CURRENT TAX ISSUES IN EXTRACTIVE INDUSTRIES

Policy Dialogue on Natural Resource-Based Development
Work Stream 3
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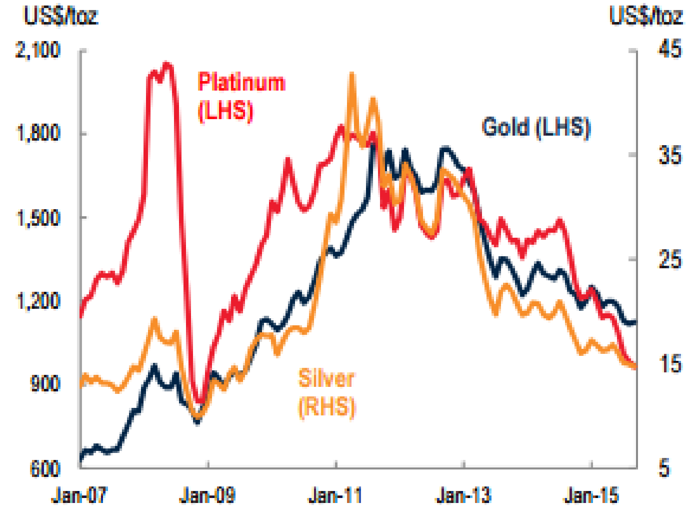
OECD
BETTER POLICIES FOR BETTER LIVES

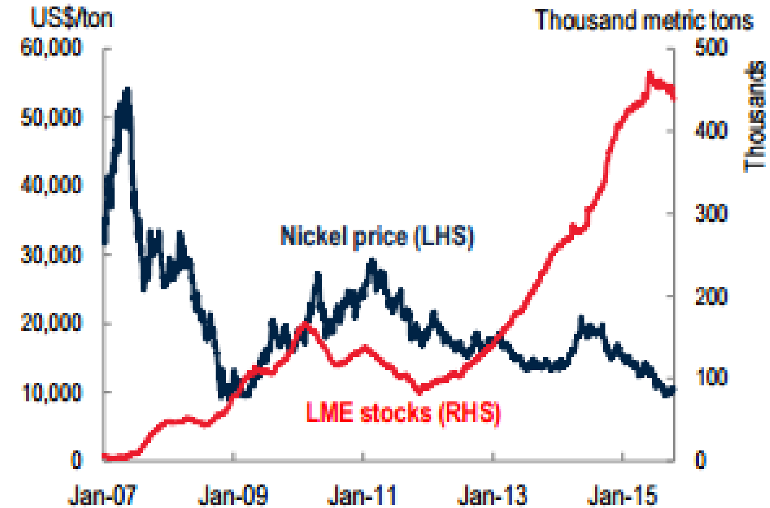
Introduction

- key focus areas:
  - Current economic context
  - Tax issues affecting the sector
  - Update on mineral product pricing

