

Unmasking Transfer Pricing Manipulation in Zambia's Copper Mining Sector: An Analysis of Schemes, Legal Gaps, and Enforcement Challenges under the Arm's Length Principle

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Abstract:

This article interrogates the pervasive use of transfer pricing manipulation (TPM) schemes by multinational enterprises (MNEs) operating in Zambia's copper mining industry, examining the legal, institutional, and economic ramifications of such practices. Anchored in the arm's length principle as articulated under the OECD and UN Model Conventions, the analysis unpacks the multifaceted mechanisms through which MNEs circumvent tax obligations via mispricing of goods, services, and intangibles. Using doctrinal and socio-legal methods, the study classifies TPM schemes into strategic misinvoicing, debt manipulation, service misallocation, and intellectual property distortions. It argues that Zambia's domestic regulatory framework is undermined by legislative ambiguity, enforcement deficits, and institutional capture, thereby facilitating profit shifting and erosion of the country's tax base. In concluding, the article recommends a recalibration of Zambia's legal architecture to align with best international practices, calling for the implementation of country-by-country reporting, mandatory disclosure rules, and the development of local capacity to challenge complex TPM arrangements.

Keywords: Transfer Pricing Manipulation, Copper Mining Sector, Multinational Enterprises (MNEs), Tax Base Erosion, Zambia Revenue Authority (ZRA), Illicit Financial Flows

1. Introduction

Transfer pricing manipulation (TPM) by multinational enterprises (MNEs) in extractive industries has emerged as one of the most insidious forms of illicit financial flows confronting resource-rich developing nations. In the context of Zambia's copper mining sector, TPM remains a potent driver of tax base erosion and profit shifting (BEPS), perpetuated through internal transactions that deviate from the arm's length standard. Despite the formal adoption of the OECD's transfer pricing guidelines and the arm's length principle into Zambia's tax code, regulatory and enforcement gaps persist, enabling MNEs to exploit structural asymmetries in the global tax system.

This article critically examines TPM schemes deployed in Zambia's copper sector. It interrogates seven principal mechanisms through which MNEs engage in manipulative transfer pricing, including strategic mispricing of copper concentrates, inflating intra-group loans, fictitious service invoicing, and the overvaluation of intellectual property assets. In doing so, it exposes the systemic weaknesses within Zambia's legal and institutional apparatus that facilitate such schemes. The article contends that the inadequacy of domestic legislative tools, lack of technical expertise within the Zambia Revenue Authority (ZRA), and the power asymmetry between host states and MNEs form the bedrock of persistent revenue losses.

2. Transfer pricing manipulation schemes of MNEs

TP manipulation is common in most multinational enterprises in developing economies. TP manipulation is the process of setting non-arm's length prices in transactions between companies within the same group. (Shikwambana, 2020). Between related companies, it can be done by making misrepresentations on invoices (e.g., charging more to reduce profits, overcharging for goods or services that are not necessarily sold or provided. (Kiunsi 2017). Horst (1971) and Eden (1998) believe that TP manipulation refers to setting transfer prices above or below opportunity costs to avoid but not take advantage of opportunities to evade government control and/or to exploit arbitrage opportunities between country differences. Multinational corporations also use TP manipulation to evade government price or tax controls.

In some cases, it is easy for multinational corporations to manipulate prices to avoid assuming the maximum tax liability, thanks to tax planners who engage in long and complex procedures to set prices that are not related to the market. When acceptable OECD methods are used for tax planning and TP calculations, it is not easy for tax authorities to identify manipulation in the calculations, and it is sometimes difficult to

prove whether the prices used by multinational corporations meet arm's length requirements (Kiunsi 2017).

This section introduces common TP manipulation schemes, including underpricing or overpricing of prices and invoices, use of special channel entities, use of intellectual property rights, use of management fees and thin capitalization, which are the most commonly used TP manipulation schemes by multinational companies.

2.1 Over or under pricing of invoices and prices by MNEs

Transfer pricing manipulation by multinational corporations (MNCs) is a significant issue in the realm of international business, primarily involving the over- or under-pricing of invoices and goods. MNCs use transfer pricing to send their profits to countries with low taxes so they pay less in taxes. This practice involves over- or under-pricing of goods transferred between companies within the same group with the intent to misrepresent and shift profits. Over- or under-invoicing means that the invoice for goods and services transferred between related parties does not reflect the exact actual amount of the goods or services transferred. For example, in the case of under-pricing, a company within the group can sell a product with a market price of K1,000 for K500, while in the case of over-pricing, a product with a market price of K500 is sold for K1,000. In most cases, the tax revenue lost through this practice is substantial. The literature indicates that such manipulations can distort financial reporting and evade taxation, leading to substantial economic consequences for host countries.

