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Assessment of Factors Affecting Tax Compliance in the Mining Industry in Zambia

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Abstract
Multinational enterprises abuse transfer pricing to erode the country's tax base by shifting profits to other jurisdictions thereby depriving the host country of revenue that would have been available for development. The study used a descriptive research design to assess factors affecting tax compliance in the Zambian mining sector. The target population was 106 transfer-pricing practitioners, tax consultants and ZRA Inspectors dealing with mines. The entire population was sampled in this study.The study collected primary data using an online-administered questionnaire involving the entire population. The study also analyzed secondary data and conducted one-on-one online meetings with industry experts. The data was analyzed using descriptive statistics. The study found that tax compliance costs in Zambia to be very high and that transfer pricing was a very complex tax concept with mean scores of 3.66 and 3.70 respectively. Additionally, the study found that Tax Authority was not aggressive in conducting compliance audits with a mean score of 3.3. Finally, the study found other factors affecting tax compliance included policy in-consistence and inadequate enforcement capacity.
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Introduction

According to Youde and Lim (2019) "tax compliance refers to taxpayers' decision to comply with tax laws and regulations by paying tax timely and accurately." Tax compliance encompasses submission of tax returns within the specified period and remittance of correct amount of taxes on time. Tax compliance is important to the development and growth of any country including Zambia.

The development and growth of a country generally pivots on obtaining revenues from the economic activities in the country and in that respect, taxes are considered one of the major national sources of a country's revenues (Varvarigos, 2016). Governments are continuously in need of funds for the purpose of investing and building public infrastructure, health services, education and other public services including reducing poverty, and as such, a need always exists to increase tax revenues to enhance development and growth. Tax revenue can be enhanced through efforts directed towards resolving the issue of tax non-compliance (Franzoni, 1999). An increase in tax compliance would reasonably enhance the tax revenue available to a country, while non-tax compliance causes intense concern throughout developed and developing nations around the world (Alm, Jeremy, & Kara, 2016).

Transfer pricing

Transfer pricing is "the process of determining the income of all parties concerned in international business transactions" (Olaoye & Aguguom, 2017). Transfer pricing therefore, tries to outline the tax base of the nations engaged in international cross-border business transactions. According to the United Nations transfer pricing Manual (2021), transactions that take place within the same Multinational Enterprise (MNE) are called controlled transactions and can be contrasted with uncontrolled transactions that take place between unrelated MNEs and therefore assumed to be at arm's length.

The Arm's length principle (ALP) is the world's accepted guiding principle for choosing an acceptable transfer price. Under the principle, transactions within a group are compared to transactions between unrelated entities to determine the acceptable transfer prices. About 80% of global trade today (in terms of gross exports), has become linked to international production networks of MNEs (Ruggie, 2018). This is because of the multiple times intermediate goods are imported, a step or two is taken in their processing, and then they are exported again as an intermediate product to the next stop, where the cycle is repeated until the final product is assembled.World trade in intermediate goods is now greater than all other non-oil traded goods combined (International Labour Organisation, 2016) .

Transfer pricing in Zambia's mining sector

According to the latest EITI reporting (2019), the extractive sector accounts directly for 9.9% of GDP and 78.4% of exports in Zambia. Indirectly, the mining sector may contribute as much as half of the GDP. The mining sector directly employs about 73,203 people representing 2.4% of total employed persons in Zambia. Transfer pricing has been identified to be one of the major reasons Zambia has not significantly benefited from its mining endowment.

The study was aimed at finding out the factors causing transfer pricing in the mining sector of the republic of Zambia.

Literature review

Tax Morale theory

Tax morale is defined most often as the inherent motivation to pay taxes. Torgler, (2012) defines tax morale as the totality of non-pecuniary motivations and factors for tax compliance that fall outside the expected utility maximization. Previous studies show that there are persons that are just honest taxpayers who do not try to evade tax because they are predisposed not to evade (Long & Swingen, 1991). The study contrasted honest taxpayers with an opposite extreme of taxpayers referred to as tax evaders who in general, have a low tax morale and act as rational actors comparing the benefits of evading taxes to the benefits of complying. Furthermore, there are individuals who may enjoy evading taxes and perceive it as a game of playing with the state (Kirchler, Muehlbacher, Kastlunger, & Wahl, 2007)

The transfer pricing regulatory framework in Zambia

The rules and regulations are based on Section 97 (A-D) of the Income Tax Act (Chapter 323 of the laws of Zambia), known as the income tax (Transfer Pricing) Regulations of 2000, as amended by the Income tax (transfer pricing) (Amendment) Regulations 2018, published on 6 April 2018. The amended regulations, integrate many of the OECD's recommendations as regards BEPS Actions 8-10, including the requirement to prepare transfer-pricing documentation, rules governing the application of the arm's length principle, and a new safe harbor in relation to low value intra-group services. The Regulations are to be read together constantly with the OECD Guidelines and the United Nations Practical Manual on transfer pricing for developing countries. In the event of inconsistencies between these documents, these regulations shall reign supreme. The threshold for application of the transfer pricing regulation is 50% participation by a corporate entity, directly or indirectly in the management, control or capital of a second corporate body.