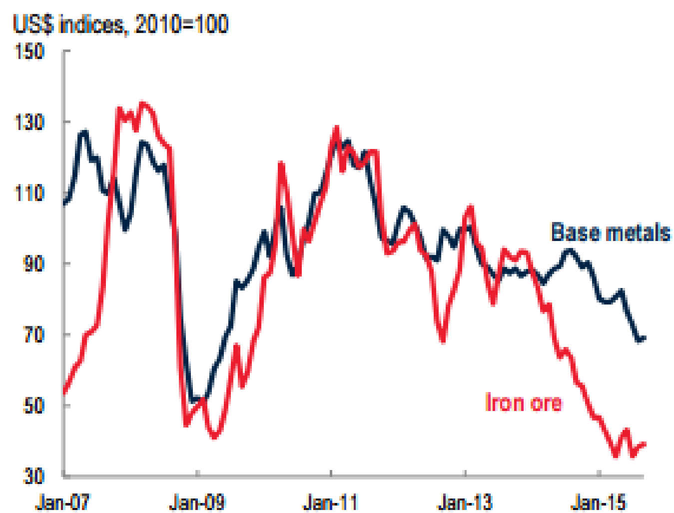
ECONOMIC CONTEXT



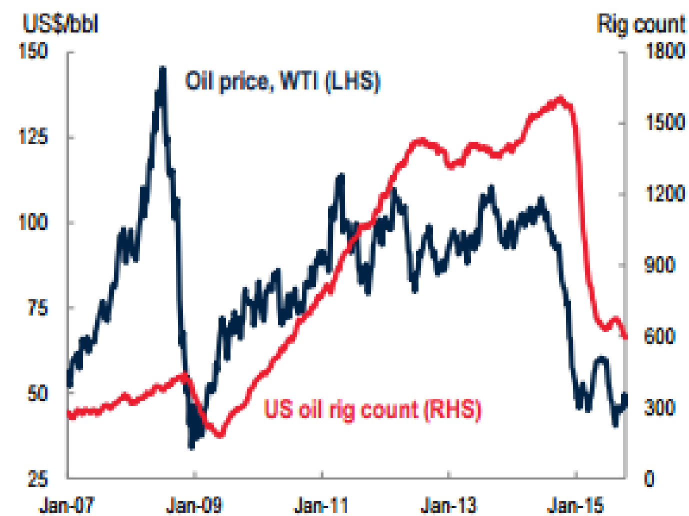
Source: World Bank.
Note: Last observation is September 2015.



Source: Bloomberg.
Note: Last observation is October 16, 2015.



Source: World Bank.
Note: Last observation is September 2015.



Source: Baker Hughes, Bloomberg.
Note: Last observation is October 9, 2015.

All charts: WBG – Commodity Markets Outlook October 2015

Economic context for mining companies

- Significant price falls across broad range of commodities
- Implications for firms: difficult operating conditions
  - Mining income falls
  - Production cuts
  - Exploration cuts
- Implications for governments: fiscal, macro
  - revenue falls
  - Mine production cuts, reducing exports and employment

Pressures created

- Industry: survive
  - Cut costs wherever possible
  - Cut production where can stabilise price outlook
  - Put (most) new projects on hold
- Government: manage revenue shortfall
  - Stabilise fiscal settings (cut spending, raise debt, draw down savings/SWFs, sell assets)
  - Pressure to impose new charges on the sector (or increase existing)
  - Modify revenue administration (productively – get better at it, or destructively – stop processing VAT refunds, aggressive revenue mobilisation)

CURRENT TAX ISSUES

Issues are broad-based

- Policy
  - Indirect transfer of EI assets
  - Tax incentives
  - Thin capitalisation
  - Stability clauses
  - Ring fencing
- Administration
  - Transfer pricing
  - Access to information held offshore
  - VAT refunds
  - Metals “streaming”
  - Project ring fencing
  - Legislative design, drafting
  - Documentation

Implications

- Addis Ababa focus on assistance on tax is very timely – there is a lot to do
  - BEPS implementation (broad-based)
  - In EI: work through current issues
    - Policy assistance (where considering changes to fiscal regime – transition is critical to get right)
    - Administrative assistance (collecting revenue based on laws already in place, ensuring those laws work as intended)

Our areas of focus

- G20 DWG asked us to look at how we could help developing countries better understand the mineral product prices used by multinationals
  - Formulation
  - Forces affecting prices
  - Transfer pricing risks

OECD WORK ON MINERAL PRODUCT PRICING

To do that, build a foundation first

- First, understand the mines and the products
- Second, what are the elements that shape those prices?
- Then, how can we assist in applying this information
  - Transfer pricing analysis
  - Understanding related issues
- There are now 4 consultation documents available for review

Where the work can go

Price = (% cu * LME) + value of gold, silver – TC – RC – quality adjustments

Customs valuation

Transfer pricing

Financing Issues

THANK YOU

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SUPPLEMENTARY INFORMATION – TAX ISSUES

Policy Issues

Indirect sale of EI assets*:* Many countries – particularly developing countries – consistently raise concerns about the ability of their capital gains taxes to tax the sale of assets occurring offshore. In the EI sector, these transactions can happen at any time in the life of the project, but the discovery of new resource deposits or new information about the extent of deposits (such as through more detailed testing) is particularly concerning, since it can result in rapid increases in the value of the exclusive right to develop those deposits. The company or individuals making the discovery often choose to sell out all or part of their interest at this point to benefit from the discovery. This sale may be of the asset directly for example, or at the company entity level. Transactions that occur abroad are of concern to many revenue authorities because they may not be detected by the EI country's tax authorities or might be structured to fall outside the EI country's tax base (such as by selling shares in the company holding the asset in a foreign country without notifying revenue authorities in the country where the asset is located). The OECD has begun detailed work on this issue, along with the IMF, World Bank and UN to assist developing countries. This report will be delivered in 2016.

Tax incentives: Countries continue to compete to ensure their tax settings are considered attractive to investors, and to encourage domestic policy goals, such as increasing inbound investment, promoting industrialisation, employment and economic diversification. In EI (particularly mining), this means countries are seeking greater participation in the value adding as resources are transformed from ores to saleable commodities. Leaving aside the efficacy of incentives, the design of incentive systems continues to cause difficulties for many countries, and the extractives sector is no exception. Common fiscal incentives include reduced tax rates for particular activities such as local value adding via smelting and refining processes for metals; accelerated depreciation deductions on plant and equipment; withholding tax cuts; incentives to encourage exploration such as through accelerated deductions, direct subsidies or refunds; and/or tax holidays to encourage companies to choose particular projects.

