IGF-OECD PROGRAM TO ADDRESS BEPS IN MINING

THE HIDDEN COST OF TAX INCENTIVES IN MINING

PUBLIC COMMENTS
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The IGF-OECD Program to Address BEPS in Mining
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THE HIDDEN COST OF TAX INCENTIVES IN MINING

Dear Members of the IGF-OECD Program to Address BEPS in Mining,

Business at OECD (BIAC) welcomes the opportunity to comment on the Consultation Draft: The Hidden Cost of Tax Incentives in Mining (the “Consultation Draft”) issued 18 June 2018. We welcome the IGF working with the OECD on these difficult issues and fully support the UN Sustainable Development Goals (SDGs) and agree that tax can be a key driver in countries’ success in meeting many of the SDGs. Specifically, we further support the IGF-OECD’s effort to increase governments’ knowledge and understanding of the benefits and costs of certain tax incentive regimes.

While we welcome the Consultation Draft’s scope and balance in many areas, we do have some concerns regarding the tone and assumptions in some places. For example, there are several implications that mining companies attempt to take advantage of developing countries’ lack of sophistication in seeking as many tax incentives as possible at the expense of the local country. In our members’ experiences, the tax incentives of a certain investment are not featured in the investment analyses until the very final stages. The implication is therefore rather that the mining industry would actually prefer to have consistency and certainty in arrangements, and to the extent rules in developing countries are more closely aligned with those in developed mining countries (e.g., Canada, U.S., Chile, and Australia), our members believe projects would be more attractive and assessed on solely commercial conditions, resulting in less opportunity for abuse and a more level playing field.

Further, a more balanced outline of both costs and benefits (e.g., conceded tax revenue versus investment, employment, increased tax revenue, additional non-tax income such as royalties or dividends resulting from ownership stakes) regarding the various tax incentives would be more helpful to tax administrations making these decisions to ensure the entire picture is told, which ensures the most informed decision can be made. In addition to these general concerns, Business at OECD does have specific comments about certain aspects of the Consultation Draft described in our more detailed attachment.

Again, we commend the work of the IGF-OECD in this area, and we remain of the opinion that both governments and business will benefit from transparent and active engagement. We look forward to working with you further, and we thank you for the opportunity to comment on this subject.

Sincerely,

Will Morris
Chair BIAC Tax Committee
General Comments

1. The title generally implies that there is a (net) cost to mining incentives, and, as a result, such cost is somehow deliberately concealed. We would recommend that the title is changed to “Assessing the Impact of Tax Incentives in Mining” or a similar title that expresses the true objective of the Consultation Draft (i.e., evaluating the efficacy and appropriateness of different tax incentives to different situations) without implying deceitful behaviour.

2. The “issue” per the original work plan released by the IGF and OECD stated that it was hoping to address "harmful tax incentives." However, the Consultation Draft released does not seem to address this point – as, rather, it seeks to guide tax administrations on the costs of all incentives. Ultimately, this change in scope may be appropriate and ultimately more beneficial to tax administrations. However, it would be helpful to explain the reasons for this change in scope in the Consultation Draft.

3. Further, we would recommend additional detail as to related benefits in the Consultation Draft, so a more comprehensive story is told. In several sections of the document, (e.g., the process of reviewing incentives), the Consultation Draft specifically and repeatedly refers to the “cost” to government revenues. This cost is often highlighted without recognising the potential benefits (and potential for overall net benefits). We would encourage a change to align these respective costs with the corresponding benefit (or ways for countries to identify the scale of benefits), if any.

4. By examining incentives in isolation, crucial context is often missed. For example, where the host country demands an equity interest in the project but cannot fund this equity share with cash, the incentive may be seen as foregoing tax revenue in exchange (it is very difficult for a large project to have a positive NPV of after tax cash flows where the host demands a significant equity interest that is not funded). While it may be the case that certain incentives are more/less appropriate than others in such instances, it would be useful to recognise these broader investment commitments in during the examination.

5. Similar to the change in focus on the issue, there appears to be a change in objectives. The stated goal of all toolkits is to address domestic resource mobilisation in order for countries to meet their SDGs. However, meeting the SDGs, does not appear to be a primary aim and are not mentioned in the Consultation Draft. We believe that the paper could be improved with commentary on this context.

6. In some areas, we believe the tone of the Consultation Draft is slightly leading at times. For example, paragraph 1 of the introduction states that "many countries...forgo vital revenues in exchange for often illusive benefits." Paragraph 2 goes on to state "nevertheless, governments may determine..." As a result of the sentence structure, the passage seems to imply that any such decision by government is inappropriate – before actually determining if such is the case. Further, much of the language is overly broad and negative in tone. For example, the second paragraph of page 8, which suggests that tax avoidance, solely, is to blame for poverty in developing, resource-rich, countries. As mentioned above, much of the Consultation Draft attempts to be balanced, however, in our opinion, the general tone would suggest that there is a specific, negative viewpoint related to tax incentives. We believe that it would be more beneficial to readers in understanding the appropriateness (or inappropriateness) of specific incentives to given scenarios if there was a broader recognition that in some cases they are appropriate.
7. Business at OECD believes that many of the potential problems and issues identified by the Consultation Draft can be solved by ensuring that proper transfer pricing controls exist to ensure there is no improper shifting of profits. We continue to support the OECD’s transfer pricing guidelines (TPG) and continued BEPS work in this area. We would encourage a focus on proper pricing versus more general, blanket policies not tied to the underlying economics.

8. Many of the issues under review may be covered and solved by agreeing to and joining a network of double taxation treaties. By joining such treaties, double taxation (a significant deterrent to investment) is avoided and potential options for manipulation could be drastically reduced.

9. We look forward to additional discussions and welcome being part of this dialogue. We, as business, could add significant value by outlining existing challenges faced by different types of incentive regimes and which (if any) are preferred. As Business at OECD has previously expressed, business will discount regimes and incentives that are “too good to be true” in their investment decision process, and in many cases will not take the potential benefits into account at all in early stages of investment decisions. These tax arrangements are but one piece of a broader decision, and a mining company would, in our experience, be unlikely to make an investment that is otherwise marginal because of an inappropriate outcome promised by a governments.

Detailed Comments

A Guide to Reviewing Mining Tax Incentives

10. In our view, the behaviour responses generally oversimplify potential business decisions by assuming that a business would manipulate payments (through transfer pricing) or ramp up/down production based on taxation holidays or other tax incentives. When discussing behavioural responses of taxpayers, there is a significant discussion about what a taxpayer could do (or what they may be economically incentivised to do if achieving a certain tax outcome was their primary business motivation) without any real recognition of the likelihood (or unlikelihood) of this happening due to commercial constraints. In actuality, most businesses are going to extract the materials as quickly and as cost-efficiently as possible, and to suggest that a tax holiday (or other provision) would, on its own, result in ramp up (or down) of activity, without consideration of other economic factors such as market demand or availability of financing (which are #2 on the priority list of what drives mining investment on page 7), is dramatically oversimplifying the business decision.

11. As mentioned above, tax incentives are not generally a priority in the investment analysis until the very final stages. If a project does not have the geology, fundamental economics, and social license to operate, businesses will normally not move forward with the project, regardless of the tax incentives offered.

