SPECIAL REPORT

Guidelines for pricing control of South African mined products

by Peter Robbins

In recent year many billions of Rands have left South Africa. A large proportion of these funds can be attributed to entirely legal factors. However, a main conduit for capital flight is through the medium of foreign trade. The most common form of illegal currency transfer is known as transfer pricing abuse.The most effective way is to artificially under-value exported products.
This paper attempts to define the problem, identify the areas within the mined products marketing process in which transfer pricing abuse is most likely to be taking place and suggest a strategy of control.

Peter Robbins, 5–11 Worship street , London EC2A 2BH, England, is consultant to the Macroeconomic Research Group at Witwatersrand university, Johannesburg, South Africa.

After many years of isolation, during the apartheid era, South African mining companies were restricted from developing a modern marketing apparatus.

The limiting effect of trade sanctions encouraged the industry to find some unconventional and obscure systems for marketing their products. These systems, coincidentally, represent ideal conduits for the illegal transfer of funds to other countries.

Many billions of Rands have left South Africa in recent years in a phenomenon known as capital flight, encouraged possibly, by the fear of political disruption in South Africa. A large proportion of these funds can be attributed to disinvestment and other disappointing but entirely legal factors. A significant proportion, however, cannot be traced to legal transactions and it is widely accepted that the scale of illegal capital flows are too large to be accounted for by individual South Africans involving themselves in petty currency smuggling.

As with many other countries that adopt restrictions on currency transferability, the main conduit for capital flight is through the medium of foreign trade. The most common form of illegal currency transfer is known as transfer pricing abuse.

The most effective way of transfering funds outside the country is to artificially under-value exported products. Since mined products make up two-thirds of exports, it has been supposed that a significant proportion of capital flight is facilitated through transfer pricing abuse of mined products.

The major mining companies have vehemently denied that they indulge in transfer pricing abuse. In spite of these denials, most South African mining companies freely admit that they are making use of secretive structures to market their products abroad and that there are very few South African controls systems which could identify, deter and punish abuse.

This paper attempts to define the problem, identify the areas within the mined products marketing process in which transfer pricing abuse is most likely to be taking place and suggest a strategy of control.

Transfer pricing abuse

Transfer pricing usually takes place when goods or services are supplied between different companies within a group of companies. The price at which these goods or services are transferred may not be related to outside market forces but they only concern governments if the choice of particular prices has an effect on the amount of taxes paid by the local company or represents a conduit for capital flight.

If companies use transfer pricing to attempt to lower their tax liability or to illegally transfer assets (especially profits) from one country to another, it is regarded as transfer pricing abuse.

The most common form of abuse occurs when a company in a comparatively high tax-rate country sells its products at a low price (compared with the open market) to an associated company in a low tax-rate country. This is known as under-invoicing.

In another form of abuse a company in a high tax country buys a product from an associated company in a low tax country at a high price. This is known as over-invoicing.

As can be seen, the effect of both types of abuse is to switch income (and, hence, tax liability) from a high tax regime to a low tax regime and, hence, to lower the total tax liability of the multinational company concerned.

These are simply the most common forms of an abuse that can manifest itself in very many ways. Other ways of achieving the same end can be by charging a subsidiary or associated company very high management or licence fees; by under- or over-claiming the quality or

quantity of a traded product; by charging more for shipping, insurance or warehousing fees; by getting local subsidiaries to pay for the holidays or other perks of the executives based in other countries and their families; etc., etc.

Transfer pricing abuse is a very common feature of international trade and most often takes place between subsidiaries of the same company based in different countries but abuse may also occur in trade between two apparently unconnected companies working in collusion within so-called 'gentlemens agreements'.

All governments are aware of the need to control transfer pricing abuse but total control is virtually impossible. It is generally agreed, however, that those governments that make most efforts to control abuse are those that suffer least from it.

Many third world countries are poorly equipped to deal with the highly technical problem of control and some realise that any attempt at control will discourage investment. Most developed countries have instituted elaborate mechanisms for controlling transfer pricing abuse and back up such mechanisms with powerful legislation which includes the right to impose severe penalties on any companies and individuals involved. Legislation involves both tax and customs areas and is enacted in sections 402 and 402A of the US Tariffs Act, section 482 of the US Internal Revenue Code, section 485 of the UK Income and Corporations Tax Act, article 57 of the French General Tax Code, etc.