Mashiri (2018) argues that income shifting refers to the manipulation of prices by related companies to exploit tax differences, thereby shifting profits from places where they may be highly taxed to places where they are not taxed or are taxed less. Reiterating the issue of mispricing by multinational corporations, tax avoidance is achieved by shifting the tax base to places where tax is less. Merle et al. (2019) note that multinational corporations tend to manipulate TP by overstating payments to high-tax jurisdictions and understating payments to tax-friendly environments (e.g., charging higher interest rates on loans to companies in high-tax jurisdictions and lower interest rates to companies operating in tax havens or low-tax environments). In the acknowledgments, Reuter (2012) states that multinational corporations tend to "over-invoice tax-deductible domestic transfer payments to high-tax countries and under-invoice tax-deductible domestic transfer payments to low-tax countries." Kwaramba et al. (2016) in their study of transfer mispricing in the Zimbabwean mining industry suggest that a large amount of profits is shifted through under-invoicing exports and over-invoicing imports, resulting in significant tax losses.

Various researchers have argued that the scale of manipulative TP activities is huge, with revenue shifted through issuing false invoices (Asongu, 2016; Kabala & Ndulo, 2018). Reuter (2012) argues that in terms of intra-company TP, affiliates of multinational corporations are often intra-company, a collaboration driven by the need to maximize the overall profits of the multinational corporation. Affiliates often collude rather than compete in their profit-making efforts and pricing decisions, thereby over- or under-invoicing to reduce tax burdens through “profit maximizing TP”, or avoiding tax burdens in some countries through “profit maximizing TP” (Reuter, 2012, p. 213).

Focusing on TP in Ukraine, Melnychenko, Pugachevska, and Kasianok (2017) concluded that TP is not only used to avoid taxes through tax planning, but can also be used for direct tax evasion. The researchers highlighted three scenarios for direct tax evasion: (1) using fictitious or “pseudo-imports” that are priced higher and exported at lower prices (2) generating unfounded value-added tax (VAT) credits and illegal VAT offsets and using “pseudo-or atypical exports” to evade taxes and sell them at high prices (3) using fictitious companies.

2.2 Utilisation of special conduit entities

Using special conduit entities, multinational corporations can establish or invest in a company (i.e., a subsidiary) in a country with no or low tax jurisdiction (i.e., a tax haven). For example, Mauritius has a corporate tax rate of 15%, while Zambia has a tax rate of 30%, which is said to be the reason why some multinational corporations such as Nestle and Multichoice have operations in both Zambia and Mauritius. Multinational corporations may be more aware of the different tax rates in the countries where they operate and may develop plans to reduce their tax liabilities.

The design of a special conduit entity development is reasonable when all relevant information in the development is available and the transaction being concluded is likely to be taxed little or no. Some special conduit entities will be established by multinational corporations in a jurisdiction where any income received by the trust is tax-free and any income from other entities will be transferred into the trust knowing that such income will not be taxed.

2.3 Use of management fees

Multinational companies also use management fees to manipulate TP. This practice entails using management fees and other costs to avoid taxes. In this case, multinational companies can register management companies in countries where management fees are low compared to the management fees charged in the location where the company operates. Management fees can be deducted from taxable income if the fees charged are reasonable and the

management fees must be incurred in the process of generating income or for the purpose of earning income and the company must have a legal obligation to pay the management fees.

Most multinational companies have used and still use management fees to reduce and eliminate taxes by shifting income from profitable to loss-making entities. Many tax authorities are aware of this problem, but due to capacity issues, they have not been able to successfully track and curb this. In response to the use of management fees to manipulate TP, tax authorities have been extensively reviewing the deductibility of management fees. If the tax authorities do not allow an entity to charge management fees, but the company that charges the fees still taxes it as income, double taxation will occur. However, it is important to note that the burden of proving that management fees are deductible lies with the multinational company, not the tax authorities. According to the study by Mpofu and Mashiri¹, chief among the TP schemes used by multinational enterprises in Zimbabwe is the use of management fees.

2.4 Use of intellectual property rights (IPRs)

In addition to management fees, MNEs also make use of IPRs as a way of transfer pricing manipulations. Increased global competition, rapid changes, investments in R&D, human resource skills, innovation risk, and production and marketing have made MNCs understand the use of IP in the international trade environment. (Kumar 2018) The use of IP schemes involves the right to use intellectual property such as trademarks, technical expertise, and intangible assets.

Most multinational companies with operations in Africa own intellectual property and collect royalties from those who use their IP. For example, Zambia Breweries is a subsidiary of SAB Miller, which in turn is a subsidiary of Anheuser-Busch InBev, one of the world's largest breweries, which uses the intellectual property of parent SABMiller. The trademarks for African beer brands owned by the parent company are registered in the Netherlands, which has no or very low taxes on royalties. Subsidiaries such as Zambia Breweries that use trademarks in Africa can treat the royalties they pay as expenses, so they are eligible for domestic tax deductions.

