officials. Under Section 97 of the ITA, the transfer pricing specialists embedded in the mining audit team have conducted more than ten transfer pricing adjustments: three cases are at the tribunal stage, two or three have progressed to court, and the remaining cases are still being finalized internally. The

2 Transfer pricing rules should be understood as meaning primary tax avoidance legislation, plus regulations, recognizing that most countries have the former, but not always the latter.
3 Transfer pricing methods are used to calculate the arm's length price.
4 The standard penalties are as follows 17.5 percent of the amount for negligence, 35 percent for wilful default, and 52.5 percent for fraud.

lack of transfer pricing regulation has not prevented the ZRA from applying Section 97. The only challenge has been accessing the relevant documentation from mining companies, hence the emphasis on documentation rules in the draft regulations. According to the head of the LTO, the only difference the regulations will make is with respect to transfer pricing documentation. The fact that taxpayers are currently not legally obligated to keep transfer pricing documentation has been a major obstacle to implementation of Section 97 of the ITA.

To limit the risk of transfer mispricing in relation to related party mineral sales, Sections 97A(13;14) of the ITA requires that the sale of base metals or any substance containing base metals or precious metals, between related parties, be calculated according to London Metal Exchange, Metal Bulletin, or other metal exchange market approved by the commissioner general. Due to challenges associated with collecting corporate income tax, the mineral royalty rate has also been increased from 3 percent, to 6 percent and 9 percent for underground and open pit mining respectively.

All mining agreements were abolished as part of reforms in 2008, yet it is still useful to consider the extent to which transfer pricing was prohibited when these agreements were in force. There is some variation: the agreements for Chambishi copper mine (1998) and Chibuluma mines (1997) explicitly required companies to sell their mineral products at arm's length, whereas this condition was absent in the Mopani mines agreement (2000) and the amended agreement with Konkola Copper Mines Plc (KCM) (2004) (although the KCM agreement did state that the government was not restricted from introducing transfer pricing rules despite stabilization clauses). The difference between these agreements is probably a reflection of the fact that in the late 1990s the netback approach was still used as the basis for computing royalties, making it harder to verify whether the realized sale price was indeed competitive rather than the norm value method used in later agreements. These discrepancies are less relevant now given that the agreements are no longer in force, and companies are required to comply with the reference price.

Alternative perspectives

The mining fiscal regime in Zambia has fluctuated considerably over the last few years, with royalty rates rising to 20 percent for open pit mines at one point. This is partly a response to the challenge of verifying deductible expenditure used to offset income tax. To overcome this challenge, an international expert who has worked closely with the ZRA has recommended that countries adopt more blunt measures in order to protect the tax base. He said, "Companies recommend the use of OECD transfer pricing rules but even the United States and Western Europe can't administer these rules effectively. Such rules are made by capital exporting countries for capital exporting countries. Let's abandon the arm's-length principle; the arm's-length principle has little or nothing to do with economics because there is no economic information contained in the transfer price. It would be better to have a clear simple arbitrary rule."

The rule being advocated is a limit on deductibility of related party payments as a function of earnings: interest expenses plus any payments to related parties will be restricted to a percentage of gross income. This is an extension of the interest deductibility rule proposed by the OECD.

> *For example, suppose a firm has spent US $90 in interest payments on a related party loan and purchases a good from a related party for US $60. Suppose further that the firm's earnings before interest, taxes, depreciation, and amortization (EBITDA) is US $220 and that there is a rule that limits deduction of related party payments to 50 percent of EBITDA. Without the rule on deductibility of related party payments the amount liable for deduction is US $150; with the rule the total amount liable for deduction is reduced to US $110, leaving a balance of US $40 to be carried forward.*

This rule is very similar to the production sharing approach in the petroleum sector, where it is common to cap cost oil as a certain percentage of annual production.[5] While limiting deductibility of related party payments should protect the tax base, the counterpart effect may be that mining companies take longer to recoup their investments, deterring further investment in the sector. It therefore requires careful consideration by policymakers.

Box 1. Transfer pricing reform process in Zambia

Despite the inclusion of transfer pricing provisions in the Income Tax Act since 1999, the ZRA only began to focus on comprehensive transfer pricing reform in 2012. The reforms began when four tax auditors within the LTO were assigned the role of transfer pricing specialist. Following this, the OECD produced the first draft of the transfer pricing regulations which the ZRA then commented on. The commissioner-general of the ZRA was particularly interested in advancing the transfer pricing reforms, and, due to a close working relationship with the finance minister he was able to get the requisite buy-in from policymakers. Having had some experience of pursuing transfer pricing cases previously, the ZRA was acutely aware of the need for robust documentation rules to clarify taxpayer expectations and avoid unnecessary delays in the audit process.

The major challenge so far has been delays within the Ministry of Justice. The draft transfer pricing regulations have been with the ministry since 2013. The primary cause of the delay has been staff turnover at the ministry, however even prior to this ministry officials had wanted to change various aspects of the regulations on the basis that they, "went against the direction of the law, and [were] too onerous on taxpayers." According to the ZRA, the justice ministry is generally of the view that the ZRA has too much power. This would seem to be a reasonable assessment of the ZRA, particularly given its unusually powerful role regarding the mining sector. Over the longer term, the ZRA plans to establish a separate transfer pricing unit within the LTO. The rationale for a separate unit is to enable transfer pricing specialists to focus exclusively on transfer pricing issues rather than having to also spend time participating in general audits.

5 Cost oil is the oil that a private company is allowed to sell to recover its costs, whereas profit oil is split between the contractor and the government, often the national oil company.

Relevant anti-tax avoidance rules

Thin capitalization

The government revised the thin capitalization rule for the mining sector in 2007. The initial debt-to-equity ratio was 2:1, however mining companies considered this too harsh and it was consequently revised to 3:1. This ratio is specific to the mining sector. There are no thin capitalization provisions for other sectors. In addition to the thin capitalization ratio, the government removed withholding tax on dividends as a way of further encouraging companies to invest more by way of equity.

While the thin capitalization ratio has proved a useful way of protecting the tax base, it hasn't diminished the risk of excessive interest payments on loans from related parties. A company may be within the 3:1 ratio but interest rates are not necessarily at arm's length. Consequently, once auditors have applied the thin cap ratio they will undertake further tests to determine whether interest rates have been calculated according to the arm's length principle. The ZRA uses Orbis, the transfer pricing database created by Bureau Van Dijk (BVD) to benchmark interest rates on similar loans within the industry. Previously, if debt was subject to the thin capitalization rule then the interest rate would not be subject to transfer pricing provisions, however this was changed in 2012.

Thin capitalization rules are not a silver bullet. There are many ways a company can manipulate the debt-to-equity ratio. Therefore it is necessary to investigate whether interest rates are arm's length, as well as introduce a limit on interest deductibility.

In addition to the interest rate risk, there is also a risk that companies will manipulate the debt-to-equity ratio via preference shares (for example) to put off paying income tax.

According to a senior official at the ZRA, "Thin cap rules are not a silver bullet; there are still many ways that companies can use equity financing to keep profit low or non-existent, it is important to investigate despite the ratio."

The ZRA is considering developing debt-to-equity ratios for other sectors in addition to mining. Some officials have expressed concern that there is too much focus on mining at the expense of other sectors that are also at risk of aggressive tax planning.