There is no provision for Advanced Pricing Agreements in the ACT. However, an enterprise may consult ZRA regarding the interpretation or application of any provisions of the law. The regulations on the other hand provides for a safe harbor in respect of low value added services, of cost plus 5%, provided that the service charge is based on an appropriate cost allocation method. Further thin capitalization rules exist in the ACT whereby deduct-ability of interest is caped at a debit equity ratio of not exceeding 3:1 (S.29).

In addition, the ACT requires disclosure of whether the taxpayer entered into any controlled or related party transactions during the year and if that were the case, significant disclosure of the nature and value of the related party transactions is required. In terms of the regulations, a person participating in a controlled transaction is required to prepare, on an annual basis, detailed documentation that is to be provided to ZRA on demand

Arm's length methods

Tax compliance in the context of transfer pricing, starts with the selection of a transfer pricing method. The selection of a transfer pricing method should always aim at finding the most appropriate method for the particular case. According to the OECD (2017), the selection process should take into account the respective strengths and weaknesses of the method and the appropriateness thereof in view of the nature of the controlled transaction determined in particular, through a functional analysis. It should also consider the availability of reliable information on comparables needed to apply the selected method and the extent of comparability between controlled and uncontrolled transaction including the degree of reliability of comparability adjustments that may be needed to eliminate material differences between them.

According to the OECD, as cited in Rudzikiene (2017), there are several methods that MNEs and tax administrations can use to determine accurate arm's length transfer prices for transactions between associated enterprises. The OECD recommends five main transfer pricing methods that MNEs and tax administrations can use and they are now briefly explained here.

Comparable uncontrolled price (CUP) method

The CUP method according to the OECD is one of the traditional transaction methods (as opposed to transactional profit methods). This method compares the price of goods or services and conditions of a controlled transaction with those of an uncontrolled transaction. To do this, the CUP method requires comparable data from commercial databases. If the two transactions result in different prices, then this suggests that the arm's length principle may not be implemented in the commercial and financial conditions of the associated enterprises. In such circumstances, the price in the controlled transaction may need to be substituted with the price of the transaction between unrelated parties. The CUP method is the OECD's preferred method in situations where comparable data is available.

Resale price method
Another traditional transaction method for determining transfer pricing is the resale price method. This method starts by looking at the resale price of a product that has been bought from an associated enterprise and then sold onto an independent party. The price of the transaction where the item is resold to the independent enterprise, is called the resale price. The method then requires the resale price margin be identified, which is the amount of money the party reselling the product would require to cover the costs of the associated selling and operating expenses. The resale price margin also includes the amount the reseller would need to make a fair profit, taking into account the functions it performed including assets used and risks assumed. This gross resale price margin is deducted from the resale price. The amount that remains after the margin has been subtracted and fair adjustments have been made is the arm's length price for the original transaction between related entities.

Cost plus method
The cost plus method is a traditional transaction method that analyzes a controlled transaction between an associated supplier and purchaser. It is often used when semi-finished goods are transacted between associated parties or when related entities have long-term arrangements for 'buy and supply'. The supplier's costs are added to a markup for the product or service so that the supplier makes an appropriate profit that takes into account the functions they performed and the current conditions of the market. The combined price is the arm's length price for the transaction.

Transactional net margin method (TNMM)
The TNMM is one of two transaction profit methods recommended by the OECD for determining transfer prices. These types of methods assess the profits from particular controlled transactions. The TNMM involves assessing net profit against an appropriate base such as sales or assets that result from a controlled transaction. The OECD states that, in order to be accurate, the taxpayer should use the same net profit indicator that they would apply in comparable uncontrolled transactions. Taxpayers can use comparable data to find the net margin that would have been earned by independent enterprises in comparable transactions. The taxpayer also needs to carry out a functional analysis of the transactions to assess their comparability.

Transactional profit split method
The second transactional profit method recommended by the OECD is the transactional profit split method. It focuses on highlighting how profits and losses would have been divided within independent enterprises in comparable transactions. By doing so, it removes any influence from special conditions made or imposed in a controlled transaction. It starts by determining the profits from the controlled transactions that are to be split. The profits are then split between the associated enterprises according to how they would have been divided between independent enterprises in a comparable uncontrolled transaction. This method results in an appropriate arm's length price of the controlled transactions.
Alternatives to the arm's length methods
Zambia's regulatory framework is primarily based on the ALP. Although when correctly applied, the ALP replicates market conditions in intra-firm trade, not only allocating value where it is created but also minimizing distortions of investment decisions and maximizing global economic welfare (Robertis, 2018), it presents practical problems. While the ALP is a much closer approximation of an uncontrolled price, it is "too resource intensive, and time consuming to be of practical use to taxpayers and tax authorities (Chamroo, 2018)". It entails large resource and skills: the tax inspectors need to understand the processes unrelated parties use to determine prices. Tax authorities need to have the expertise to stage the role of unrelated parties and establish the specific characteristics of the group affiliate to determine an appropriate price. It is often very likely that a degree of judgement influences the assessment of the appropriate price. Comparability arguably requires more than a comparison of the relevant prices but also the specific circumstances of the parties. It is for this reason that some jurisdictions opt for alternatives and hybrid regimes. Zambia uses some of these alternatives in certain circumstances