These incentives encourage the expansion of the EI sector, but may transfer more of the gains from EI activities to the producer than was originally intended. This can be because the true fiscal cost of the concessions is not well understood, or the concession, once afforded, is used in unforeseen ways (such as restructuring to move costs to the higher-taxed parts of the production chain to increase tax deductions and moving sources of revenue to the relatively tax-preferred parts; or through intra-country profit shifting though transfer pricing). Authorities may also attempt to 'claw back' revenue through additional taxes or charges, increasing uncertainty and costs for business. To assist developing countries, the IMF, World Bank, UN and OECD have recently published a report offering guidance on the design and governance of tax incentives. This report is based on recent country experiences and extensive review of academic and other studies, and suggests good practices in these areas.

Policy Issues

Profit shifting through 'thin capitalisation': The unreasonable or excessive use of debt deductions is often raised as a tax base erosion issue in both developed and developing countries, where profits are transferred between countries using debt financing transactions. Many developing countries do not yet have laws limiting the extent of debt deductions possible under corporate income tax, exposing them to increased risks that companies will allocate higher debt levels to their jurisdiction, reducing profits and government revenue. Whilst not definitive, there is evidence that multinational enterprises respond to changes in tax rates by changing the structure of debt within the group. BEPS Action 4 directly addresses this issue. A common international approach aims at ensuring that an entity's net interest deductions are directly linked to the taxable income generated by its economic activities and fostering increased coordination of national rules. Developing countries may need assistance however to implement this BEPS response in a way that is tailored to local conditions.

Stability clauses: many developing countries have implemented laws or other legal instruments providing protection to investors against changes in fiscal settings once an investment has taken place. These are requested by some companies to provide greater certainty to the fiscal settings that will be applied to a resource project, but in some cases the operation of this law also prohibits potential changes that may be needed to correct a defective or erroneously drafted law (for example, where a tax benefit was afforded to the company that was unforeseen or never intended).

Project 'ring fencing': Ring fencing is the fiscal boundary within which costs and revenues of companies in common ownership may be consolidated for tax purposes (IMF, 2012). Some countries keep different resource projects separate for revenue purposes, typically because this means the profitability of each project is taxed on its own "merits" (that is, more profitable projects raise more revenue, as the costs of other projects cannot be used to reduce revenue charges). Similar to the incentives created by tax incentives, ring fencing creates incentives for domestic cost shifting wherever possible (such as where offshore project activities have a higher tax charge than onshore activities), requiring close scrutiny by revenue authorities. In addition, ring fencing can create administrative complexities where certain functions or services are centralised (for example, different mines owned by the same company may use the same beneficiation facilities), or where infrastructure or equipment is shared across different projects, since authorities and companies must establish how much of each is to be apportioned to each project.

Administrative Issues

Transfer Pricing: Based on the discussions held to date at the Policy Dialogue, countries have noted ongoing difficulties in applying transfer pricing approaches to EI product transactions. In addition, as noted in a report to the G20 Development Working Group: *" … countries often find it difficult to apply the [transfer pricing] criteria … to assess whether intra-group transactions accord with arm's length practices and consequently, whether transaction terms in controlled transactions are excessive or unwarranted." (OECD, 2014)*

These difficulties can be for several reasons. Firstly, the information simply may not exist (for example, some rare earth elements, transactions may be so infrequent and opaque that finding comparable uncontrolled transactions may be almost impossible). Secondly, countries may not know what information they require or where to look for comparable transactions, or may not have the expertise to apply the arm's length principle effectively. And thirdly, the information may be difficult to obtain, particularly where networks with fellow revenue authorities are limited, or where taxpayers deliberately conceal important details of the transaction offshore (such as their relationship to the purchaser of a commodity).

Developing countries also frequently identify the role of related party intermediaries in trading and logistics as being active in base erosion through transfer pricing. This risk relates to the level of remuneration for the services provided by the related party in marketing and selling EI products to final customers – from the perspective of many developing countries, these entities charge significant fees for services, often without any physical transformation of the product between EI producing country and final customer. In other cases, revenue authorities may not be able to ascertain the identity or role of related parties offshore (see access to information below). Significant additional work is currently underway to develop toolkits on some of these issues.