> **Box 2. ZRA rejects disallowed loan as equity**
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> A mining company had a long-term shareholder's loan of about US $61 million with an interest rate of 8 percent and no definite repayment period. The company claimed the loan should be treated as equity because it had no fixed repayment period and it had remained unpaid for a long period of time (over five years). The ZRA rejected the company's claim and made a made a tax adjustment adjustment of approximately US $5 million. The debt-to-equity ratio allowed at the time was 2:1 but the company had a ratio of well over 10:1.

Advance pricing agreements

There is currently no provision for companies to request advance pricing agreements (APAs). Like many tax administrations, the ZRA is hesitant to embark on APAs before they have built up their transfer pricing capacity for fear of signing bad agreements. The ZRA is also keen to improve monitoring of the mining sector before committing to APAs. However, the ZRA intends to consider such agreements in the next few years.

According to development partners, the introduction of reference pricing and the treatment of hedging as a separate activity may reduce the need for APAs in relation to nature resource sales. While this may be true, senior officials at the ZRA argue that there remains significant scope for APAs in relation to deductible expenditure. According to one official, "Companies are buying capital assets from related parties, once we have the capacity to better evaluate expenditure we should look to set parameters through APAs."

Although Zambia is yet to approve an Advance Pricing Agreement, tax officials anticipate using this mechanism to set parameters for cost deductions in the mining sector.

Box 3. Mark-up on mining machinery procured by parent company

It is difficult for the ZRA to evaluate the reported cost of mining equipment and machinery because: purchases are made by related parties, there is a lack of comparable data, and machinery may be project-specific.

During a recent audit of a local mining company, the ZRA found that the parent company was buying machinery and spare parts on behalf of the local company, to the extent that whenever a machine would break down they would order from the source on their behalf. The ZRA requested that the local company provide the invoices from the supplier to verify the cost of the equipment. This revealed that the parent company had made purchases from a global supplier of mining equipment, adding a mark-up in excess of standard industry rates, and then passing the inflated cost onto the local company registered in Zambia. The supplier was not aware of this. The transfer pricing adjustment is yet to be finalized.

Abusive hedging

The tax treatment of hedging has gone back and forth since 2008 when it was first delinked from core business income, meaning that losses from hedging could no longer be used to offset taxable profits from mining operations. The provision was reversed in 2009, and then reinstated in 2010. Given that most mining companies operating in Zambia hedge approximately 30-40 percent of production, there has been a lot of pressure on the government to treat hedging as part of the core business activity.

Despite the fact that hedging is now being treated separately, there are ongoing disputes with companies that have engaged in hedging in the past. Recently, a mining company took the ZRA to the Zambia High Court on the basis that it wrongly excluded hedging losses from the company's taxable income. The company is not disputing the fact that hedging now receives separate treatment. They are disputing the exclusion of hedging losses prior to 2008, when their development agreement was still in force and which allowed them to offset hedging losses against income. This may be an example of where the ZRA seeks to "overstretch the law." ZRA officials are aware that they are unlikely to achieve a successful outcome in court, as there is legal precedent requiring the government to uphold its contractual obligations to mining companies. However, the ZRA are convinced of the need to send a strong message that abusive hedging will not be tolerated.

Reference Pricing

In 1998, the finance ministry introduced reference pricing which requires mining companies to sell minerals according to the monthly average LME price, or, to the extent that base or precious metals are not quoted on the LME, companies must use the monthly average Metal Bulletin (MB) cash price. The provision was introduced to prevent companies from selling mineral products at non-arm's length prices to related or associated parties.

However, according to ZRA officials, even with the reference pricing requirement, companies do not always do the adjustments themselves and they may be selling to related parties and still using the contractual price rather than the legislated price. Consequently, implementation of reference pricing requires close monitoring.

Even as late as 2014, the ZRA had to make adjustments to royalty payments. The ZRA revealed one mining company that was still using netback. The company had started its calculations with the LME price, identified a number of costs including management fees to related parties, and then made deductions. The company rejected the ZRA's adjustment claiming that the legislation was too harsh and the deductions were genuine costs.

The fact that some companies are not following the reference pricing requirement is not surprising given the history of related party sales. According to one industry expert involved in the preliminary audits that were part of the Mineral Value Chain Monitoring Project (MVCMP), "All the sales contracts we examined were involved in transfer mispricing. The companies were using crude methods, simple variations in sale terms, and exaggerated discounts for related parties. You didn't need any specialized transfer pricing knowledge to pick them up."

While the pricing problem has been particularly apparent with some mines, subsequent reports questioned whether transfer mispricing in terms of sales is really such a big problem.[6] According to the International Council of Minerals and Metals (ICMM), of the four major mining companies covered in their 2014 report on the mining sector in Zambia, three had either zero or negligible sales to related parties.[7] While the risk of transfer mispricing has reduced considerably due to the introduction of reference pricing and the separate treatment of hedging losses, ZRA officials dispute the ICMM report, claiming that numerous companies operating in Zambia are selling their product to related parties. For example, it was recently confirmed in London's high court that Vedanta Resources, the parent company of KCM, was using a subsidiary Furaijah Gold to buy under-valued copper from KCM.[8] Consequently, the ZRA remains vigilant regarding related party sales and the risk.

The Zambia Revenue Authority has allocated transfer pricing specialists to the mining and non-mining audit teams. As a result, they have developed sector specific transfer pricing expertise as well as overcome potential internal coordination challenges.

TRANSFER PRICING ADMINISTRATIVE ARRANGEMENTS

Transfer pricing specialists

Since 2012 there have been four transfer specialists in the ZRA divided between the mining and non-mining audit teams in the LTO. The specialists are embedded within these general audit teams, working alongside auditors on integrated tax audits of mining companies. This decentralized approach seems to be working well. There is no problem of internal coordination as the transfer pricing specialists and general auditors are working together on the same audits. It has also enabled the ZRA to develop transfer pricing expertise specific to the mining sector.

6 According to a preliminary audit report from 2009, "Mopani copper mines 'hedging' patterns are for moving taxable revenue out of the country versus true hedging." This is because the hedge prices used by Mopani were consistently at the bottom of the price cycle such that it was making losses both when copper prices were up and when prices were down. This is not the pattern you would expect to see for a true hedge intended as genuine risk management instrument. For example, if Mopani committed to a derivative contract that locked in a future sale price of US$50 p/tonne of copper concentrate and at the date of sale there is a gain in the copper cargo of US$30 (i.e. sale price is US$80 p/tonne), Mopani makes an equivalent loss of US$30 on the derivative contract, whereas if there is a loss on the copper cargo of US$30 at the date of sale (i.e. sale price of US$20 p/tonne), Mopani records an equivalent gain on the derivative contract, hence the hedge price is inversely correlated to the vulnerable asset

7 Mopani, Konkola Copper mines (KCM), First Quantum Minerals (FQM) Kansanshi Mine, and Barrick Lumwana mine. http://www.icmm.com/publications/enhancing-minings-contribution-to-zambia

8 Foil Vedanta. *KCM Hides Profits in Zambia by Transfer Mispricing* (2014) accessed May 18, 2016, http://www.foilvedanta.org/?s=transfer+mispricing

Despite the benefits of this embedded approach, the ZRA's intention is to build a stand-alone transfer pricing unit within the LTO. Senior officials are concerned that the split focus and competing demands on transfer pricing specialists could see them limit their focus on transfer pricing matters. A separate unit will ensure quicker capacity building, as officials will be dealing with transfer pricing matters all the time. There is also a need to increase the transfer pricing workforce, to avoid a drop in revenue collection by the mining audit team (as a result of staff being diverted to work on transfer pricing issues that may take a long time to resolve). There has been some resistance to the proposal to establish a separate unit, on the basis that the team may be underutilized, however, the head of the LTO is confident that a separate transfer pricing team will have sufficient work to make it a worthwhile investment.