12. In Step 1 of the process, which outlines the type of tax incentive, the incentive is immediately followed by a potential (harmful) behavioural response. In our opinion this has a significant negative connotation to the potential tax incentive. As noted, some may be more beneficial than others, but the form as outlined seems to overly focus on manipulative actions and not on the broader circumstances.
13. The Step 2 analyses question how a tax incentive is designed. Generally, we find that the discussion is helpful and properly identifies the relevant interacting factors. However, one minor comment is with regards to whether the tax incentive is open-ended – and the paper’s conclusion that there should be opportunities for review and sunset clauses. We would caution against the use of open-ended review, as it would result in significant uncertainty that would need to be considered and priced into the potential investment by business. Alternatively, if the incentive provides clear parameters and timing for this review process (provided such is two-sided), it could provide greater certainty (for both tax administration and taxpayer) that the deal operates as intended per the latest economic realities.

Risk Review of Mining Tax Incentives and Related Behaviour Responses

14. Broadly, out of the potential options, our members agree that income tax holidays are likely not the most effective. However, we would caution against broadly stating that businesses would simply increase the rate of production within the tax holiday window. As mentioned above, businesses are going to extract the materials as quickly and as cost-efficiently as possible and to simply suggest they can quickly and easily manipulate the process is oversimplifying the actual facts and commercial drivers.

15. Regarding the withholding tax relief section, we think it is prudent to remember that interest is only one element to a complex financing equation (which also includes royalties to governments, third-party interest, dividends, and other equity payments). We believe that these assessments should rather be done on a case-by-case basis depending on the actual facts at play, looking to the OECD’s TPG and the arm’s length principle.

16. As with our prior commentary, we are strong supporters of the OECD TPG and the arm’s length principle. Regarding management fees, we agree that the more appropriate method would be to follow the arm’s length principle versus some arbitrary amount based on operating and capital costs. However, some management fees will not simply be low-value adding services (LVAS) and it may be appropriate to pay for them at a rate of higher than cost plus 5 percent. Further, there is a concern of double taxation if the local mining jurisdiction simply denies all or part of the management fee deduction (as the entire amount at the recipient would be included in income) where it is demonstrably arm’s length. Accordingly, this should be assessed and agreed to by tax administration and business before such a difference could result in double taxation (e.g., through a unilateral or bilateral advanced pricing agreement).

17. We generally agree that if properly structured, cost-based incentives can most properly incentivise mining activities while furthering revenue goals by preserving cash flows by delaying taxation and basing the incentive on the amount of investment.

18. We find the recommendations regarding export processing zones are generally appropriate, other than the retention of a right of approval over major related party sales contracts. Businesses should be permitted to operate without government approval for basic transactions, as such would significant disrupt business processes and result in significant uncertainty. Governments may, and should, retain the right to challenge whether a specific price is arm’s length, but it should not retain a legal right of first-approval for basic business dealings.
Comments on the consultation draft of “The Hidden Cost of Tax Incentives”
Commonwealth Secretariat Comments

The Commonwealth Secretariat (ComSec) acknowledges the commendable effort employed by the IGF and OECD Development Centre in the development of the toolkit on “The Hidden Cost of Tax Incentives”. The toolkit will add much needed dimension to the discourse on the mining sector. It is also worth noting that the positions put forward in the paper apply across the extractives industries and will be beneficial to practitioners in the petroleum sector as well.

Comsec’s comments are predicated on the belief that the goal of the toolkit is to ensure that governments of resource-rich countries are better equipped to identify, and cost potential behavioural responses by investors to mining tax incentives.

The discussion, analysis and recommendations in the toolkit are well thought out and presented and we believe the document can be enhanced if the following suggestions are incorporated:

1. The title of the document – whilst very catchy - does not relate well with the content. There was an expectation that the paper would have quantified the value lost to governments, however, the focus is on how the various incentives can be “gamed” (behavioural responses) and recommendations to remedy. Possible options include “Unintended consequences of mining tax incentives” or “Mining Tax incentives – open for business or open for abuse?”.

2. Box 2: A note of Caution should include clear statements on a) redundancy levels b) estimated losses that are discussed in the reference materials.

3. Section a) A step-by-step guide to reviewing mining tax incentives would benefit from the inclusion of the motivation and intended objectives of the tax incentives as they relate to the mining sector. Whilst there are references made to other papers that address this, a synopsis would aid in providing the reader with a well-rounded view of the salient issues and thereby enabling this to be a “stand-alone” toolkit on “Mining Incentives”.

4. Under the section “What is a mining tax incentive?”
   - Consistency in treatment of “sliding scale royalty” and “resource rent taxes”
     If the principle for defining “an incentive” is any deviation from the general tax code, this would suggest that any sliding scale should be treated as such - whether it is applicable to royalties or corporation tax. Given the behavioural responses would be the same in both instances, we would suggest that there is some discussion on resource rent taxes as well. This would require a change to Table1: “Mining Fiscal instruments and corresponding tax incentives” as well as within the toolkit (pgs 12, treating separately in the “Risk Review of Mining Tax Incentives and related Behavioural Responses – Taxes on Income”, possible reference on pg 32-33).
   - The classification of royalty deferral as an incentive is unclear – the royalties are still due and payable, albeit at a later date.
Tabular representation

Given the various potential users of the toolkit it may be helpful to include the Double Taxation Agreements and investment laws in Table 1. A re-categorization of “fiscal stabilisation” is also appropriate as it could be applied various fiscal instruments. A suggestion for consideration is included below

<table>
<thead>
<tr>
<th>Mining Fiscal Instruments</th>
<th>Corresponding Tax Incentives</th>
</tr>
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<tbody>
<tr>
<td>Royalties</td>
<td>- Reduced royalties</td>
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<tr>
<td></td>
<td>- Royalty holidays</td>
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<tr>
<td></td>
<td>- sliding scale royalties</td>
</tr>
<tr>
<td>Taxes on Income</td>
<td>- accelerated depreciation</td>
</tr>
<tr>
<td>e.g. corporate income tax</td>
<td>- investment allowance / tax credit</td>
</tr>
<tr>
<td>withholding tax</td>
<td>- longer loss carry forward</td>
</tr>
<tr>
<td></td>
<td>- withholding tax relief (interest, dividends, services e.g management fees)</td>
</tr>
<tr>
<td></td>
<td>- income tax holiday</td>
</tr>
<tr>
<td>Other</td>
<td>- sliding scales (e.g resource rent taxes)</td>
</tr>
<tr>
<td>e.g. value added tax (VAT), customs duties, surface rentals, capital gains</td>
<td>- suspension</td>
</tr>
<tr>
<td></td>
<td>- partial or total exemption</td>
</tr>
<tr>
<td></td>
<td>- import / export duty relief</td>
</tr>
</tbody>
</table>

5. “Where are incentives found in the law?” In page 9, first paragraph, replace “sources of law” with “legal instruments”. Inclusion of a fourth source, Project specific legislation.

6. We would strongly encourage changing Step 3: “What is the potential effect on government revenues?” to “What are the expected net benefit from the incentives?” or “How does government ensure the advantages of incentives outweigh their potential disadvantages”.