Governments demand that their tax revenue be based on the true financial performance of the companies in their country. This means that they expect these companies to use the correct market price for goods and services that they trade in with overseas entities.

Central to the process of establishing the 'correct' price of a good or service transfered between different parts of the same company, is the idea that the price should be the same as a price for the same good or service freely bought and sold between completely unconnected companies. This is known as 'the arms-length price'.

Special problems concerning mined products

The most common form of abuse for mining countries that have restrictions on currency transfer, is the under-invoicing of exports. The under-invoicing of exported mined products is fairly easy to detect but difficult to prove. Since the turnover in the sale of a product is large compared to the purchase of imported inputs or services (areas also subject to transfer pricing abuse), this form of abuse can be used to transfer very large amounts of money.

Establishing the arms-length price for many manufactured products is relatively easy. Such products are usually produced as identical items and have to be advertised and promoted for sale. Catalogues and promotional material openly display the sales prices and conditions of sale. In addition, the manufacturer usually sets a fixed price for the product for relatively long periods of time.

Although some mined products are exported in a consistant form, many are not and prices differ between grades and quality. The price also varies constantly on the international markets and the sales price achieved varies with the quoted world price according to the luck or skill of the sales-person concerned and the relationship between the buyer and seller.

Prices also vary according to the volume of sales. Sales contracts are made on widely differing delivery and payment terms depending on the location of the buyer, his creditworthiness and local conditions. Suppliers might also wish to offer certain buyers a favourable price in order, say, to get his business away from another supplier.

Government approaches

It can be seen that outside parties, such as governments, find it difficult, in these circumstances, to determine the price the seller 'should' have used in a certain transaction. The exporter is always in a good position to justify any price used.

Governments tend to have two general strategies. The first is to check as accurately as possible the sales price used by the exporter. This usually involves comparing the sales price with that achieved by other sellers or with prices quoted from authoritive sources. Such an approach necessitates the government agency concerned having access to documents supplied by the exporter that notate all the conditions of sale including price. These documents need to be certified by the exporting company as correct. This method of control will certainly prevent many very serious cases of abuse. Determined abusers will not be detered or prevented from illegal transfer pricing by this method, however.

The other strategy is for the government to determine a fair price for the goods and simply use that price when determining tax liability (or tariff duty if applicable).

In the US both customs and tax authorities have a very wide choice of defining the arms-length price based upon the price at which similar goods produced by other producers are sold or even offered at the same time.

The first approach taken by government agencies towards transfer pricing include the formulation of legislation to require exporters to reveal details of their export sales contracts and shipping arrangements for exported goods.

Such details need to be made available to the relevant government agencies but in some countries, such as Greece and Zimbabwe, a single government unit is made responsible for coordinating the examination of export data and for collaborating with other agencies such as

the central bank, customs and tax authorities, to investigate transfer pricing abuse.

Unfortunately, governments are unable to rely on the exporting company's data alone to test for transfer pricing abuse. Although it is obviously necessary to confirm that sales returns are those expected from the terms laid down in the sales contract, it would be wrong to assume that the sales price stated in the contract is the arms-length price.

For this reason most governments enact additional legislation to allow them to check if arms-length prices are applied and to apply them if they are not.

In countries with a freely convertible currency transfer pricing asbuse is more of a concern to tax authorities and in these countries it is generally the tax authorities who investigate and prosecute cases of abuse.

In countries where the currency is not freely convertible, however, it is generally the central bank (or the Ministry of Finance) that takes responsibility for transfer pricing control. This is because both tax and balance of payments considerations are involved. (In the long run, of course, the development of the whole country is effected by transfer pricing abuse).

Known concerns involving transfer pricing of South African mined products

It has been difficult to investigate the existence or degree of transfer pricing abuse in the South African mining sector because mining companies do not make public the detailed data required to make such an investigation. The previous South African government has never published the necessary information to allow such an investigation. In spite of these difficulties it has been possible to make a prima facie case of transfer pricing abuse against the South African mining industry.

Firstly, it is not difficult to show that the industry has a motive in cutting its tax liability. The prices of mined products have been historically low for a number of years and the industry has found it difficult to make large profits. Any savings in tax would make a great difference to the income of shareholders.