Administrative Issues

Access to information on activities of foreign parties: Accessing taxpayer information held offshore continues to significantly impede the job of revenue authorities. This lack of information makes comprehensive transfer pricing analysis more difficult, if not impossible, to undertake (since, for example, the revenue authorities may not know the exact arrangement for the final sale of resource product and whether price manipulation is occurring, or what role offshore intermediaries are playing). In addition, financing arrangements offshore may not be clear (particularly whether a multinational enterprise is concealing a financial arrangement such as a loan with its offshore affiliates through back-to-back loan arrangements. (In their simplest form, back-to-back loans are financing transactions between related parties done through an unrelated intermediary.)

Administering Value Added Tax (VAT) refunds: VAT systems are designed to operate so that the tax is only paid on the final sale of goods and services. VAT paid on intermediate inputs into production is refunded. This is done to ensure the VAT does not become embedded into the costs of production, which drives up prices and affects business competitiveness.

This 'cascading' nature of VAT systems with refunding means they require the compliance attention of revenue authorities to minimise fraud or erroneous payments. But many developing countries struggle to refund VAT in a timely way, because: the volume of payments requiring verification may stretch the resources available; revenue collections may be already behind targets, making authorities reluctant to process further outflows; or officials may be punished if refunds are paid in error, making them seek detailed line-by-line verification from taxpayers. In some cases, refunds may not be paid in order to claw back lost revenue (such as where tax holidays have been afforded on corporate profits) or because relationships with taxpayers have become adversarial. In these circumstances where VAT refunds to EI product exporters are refused or significantly delayed, the VAT becomes a real burden on companies, potentially undermining wider efforts to attract the investment.

Administrative Issues

Metals streaming: Certain financing arrangements can reduce the tax base of mineral producing countries and transfer profits elsewhere. These arrangements enable mining companies to access funds for partial or complete mine development and construction, and can fill a financing gap where funds are not available from traditional sources such as banks. Streaming agreements can be between unrelated or related parties, with terms that appear relatively advantageous to the financier. For example, significant risks are borne by the mine, such as the risk the mine is not brought to production (addressed by the financier obtaining title over a share of the proven reserves of the mine) and any cost over-runs in bringing the mine to production must be met by the mine. In addition, the commitment to selling mine output is applied over the life of mine, meaning the sales commitment also applies to additional discoveries.

Streaming reduces the tax base of resource-producing countries, where fiscal settings (such as *ad valorem* royalties and CIT) use sales revenue as part of tax calculations. In addition, since the amount of financing provided is linked to the discounted price (see Figure 1), mines have strong incentives to agree to lower fixed prices, since this increases the up-front finance provided to them. Streaming agreements also pose challenges for revenue authorities because they contain both debt and equity characteristics, which can add complexity for developing countries and give rise to mismatches in tax treatment where agreements are with foreign parties. Moreover, product sales require careful transfer pricing analysis when undertaken between related parties to ensure base erosion through transfer pricing is not occurring.

Streaming arrangements are not, of themselves, tax avoidance mechanisms. Rather, agreed terms reflect the relative bargaining position of each side of the transaction. In the absence of more advantageous funding from more ‘traditional’ sources, companies may be forced to agree to relatively tougher terms if they wish to see a project proceed.

Streaming example (simplified)

Spot price - $400 = return to Finance co.

Mine Co

Provides Mine co $100 m finance

Finance Co

Builds copper mine, starts production

Sells agreed amount of gold (by-product from the mine) at fixed price $400 to Finance Co

Sells copper products to customers (e.g. as a copper concentrate)

Administrative Issues

- **Project ‘ring fencing’:** In addition to the policy challenges identified, ring fencing can also create administrative complexities where certain functions or services are centralised (for example, different mines owned by the same company may use the same beneficiation facilities), or where infrastructure or equipment is shared.
- **Legislative design and drafting:** For many governments, one of the most difficult challenges in taxation is to clearly specify a tax policy, and then translating that policy into a well-crafted set of legal provisions. Difficulties are particularly acute when governments are designing laws for a new sector or for which they do not have sufficient prior experience. Mistakes are very common. In many developing countries, the sheer number of public officials qualified to design and legislate policies – and with the sector-specific knowledge needed - is limited. Some countries rely on private consultants or even firms themselves to assist with drafting. This increases the risks that laws lack clarity or include benefits or loopholes that were not intended.
- **Taxpayer documentation and transaction verification:** Documentation requirements may not provide revenue authorities sufficient information needed to assess taxpayer compliance with existing laws. For example, transfer pricing analysis requires companies to clearly identify transactions with related parties and to explain how those transactions comply with the arm’s length principle. Taxpayers may be providing incomplete or poor quality information, with authorities having little capacity to review and seek improvements. This may also be the case where authorities must verify that exports of EI products actually accord with what companies say they are (to mitigate risks that companies under-report the contents of shipments).