It is important to highlight that there are multiple factors to consider either via a “Box” or at a minimum preface the current description on pg. 13 with a graphical representation from one of the reference documents (see example below) and thereafter stating that the toolkit will be focused on the quantification of Revenues: before and after the incentives.
We believe that there is a need to articulate that incentives should not be looked at in isolation on any individual instrument or as for comparison purposes between different jurisdictions (whether at a national level or at EPZs). Instead it is important that the total fiscal package is considered and that this requires the need for net cash flow analysis.

It is also worth including into step 3: the need to look at revenue forecasting from a “portfolio” perspective as the capital profile required from subsequent projects may impact certain incentives. This may also be a possible behavioural response to certain incentives – i.e. sequencing follow-on investments or re-developments.

The checklist on Box 3 can be strengthened with some of the above amendments as well as:
- the need for “whole-of-government” approach to the offering of mining incentives and in particular the importance of Ministry of Finance involvement
- ensuring there are resources to effectively monitor and report on the various mechanisms – both people and systems. Co-ordination is generally a key challenge.
- Merge points 2 and 3

7. Inclusion of two items on page 23 under 3.2 Recommendations
   - c) Ensure that uplifts are not compounded. See example below.
   - d) Ensure there is capacity to monitor compliance

8. “4. Export Processing Zones” (EPZs). It is worth mentioning that in addition to foregone government revenue, there are also costs for establishing EPZ infrastructure and subsidised services. These should be estimated and included in the financial modelling. This aspect of cost may also be subject to “behavioural responses” which lead to inefficiencies and wastage which consequently result in higher than intended overall burden to the state.

Inclusion of some discourse that EPZs, in some instances also carve out dispensation of labour laws may be beneficial. This has serious implications for health and safety of workers which should not be ignored. In addition, there may be local disruptions if so granted without support from unions etc. which can impact project schedule and/or production. This can be argued as a “behavioural response” from another stakeholder – which can have ramifications and erode anticipated benefits. Suggest inclusion of a new item under 4.2 Recommendations “d) Ensure appropriate safeguards to avoid a race to the bottom on labour standards and to maximise job creation benefits.”

9. Stabilization of Fiscal Incentives. A paragraph should be included to address the unintended consequence that in situations where advancements in industry and global standards have been made, investors may claim that they do not apply. The result of this behavioural response is that it reduces Governments ability to reduce tax leakage. E.g BEPS. Whilst this is addressed within the Recommendations (7.2 a) this is significant exposure and we believe is worthy of a standalone recommendation.
10. Under the conclusions section (pages 42-43):

- The first point should be restated to re-iterate that “it is critical that before agreeing any incentives for the mining sector, the strategy and expected net benefits should be clearly articulated and transparent”.

- Financial modelling and scenario analysis is imperative to support effective incentives in the sector. A base case should be clearly established against which scenarios are un on sensitivities on key inputs along with the behavioural responses described within the toolkit. This is critical for understanding the trade-offs associated with incentives.

- The element of “most damaging incentives” are introduced, for which tax holidays are highlighted. Whilst we agree with the comment, the toolkit can benefit from the establishment of criteria for assessing which are potentially damaging with a simple “low/medium/high” rating.

- There is also the general point on capacity building that is needed. Whilst efforts are generally targeted on the “technical” aspects of the industry such as subsurface and engineering disciplines, there should be due attention to building the commercial and economic modelling skills within developing countries to aid in the decision-making process.
THE HIDDEN COST OF TAX INCENTIVES IN MINING

CONSULTATION DRAFT
This toolkit has been prepared under a programme of cooperation between the OECD and the Inter-Governmental Forum on Mining, Metals, Minerals, and Sustainable Development (IGF), as part of a wider effort to address some of the challenges developing countries are facing in raising revenue from their mining sectors. It complements action by the Platform for Collaboration on Tax to produce toolkits on top-priority tax issues facing developing countries.

It reflects the views of staff of the OECD Centre for Tax Policy and Administration Secretariat and IGF, but should not be regarded as the officially endorsed view of either organization or of their member countries.

The lead organisation for this toolkit was the IGF. It is a consultation draft.

More Information on the Program:

This program builds on the OECD BEPS Actions to include other causes of revenue loss in the mining sector, such as the use of harmful tax incentives, abusive hedging arrangements and metals streaming.

The program will cover the following issues:

1. Excessive interest deductions
2. Abusive transfer pricing
3. Undervaluation of mineral exports
4. Harmful tax incentives
5. Tax Stabilisation
6. International Tax Treaties
7. Metals Streaming
8. Abusive Hedging Arrangements
9. Inadequate Ring-fencing


Acknowledgements

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Introduction

In a world of mobile capital and profits, many developing countries use tax incentives in the hope of attracting domestic and foreign investment. Their effectiveness however, has often been disputed, not least in relation to the mining sector, which involves location specific resources that cannot be moved. Tax incentives are also costly, leading many countries to forgo vital revenues in exchange for often illusive benefits.

Nonetheless, governments may determine that they would still benefit from introducing tax incentives for the mining sector because of some specificities in their jurisdiction. For example, changing tax arrangements may appear easier to deliver than other investment-promoting actions such as infrastructure. In such cases, tax incentives need to be carefully designed to be effective (that is, they achieve their policy objective) and efficient (the policy goal is achieved at the minimum cost to government revenue).

Box 1. Efficiency? Effectiveness?

Effectiveness is when...
- The policy objective is achieved
  - E.g., increased investment (which must also yield the desired social benefits in broader welfare terms, jobs for example).
- The investment would not have happened without the incentive.

Efficiency is when...
- Objectives are achieved at low social costs
  - E.g., low revenue losses for government, no displacement of investment, etc.
- The resource cost of administering the incentive is low.

The framework is covered in detail in the Platform for Collaboration on Tax (PCT) report Options for Low Income Countries’ Effective and Efficient Use of Tax Incentives, which is the backdrop to the toolkit currently at hand, developed by the Intergovernmental Forum on Mining, Metals, Minerals and Sustainable Development (IGF), and the OECD.

About this Toolkit

This toolkit looks at tax incentives in the mining sector. For many developing countries, receipts from mining are often a major source of revenue. The central task for policy makers, therefore, is to design fiscal regimes for the mining industry that raise sufficient revenue, whilst providing adequate inducement to invest. Many times, governments have given tax incentives to mining investors that have turned out to be overly generous, forgoing significant tax revenues, and sometimes resulting in conflict with investors.
Preventing similar occurrences from happening again, demands sector-specific guidance on the design and use of tax incentives.

Building on the efficiency and effectiveness framework, this toolkit zeros in on the types of behavioural responses of taxpayers, and unintended consequences that might flow from providing tax incentives. For example, if a mine is given a time-limited tax holiday one response might be to speed up the rate of production to increase its tax-free revenue during the period (the “behavioural response”). When the holiday expires, there is less ore left to extract than if the mine had maintained a normal rate of production, further reducing government revenue (the “unintended consequences”).

The goal of this toolkit is that governments of resource-rich countries are better equipped to identify, and cost potential behavioural responses by mining investors to tax incentives.

How is it structured?

The toolkit is divided into three sections.

a) A **step-by-step guide** to reviewing mining tax incentives
   - What is the type of tax incentive, and the related behavioural responses?
   - How is the incentive designed?
   - What is the cost to government revenue?

b) A **detailed risk review** of mining tax incentives: definitions, behavioural responses (including real-life examples), and recommendations for how incentives could be better designed to mitigate unintended revenue losses.

c) An **information checklist** that highlights some of the information government needs to assess possible behavioural responses, and the impact on revenue.