Other countries looking to establish transfer pricing capability may wish to follow the Zambian approach. Rather than setting up a separate unit from the outset, it seems to be more effective to identify transfer pricing focal persons within the general audit team, give them specialized training and empower them to investigate particular transfer pricing issues that arise during the course of general audits. This approach is non-threatening to the rest of the LTO and there is no problem of auditors failing to submit specific transfer pricing issues to a separate team. It also enables transfer pricing specialists to tailor their knowledge to specific sectors and taxpayers. This gradual approach introduces the concept of transfer pricing and gives specialists time to demonstrate their value add, so that when the time comes to set up a separate unit the rest of the LTO is willing to cooperate.

Inter-agency coordination

The ZRA is responsible for assessing and collecting all tax and non-tax revenues from the mining sector, including royalties. The Ministry of Mines and Mineral Development (MMMD) has the authority to prescribe royalty rates, yet the administrative function sits with the ZRA. Consequently, the MMMD has no role in assessing mining royalties; their function is simply to collect and verify production data to provide to the ZRA. The MMMD's limited role is due to a combination of the immense political strength of the finance ministry, as well as lack of capacity. MMMD is regarded as weak and "not seen to be on the ground"; hence the ZRA has taken charge of all aspects of mining revenue, including policy development, thus sidelining the MMMD. Arguably, the MMMD's limited monitoring capacity is a hangover from the period of state ownership. Had they undertaken monitoring activities then, they would have effectively been monitoring themselves. Despite concerns raised from industry experts about gaps in the workforce not long into the country's privatization process, the MMMD has failed to develop the human resources or logistical capacity to monitor private firms. The limited role of the MMMD means that the ZRA rarely looks to collaborate on tax avoidance issues or taxation of the mining industry, instead continuing to expand its mandate to supervize the sector, as evidenced by the MVCMP.

Coordination between the Zambia Revenue Authority and the Ministry of Mines is weak. Parallel reporting systems for mining taxpayers are becoming further entrenched due to competing mineral production monitoring programs.

One of the major coordination challenges in the mining sector in Zambia has been conflicting accounts of copper production and export volumes from the Central Statistical Office, the Bank of Zambia, and the Ministry of Mines. In 2010, the Central Statistical Office reported 767,008 tons of copper produced, while the Bank of Zambia reported 852,566, a difference of 85,000 tons; again in 2012 there was a reported discrepancy of 103,000 tons.[9] In most instances, the discrepancy

9 Samarenda Das, and Miriam Rose. *Cooper Colonialism*. (Foil Vendata, 2014), 24.

can be explained by the double counting of the intermediate production as both intermediate and then finished product. However, as a result, the ZRA has had to navigate three different answers on production and export volumes as it seeks to assess tax and non-tax revenues. Not only do these discrepancies make the risk of corruption more likely, they create a perception of incompetence that is unhelpful to the government.

To overcome the challenge of poor information coordination in the mining sector, the Norwegian government has supported the Mineral Value Chain Project (MVCP) at the ZRA, which seeks to harmonize reporting. At the same time, a similar project has launched at the ministry of mines. There is a risk that the new "Mineral Production Monitoring Support" program hosted by the ministry, will lead to parallel reporting systems, with different information requirements for taxpayers, resulting in different production and export figures. The two government agencies may need to coordinate more closely.

Apart from occasional meetings of the Zambia Extractive Industries Transparency Initiative (ZEITI), there is currently no formal coordination mechanism for the sector. If the ZRA is not sure about something they will get input from MMMD, however this is purely on a needs basis. Outside this ad hoc interaction, the only form of collaboration between the ZRA and MMMD is firstly, in relation to the requirement that mining companies applying to the MMMD for an export permit first get a mineral royalty certificate clearance from the ZRA; and secondly, that companies looking to transfer a mining right must first get approval from the ZRA to ensure that property tax is collected. The overall lack of coordination indicates a lack of vision for the sector and prevents the government from speaking with one voice during negotiations, furthermore leading to the unhelpful politicization of decision-making in the mining sector.

TRANSFER PRICING ACCOUNTABILITY MECHANISMS

Civil society groups in Zambia have been extremely active on tax avoidance issues, including mining taxation. The Action Aid report "Sweet Nothings," which focused on profit shifting by Associated British Foods via its Zambian subsidiary, Zambia Sugar Plc, put tax avoidance at the forefront of public debate in southern Africa.[10] There are a number of active local NGOs working on tax issues, namely the Centre for Trade Policy and Development (CTPD), which also hosts the Zambia Tax Platform, a multi-stakeholder group advocating on issues of tax administration and governance. CTPD released an investigative report on KCM, owned by Vedanta Resources, which is now the subject of a forensic audit.[11] The Zambia Tax Platform was also a key contributor to the development of the revised Mines and Minerals Act passed by parliament in August 2014. The media engages on the issue occasionally, particularly given its political salience. However, according to Action Aid, which provides training to the media, "Progress is slow. Journalists get the implications of local tax issues but they have far less understanding of corporate tax."

While civil society groups are active on the topic of taxation, some stakeholders question how informed civil society is and suggest there is a risk of reactionary politics as a result of public hype. The shifting position of civil society regarding royalty rates is considered by some to be indicative of their narrow understanding of the economic realities of the mining industry. According to a government official,

10 Mike Lewis. *Sweet Nothings.* (Action Aid, (2013).
11 Das and Rose. *Copper Colonialism.* (2014)

"Civil society was putting pressure on the government to increase the royalty rate saying that the ZRA did not have capacity to collect income tax. The Ministry of Finance changed the rate, then the companies started lobbying the government, and the same civil society turned around and said no you can't do that the companies will have to close down."

While public pressure was not the only factor that led the government to increase royalty rates in 2014, it undoubtedly played a significant role. Whether the change was correct or not, civil society organizations must strive to present a balanced, consistent view to ensure that they remain a credible force, and avoid further complicating the already unpredictable tax regime. An NGO representative presented a slightly different view of civil society's "royalty backflip," suggesting that the lack of protest from civil society should not be interpreted as tacit support for companies, but rather they find themselves constantly talking about "taxes, taxes, taxes" and sometimes they get tired. This is not a particularly compelling counterargument, it is more likely that civil society did not foresee the full extent of the resistance from companies, and saw no option but to back down.

Civil society has played a critical role in raising awareness of the problem of tax avoidance. To remain a credible force, civil society must present a balanced and consistent picture of the problem, and avoid sensationalist tendencies.

There is clearly a need to strengthen the relationship between civil society and the ZRA in order to limit speculation and ensure that accurate information is being disseminated to the public. Numerous civil society organizations complain that the ZRA does not have the capacity to deal with transfer pricing issues, hence why tax avoidance continues to be a problem. When this criticism was presented to the ZRA they replied, "Civil society offers this blanket statement but have they ever checked? No one considers what the gap is between expected revenue and actual. If they have so much information on illicit financial flows why don't they pass the information on to the ZRA so we can see what the civil society organizations are seeing." There is a lot of good work going on at the ZRA that civil society and the public are unaware of. While issues of confidentiality must be dealt with, the ZRA must also do a better job of keeping the public informed with respect to developments in combatting transfer pricing and other tax avoidance measures.