During the last couple of years several major mining companies have been making increasing use of sales agencies based in tax-haven countries, especially in Switzerland and more especially in the canton of Zug in Switzerland. The tax rate in Zug is zero for profits made overseas. Strict and secretive Swiss commercial laws make that country an ideal intermediary for companies indulging in transfer pricing abuse. (Cases of transfer pricing abuse taking place in Zimbabwe and Sierra Leone and investigated by the United Nations Centre on Transnational Corporations, found that Switzerland is the principal facilitator of the abuse).

The sale of so many South African mined products, including steel, coal, nickel, diamonds, gold and chrome through Swiss sales agents offers the companies an opportunity and a means of transfer pricing abuse. It also offers very little opportunity of detection. It should be remembered that consumption or further fabrication of South African mined goods in Switzerland (or any other tax-haven) is insignificant.

In many cases the sales commission paid by South African mining companies to associated or non-associated foreign sales agents is many times the going rate for such services.

These are not classic cases of transfer pricing abuse involving under- or over-invoicing of goods but, if some of these very high commissions are paid back to the producer in another country (double invoicing), transfer pricing abuse is taking place.

We are also aware that many export sales contracts are made with companies associated with the South African producer or with their foreign subsidiaries.

It has also been confirmed that hedging operations for products exported from South Africa are conducted by foreign entities. The extra profitability provided by hedging and any other market operations seem not to get repatriated to South Africa.

In addition, we also know that South African mining companies bear almost the total cost of the sales promotion of various manufactured products made from platinum, diamonds and gold. Their foreign customers, who are often associated companies, which make substantial profits from the manufacture and sale of the fabricated form of these products, pay very little for this promotion cost. This situation is analogous to an iron-ore mine paying the advertising bill for a new range of automobile.

Previous South African governments have not published export trade figures for many categories of product in order to protect sanctions busting operations used to support the apartheid regime. We do not have the necessary figures to compare the sales revenue received for mined products with arms-length prices.

From anecdotal evidence, however, it would appear that for many years South African mining companies have had a policy of systematically transfering funds out of South Africa as a hedge against nationalisation and in order to reduce income tax liability.

There are a number of other incentives that companies have for transfer pricing abuse. If companies want to keep wages down, they don't want to post high profits. Transferring the profit abroad is one way of doing this. If the local currency is likely to be devalued, companies will prefer to keep their assets in stronger currencies.

Now that the ANC has formed the government of South Africa it will soon be possible to know if sufficient data is

available to prove one way or another if the classical form of transfer pricing, i.e. over-invoicing imports and under-invoicing exports, has been taking place. We now know, however, that existing government agencies are neither able to detect or control transfer pricing abuse in the mining industry.

It has been established that the previous South African government has relied upon the Reserve Bank to control and deter the abuse of transfer pricing. It seems, however from talks held between Dr Paul Jourdan and officials from the Reserve Bank, that the Bank has not been able to exercise proper control. At this juncture it is impossible to say whether this is due to negligence, lack of understanding of the nature of transfer pricing or lack of resources. (Considering that the issue of capital flight has been of considerable concern in the economy for some years it is difficult to believe that the latter excuse is plausible).

We now know that the Reserve Bank attaches no significance nor takes any special interest in the fact that sales agents are based in tax-haven countries. We also know that, so long as sales commissions paid to foreign agents are at or below 5% ad valorum, no effort is made to investigate whether the service offered is worth the fee paid. Exporters are not asked to supply the Reserve Bank with copy contracts, invoices or bills of lading so no real checks are made to ensure that arms length prices are paid. In addition, the Reserve Bank claims that it cannot cooperate with the tax authorities due to some legal constraint.

In short, there has been very little control of tranfer pricing abuse in the past.

Other, macro-economic research projects, notably those conducted by Zav Rustomjee, have identified the mining sector as the probable conduit for a large proportion of the nations capital flight difficulties.

The mining companies have denied any suggestion that they have been involved in transfer pricing abuse. On the other hand they are not prepared to give us the necessary information to prove or disprove their claim.

It may well be that the companies feel that, since they have never had any objection to their activities from the Reserve Bank, they do not think that they have abused the system.