Supplementary guidance on how to integrate behavioural responses into project-level financial models, plus a dataset of incentives from approximately 160 mining contracts in 22 countries are forthcoming.

Who is this toolkit for?

The toolkit is intended for use by government decision-makers to analyse tax incentives in relation to mining fiscal regime design, and contract negotiation. The aim is to generate informed, well-grounded decisions particularly with respect to the potential revenue cost. It may also be used by tax administrators to identify potential risks to the tax base, and shape audit priorities. Finally, the toolkit may help parliamentarians, and civil society examine tax incentives in order to strengthen government accountability.
What gap is the toolkit filling?

There is a wealth of information available on mining fiscal regime design. Readers should refer to the International Monetary Fund (IMF) handbook series on natural resource taxation, the United Nations Handbook on Extractive Industries Taxation (2018), and the World Bank Sourcebook for mining tax administration (2013). In addition, there is authoritative guidance on the design and use of tax incentives not specific to mining. For example, the PCT report Options for Low Income Countries’ Effective and Efficient Use of Tax Incentives for Investment, including the background document which suggests practical ways to assess the costs and benefits of incentives; and ‘Rethinking Investment Incentives’ by the Columbia Centre for Sustainable Investment.

These documents are important context, however there were two gaps identified that this toolkit seeks to address. The first was guidance on tax incentives in the mining sector specifically. Whilst tax incentives feature in the literature on mining fiscal regime design, there is no guidance specifically devoted to the topic. The second was insights on how mining investors may change their behaviour in response to tax incentives to maximise the tax benefit beyond what government intended. Government decision-makers and technicians are increasingly aware of the direct impact of tax incentives on revenue collection, but less so the ways incentives may be misused.
Box 2. A Note of Caution

This toolkit should not be read as an endorsement of tax incentives, but rather a pragmatic attempt to assist officials with providing comprehensive advice to ministers and, where a decision to give incentives is nevertheless made, to then minimise their harmful effects.

Before using tax incentives, policymakers should consider the following:

There are many drivers of mining investment decisions. One survey\(^1\) of mining companies lists the following factors in order of priority:

a) quality of the resource;

b) economic factors - location of the resource (i.e. transport costs, ease of export); price outlook for target minerals, and technology (i.e. challenges relating to recovery of the mineral).

c) policy climate - enforcement of existing rules, taxation, security of tenure, infrastructure, political stability, labour issues, and security, to name a few.

There is no empirical evidence that tax incentives attract mining investment in developing countries.

- (Klemm and Parys 2011) find that tax incentives may have a small positive effect on foreign direct investment (FDI) but no effect on increasing fixed assets, for example, machinery, equipment and buildings, which means new foreign direct investment mainly displaces other investment.
- (James 2009) finds that tax incentives are not able to compensate for serious deficiencies in a country’s policy environment, and economic factors.

Despite their questionable efficacy, tax incentives remain a quick “go to” response for many countries eager to attract investment and to drive industrialisation and local value adding.

This toolkit takes the view that it is essential that governments carefully consider the trade-offs related to tax incentives: the revenue cost, versus the benefits from the investment (i.e. jobs, infrastructure, revenues etc). It seeks to assist in this process, recognizing that in many developing countries officials are (and will be) tasked to design and implement tax incentives to promote their mining sector.
Tax Incentives for Mining Investment

Mining is a high-risk, long-lived business. It is capital intensive, with significant investment in exploration and development, mostly sourced from the private sector. It has long periods of pre-production during which no revenue is earned. It is high risk because it depends on exploration being successful, and its profit is sensitive to highly volatile commodity prices and exchange rates. In this light, governments sometimes choose to offer carefully designed tax incentives to induce mining investment.

On the other hand, mineral resources are finite, non-renewable, and generally owned by the state for the benefit of its citizens. Thus, government has a responsibility to transform its mineral wealth into lasting development outcomes. However, according to Breaking the Curse (2009), African governments have granted too many tax concessions and subsidies to the mining industry, which have been made worse by aggressive corporate tax avoidance. As a result, citizens of mineral-rich countries continue to live in poverty.

To break this particular manifestation of the ‘resource curse’, government must carefully consider if or when tax incentives are necessary to attract mining investment, and how to design them in a way that minimises the cost to government revenue.

What is a mining tax incentive?

The analysis of tax incentives faces fundamental definitional obstacles, related to the determination of the relevant benchmark. The benchmark, and hence what constitutes a tax incentive, will differ from country to country.

In this toolkit, by a ‘tax incentive’ is meant:

......any special tax provisions

......granted to mining investors

......that provide favourable deviation

......from the general tax treatment that applies to all corporate entities.

E.g., The benchmark (i.e. the general tax treatment) is that all corporate entities must pay income tax at a rate of 30 per cent. The incentive is that mining investors pay income tax at a rate of 25 per cent.

The incentive need not apply to mining alone, it could be that other sectors, or categories of investors also receive the same benefit provided it is not the general tax treatment.
The first column in Table 1 outlines the main fiscal instruments (taxes, royalties, etc.) that determine how the revenues from mining projects are shared between government and investors. The second column lists the corresponding tax incentives that government may use to compete for mining investment, that are covered in detail later in this toolkit.

Table 1. Mining fiscal instruments and corresponding tax incentives

<table>
<thead>
<tr>
<th>Mining fiscal instruments</th>
<th>Corresponding tax incentives</th>
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<tbody>
<tr>
<td><strong>Taxes on income</strong></td>
<td>- income tax holiday,</td>
</tr>
<tr>
<td>(e.g., corporate income tax, resource rent taxes, withholding taxes)</td>
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<td>- withholding taxes relief on interest expense, dividends, services (e.g., management fees)</td>
</tr>
<tr>
<td><strong>Taxes on production</strong></td>
<td>- reduced or deferred mineral royalties,</td>
</tr>
<tr>
<td>(e.g., mineral royalties)</td>
<td>- royalty holiday,</td>
</tr>
<tr>
<td></td>
<td>- sliding scale royalty</td>
</tr>
<tr>
<td><strong>Tariffs on imports and exports</strong></td>
<td>- import duty relief,</td>
</tr>
<tr>
<td>(e.g., tariffs on import of capital inputs)</td>
<td>- export processing zones</td>
</tr>
<tr>
<td><strong>Others</strong></td>
<td>- stabilization of fiscal terms</td>
</tr>
</tbody>
</table>

For an overview of mining fiscal regime design see *Fiscal Regime Design: What Revenues the Government Will be Entitled to Collect (2015).*

Where are incentives found in the law?

The benchmark will always be derived from the general income tax code, this is because it is the law that applies to all taxpayers by default. Tax incentives, however, may be contained in additional sources of law. For mining specifically, tax incentives may be found in three sources of law:

1. **The general income tax code**, which may include special provisions for mining, either in a separate schedule or chapter, or in the main part of the code. E.g., a lower rate of corporate income tax.
2. **The mining law**, which may contain more detail on the sector-specific fiscal regime. E.g., a reduced rate of tax collected on imported goods for mining.
3. **The mining contract**, which may include project-specific fiscal terms. E.g., a complete exemption from paying taxes for a period.
There are two additional potential sources of law that may contain mining tax incentives but are not covered in this toolkit. These are Double Taxation Agreements (DTAs), and investment laws. DTAs are bilateral, or multilateral agreements between countries that set out which country has the right to collect tax on different types of income. These will be covered in detail in separate guidance under the IGF-OECD cooperation.