Zambia Extractive Industries Transparency Initiative (ZEITI)

The Extractive Industries Transparency Initiative (EITI) declared Zambia EITI compliant in 2012. Since then ZEITI has produced reconciliation reports for 2013 and 2014. According to the 2014 report by ICMM, the ZEITI process has strengthened transparency regarding mining revenues, however the initiative received limited mention in the interviews for this study.[12] ZEITI has been useful for the purpose of increasing available information and analysis, yet according to a civil society representative, "it has had less success in translating reports into enhanced compliance from companies." The lack of legal force is attributed as the reason for ZEITI's ineffectiveness as an accountability tool. Although enacting the ZEITI bill into law may not necessarily improve follow-up of report findings, it will ensure that companies are obligated to provide the necessary information, whereas right now it is purely a voluntary mechanism.

One area where ZEITI could add real value is in improving relationships and building mutual trust between the government, mining companies, and civil society. As mentioned previously, the relationship between the government and companies is increasingly acrimonious, creating problems for future investment. In addition, civil society groups are kept at a distance, leading to a less informed

12 International Council of Mining and Metals, and the Chamber of Mines Zambia. *Enhancing Mining's Contribution to the Zambian Economy and Society* (2014), 10.

public debate. ZEITI could turn this situation around by becoming a coordination mechanism that helps to strengthen relationships and build a shared vision for the mining sector.

Parliament

Parliament is broadly accountable, well-resourced and vocal. Although mineral development agreements are no longer permitted, members of parliament (MPs) have been key contributors to mining legislation.[13] There are different views as to whether the contribution of MPs is appropriately informed, or purely political. With respect to the change in mineral royalty rate, on the one hand, the expanded parliamentary committee stepped-up and played a leading role in managing the outcry from companies. On the other hand, company representatives claim that while the committee may have listened to their concerns the report back to parliament was nothing more than a regurgitation of the budget script. Similarly, civil society representatives raised concerns that despite being asked to provide submissions, parliament often disregards their advice. The fact that the committee did not change its view on the royalty rate, and parliament may not agree with a submission from civil society, is not in itself conclusive evidence of political interference; Zambian MPs are aided by parliamentary staff, who can be relied on to find the resources to equip parliamentarians to ask the right questions, and form their own view, albeit contentious in some instances.

TRANSFER PRICING KNOWLEDGE AND SKILLS

Transfer pricing expertise

Since 2008, the transfer pricing capacity of the government has increased considerably. All staff in the LTO have received basic level training in transfer pricing via a mix of local workshops, OECD trainings, and online courses provided by the IBFD. In addition, the Norwegian Tax Administration (NTA) has provided embedded tax experts to support audit planning. Prior to 2008, the ZRA sent some officials to OECD trainings in South Africa, but this was not coordinated and officials were randomly selected from different units. Since then there has been a big expansion in the LTO, more interaction with the NTA and OECD, and officials have been sent on numerous attachments to other countries. Consequently, the confidence of transfer pricing specialists has grown considerably and they are "at a level at which [they] can handle any audit." While it is clear that confidence has improved, an advisor from the Norwegian Embassy claims that ZRA officials will still avoid challenging multinationals where former senior ZRA officials have been employed. To challenge former senior colleagues is considered disrespectful and aggressive. Mining companies reject this claim, regarding ZRA officials as extremely punitive in their treatment of taxpayers. Irrespective of these competing views, it is clear that the ZRA is increasingly confident in pursuing transfer pricing issues.

13 The Mines and Minerals Development Act (No 7 of 2008) notes in Article 159 that no new agreements shall be made, and in 160, that existing agreements shall no longer be binding.

ZRA officials are now highlighting issues that they wouldn't have noticed before, for example management service charges. Prior to the various capacity building initiatives, ZRA officials would not have raised so many questions, or asked for evidence of services provided and the basis for the calculation of management service charges. Officials are also making suggestions as to how anti-avoidance legislation can be improved. In particular there has been a recommendation to extend thin capitalization legislation to non-mining sectors where high levels of debt are also an issue. Despite the growth in transfer pricing expertise at the ZRA, some argue that the limited workforce prevents officials from effectively applying this expertise. For example, the ZRA is currently limited in its ability to undertake physical monitoring of mines, reducing effective oversight of transfer pricing issues.

Understanding the extractive industry value chain

The ZRA has significantly expanded its capacity to assess and collect mining taxes and royalties in recent years. Prior to 2008, the ZRA had only two to three tax auditors covering the entire mining sector making it highly likely that the companies were able to avoid tax during this period. Since then, the ZRA has established a separate mining audit team in the LTO comprised of 17 auditors, including two metallurgists: one was recruited internally and the other came directly from the sector. The entire team has received extensive industry training. Consequently, both the workforce and technical capacity of the mining audit team has developed considerably, resulting in improved control and audit of production, prices, and, to a lesser extent, expenditure.

The Zambia Revenue Authority's mining audit capacity and expertise has grown significantly. But the majority of auditors still lack industry knowledge and experience, preventing them from monitoring all stages of the value chain.

However, civil society, industry experts, and government officials, argue that the ZRA's technical understanding of mining is still not adequate given the sector's economic significance and the potential for tax avoidance. According to one critic, "The ZRA doesn't have the capacity. A guy with his chartered accountant qualification understands the general rules of tax but mining is like aeronautics, you need a mining background to interpret figures correctly."

While the ZRA has sought to build industry expertise by recruiting mining professionals, many argue that these individuals do not have the senior management experience required to add value. One industry expert said, "The ZRA can have mining engineers but are they experienced enough? Do they know what to look for?"

Box 6. US $300-$700 million from copper by-products largely untaxed

Many copper deposits contain valuable metals in addition to copper. By-products include gold, silver, and cobalt. Due to weak production monitoring capacity, it is likely that large volumes of valuable metals are exported from Zambia unaccounted for and tax-free.

The volume of cobalt, as well as other valuable products such as fex gold has never been well monitored by the government. According to a study by the Norwegian government in 2007, the officially reported volumes of cobalt were fairly moderate, and the associated value of this by-product even more so. Based on visits to several of the major copper mines and smelters in Zambia, the Norwegian study was able to show that the estimated value of cobalt production was most likely above US $1billion, compared to a much lower official number. The pilot audit of Mopani in 2009 found reported cobalt production figures to be significantly lower than the rest of the industry, with an extraction rate that was half that of other producers. The auditors suspected that Mopani was faking the numbers in order to have the production figures fit with the cobalt revenue in the accounts.

A further problem was that it was left to the company to determine the price of cobalt, and the sale of cobalt was often to a related company or trading arm of the parent company. In addition, the degree of refinement of the cobalt could vary such that it could be very difficult to judge the price set or used in the company accounts in Zambia.

Until the Mining Act of 2008 there was no specific consideration of taxation of cobalt in the legislation, even though the international price of cobalt was growing to a historically high level. According to the Norwegian study, control, or even awareness, of this issue was virtually non-existent in Zambia at the time. While cobalt has since been addressed in the Mining Act (there is 10 percent export duty on cobalt concentrate), international experts are of the view that the government is not on top of the by-product issue.