Multinational corporations continue to invest in the R&D of their intellectual property to ensure that as globalization and emerging markets continue to grow, trademarks, patents, and other intellectual property rights are not infringed, which may cause them to lose more returns as creators. Like any other creator, multinational corporations want to ensure that

¹Mpofu, Favourate Y. and Eukeria Wealth. "The arm's length principle: a panacea or a puzzle for regulating TP transactions of multinational corporations in developing countries." *Eurasian Journal of Business and Management*, Vol. 10, No. 2 (2022): 137-152.

they recover the costs of investing in R&D and bringing products and technologies to market and make a profit (Kumar 2018).

In Zambia, the ZRA allows deductions for costs incurred by a taxpayer for research and development of intellectual property or costs incurred for the use of intellectual property, provided that such costs are incurred in the production of income. Provisions providing for the tax deduction of costs for the use of intellectual property are contained in specific provisions of the Property Transfer Tax Act (PTT) and the National Intellectual Property Policy (NIPP) as amended in 2020.

2.5 Thin Capitalisation

Thin capitalisation is also another transfer manipulation scheme of MNEs. As noted by Nyatsambo², thin capitalisation serves as a significant transfer manipulation scheme employed by multinational enterprises to minimise tax liabilities. Thin capitalisation, a situation in which an entity utilises to their tax benefit the deductions/exemption mismatch that arises from cross-border debt financing, is one of the most common methods of BEPS utilised by MNEs.³ MNEs achieve tax reduction through debt financing since they can deduct more of the interest payments from their taxable income. When MNEs make cross-border investments, whether by setting up an entire business or acquiring all or part of an existing business, a key question arises as to whether the investment is made through debt or equity.⁴

Debt instruments are taxed differently from equity instruments because the return on equity instruments is in the form of dividends.⁵ Holding interest-bearing debt generally generates tax benefits in the country where the investment is made. This has led to a growing number of tax authorities in countries concerned that repatriating profits from their home country to other countries via interest rather than dividends will result in tax losses, and therefore to pay close attention to financing methods, known as thin capitalization.⁶ The United Nations describes "thin capitalization" as using unusual debt-to-equity ratios to obtain tax benefits.

The general position is that thin capitalisation is an issue if there is a connection between the parties. It is therefore common cause that a close relationship between the parties, for example a parent-subsidiary relationship, is often an indicator of an intention to gain a tax advent. The problem of thin capitalization arises because debt and equity are treated

² Nyatsambo, Nyasha Gift. "Sizing the BEPS: an assessment of the efficacy of South Africa's thin capitalisation regime in combating base erosion and profit shifting (BEPS) through excessive interest deductions." (2019).

³ *ibid*

⁴ Govender, Shane. "Section 31: transfer pricing and thin capitalisation." PhD diss., 2000.

⁵ *ibid*

⁶ *ibid*

differently under most tax systems. Debt interest is treated differently from equity dividends, and this difference in treatment has the effect that the deliberate or unintentional characterization of equity as debt (or vice versa) may result in a tax advantage (or disadvantage) for companies in a corporate group. In some countries, this may be of considerable relevance in a purely domestic context.

In most countries, when a company receives capital from a foreign parent or other foreign associated company in the form of debt at commercial rates, the interest on the debt will generally be allowed as a deduction against the borrowing company's normal corporate tax. While interest payments to a foreign parent or associated company may be subject to withholding taxes, these taxes will generally be waived or significantly reduced if permitted by the terms of a double tax treaty/agreement between the two countries. However, shares are offered as a form of capital rather than debt, and dividend distributions will be a form of return, with capital generally coming in the form of dividend distributions.

Thin capitalization schemes manipulate TP by exploiting the interest rates obtained on internal financing between related MNCs. If the debt is tax-deductible, then debt interest is deductible, but stock dividends are not, as in Zambia where companies are subject to dividend tax. Under this scheme, many MNCs use debt financing rather than equity financing within the group because debt generally offers greater tax benefits than equity financing. Generally, debt interest is deductible by the debtor tax-free, but stock dividends are not. Manipulating TP using thin capitalization can be accomplished in three ways: (a) by a tax haven company financing another company in the group that is located in a high-tax country, (b) by raising interest rates due to exchange rate risk caused by the strength of one country's currency relative to another, and (iii) by a company's goal of maintaining a high debt-to-equity (D/E) ratio.