**Tax Incentives and the OECD Base Erosion and Profit Shifting Project**

Tax incentives may provide an additional motivation for investors to engage in base erosion and profit shifting (BEPS) practices. According to the OECD BEPS project, which was launched in 2013, BEPS refers to tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations.

The BEPS practices mentioned in this toolkit are abusive transfer pricing (BEPS Actions 8-10) and thin capitalisation (BEPS Action 4).

- Transfer pricing is a business practice that consists of setting a price for the purchase of a good or service between two related parties. It becomes abusive when the related parties distort the price of a transaction to reduce their taxable income. More information: *Toolkit for Transfer Pricing Risk Assessment in Mining*

- Thin capitalization arises when a company is financed through a high level of debt compared to equity, which results in excessive interest deductions.

The use of tax incentives may make government revenues more vulnerable to these BEPS practices, than if the general tax treatment applied.

E.g., A mine receives management and administrative services from a foreign related party, located in a lower-tax country. It must pay a fee in return (the “transfer price”). Normally, this fee would be subject to withholding tax in the country where the mine is located. However, due to an incentive there is no tax to be paid. In response, the related party artificially increases the fee, thus stripping profit out of the mine, and transferring it offshore. This is a case of a tax incentive increasing the motivation of the group of companies to manipulate the transfer price.
A Guide to Reviewing Mining Tax Incentives

Step 1: What is the type of tax incentive?

Table 2. Type of tax incentive and the related behavioural response

<table>
<thead>
<tr>
<th>Tax incentive</th>
<th>Potential Behavioural Response</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax holidays</td>
<td>Investors may increase their income during the tax-free period by speeding up the rate of production, and shifting the profits offshore.</td>
</tr>
<tr>
<td>Export processing zones (EPZs)</td>
<td>EPZs may set up a competing fiscal regime between the mineral processing facility, and the mine. In response, investors may seek to reduce their taxable income by selling its mineral production at below market rate to its related party smelter, which is subject to lower tax rates in the EPZ.</td>
</tr>
<tr>
<td>Royalty-based incentives</td>
<td>Investors may shift revenues into the tax-free period, like the response to a tax holiday. A sliding scale royalty may encourage tax planning strategies to avoid falling into a higher royalty bracket.</td>
</tr>
<tr>
<td>Withholding tax relief on interest and services</td>
<td>Investors may increase the amount of interest expense, and charges for administrative services paid to foreign affiliates, usually in low tax jurisdictions.</td>
</tr>
<tr>
<td>Cost-based incentives (e.g., accelerated depreciation)</td>
<td>Investors may inflate their capital expenditure (i.e. money spent on assets, building, and equipment) above what is needed, in order to maximise the tax benefit (“gold plating”).</td>
</tr>
<tr>
<td>Import duty relief</td>
<td>Investors may increase the cost of machinery and equipment purchased from related parties to increase their deductible expenses.</td>
</tr>
<tr>
<td>Fiscal stabilisation assurances (i.e. the mining fiscal regime is frozen)</td>
<td>Combining tax incentives with excessive use of fiscal stability provisions will magnify the adverse impact of tax incentives, including the unintended consequences, by potentially cutting off government ability to correct mistakes and unexpectedly large revenue losses.</td>
</tr>
</tbody>
</table>
Step 2: How is the tax incentive designed?

Does the tax incentive create parallel fiscal regimes side-by-side?

- Incentives that apply to one segment of the mining value chain (e.g., processing), and exclude others, may create opportunities for transfer pricing manipulation.

Is the ‘base’ to which the tax incentive applies clearly defined?

- Where the ‘base’ is expenditure (i.e. in the case of an investment allowance), it is necessary to clarify (i) what type of expenditure is included; (ii) whether losses can be carried forward to be offset against income in future years, and (iii) if they can be added to the deductible expenditure;

Does the incentive create cliff edges?

- The abrupt ending of a tax incentive may create an incentive to shift profits forward to avoid paying taxes when the incentive ends.
- E.g., in the case of sliding scale royalties, where the rate adjusts depending on the price (or other variables), companies near to the boundary of a rate change may be incentivised to under-price sales.

How does the tax incentive interact with other tax incentives?

- When combined, certain groupings of incentives may increase the revenue cost; E.g., combining an income tax holiday with an exemption from withholding tax on shareholder dividends will result in significant profits going completely untaxed.

Is the fiscal stabilization clause limited in time and scope?

- E.g., Stabilisation could be limited to specific fiscal terms relating to capital recovery, income and withholding tax rates, royalty rates, and the maximum rate on import duties. All other changes in tax law that apply generally and do not discriminate against mining would apply

Is the tax incentive open ended?

- There should be opportunities for review, as well as sunset clauses to reduce the potential costs of badly designed tax incentives programmes. E.g., government could specify that an investment tax credit be carried forward for the first three “profitable” years; thus, preventing the deferral of tax payments for long periods.
Step 3: What is the potential effect on government revenues?

*Estimate baseline revenues from the mining project*

- Baseline revenues are what would be collected without the incentive;
- When modelling tax incentives for the mining sector the appropriate baseline will be the tax regime that applies to general taxpayers. For specific mining projects, the appropriate baseline will be the mining fiscal regime, which may be in sector specific law, or the general tax code.

*Estimate the revenue cost of the proposed tax incentives*

- Incorporate the specific tax incentive to the fiscal regime being modelled;
- Calculate the difference between baseline total revenues and total revenues after the tax incentive is applied.

*Estimate the cost of the behavioural response(s) that may flow from tax incentives.*

- While it might not be possible to know the extent of the behavioural response, attempting to model it can still give an indication of the risks involved and the potential orders of magnitude.

*Run scenario and sensitivity analyses to determine the revenue cost of the incentive depending on different underlying assumptions.*

- The revenue cost of tax incentives may vary depending on the rate of production, the cost profile of the mine, and future commodity prices. It is necessary to model different scenarios to establish a robust cost estimate.

---

**Box 3. A Checklist for Good Governance and Tax Incentives:**

- The government should have clear, measurable policy objectives for the incentives regime that are publicly stated, subject to public consultations, and regular monitoring;
- Incentives should be given out through laws only, rather than individual mining contracts;
- Incentives should be available to all mining investors based on clearly articulated eligibility criteria prescribed in the law;
- The government should regularly calculate, and report publicly, the amount of revenue loss attributable to incentives.
Risk Review of Mining Tax Incentives and Related Behavioural Responses

TAXES ON INCOME

1. INCOME TAX HOLIDAYS

**Definition:** A tax holiday is a tax-free period. The duration may vary from one year, to the entirety of the project. It may take the form of a complete exemption from profits tax, or a reduced rate, or a combination of the two (Zolt, 2015).

1.1 Behavioural Responses

a) High-grading

“High-grading” involves companies increasing the rate of extraction, or preferentially extracting high-grade ore, compared to what they would otherwise do absent tax considerations. The result is that the amount of tax relief is well above that originally envisioned by government. This is most likely to occur when the tax holiday is time-limited, for example, five years in Cote d’Ivoire, and unconstrained (i.e. not linked to the level of production).