The prima facie case against the industry does seem very strong, however, and certain practical steps should be taken by a democratic government to investigate this issue and to curb any abuse as soon as it assumes power.

Future action

ANC policy towards the mining companies has developed and changed during the few months leading up to national, democratic elections. The commitment to control transfer pricing abuse has, however, been enshrined in the 'Reconstruction and Development Programme'. Such control is likely to take the form of an auditing system within a legislative framework which will be the responsibility of the Reserve Bank to apply.

The ANC is likely to institute a programme of research to determine the best way of increasing and maintaining the control of transfer pricing abuse for mined products. Such a programme will need firstly to research the existing legislation to determine if any extra legislative apparatus is necessary.

In order to be effective, legislation should :

- require export companies to submit copies of their sales contracts and sales invoices to government agencies for pre-shipment approval of all exports. Government agencies should have direct access to all company records concerning exports and foreign exchange dealings, including details of shipping, transport, packing, insurance and processing contacts
- allow government agencies to cooperate with each other and exchange any information in the interests of preventing abuse.
- prevent exports of goods or services at terms and conditions that are not deemed to be in the national interest.
- disallow the appointment of foreign sales agents and/or prevent sales agency agreements that are not considered to be in the national interest.
- prevent South African companies from paying licence fees, royalties, management and advertising fees and any other payment to a foreign entity if such payment cannot be fully justified.
- allow for the government to 'deem' an arms-length price for taxation purposes in cases where export sales prices are not consistant with market prices.
- allow for the punishment of the abuse of transfer pricing.

Such legislation will almost certainly exist within tax law but it may be necessary to expect a wider definition of the legal nature of such abuse.

Legislation has been framed in many countries to address all the above points and any research programme should investigate the legal framework adopted by such countries to determine whether existing South African legislation is adequate or if new laws need to be enacted.

Secondly, and in parallel, it would be necessary to investigate the past record of the mining companies in order to assess what urgency there may be for changes in legislation and/or additional transfer pricing control. In order to conduct this research it will be necessary to gain immediate access to Reserve Bank records and, if possible, access to existing company records covering export contracts.

Thirdly, it would be advisable to bring together senior officials from the Reserve

Bank, Tax, Customs, Ministry of Mines and the Police to examine existing structures, if any, used to tackle transfer pricing abuse. This should lead to the setting up of two institutions; 1) a Special Committee made up of the above senior officials which would be responsible controlling future abuse, and 2) a Special Unit consisting of experts from the agencies, plus accountancy and back-up staff, to be permanently established to administrate control systems.

In practice the unit should be ultimately answerable to either the Reserve Bank or the Ministry of Finance but care must be taken not to reduce the unit's effectiveness with bureaucratic duties.[In time such a group could be widened to control transfer pricing abuse and other forms of illegal foreign currency activities in all sectors].

Special units of this type that have been effective in other countries include the Inspection Division of the Moroccan Office des Charges, the Income Tax Investigation Department in Tanzania, SITET in Zambia, the Price Research Council in Greece, the Colombian INCOMEX and the National Economic Conduct Inspectorate in Zimbabwe.

The National Economic Conduct Inspectorate, NECI, was set up in Zimbabwe in the early 1980s to address these problems and contact should be made with this organisation to determine what lessons need to be learned. (It should be said that NECI has come under some considerable political and financial pressure to be less enthusiastic about its work in certain areas but has remained impartial. Some effort should be made to determine how this was achieved as any similar organisation is bound to suffer from the same type of pressure).

NECI was assisted initially by the United Nations Centre on Transnational Corporations. This organisation supplied training by its own staff and funded training by some experienced officials from other countries with similar problems. It seems, however, that the UNCTC is unlikely to be able to offer similar help to other countries now that transnational corporations have succeeded over recent years in reducing the amount of public examination they are subjected to, especially in third world countries.

The abandonment of confidentiality between government departments is a feature that distinguishes this approach from the one normally followed by advanced industrialised countries. Different government agencies must cooperate and exchange information if this effort is to work effectively.

In order to give the Special Unit (SU) the necessary authority to carry out its work quickly and efficently, its inspectors should be granted the same powers of search and investigation as policemen, tax inspectors and customs and excise officers.

Experience has shown that the work of the SU should be introduced progressively rather than attempt to examine each and every import and export. A list of the more important exported mined products should be compiled and, of these, the ones that most lend themselves to transfer pricing should be examined first.