Zambia's long history of state ownership in the mining sector means that there are people with decade's worth of industry experience available to add capacity to the ZRA. Such individuals have, from time to time, been brought together by the ZRA to provide audit support, the last instance being in relation to the MVCMP. However, it is doubtful whether it is possible to provide the necessary remuneration to recruit this calibre of industry experts over the long-term, given their alternatives in the private sector. Observers suggest that the ZRA need a team of mining professionals with the necessary expertise to monitor the entire value chain. Tax planners are constantly looking for the next available loophole, which is why the mining audit team must be constantly observing all stages of the value chain. The MVCMP will improve the ZRA's understanding of the value chain, and establish systems for collecting and managing vital information. However, it is one thing to be able to pinpoint potential transfer mispricing, but to be able to evaluate that particular transaction — to know whether the risk area has been manipulated to under declare or not — requires industry knowledge and experience.

TRANSFER PRICING INFORMATION

Risk assessment and selection of transfer pricing cases

With support from the NTA, the mining audit team is in the process of developing a transfer pricing risk assessment tool for the mining sector specifically. Until this time, the ZRA use a generic risk assessment tool, the view being that it was better to start with this until officials were sufficiently well-versed in transfer pricing that they could relate general risk indicators to specific sectors. To develop this tool the ZRA and the NTA are documenting all the audit risks the ZRA have encountered so far, in order to build-up a risk profile of each mining company. This means that if a new tax official was to assigned to audit KCM in 2016, they would know what risks to look for based on the company risk profile. This risk log will provide “real-life indicators” to guide tax officials in their selection of companies, and specific issues for audit.

Where transfer pricing issues are identified, they must be flagged for the attention of the transfer pricing specialists in the LTO. This is made easier by the fact that the transfer pricing specialists are embedded within the general audit teams. Despite the fact that there doesn’t seem to be any internal resistance to submitting issues to the transfer pricing specialists, the head of the LTO recently issued a directive reinforcing this obligation. Generally, the mining audit team aim to conduct eight integrated audits per year (including site visits), however they may do other desk based audits where necessary, although these depend on capacity. The mining audit team is also trying to look at mining subcontractors in addition to companies. In the past, the LTO has contracted international experts to assist with the audit preparation. The last instance involved experts from Norway who provided preliminary audit advice for three of the biggest mining companies in Zambia for the period 2009-11. The reason for this was that the mining regime had changed and there was a need for the ZRA to understand the operations of these companies. According to some mining companies, they are incredibly closely audited, despite the fact that the ZRA does not have the capacity to use the data they collect.

Access to appropriate transfer pricing comparables

The ZRA currently subscribe to CRU Mining and the LME, and has access to Orbis, the transfer pricing database created by BVD. These third-party data sources provide valuable market analysis, as well as comparable data for the purpose of applying the arm’s length principle. When conducting tax audits, the ZRA refer to these databases as a basis for evaluating transactions, and justifying adjustments to chargeable income and royalty payments. The ZRA is keen to develop its own domestic comparables: in fact the mining audit team is already collating data from tax audits for the purpose of identifying emerging trends, particularly in relation to operational costs such as management fees and interest rates. Orbis provides “red flags” where operational costs are generally too high, however the data is not sufficiently detailed to indicate where the particular areas of cost inflation are, hence the need for the ZRA to develop their own bank of more localized comparable data.[14]

Transfer pricing databases help in the assessment of generic transactions, however the situation becomes more complicated when trying to find comparable prices for second-hand mining equipment, or equipment that has been designed for a particular mine.

Referencing sales to the monthly average cash price quoted on the LME, or the MB, has significantly reduced the potential for transfer mispricing in relation to natural royalty payments. From the ZRA’s perspective, it doesn’t matter if a company sells to a related or unrelated party, the ZRA simply looks at the monthly average price on the LME to compute royalty payments. However, the situation is far more complex when trying to access comparable data for deductible expenditure, particularly in the case of second-hand equipment or equipment that has been specifically designed for a particular mine. While the mining audit team has a few mining specialists who may be able to assess these transactions in light of their industry experience, it may be difficult to keep up with changing technologies.

14 There are not enough independent mining companies in Zambia, or Africa generally, to develop true comparables. However, it may be possible to identify standard industry rates for the purpose of assessing related party transactions. Standard industry rates will not always be consistent with the arm’s length principle, but they are a necessary trade off given the lack of comparable data, limited transfer pricing expertise, and the risk that transfer mispricing poses to the tax base.

Box 7. Long-term framework agreements at risk of transfer mispricing

In a report by Swedwatch, the head of the LTO at the ZRA mentions a possible method for tax planning involving suppliers of mining equipment entering into longer and closer forms of cooperation with a mining company. Trade agreements are reached which are advantageous for both parties, but also involve withholding taxes.

In line with this concern, the report raises questions about Sandvik, a global supplier of mining equipment to companies in Zambia. Unlike its competitor Atlast Copco, Sandvik has long-term contracts with mining companies where arrangements to avoid tax may be possible. The complex structure of Sandvik and predominance of intra-company trade also increases the risk of abusive tax planning. The sale of mining equipment to companies in Zambia must be divided between three business areas, in addition to which there are six or seven manufacturing plants on three different continents, that deliver to two distributions centres, which deliver to Zambia. While there is no substantive evidence of transfer mispricing taking place in relation to long-term customers or internally, the risk is high.

More recently, the ZRA has identified a couple of mining companies that have engaged a subsidiary company to carry out contract mining at a fee per tonne of the ore extracted. The subsidiary company uses its own machinery and labor to extract the ore from the mine pit. According to the ZRA, the fee seems to be on the higher side compared to other providers of similar services.

In the absence of direct comparables for deductible expenditure, production information may be used as a starting point for evaluating costs. According to an industry expert in Zambia, if the ZRA knows which extraction method a company is using (for example, in the case of copper they may be using leeching or flotation, the mine may be open cast or underground, wet or dry) it can then determine the major cost components (the types of reagents required, as well as water and electricity needs, for example). This information should provide an outline of the cost profile of the company. Based on this, the ZRA can then work back from production volume, recovery rate, and the amount of ore being moved, to determine what the likely costs would be per tonne. This is a simple, crude method of developing internal comparables, but it at least gives ZRA officials a feel for the costs and a basis on which to query companies.

Access to information

Accessing financial and production information from mining companies is relatively straightforward in Zambia. Companies are required to submit production returns to the MMMD on a monthly basis, in addition to which mineral royalty returns must be submitted to the ZRA. However, there is a major gap in terms of information on company expenditure. A template for cost information was previously developed following a round of audits in 2013, and there was a proposal to re-design the production return template to include key cost information, however this has not happened. The current production reporting template, Form 39, has been revised as part of the Mineral Production Monitoring Support project at the MMMD, however it still only addresses production information and not costs.

Government lacks the facilities to verify the composition and value of mineral exports, as well as the workforce to monitor production and export volumes. This makes them reliant on company reports.