However, while high-grading with the express purpose of avoiding tax is a possibility, it is also not unusual for a company to want to mine high value, easy to access ore first, to improve its cash flow, rather than the other way around. For example, if there is a gold dome on a copper deposit, the company will mine the gold first. Therefore, it is important to closely examine the circumstances surrounding high-grading, to determine whether it is a behavioural response to the tax regime, or simply a mechanism to improve the profitability of the mine.

b) Abusive Transfer Pricing

It is common for mining companies to have multiple projects in the same country. If the individual mines are subject to time-bound tax holidays, for example, a period of five years, there may be an incentive for companies to shift profits from older mines no longer enjoying tax holidays, to newer mines, using the mechanism of abusive transfer pricing (IMF, 2017). For example, the older mine might procure goods and services from the newer mine at an above market rate. A more extreme measure is to physically move mineral production from one to the other, so it is counted as part of the new mine’s production, minimizing the group’s overall tax bill.
More reasons not to grant income tax holidays

Irrespective of the potential behavioural responses, income tax holidays are an inefficient and ineffective incentive for mining.

Table 3. Reasons not to offer income tax holidays to mining investors

<table>
<thead>
<tr>
<th>Reason</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mining is location specific</td>
<td>The resource is available only, or primarily in a particular place, making it difficult for investors to move where they are offered better fiscal terms.</td>
</tr>
<tr>
<td>Marginal mines benefit less from tax holidays than more profitable mines</td>
<td>E.G., if a mine’s gross profit is $200 and its operating costs are $50, a tax holiday means it keeps $150 in revenue; whereas for a mine that has the same costs but only $100 in profits, it keeps just $50 in revenue. Government forgoes more revenue from the profitable project, (less likely to require tax incentives) than the marginal project, whose viability may depend on favourable fiscal terms.</td>
</tr>
<tr>
<td>Tax holidays have no impact on the cost of investing</td>
<td>Tax holidays are only relevant once a mine is profitable, and in a tax paying position, which may be years after the decision to invest.</td>
</tr>
<tr>
<td>Mining companies are not well disposed to tax holidays</td>
<td>They would prefer countries to improve other aspects of their mining fiscal regime to make it more competitive (ICMM, heads of tax network, personal communication, October 2017).</td>
</tr>
</tbody>
</table>

1.2 Recommendations

If government regards tax holidays as essential, they should include these conditions:

a) A minimum amount of investment, or the creation of new jobs.

Governments should bear in mind that these conditions may be gamed by investors by overvaluing the assets contributing to the investment, or making up the number of employees by hiring staff with minimal duties at low wages.

b) Depreciation costs should be deducted in assessing taxable income.

During the tax holiday, there is no taxable income against which to offset deductions for the depreciation cost of mining plant and equipment. Unless stated otherwise, companies will accumulate these deductions, deducting them from taxable income once
the tax holiday expires. In effect, the tax holiday is extended, reducing future tax collection (Guj 2014). To avoid this, governments should require that depreciation costs be deducted in assessing taxable income to which the tax holiday applies.

c) Limit the holiday to the time anticipated for a specified tonnage to be extracted.

Government may reduce the risk of high-grading by agreeing a tax holiday on a tonnage-of-ore-extracted basis i.e. once the agreed tonnage has been extracted the tax holiday expires (Guj, 2014). The 2012 Mali Mining Code states that if production exceeds the levels approved annually by the company’s board of directors by 10%, the generally applicable corporate income tax rate is applied to the excess. An alternative would be to benchmark production to the feasibility study, rather than the decision of the board.

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**Box 4. ‘Pioneering Status’ in Singapore**

The Government of Singapore offers a concessionary tax rate, or complete exemption to “pioneering” investors for five years, provided they fulfil certain conditions on an annual basis, including total business expenditure, the creation of jobs, payments to local suppliers, and knowledge and technology transfer. The incentive is in the law, it is available to all investors that fall into the category of “pioneering”. If the conditions aren’t met the tax rate steps up.

The incentive is monitored by the Economic Development Board (EDB). Investors that are granted the incentive must submit regular progress reports to the EDB for the evaluation of performance. If there is any breach of conditions, the incentive may be revoked, as well as recovery of associated benefits.
Example: High-grading in the Gold Sector

MineCo is a gold mine in Country D. It is subject to a corporate income tax holiday for the first five-years of production, per Country D’s mining law.

MineCo started production in 2000. According to the feasibility study, MineCo was expected to continue to produce until 2015. However, in 2008, mining stopped, and the site was converted into a stockpile retreatment operation. There are two strong reasons to suspect MineCo was engaged in high-grading:

1. MineCo reached peak production in the first five-years from when production started. Between 2000 and 2005, MineCo produced 3,781,668 (000oz) of gold, roughly 63% of the mine’s total production.

   ![Actual Gold Production (000oz)](image)

2. MineCo extracted the higher-grade ore during the first few years of production, despite the gold price being comparatively low at the time.

   ![Production Grade](image)
2. WITHHOLDING TAX RELIEF

**Definition:** WHT requires the taxpayer to withhold some income tax on outbound payments. For example, a taxpayer in Country A borrows $1000 from a lender in Country B; the lender requires 10% interest on the loan, which is $100. The WHT rate in Country A is 5%, meaning the borrower must withhold $5 income tax on the $100 interest it pays to the lender.

WHT is usually levied on management charges, shareholder dividends, and interest expense on foreign loans. The significance of these costs to mining operations make administration of WHT critical to revenue collection, conversely this may be used to justify exemptions; for example, a reduced WHT rate on interest payments.

2.1 Behavioural Responses

WHT applies to payments to foreign entities, primarily related parties, and includes:

- payments of interest,
- management or administrative charges, and
- shareholder dividends.

Base erosion and profit shifting risks are significant with respect to the first two types of outbound payments. Dividends, on the other hand, cannot be deducted from taxable income (unlike interest expense, or service payments), in which case, there is limited incentive for investors to artificially inflate dividends to maximise WHT concessions. Notwithstanding, WHT is the last chance for governments to tax profits before they leave the country, as such it may be unwise to offer a reduced rate of WHT on dividends irrespective of the low tax risk. Governments that offer tax holidays, should be wary of also giving WHT relief on dividends, as this may result in profits going entirely untaxed.

a) Excessive interest deductions

Mining requires significant up-front finance during construction and pre-production phases, and additional financing throughout the mine’s life to maintain operations and fund expansions. While parent companies can attract commercial lenders at the global level, this may be more difficult for mining subsidiaries based in developing countries, primarily due to country risk. In most cases, debt is provided by a related party company resident in a low tax jurisdiction. If WHT is reduced, or exempt, the host country ends up with interest allowed as a deductible expense, and no tax on the interest income receive by the related party. Moreover, it encourages the group to highly leverage its mining subsidiary to strip profits out via interest expense.
b) Inflated Management Charges

Mining subsidiaries can access a range of administrative and technical services from their parent company, or, in some cases, from a specially designated related party services company. In most instances, the parent or services company covers the cost of delivering these services, then charges it as management service fees to its subsidiaries.