A high proportion of exports to related companies or through tax-haven countries would be obvious areas to consider. Any anecdotal or circumstantial evidence should also be taken into consideration.

To begin with this 'spot check' approach should be applied until confidence and authority have been built up. Experts have suggested that no more than ten people (plus clerical staff) should be employed by the unit until it has a record of protecting national assets, resisting corruption and preventing abuse.

The SU will need to hire individuals or organisations in countries where South African mined products are sold in order to help determine the prices actually being paid for South African mined goods.

Modus operandi of the special unit

If clear evidence is found to show that some South African mined products are consistantly sold by the South African exporter at below the going world price, the next step would be to examine the relationship between the producers and the overseas cutomers concerned.

In many cases of transfer pricing the customer for products sold at cheap prices is a company in the same group as the producer. This may not always be the case, however. Some transfer pricing is arranged between companies with no direct financial or corporate link. An unconnected buyer of an artificially cheap product from a South African producer can easily pass this benefit back to the producer outside the country. This practice is sometimes refered to as 'double invoicing' but, of course, the parties to this practice are never likely to allow copies of the 'real' invoice to be made available to an outside party. Naturally, such activities are more easily performed in tax-haven countries like Switzerland.

In order to prove that transfer pricing abuse is taking place it is only necessary to show that products are consistently sold by a producer to an associated company in another country at prices below arms-length prices. Where products are sold to an unconnected company at consistently low prices, it would be necessary for the examining authority to obtain direct evidence of return payments from the buyer to the supplier in order to prove transfer pricing abuse.

Before discussing in detail the processes necessary for controlling abuse, it is first necessary to examine the method by which sales of mined products are made and how sales prices are arrived at.

South Africa exports some fifty different mined products and the markets of all these products are different. The products range widely and include materials like iron ore, which is so cheap to produce that the cost of transporting it is

greater than its cost of production, and platinum and diamonds, which are so precious that they must be transported to customers quickly by air to save the cost of finance.

For the purposes of transfer pricing investigation, a distinction should be made between those mined products that are traded formally on one or other of the world's commodity markets and those that are not.

Formally traded commodities

Almost all sales prices for those commodities traded formally are directly linked to the prices arrived at on the commodity market in question. This is because most players in the markets of these products accept that the price arrived at by the formal market is a reasonably fair indication of the 'true' price of the product at any given time. For example, a sale of copper cathodes from South Africa to England might be made at 'the average settlement price for copper cathodes on the London Metal Exchange for the month of delivery less five dollars per tonne CIF UK'.

The price for copper scrap, alloys, wire and concentrates will also be linked to the moving commodity market price of pure copper cathodes even though no sale is made to customers on an 'in Metal Exchange warehouse' basis or through metal exchange brokers.

The mined products which are traded formally in this way are copper, lead, zinc, tin, aluminium, nickel, silver, gold, platinum and palladium.

It is generally easier to determine the arms-length price for these formally traded products than it is for commodities which are not traded on commodity exchanges. Fortunately, these products cover the bulk of South Africa's exports.

The arms-length price for any of these commodities will be the price arrived at on the formal market at the time of sale plus/minus and premium or discount for the quality of product sold compared with that defined by the formal market, minus the transport and other costs involved in getting it to an equivalent destination to that (again) defined by the formal market.

The task of obtaining the traded price of a commodity at any given time on one of the commodity markets is very simple. Such prices are quoted in most financial newspapers and journals and by most of the wire services. It is a more difficult task to determine the correct discounts and premiums to match the quality and transport variables.

Let us take as an example nickel cathode squares. The London Metal Exchange arrives at eight prices per day for nickel. (The LME is the only commodity exchange to trade nickel). These eight prices are the buyers'and sellers', morning and afternoon, and cash and three month price. Most contracts for nickel deals would be based on the 12am cash sellers price, known as the Settlement Price.

The LME accepts any class 1 nickel including full sized cathodes so the high quality 1 x 1 inch or 2 x 2 inch plating squares produced by the two South African producers are bound to attract a premium over the LME price.

For large, long-term supply contracts this premium is likely to be a few cents per pound but for spot sales of small quantities, the premium could be much more. This premium (as well as the nickel price, of course) will change constantly with the changing forces of supply and demand.