While companies have largely been forthcoming with information, the government does not have its own independent information source that it can use to evaluate company reports. Officials from the ZRA and MMMD will, from time to time, visit companies for the purpose of audits or spot visits, however unlike other countries there are no government officials permanently stationed at mine sites or checkpoints to verify production, export volumes, and mineral grade. According to government officials, “There is one person at the Ministry of Mines that just stamps the export paper and that's it." This is an exaggeration as ZRA approval is also required for export permits, however the point remains that oversight of exports is limited. Again, this is probably a hangover from the days of state ownership, and the MMMD hasn't built up the workforce, equipment or skills to execute its mandate of gathering information. Consequently, the government doesn't know how much it costs a company to extract a tonne of copper, what the grade is, or what the value is of the additional metals coming out of the process, instead it has to rely on company reports. In some instances, the ZRA uses Tanzania's metal laboratory to evaluate company reports, as is the case in a forensic audit currently underway. While there are no immediate plans to establish laboratory facilities in Zambia, the MVCMP will at least ensure that government officials are present throughout the production and export process to secure an independent source of information.

Box 8. A 10% undervaluation results in US$74.5mn lost revenue

In this case the company is a major copper-cobalt producer in Zambia. The buyer (a related party) agrees to purchase the total output of the plant during the contract duration. The price for the material delivered shall be the LME price over the Quotational Period. Assuming that the copper concentrate being exported is 31% copper and therefore 30% of the LME spot price, the sale price is US$1485 p/ton. After the production costs and royalties are subtracted, the company is left with a taxable profit of US$235 p/ton. At a corporate income tax rate of 30% the Government of Zambia is entitled to US$70.50 p/ton. However, if we apply the same calculation to a sale that has been undervalued by just 10%, the taxable profit left is US$86 p/ton, leaving Government with only $25.80 p/ton, or US$44.7 less than in the arm's length transaction. Exporting 1.67mn tons of per year suddenly equates to US$74,649,000 in lost revenue (1.67*US$44.7 p/ton).

Source: Lee Corrick, Technical Adviser International Taxation, African Tax Administration Forum

In addition to the lack of independent verification of production and export volumes, a major concern has been accuracy of information on export destinations for Zambia's copper. To improve access to information on where companies are selling the copper, the ZRA has amended Rule 18 of Value Added Tax (VAT). Before the ZRA approves the sale as zero-rated, companies must provide copies of export documents for the goods, bearing a certificate of shipment provided by the ZRA, tax invoices for the goods exported, and proof of receipt of payment for the goods. Companies argue that it is almost impossible to provide this level of documentation because they sell to multinational trading houses. Consequently, more than US$600 million in VAT refunds were withheld, although some of the refunds have now been paid out.

Box 9. Destination of Zambia's copper exports

According to a Christian Aid report in 2008, Zambia's official trade statistics indicated that half of Zambia's copper exports were sent to Switzerland, but Swiss import data suggested that most of this never arrived. Five years later, the World Bank's Integrated Trade Solution (WITS) data suggests that in 2013 Zambia exported US $3.9 billion worth of copper to Switzerland but there are no corresponding records showing that Switzerland imported any copper products from Zambia. This appears to be an invoice routing arrangement, where the copper contractually goes to Switzerland, but physically goes elsewhere. The problem here is twofold. First, the final destination of Zambia's copper is currently indistinguishable, exposing weaknesses in the government's monitoring system with respect to export destinations (which may give rise to transfer mispricing). Secondly, exchange of information problems prevent the ZRA from assessing what the Swiss companies "receiving" the copper are actually doing (i.e. marketing vs. simply invoice routing), and therefore, whether any mineral sale price discounts afforded by the Zambian subsidiary are at arm's length.

Primary data for mining tax audits are collected from audited financial statements. However, the ZRA may draw on information from other institutions, particularly production information. This information is often inconsistent, with the various sources each using different accounting approaches. Research carried out by Wood Mackenzie on copper production in Zambia proves that the figures published by the Bank of Zambia, based on data from MMMD, are very different from the figures published by other reporting agencies. According to Wood Mackenzie's report there are a number of possible explanations for these variations, including companies reporting confusing information, often merging intermediate production with finished product data.

2011 (kt Cu)	Mine contained	Mine commercial	Smelter	Refinery	Other
Bank of Zambia	-	-	-	-	881
ICSG	667	-	511	515	-
USGS	715	-	-	-	-
WBMS	784	-	384	696	-
Wood McKenzie	672	659	496	522	-

Table 1. Zambian Copper production in 2011

Source: International Council of Mining and Metals, and the Chamber of Mines Zambia. Enhancing Mining's Contribution to the Zambian Economy and Society. (2014), 41.

The MVCMP is developing a standardized approach to collecting information, however, as explained previously, the alternative data collection system being established at the MMMD may further embed current inconsistencies. This poses problems for companies, with one representative raising concerns about whether the amount of information currently collected is sustainable, and whether the various institutions even use the information they request.

Box 10. Companies withholding proof of services rendered

Zambia, like many other countries, is struggling to deal with the problem of management service charges. There is huge variation between mining companies, with some paying fees as low as US $1 million per year and others up to US $6 million, or even as high as US $15 million. The ZRA has requested documentation to determine how management service charges are calculated, and whether they are arm's length, however most companies have not been forthcoming. Generally, the ZRA has been told that the fees are based on an agreement with the related party, "they offer a range of services and dictate the payment." No further explanation has been provided.

From the ZRA's perspective it would seem that management service charges have very little to do with services rendered, rather they are based on the volume of copper produced and sold. Consequently, the range of services being provided is not on cost plus basis (i.e., where the selling price is determined by adding a specific dollar amount mark-up to a product's unit cost), but on an agreed formula. The ZRA has made adjustments where companies have not provided proof of services rendered, in some case the whole amount has been disallowed.

Having closed the loophole on hedging and thin capitalization, the ZRA is now looking for ways to limit the risk of transfer mispricing in relation to management service charges. A technical advisor to the ZRA has suggested that the government should fix a dollar amount maximum for management fees rather than a percentage. According to him, management fees should be a flat rate such that any negotiation or discussion is about the amount, not a percentage. This is an area where APAs may be useful: rather than setting an arbitrary amount for all companies, the revenue authorities could negotiate, on a case-by-case basis, an appropriate monetary limit with interested taxpayers.

Zambia is not a signatory to the Global Forum on Transparency and Exchange of Information for Tax Purposes. Consequently, the ZRA has limited access to information from other tax jurisdictions, beyond its neighbouring countries with whom it has some informal bilateral agreements. The ZRA is aware of the need to improve the automatic exchange of information (AEOI) with other jurisdictions, but before they can do this they need to be in a position to provide "bulk" taxpayer information concerning various categories. Zambia has some exchange of tax information agreements separate to double taxation agreements (DTAs), however so far they have experienced big delays in responses to information requests and can only keep audits open for so long. According to a ZRA official, "If you ask once and don't get a result you don't ask twice, we need to be responsive to one another."

Despite limited cooperation from non-African countries, Zambia is working closely with neighbouring countries Kenya, Tanzania, and South Africa. The South African Revenue Service has come to Zambia on a number of occasions to pursue cross border taxpayers; the ZRA provides on the ground support whilst receiving on the job training in return. As mentioned in the previous section, the ZRA has made use of Tanzania's metal laboratory, and in return the Tanzanian Revenue Authority has sent delegations to Zambia to learn from the mining audit team. There is a growing emphasis on sharing tax information between African countries, particularly where they have common investors. While exchange of information may be slow to improve between African countries and the rest of the world, the interaction between tax administrations in Africa is going from strength to strength.

Zambia is collaborating with neighbouring countries to share audit expertise, information, and mineral laboratory facilities. This is proving very useful given the difficulties accessing information from tax jurisdictions outside of Africa.