The behavioural response is that companies use management fees to transfer profits from the mine to a foreign affiliate, usually in a low-tax jurisdiction. Provided that WHT applies, there is a cost to companies inflating management fees (e.g., if WHT is 15% and the taxpayer increases the fee from $100 to $200 the tax cost also increases from $15 to $30) that may reduce dividends, as well as increase financing costs. However, if WHT is lowered, or exempted, any safeguard against profit shifting is eliminated, and it is highly likely management fees will increase.

In some cases, there may be an additional incentive which relates to how the management charge is calculated. Rather than enforcing the arm’s length principle, which requires taxpayers to price transactions between related parties as if they were taking place between unrelated parties, the government agrees to the taxpayer deducting a fixed amount, or percentage, for management service charges. It is not uncommon to see mining companies operating in Africa charging a percentage of the mine’s total sales revenue, which has no relationship with the actual service that has been provided. These combined incentives make profit shifting highly likely.

2.2 Recommendations

a) Limit excessive interest deductions.

See IGF-OECD Consultation Draft Limiting the Impact of Excessive Interest Deductions on Mining Revenues for an in-depth review of potential policy responses.

b) Legislate the cost-plus method for management fees.

Governments are advised to adopt OECD BEPS Action Items 8-10 which states that in the case of routine services, for example, management services, the charge should be the cost of providing the service, plus a mark-up of 5%. 
Example: Fixed Management Service Charges

In 2010, MineCo, signed an Investment Agreement with Country C to develop a gold mine. The agreement states that service charges paid by MineCo, to its parent company HeadCo, in return for a range of management and administrative services, will be calculated as follows:

- Four per cent of all capital and operating costs incurred from the beginning of the agreement until production starts, and
- Seven per cent of capital and operating costs incurred after commencement of production.

The provision deviates from Country C’s general tax code, which states that the transfer of goods and services between related parties should be made at the ‘market price’. It also prevents the tax authority in Country C from making any adjustments should the charges be found to be non-arm’s length.

HeadCo is the majority shareholder of MineCo. Since 2011, it has been the manager of the MineCo gold project. The services provided by HeadCo include mining expertise and technical services, procurement and logistics, risk and compliance, commercial services and human resources services. Most of these services would be defined as “low-value adding”\(^1\) according to OECD BEPS Actions 8-10, and should be charged on a cost-plus basis, with a mark-up of approximately five per cent. Cost-plus refers to the cost of providing the service, not the capital and operating expenditure of the mine, which is the basis for calculating management charges paid by MineCo to HeadCo. According to analysts, service charges are likely to cost MineCo approximately $4.8 billion.

Transfer pricing practitioners regard fixed fees as non-arm’s length. This is because no independent parties would agree to a fixed amount for service charges over an extended period, for example the life-of-mine. Service charges should be calculated each year; the expectation being that the value of the charge should change because companies are becoming more cost efficient.

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\(^1\) Services that are of a supportive nature; not part of the core business of the group; not dependent on contributing to unique and valuable intangibles; and do not involve substantial or significant risk.
3. **COST-BASED INCENTIVES**

Cost-based incentives include investment allowances, investment tax credits, accelerated depreciation, and loss carry forwards, all of which decrease the cost of capital. These types of incentives are better suited to mining investments than tax holidays.

- They allow taxpayers to recoup their investment through appropriate deductions from their taxable income, or directly from their tax bill;
- They defer tax to later stages in a project’s life and therefore don’t eat into cash flows in the initial critical years when capital is most needed;
- It is easier to anticipate the revenue cost of the incentive because it is based on the amount of investment.

**Definitions:**

**a) Accelerated depreciation:** Capital expenditures result in assets, for example, a drilling rig, that has a useful life of several years. Resource accounting and tax systems usually spread the cost of the asset over its useful life (known as depreciation or amortization), rather than upfront when the expenditure is made. Mining companies may be allowed a faster rate of depreciation on assets to recoup their costs sooner.

E.g., if the asset costs $200 and the standard depreciation period is ten years, the company can deduct $20 from its taxable income each year for ten years. An accelerated depreciation rate of five years would allow $40 to be deducted each year for five years. This means the project will pay less tax in the first five years and therefore recover its costs quicker.

**b) Investment allowances:** An investment allowance gives the taxpayer the right to offset a percentage of its capital expenditure against its taxable income in the year the expenditure is made, rather than spread over time through depreciation.

E.g., if the taxpayer spends $200 and the allowance is 50 per cent, it can deduct $100 from its taxable income in the first year. Applying a 20 per cent corporate income tax rate means the taxpayer’s liability is reduced by $20. This enables even quicker cost recovery than accelerated depreciation.

**c) Investment tax credits:** An investment tax credit enables a taxpayer to reduce the amount of *tax payable* by a portion of its investment expenditure in the first year, rather than reduce its *taxable income*, as with investment allowances.
3.1 Behavioural Responses

Investors may artificially inflate the cost of investment to increase the tax benefit.

The behavioural response to cost-based incentives can be broken down into four types:

1. Investments which were not intended to be eligible, or fall outside the time-period of the incentive, are included.

2. Taxpayers inflate the cost of capital items purchased from related parties; sometimes referred to as “gold plating.” Cost-based incentives may induce companies to spend more on capital investment which involves related parties, to defer tax for longer, and thus claim a greater share of project revenues. However, depending on the marginal tax rate and the generosity of the allowances, the cost of gold plating may ultimately exceed the tax benefit.

3. Investment allowances and credits may pose a further base erosion risk depending on how they interact with the standard depreciation regime, specifically, whether they provide an opportunity for the same capital costs to be deducted twice: once through the investment allowance/credit, and again through depreciation. In principle, costs should only be deducted once. E.G., if the investment allowance provides for 100 per cent of capital costs to be deducted in the first year, the asset’s costs should not also be deductible via depreciation; if the investment allowance is 50 per cent, only the remaining 50 per cent of the asset’s value should be deducted through depreciation.

E.g., For example, if the investment is $200 and the investment credit is 50 per cent, the taxpayer can reduce its tax liability in that year by $100. If the tax payable is $40, the taxpayer can apply this $100 investment credit to reduce its tax liability to minus $60. This balance could be paid back to the investor from the tax authority, carried forward to offset tax liabilities in future years, or expire. The investment credit is four times more generous than the investment allowance (minus $60 versus a $20 tax liability).

d) Longer loss carry forward: The general tax code usually allows operating losses to be carried forward to offset taxable income in a future year, with a limit on the loss carryforward period. The large, upfront costs involved in mining mean that a longer loss carryforward period may be allowed. This reduces tax revenues where losses that would have otherwise expired can continue to be carried forward to reduce taxable income.
4. Assets which get the accelerated treatment are then exported, and transferred to another country to be offset against income tax there (see the section on import duty relief).

3.2 Recommendations

Governments that wish to provide cost-based tax incentives to mining investors should adopt the following complementary measures to protect against the risk of base erosion:

a) Clearly define the assets, and asset categories to which the cost-based incentive applies, as well as the time-period.

E.g., in Mongolia the government offers an investment tax credit for depreciable capital assets during the construction of a mine, but caps it at 80 per cent of taxable income, and only allows the expenditure to be carried forward for three profitable years before it expires.

b) Monitor import duty concessions for mining imports.