In order to establish a fair, arms-length price, it is essential to regularly access information on the consumer market. Such information is available from traders, competitors and the consumers themselves. For this reason, it would be advisable for the SU to use the services of an individual or a company in the main consuming centres who are in regular contact with the kind of organisations who can confirm market trends in premiums and discounts.

Once the market premium or discount to the formal price at the time of pricing is known, the only other factors needed to establish the arms-length price are the costs incurred in getting the nickel from South Africa to the location of the nearest centre of delivery defined by the commodity exchange in question. Using our nickel and LME model, we know that LME prices apply to an 'in Warehouse Rotterdam' basis, amongst others. Since most South African nickel is sold in Europe, it should be possible to find out what the producers pay to move it to Rotterdam or equivalent destination. It should also be a simple matter to find out the extra cost of delivering the nickel to the buyer's works (if applicable) and the extra cost of finance, insurance, etc., also from Rotterdam.

The arms-length FOB South Africa price (the price which the buyer should actually have paid) is, therefore:-

The LME price, + or - the quality premium or discount, minus freight and other costs to 'in warehouse Rotterdam' plus delivery and other costs from Rotterdam to buyers works.

By comparing this price with the actual foreign exchange receipts for the parcel of metal concerned and/or the sales price as defined by the sales contract, it will be possible to determine if transfer pricing is taking place.

Although most cases of abuse involving exports confine themselves to under-invoicing the value of the exported product, some companies over-invoice costs, such as freight, insurance and warehousing charges. The SU should attempt to get independent verification for all these charges rather than except the charges indicated on exporters' invoices. (It should be said that abuse of this kind involves collusion with shipping lines, insurance companies, etc., so although this form of abuse is certainly not unknown, it is a rarer occurence).

It would also be useful to compare the export sales prices achieved by different South African producers of the same product (where this is applicable). Collusion between producers, to bamboozle government agencies with similar sales figures, cannot be ruled out but such collusion would be difficult to organise. By comparing sales prices achieved at the same time for the same product it should be possible to discover any patterns of abuse.

Patterns of abuse can also be discovered by comparing the sales prices achieved by those customers which are part of the same group as the exporter and those that are not. Comparisons should also be made between sales made directly and those made through sales agents and between sales made to industrial countries and those made to tax-haven countries.

Non-formally traded commodities

Discovering the true, arms-length price for a commodity which is not traded formally on a commodity exchange is more difficult.

Such commodities are privately traded between producers, merchants and consumers. No publicly accessible commodity exchange trades in these goods so other means must be used to discover the true market price at any given time.

Fortunately, there are two or three authoritive journals that quote traded prices for most non-formally traded mined commodities (and steels). These journals regularly ask traders what prices they have traded at for the commodity in question. Although there is no penalty for that trading company if it decides to fabricate prices it reports to the journal, it is unlikely that this will happen over the long term.

All traders find it useful to have accurate prices quoted in the journal and are, therefore, reluctant to mislead it. For this reason, the quotations for commodity prices in these journals are considered to be fairly reliable.

Armed with the exporter's sales contract and the price reported in these specialist journals for sales made of similar products at the same time by other buyers and sellers, it is possible to estimate the likelyhood of abuse taking place. Such evidence does not establish a very accurate arms-length price, however.

The best evidence for establishing correct prices is only obtainable from the trade - that is from insiders within the trade. Most merchants who specialise in the products in question have to rely on the high quality of their information sources in order to be able to make a living. Traders spend most of their time assessing information from all the consumers, producers and other traders of the product in question. Very close estimates can be made of the volume of sales and details of price and contractural conditions by the daily process of offering and bidding in the market.

Traders do not find it difficult to find out the names of suppliers of a given product to individual consumers and one can be reasonably sure that the prices and conditions of sale from these various suppliers are going to be very similar at any given time. If only one set of sales conditions can be discovered, it follows that all the others will be more-or-less the same.

The SU must get close to this network of information either directly or through hired agents. It will be necessary to give information in order to obtain information.

Non-formally traded mined products are less uniform than formally traded ones. The bulk of Western consumers can take either South African charge chrome or Russian high carbon ferrochrome. The difference in price paid by consumers for these two products will vary with availability and, again, this information can only be obtained by regular contact with the market players.