Effects of complexities of transfer pricing rules and methods
Tax complexity is described as the actions taken to address business issues related to tax law, and these include dynamic changes, excessive details, numerous computations and distinct business records (Alshira'h, Alsqour, & Lutfi, 2020). According to Jackson and Milliron (1986) as cited in Alshira'h et al., (2020), tax complexity is one of the top drivers of tax compliance behavior. In Cuccia and Carnes (2001) and Cuccia and Gregory (2001) studies, a negative relationship was supported between tax complexity and the tendency to comply with tax

regulations. This was echoed in Abdul-Jabbar and Pope's, (2008) study, where the authors reported an inverse impact of increased tax complexities and tax law amendments on the compliance performance of taxpayers. The latter study showed that tax complexity frequently related to tax compliance costs, and as such, majority of businesses chose not to comply with them. However, other studies found tax complexity lacked a significant relationship with tax compliance as found by Biabani and Ramezani (2011), yet even other studies like Yahaya (2015), reported a positive relationship..

Method

The study used a descriptive research design. A mixed method approach was used to analyse data. Interviews were used to collect primary out of the target population of 106. The study sampled the entire population. Statistical descriptive were used in analyzing the data

Discussions

The bulk of mining transactions are controlled.

Table1 below shows the extent of related party transactions in the mines. The results show that 7 out of every 10 experts agreed that most transactions are self-trading and 31 % strongly agree. This translates to a mean score of 3.84 that indicates agreed. Internal transactions are the bedrock of transfer pricing.

#	Internal transaction volume indicator	N	SD	D	U	A	SA	Mean	Std Dev	Decision
			1	2	3	4	5			
1	Vertically integrated	87	6	3	15	48	15	3.72	1.02	Agree
2	Has sister operating subsidiaries out side Zambia	87	6	0	0	51	30	4.14	0.98	Agree
3	Most of the business in terms of revenue is with sister subsidiaries outside Zambia	87	3	12	6	30	36	3.97	1.17	Agree
4	Most of the business in term of expenditure is with sister subsidiaries outside Zambia	87	3	21	15	21	27	3.55	1.26	Agree
	Aggregate		0.05	0.10	0.10	0.43	0.31	3.84		Agree

Table1: Volume of controlled transactions

TP is very complex, compliance costs are high and ZRA not aggressive.

The study results show that compliance costs in Zambia are prohibitively very high both from the MNEs perspective in terms of complying with transfer pricing rules and regulations and from a ZRA perspective in terms of enforcing those rules and regulations. These high costs explain the other research finding of ZRA's lack of aggressiveness in conducting compliance audits. This finding provides some evidence of the deterrent theory. The economic theory as proposed by Becker (1968) claims that deterrence is the main factor affecting management of tax compliance declaring that taxpayers are rational in behaviour and tax non-compliance is a direct result of the perception taxpayers develop about the benefits and risks associated with the vice.

The findings show that transfer pricing is a very complex tax concept that requires extensive resources to manage and this is beyond the reach of most developing countries including Zambia. Furthermore, on ZRA aggressiveness, the study results showed that the revenue authority is not aggressive in conducting compliance audits on the mining enterprises.

The study results show that there are other factors affecting tax compliance in the area of transfer pricing other than compliance costs, transfer pricing complexity and ZRA aggressiveness. These factors include burdensome of documentation requirements, inadequate legislative framework especially the Income Tax ACT, lack of comparable arm's length prices, policy inconsistencies, and political interference and corruption.

5. Conclusion

The study findings show that Zambia has no capacity to deal with a transfer pricing policy framed on arms' length principle. This is not withstanding the efforts and progress that has been made to curb the vice. Transfer pricing is resource intensive, the application of its concepts are constantly, and rapidly changing to catch-up with changing world business. For as long as the legal framework remains anchored on the Arms' length Principle, countries especially developing countries will always play catch-up to these MNEs because of the speed with which they can change practices that cannot match that of developing countries including Zambia**.**

Recommendations

In view of these findings, the following recommendations are hereby made:

- In the short to medium term, improve transfer-pricing capacity in the country. Capacity needs to be built at ZRA in terms of training and skills and access to databases and other resources. Capacity needs to improve in other agencies of the country including Ministry of Finance, the Courts, National Prosecution Authority, Financial Intelligence Centre.

- Cap management fees that are prone to mispricing. These measures will help safeguard the tax base and reduce the transfer pricing monitoring burden.
- Establish a legal framework for APAs. There is currently no provision for companies to request advance-pricing agreements;
- Implement BEPs action 15 by ratifying the multilateral Instrument (MLI) on treaty abuse; and in the long term;
- Work with regional groupings such as SADC to explore formulary apportionment or parts thereof to reduce complexity and compliance costs.

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