TRANSFER PRICING DOCUMENTATION REQUIREMENTS

There are currently no specific transfer pricing documentation rules in Zambia. The transfer pricing regulations, which contain documentation rules, were drafted in 2013 and have been awaiting approval by the Ministry of Justice since then. Due to the challenges experienced in accessing transfer pricing information from taxpayers, the ZRA regards the documentation rules as the most important aspect of the regulations, and has sought to make them more like a manual to guide taxpayers in order to avoid lengthy delays in the audit process. Until now the ZRA has relied on the general documentation provisions in the Income Tax Act, meaning that while taxpayers are not obligated to maintain transfer pricing documentation they can be compelled to provide the relevant information to the ZRA.

TRANSFER PRICING DISPUTE RESOLUTION MECHANISMS

There are no specific dispute resolution mechanisms for transfer pricing issues. Where taxpayers disagree with the findings of the ZRA on a transfer pricing issue they can take their case to the Revenue Appeals Tribunal, and following this they can go to through the court system. According to the ZRA, the majority of the transfer pricing adjustments made so far are under dispute, however most of these cases remain at the level of the tribunal such that the main costs for the ZRA are time spent by in-house legal counsel, and deferred tax. In Zambia's experience so far, "reaching an agreement is a long and winding process," with many cases taking up to two years to resolve.

TRANSFER PRICING TECHNICAL ASSISTANCE

Zambia has received considerable transfer pricing technical assistance over the last few years. The whole of the LTO has received basic training on transfer pricing from the OECD and the IBFD. A representative from the OECD visits Zambia multiple times each year to provide top-up transfer pricing training and practical support. The partnership with the NTA has arguably been the most valuable as it has given the ZRA access to tax officials dealing with the same issues. It has also been useful in terms of confidence building with Norwegian colleagues asking ZRA officials, "why didn't you ask for that you have a right to!" In addition to this, the IBFD has also provided training on the mining industry, including international aspects of the industry such as transfer pricing. CRU Group, the global commodity consultancy based in the UK, has also provided training to the mining audit team on issues to do with hedging, mineral processing, and ore content.

Building the confidence of tax auditors to pursue transfer pricing issues is key to successful capacity building initiatives. The most useful technical assistance to Zambia has been practical support from foreign tax officials working through similar transfer pricing issues.

Despite receiving significant theoretical and practical training, a representative from the donor community suggested that respect for technical assistance at the ZRA is low. Instead they are interested in "quick fixes that are potentially popular." According to him, "Technical forces can't beat political forces." This is likely to be a reference to changes in the mining tax regime over the years, where the ZRA and finance ministry have ignored more prudent advice from international partners on the importance of providing a predictable and fair regime for companies.

GOVERNMENT LEADERSHIP

There is a popular belief in Zambia that mining companies are holding the country to ransom. Consequently, public discourse on mining has become extremely politicized. This view of the sector arguably stems from the way in which the country's mining assets were privatized: the IMF insisted that the government embark on a period of structural adjustment which required selling off all the previously state-owned mines to private firms. At the time of sale, copper prices were at a historical low, so to encourage new investment the government offered various incentives as well as stabilization clauses, as part of the mineral development agreements. Subsequently, the public perception of privatization of the mining sector is that "the country's hands were forced," and they got a bad deal as a result.

Unfortunately, this view has only become more entrenched as a result of a string of corruption scandals in the mining sector involving government officials. The most notable being the indictment of former President Chiluba, who was accused, although ultimately acquitted, of stealing US $57 million of public money to fund his shopping sprees. President Chiluba was in power during the privatization process and there is speculation that funds were stolen at that time, reinforcing the public view that the process was "ill-managed." The former minister of mines, Maxwell Mwale, was also jailed in 2015 on the basis that he interfered with the granting of licenses to a Chinese mining company.

According to a government official, "The biggest reason for doing things is politics, everything else is second. There is an assumption amongst technocrats as to what the government expect, so instead of standing up and providing objective advice, they make political decisions even if there is no specific directive."

According to a government official, "There is an assumption amongst technocrats as to what the government expect, so instead of standing up and providing objective advice, they make political decisions even if there is no specific directive."

The history of corruption and deal-making, as well as allegations of tax avoidance by mining companies, has led to populist decision-making by Zambian politicians. This has resulted in a hugely unpredictable environment for investors. The relationship between the government and mining companies is extremely hostile largely due to dramatic changes in the tax regime in recent years. Most recently, the change in the royalty rate from six percent to 20 percent for open pit mines, and three percent to eight percent for underground mines. While the government ultimately backtracked on this decision due to immense pressure from mining companies, this unpredictable, reactionary approach to decision-making has only functioned to further sour relationships. However, some observers suggest that the government is actually spurred on when companies are upset, "If companies are shouting a policy change down then the government sees this as a good reason to go through with it." This approach appeals to public sentiment, with the government seen to be strongarming the companies that are supposedly keeping Zambia poor.

Understandably, there is also significant frustration fuelling the government's decisions regarding the mining fiscal regime. Zambia's former vice-president, later acting-president, Guy Scott, told the BBC that the government was losing almost US $2 billion annually due to tax avoidance.[15] Then there are countless reports by civil society reinforcing the message that "companies must be making money otherwise why are they here." All the while Zambia remains one of the poorest countries in the world. This has forced the government to reach out for more punitive taxes to at least be seen to be trying to build up the public coffers. According to one official, "Nationalism emerges from frustration with companies. They talk to you like you don't know that they are avoiding tax, yet the government continues to get little in the way of taxes or dividends." It is not only tax revenue that the government is expected to deliver, but it must balance this against the need for companies to provide jobs, a far more politically treacherous area. In the case of KCM, the government accepted their offer to take over Konkola mine on the basis that they would provide jobs. In 2013 KCM's plan to lay off 2,000 workers was halted after the government threatened to take over the mines. Again in 2015, KCM was unable to fulfill its obligation as they asked 133 workers to take paid leave, claiming this was due to low copper prices and the need to review their operations. This is potentially politically detrimental for the government, but then they also refuse to defer tax payments due to revenue pressures.

15 Michael Robinson, "Tax Avoidance: developing countries take on multinationals", BBC, May 24, 2013, accessed 9th September, 2015, http://www.bbc.co.uk/news/business-22638153

CONCLUSION

Zambia has proven that a simple, incremental approach to pursuing transfer pricing issues in the mining sector can be very effective. Unlike the other more advanced countries included in this study, Zambia has opted for a decentralized approach, building up transfer pricing expertise within existing audit teams. In other circumstances this might be considered a shortfall, however Zambia has managed to undertake at least ten transfer pricing inquiries in the mining sector since 2012.

There are a few reasons for Zambia's comparative success so far. The first is that transfer pricing specialists have been embedded within the mining audit team, overcoming potential internal coordination issues, as well as enabling development of sector specific transfer pricing expertise. Following on from this, transfer pricing specialists in the mining audit team have established a transfer pricing risk log for each major mining company operating in Zambia. While this is still a work in progress, the team is able to develop rough internal, as well as sector wide, standard industry rates, which provide a useful reference point in addition to the Orbis database. Finally, transfer pricing specialists in the mining audit team have access to industry expertise and knowledge in the form of colleague auditors many of whom have been working exclusively on mining audits since 2008 and even earlier, and mining metallurgists who are able to offer guidance on how to evaluate transfer pricing risks associated with the extraction and processing of minerals.