As with formally traded commodities, comparisons of prices paid by different types of customer and accepted by different South African producers of the same product are likely to throw up any existing patterns of abuse.

Action to be taken

In most cases of the abuse of transfer pricing investigated by government agencies, no prosecution follows. The reasons for this can be the need for a government to keep on reasonably good terms with the company concerned or because sufficient hard evidence could not be obtained. (This is not to say that important cases of abuse have not been successfully prosecuted). The main reason for attaching stiff penalties to laws against abuse is to give a disincentive to would-be abusers.

If a government agency can demonstrate that a particular exporter consistantly sells a product at lower prices than another company, or if an exporting company sells at lower prices to its associated company than it does to unconnected companies, then it is a fairly clear signal that transfer pricing abuse is taking place. What can that government agency do if its evidence for abuse falls short of that needed to mount a successful prosecution?

In the first place, it may be that the mere discovery of the apparent abuse will act as a warning to the company and the abuse will cease. The threat of prosecution by a government agency to recover tax losses retrospectively is usually taken seriously by mining companies especially if they are trying to win contracts in other countries. A company will often make some gesture, such as an out-of-court settlement or a new local investment, in exchange for the dropping of the threat of charges and to avoid adverse publicity. Publications of the findings of the SU is one of several penalties available to a government. Another might be for a government agency to require the

company in question to be subject to more onerous reporting obligations.

More straightforwardly, a government might use legislation similar to that adoped in the USA which allows it to simply 'assess' the arms-length price that should be used for taxation purposes. This, of course, does not directly tackle the problem of transfer pricing being used as a conduit for capital flight. Such measures give a strong incentive for companies to behave properly, however, because a court might accept a very high assessment of the arms-length price if evidence of long-term abuse can be established.

Appart from using the assessment method to determine the arms-length price, other methods are also used for tax assessment purposes. An average of all sales prices for all exporters of a similar product over a given time period, for instance.

Another might be to base the price on that traded on a commodities exchange or that published in an authoritive journal. Such arrangements could be negotiated or, if necessary, imposed.

Exporting companies very often blame their own incompetence for failing to sell at 'the going price'. This excuse should not deter a government's efforts to use an arms-length price for tax purposes. Such efforts will give the export company a good incentive to improve sales performance if there is indeed any truth in the explanation.

Information concerning the internal practices of a company can often be had from retired employees or employees who have left the company. Some provision should be made to encourage such 'whistle-blowing' and protection and indemnification should be given to the individual concerned.

It is important in such cases to be certain that such individuals do not have a particular grudge against the company or an individual in that company.

Tackling other forms of transfer pricing abuse

a) Use of tax-havens. An examination of the current practice of South African mined products exporters offers strong evidence of forms of transfer pricing abuse other than under-invoicing exports.

The most common form of potential abuse is the payment of very high sales commissions to sales agents based in Switzerland and other tax-haven countries. Such agents are used as intermediaries for sales of South African products to other countries all over the world.

The argument used by exporters to support the use of these agents is that such agents are simply the best. They may have staff that talk the necessary languages of the buyers in consuming countries or they may have the best contacts. Their services are not claimed to be cheap.

Many Swiss companies used as sales agents, lawyers and accountancy firms have been closely associated with sanctions busting both for Rhodesia and South Africa. The close relationship between South African entities and Swiss entities has grown up over many decades because of the latter's ability to secretly and expertly help companies to transfer currency and goods and to avoid paying taxes. Helping a foreign company to commit a crime in its own country is not a crime in Switzerland so long as the particular crime is not a criminal offence in Switzerland. Tax evasion is not a crime in Switzerland nor is currency transfer outside the country. These are the usual reasons for choosing Swiss trade intermediaries.

Marc Rich & Co is the most famous mined product dealer and sales agent in Switzerland. Marc Rich himself is not allowed to leave Switzerland because almost all other countries have an extradition treaty with the United States where Rich has been indicted of many charges of tax-evasion, trading with the enemy and racketeering. He is known to have facilitated many trades against UN sanctions and has a long history of supporting apartheid by breaking the oil embargo. He had close ties with the ex-leaders of Bophuthatswana. Marc Rich & Co are one of South Africa's largest coal sales agents for sales around the world. Is it likely that a company with this record would shrink from helping a South African mining company to evade tax?