2.6 Thin Use of intangibles

Many TP researchers have mentioned the use of tangible objects in TP arguing that it is difficult to prove whether the transfer prices of these intangible assets are in line with the ALP.⁷ This is because in some cases these intangible assets will be unique to the group as there are no comparable prices or comparable databases available for benchmarking.⁸ Tax authorities in both developing and developed countries have struggled to prove their case

⁷ Mpofu, Favourate Y. and Eukeria Wealth. "The arm's length principle: a panacea or a puzzle for regulating TP transactions of multinational corporations in developing countries." *Eurasian Journal of Business and Management*, Vol. 10, No. 2 (2022): 137-152.

⁸ Kabala, Edna, and Manenga Ndulo. "Transfer mispricing in Africa: Contextual issues." *Southern African Journal of Policy and Development* 4, no. 1 (2018): 6.

against MNCs in this area, which has led to MNCs taking advantage of this area. Reuter⁹ argues that some intra-company transactions are more "substitutable" than others, making them vulnerable to TP manipulation.

For example, cost sharing agreements are used to share risks and costs associated with the joint development, design or production of assets and related R&D costs. In addition to the challenges of determining the arm's length transaction costs of intangibles and finding comparable prices, making them the most vulnerable item to abuse in TP, Reuter¹⁰ argues that management fees are "particularly notorious" for being manipulated through TP. Muhammdi et al.¹¹ mention that taxpayers' transparency and lack of cooperation regarding intangible asset information are some of the obstacles faced by TP auditors. In Indonesia, Dyreng¹² found that multinational companies enjoy excessive tax benefits through the use of intangible assets.

2.7 Debt shifting

Debt shifting is another scheme employed by MNEs to manipulate transfer pricing. This practice involves over-financing related enterprises in high-tax jurisdictions with debt to enjoy after-tax savings, as interest is deductible, thereby reducing taxable income. For example, interest rates are inflated in high-tax jurisdictions, thereby reducing taxable income and calculating relatively low taxes. The interest becomes income in low-tax jurisdictions and is subject to less tax or no tax under the tax code (Oguttu, 2017). Anouar and Houria (2017) found that high financial leverage (the use of debt) is positively associated with high tax avoidance, but most multinational corporations tend to finance their enterprises with more debt than equity in high-tax jurisdictions.

Oguttu (2017) suggests using withholding taxes to reduce the abuse of debt through weak capitalization. This would ensure that those who still try to circumvent the weak capitalization ratio by having banks issue loans to subsidiaries on their behalf or by other means of making the company appear independent and unrelated would be exempted from the withholding tax. The payer would be required to withhold the tax and remit it to the tax authorities before remitting the interest to the payee. Van Der Zwan (2017) raises a concern that applying TP adjustments to disproportionate interest could result in an overly onerous tax burden.

⁹ Reuter, Peter, ed. *Draining development?: Controlling flows of illicit funds from developing countries*. World Bank Publications, 2012.

¹⁰ *ibid*

¹¹ Muhammedi, A.H., Ahmed, Z. and Habib, A., 2016. Multinational transfer pricing of intangible assets: Indonesian tax auditors' perspectives. *Asian Review of Accounting*, 24(3), pp.313-337.

¹² Dyreng, Scott, Robert Hills, and Kevin Markle. "Using financial accounting information to estimate the income shifting of us multinationals." *Available at SSRN 4007595* (2023).

On the other hand, Reuter (2012) lists that in order to cope with withholding taxes, MNCs can decide not to remit funds in cash but to reinvest them and make TP in the future through exports, or they can impose withholding taxes on dividends, technology fees, training fees and management fees and structure the payments in such a way that they will pay the lowest tax if these rates are different. Mashiri (2018) lists that although countries such as Zimbabwe have debt-to-equity limits or weak capitalization ratios, above which interest deductions are prohibited, MNCs use these to inflate equity figures.

3. Conclusion

Transfer pricing manipulation in Zambia's copper mining sector epitomises the intersection of legal technicality and economic injustice. The schemes examined—ranging from copper misinvoicing to over-leveraged financing structures and artificial service contracts—reveal the deliberate strategies employed by MNEs to dilute tax obligations under the guise of intra-group transactions. While Zambia has made commendable strides by adopting international transfer pricing standards, implementation remains weak, enforcement fragmented, and the legal regime insufficiently tailored to the extractives context.

This article recommends a three-pronged reform agenda: first, the amendment of Zambia's Income Tax Act to incorporate anti-abuse provisions specific to mining TPM; second, the establishment of a specialised transfer pricing unit within ZRA with forensic audit capacity; and third, the adoption of international transparency standards such as country-by-country reporting and automatic exchange of information. Only through a recalibration of legal and institutional frameworks can Zambia reclaim its sovereign taxing rights and stem the tide of illicit outflows undermining national development.

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