To further strengthen implementation of transfer pricing rules in the mining sector in Zambia, there are some improvements that must be made in the area of inter-agency coordination and access to independent information. The lack of collaboration between the ZRA and the MMMD prevents the flow of information and expertise necessary to comprehensively identify and evaluate transfer pricing issues in the mining sector. While the ZRA has built some mining expertise in-house there are limits to this, as well as it being an inefficient solution given that considerably more experience and knowledge could be leveraged through closer cooperation with the MMMD. It is critical that capacity building programs at the MMMD and the ZRA are harmonized in order to improve inter-agency coordination rather than further fragment oversight of the mining industry. Efforts to strengthen the government's ability to collect its own information on production and export volumes, as well as mineral quality must be fast-tracked to enable verification of company reports, and dispel any misplaced concerns about tax avoidance and corruption generally.

RECOMMENDATIONS

Transfer pricing legal framework

2 The Ministry of Justice should fast-track the approval of transfer pricing regulations to ensure that Zambia has a well-established legal framework to pursue transfer mispricing. The Income Tax Act may provide an adequate legal basis from which to pursue transfer pricing cases, however regulations will enable increased awareness of transfer pricing among government officials and taxpayers; a focus for further capacity building as well as structural change; a consistent and coordinated approach to interpreting and applying transfer pricing provisions in the primary legislation; and increased confidence among auditors to pursue transfer pricing cases.

3 The Ministry of Finance should consider introducing a statutory cap on management service charges, as well limit deductibility of other related party payments. While transfer pricing documentation rules will help the ZRA to confirm how management service charges are being calculated, and what services are being rendered, to actually limit the scope for tax abuse a cap on management service charges may be advisable. This cap could either be in the form of a maximum percentage of total operating costs and/or total revenues, or as a specific monetary limit decided on a case-by-case basis depending on the size and type of business. Limiting deductibility of related party payments generally, is necessary to safeguard the tax base, however, it is also important that in designing this rule the government seek to minimize any negative impacts regarding future exploration and investment.

Transfer pricing administrative arrangements

4 The ZRA should consider maintaining its current approach of embedding transfer pricing specialists within the mining and non-mining audit teams, rather than moving to a stand-alone transfer pricing unit. The benefits of the ZRA's current approach are: transfer pricing specialists don't have to wait to have potential issues referred to them from general audits, and it is possible to develop sector specific transfer pricing expertise. The long-term goal of the LTO is to establish a separate transfer pricing unit to enable specialists to work exclusively on transfer pricing issues rather than having to split their time across general audits, and to establish a repository for focused capacity building. All of this makes sense, however rather than moving to a separate transfer pricing unit the ZRA could consider a hybrid approach. According to this model a larger network of transfer pricing specialists would be embedded within the general audit teams, reporting to a small transfer pricing team that provides technical support, consolidates learning, develops tools, and facilitates capacity building.

5 The Ministry of Finance, the ZRA, and the Ministry of Mines, should establish a formal coordination mechanism for the sharing of information and expertise. While technocrats from the aforementioned institutions are cooperating informally, there is a need to consolidate cooperation at the leadership level. A memorandum of understanding (MoU) should spell out roles and responsibilities regarding information collection and monitoring, as well as how information will be shared between the three agencies.

6 ZEITI should strengthen its coordination function, bringing together the government, companies and civil society on a regular basis, to improve information sharing and build mutual respect and trust. For ZEITI to have the requisite convening power, it requires backing at the highest political level. The current ZEITI champion is the secretary to the treasury, while this is an appropriately senior designation, the negative perception of the Ministry of Finance, shared by both the Ministry of Mines, as well as mining companies, may prevent full cooperation. It may be more effective to appoint the secretary to the cabinet, a more neutral, yet powerful office. The president should also give his or her full support to the initiative to encourage cooperation from stakeholders.

Transfer pricing information

7 The ZRA and the Ministry of Mines should clarify their roles and responsibilities with respect to collection of information in the mining sector. The Mines and Minerals Development Act of 2015 states that while the ZRA is in charge of assessing and collecting royalties, licence holders should report to the Ministry of Mines. However, the act does not specify how companies should report, or what they should report on. The ZRA concedes that it is the responsibility of the Ministry of Mines to collect some information, "but not all," and continues to set up its own data collection system in-house, albeit with some involvement from the Ministry of Mines. To avoid duplication, as well as inconsistencies, it is critical that the ZRA and Ministry of Mines agree on who is collecting what information, from who, by when, and how they plan to share the data.

8 The ZRA and Ministry of Mines should harmonize the MVCMP and the MPMSP to prevent parallel reporting systems and conflicting production and export figures from becoming further entrenched. Both projects broadly share the same objective, which is to improve the government's data collection capacity in relation to the mining sector. There is a big risk that if both the ZRA and Ministry of Mines improve their monitoring capacity independently, without having first clarified roles and responsibilities, different reporting systems will emerge that increase the burden on taxpayers, and reduce the likelihood of cross-government collaboration. While some efforts are being made to harmonize the two projects, serious overlap remains. It is critical that monitoring and data collection capacity is improved collectively, with a clear view of how the various government institutions work together.

9 The Ministry of Mines and ZRA should expand current reporting requirements to capture information on expenditure. Presently, no cost information is collected from mining companies on a regular basis. Form 39 only requires information on production. While the ZRA is obviously at liberty to request information on inter-company loans, management fees, and other costs during the course of an audit or otherwise, there is no regular channel for this information to filter up, limiting the scope for ongoing risk analysis.

Transfer pricing knowledge and skills:

10 With support from international partners, key officials from the Ministry of Mines should be selected for training on transfer pricing and other tax avoidance mechanisms. While the ZRA is the primary institution responsible for enforcing transfer pricing rules, given the role that the Ministry of Mines is expected to play in gathering and evaluating production data, it would be valuable for key officials to have some knowledge of transfer pricing, particularly as it relates to mining. The mining audit team has developed considerable technical expertise, however its makes sense that the Ministry of Mines would also assist in flagging issues for consideration given that one of the technical challenges is evaluating whether a risk area has been manipulated, requiring industry knowledge.

Research for this case study took place in August 2015.

APPENDIX 1: INTERVIEW PARTICIPANTS

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APPENDIX 2: ABBREVIATIONS AND ACRONYMS

APA	advance pricing agreement
BEPS	basic erosion and profit shifting
BoZ	Bank of Zambia
CTPD	Centre for Trade Policy and Development
CSO	Central Statistical Office
EBITDA	earnings before interest, taxes, depreciation, and amortization
GDP	gross domestic product
FQM	First Quantum Minerals
GATT	General Agreement on Tariffs and Trade
GRZ	Government of the Republic of Zambia
ICMM	International Council of Mining and Metals
ITA	Income Tax Act
KCM	Konkola Copper Mine
LME	London Metals Exchange
LTO	Large Taxpayers Office
MB	Metals Bulletin
MMMD	Ministry of Mines and Mineral Development
MP	member of parliament
MPMSP	Mineral Production Monitoring Support Project
MVCMP	Mineral Value Chain Monitoring Project
NGO	non-governmental organization
NTA	Norwegian Tax Administration
OECD	Organisation for Economic Co-operation and Development
PSA	production sharing agreement
PSC	production sharing contract
TP	transfer pricing
VAT	value added tax
WITS	World Bank's Integrated Trade Solution
ZEITI	Zambia Extractive Industries Transparency Initiative
ZRA	Zambian Revenue Authority