Government strategy should be directed towards transparency in trade and in encouraging companies to adopt an efficient, modern and cost conscious marketing policy. Discouraging the use of sales agents based in tax-haven countries would assist in all these aspects.

South African companies should require special permission from the Reserve Bank to use the services of agents based in tax-haven countries. Permission could be granted when the role of the agent was to make sales within the tax-haven country only. Since most of these countries are small and/or poorly industrialised, such sales are bound to be insignificant.

Instead, South African exporters should be encouraged to make sales directly to customers. So long as such marketing is done professionally and so long as proper communications are maintained, customers much prefer such direct contact. It should be noted that so long as agents are used, producers will never build up a close relationship with consumers. These valuable contacts are, instead, enjoyed by the agent and are often used to sell competitors' products. The interest of the agent is very different from the interest of the producer.

For this reason exporters should require permission to appoint any foreign sales agent and should be able to justify the added expence, demonstrate that the commission rates are competitive and show that the agent has no conflicting interests. Permission to continue the arrangement should be regularly required.

b) Sales promotion costs. The SU should commission an independent audit of the costs incurred by South African companies to promote the sale of mined products is justified and is not being used as a cover for transfer pricing.

c) Hedging and the use of other market facilities. It appears that at least some South African mining companies use their foreign subsidiaries or other foreign entities to hedge sales of their products or use the options markets or other formal market facilities to insure against market loss or enhance profits.

Companies should certify that if such action is being taken, any profits made by the action should accrue to the South African company.

d) Over-invoicing imported supplies. We must assume that some system exists to make sure that the cost of imported products or overseas services are properly checked. The SU needs to review whatever system is in use.

Using foreign expert companies to control transfer pricing

Some countries have decided to hire specialist companies such as SGS to take over control of transfer pricing for them. Sometimes this has been done at the insistance or suggestion of the World Bank or other UN agency as part of a wider structural adjustment programme.

It should be said that the service offered is very expensive. Usually the expert company will not take on only part of the export or import trade but will insist on all or nothing. (Not, for instance, only trades worth more than 10 000 USD). The cost is usually 2 per cent of the total value of all exports and imports. In many cases this fee has been shown to be greater than the savings that were expected to be made. For these reasons, some of the third world countries that took out contracts with these firms have cancelled them.

SGS is itself a Swiss multinational and has private dealings with most if not all of the companies under inspection. They certainly have a large and efficient database of the prices for millions of different types of goods. Many of these are, however, not applicable to South African trade and the individuals working for the company are unlikely to have as good an understanding of the markets of South African products as South Africans.

Building up ones own expert group with special knowledge of the South African situation is likely to be cheaper and more efficient in the long run. More importantly, perhaps, any official based in the home country is going to be subject to local laws designed to combat corruption.

Outside expert help from companies or individuals is bound to be required to obtain accurate sales prices in consuming countries, for instance, but contracts with these companies should be made dependent on full reporting, strict time duration and proper contractural control.

Conclusion

All mining companies, by their nature, need to have most of their assets in a fixed location. Most countries impose controls over the companies' potentially mobile assets – finished product and liquid assets.

Like all large companies, however, mining companies want to have the widest possible choice over where and how they might invest. In addition, they have an inbuilt interest in keeping their tax bills to a minimum.

Companies operating in countries like South Africa, that restrict the convertibility of their currency, feel paticularly restricted.

These companies have every incentive to maximise the amount of untaxed assets that they can get out of the country. This natural reaction does not necessarily mean that they see no future for mining in South Africa. Nor does it mean that they do not wish to invest in South Africa in the future. What it does mean, however, is that they, the mining companies, want to decide where best to invest. Assets trapped inside the country must be invested in the country. Each internal Rand invested relieves the country of the need to attract external investment on terms which are over-generous to investors - terms that the mining companies would prefer.

We only have prima facie evidence that transfer pricing abuse is occuring but, even if there were no such evidence, it would be the duty of the relevant government agencies to try to minimise possibility of it occuring.

Action should be taken quickly to examine existing controls and strengthen them if they are inadequate. The historical record should be examined to determine if and where abuse has been taking place and on what scale and, if possible, action should be taken to recover lost revenue. ■

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