Monitoring revenue forgone from import duties is always advisable, but, in the context of cost-based incentives, there is an even greater need to ensure mining investors are not using their duty-free status as an added opportunity to inflate the value of imports to increase the tax benefit (see section on Import Duty Relief).
Example: Capital Allowance Uplift

MineCo is a gold mine located in Country A, it benefits from a Capital Allowance Uplift ("uplift") for mining expenditures. The provision in the general tax code states that:

- All expenditure is deductible in the year it is incurred;
- An uplift of ten per cent is allowed on unredeemed qualifying capital expenditure (UQCE), which include development costs, but not exploration costs;
- The “allowance base” for calculating the uplift includes the uplift earned in the previous year. This final feature means the incentive is compounded. As a result, the date on which the first tax is due from a mining operation can be deferred for a long time.

Figure 1. The impact on MineCo’s cost deductions with and without the uplift

<table>
<thead>
<tr>
<th>Year</th>
<th>Without uplift</th>
<th>WITH uplift</th>
<th>Uplift is COMPOUNDED</th>
</tr>
</thead>
<tbody>
<tr>
<td>UCQE</td>
<td>82</td>
<td>82</td>
<td>82</td>
</tr>
<tr>
<td>Year 2</td>
<td>UCQE (Yr 1)</td>
<td>82</td>
<td>82</td>
</tr>
<tr>
<td>Tax income</td>
<td>18</td>
<td>18</td>
<td>18</td>
</tr>
<tr>
<td>Deduction</td>
<td>64</td>
<td>64</td>
<td>64</td>
</tr>
<tr>
<td>Uplift</td>
<td>64</td>
<td>64</td>
<td>64</td>
</tr>
<tr>
<td>Total expenses</td>
<td>70</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Remaining 54 is carried forward</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Year 3</td>
<td>UCQE (Yr 2)</td>
<td>64</td>
<td>70</td>
</tr>
<tr>
<td>Uplift (Yr 2)</td>
<td>70</td>
<td>70</td>
<td>77</td>
</tr>
<tr>
<td>Total exp. (Yr 2)</td>
<td>77</td>
<td>77</td>
<td>77</td>
</tr>
<tr>
<td>Uplift (Yr 3)</td>
<td>77</td>
<td>77</td>
<td>77</td>
</tr>
<tr>
<td>Total exp. (Yr 3)</td>
<td>77</td>
<td>77</td>
<td>77</td>
</tr>
<tr>
<td>Tax income</td>
<td>18</td>
<td>18</td>
<td>18</td>
</tr>
<tr>
<td>Deduction</td>
<td>46</td>
<td>59</td>
<td>67</td>
</tr>
<tr>
<td>WITH uplift + COMPOUNDING deduction increases by 21</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: Tax income should be read as taxable income before deduction of UQCE.

For MineCo, Country A’s biggest large-scale gold mine, the uplift permanently deferred all income tax. However, due to political pressures to increase taxation on the sector, MineCo has voluntarily relinquished the incentive. But, it already has a balance of $900 million that can be offset against future income tax – comprising $440 million in UQCE, plus $460 million in accumulated uplift. Only when MineCo uses up all these deductions will it start to pay income tax.

Governments must clearly define the base to which the tax incentive applies. It is unlikely that Country A intended the uplift to be compounded year-on-year, as the effect was to defer income tax for a considerable period. The provision was repealed only three years after it was introduced, however, due to fiscal stabilisation, investors could retain the incentive.
4. **EXPORT PROCESSING ZONES**

**Definition:** A common characteristic of Export Processing Zones (EPZs) is the provision of special incentives to attract investment, mostly foreign, for export production. Incentives may include tax holidays, duty free export and import, and free repatriation of profits.

### 4.1 Behavioural Responses

EPZ’s may set up competing fiscal regimes which lead to transfer pricing abuse.

EPZ status is usually granted to a company’s mineral processing operations alone, and includes incentives such as tax holidays, duty-free export and import, VAT and withholding tax relief. Whereas the mine itself, responsible for extracting the product for export but outside the EPZ, may be obliged to pay tax on profits, as well as mineral royalties, depending on the applicable fiscal regime. Consequently, there is an incentive for the company to shift profits from the mine to the processing facility to reduce its overall tax bill. The most obvious way to do this is by under-pricing the intermediate mineral product sold to the processing facility for smelting and refining; thus, reducing the company’s taxable income.

**Box 5. EPZs may harm the tax base of other countries**

Countries using poorly designed incentives risk contravening the OECD initiative on Harmful Tax Competition launched in 1998, and, more recently, **BEPS Action 5**.

An EPZ may be a “harmful preferential regime” if:

- The regime is preferential (i.e. it offers some form of tax preference in comparison with the general principles of taxation in the relevant country, for example, a lower corporate tax rate);
- The preferential regime is potentially harmful (some key factors include the regime imposing no or low effective tax rates, or being ring-fenced from the domestic economy);
- The preferential regime is *actually* harmful (i.e. the tax regime shifts activity from one country to the country providing the preferential tax regime).

Where a preferential regime is found to be actually harmful, the relevant country will be required to abolish it, or remove the features creating the harmful effect.
4.2 Recommendations

If government wants to extend EPZ status to mining activities, policymakers should consider the following measures:

a) Constrain the application of EPZ status to customs and indirect tax exemptions, or to areas which are closely supervised – excluding upstream activities;

b) Monitor all transactions with affiliates with EPZ status to ensure they comply with the arm’s length principle. Transfer pricing rules will need to cover instances of transfer pricing manipulation at the domestic level, as well as cross-border transactions.

c) Retain the right of approval over major related party sales contracts, sourcing external expert advice to determine an appropriate benchmark price.
Example: Undercharging for Minerals Sold to a Related Party with EPZ Status

HeadCo is a major global supplier of heavy mineral sand products located in Country A. It operates HoldCo, a 100 per cent owned subsidiary in Country B (low-tax country), which operates through branches, MineCo, and ProcessingCo in Country C (mining country).

In 2000, Country C granted ProcessingCo EPZ status, which means it is exempt from corporate income tax. Its only tax liability is a revenue tax of one per cent charged after six years of operation, which became payable in 2013. By contrast, MineCo, also in Country C, is subject to a three per cent royalty, plus corporate income tax at a rate of 17.5 per cent for the first ten years of production (2007 onwards), thereafter transferring to the standard rate of 35 per cent.

MineCo sells 100 per cent of its production to ProcessingCo. Between 2007 and 2013, when the latter is tax exempt, MineCo is found to have sold its mineral production to ProcessingCo at below market rate, thus reducing its taxable income, as well as royalties, which are calculated on the sale price received.
5. IMPORT DUTY RELIEF

**Definition:** Import duties are taxes collected on imported goods. The tax is usually based on the value of the good. For example, if import duty is ten per cent on mining inputs, a company that brings in drilling equipment valued at $500,000 will have to pay $50,000 in tax.

5.1 Behavioural Response

Companies increase the cost of imported equipment and machinery procured from related parties.

The main tax risk from import duty exemptions is companies increasing the cost of imported equipment and material procured from related parties to reduce taxable income in the host country. Import duties reduce the incentive to artificially inflate the cost of imported equipment and machinery as the duty provides a direct financial cost to importing goods at higher prices. Import duty relief reduces that direct financial cost, while a waiver removes it altogether.

Companies could artificially inflate prices by:

- paying the retail price for older equipment and machinery that has been used by an affiliate company in operations elsewhere, and should therefore be purchased at a lower price that reflects the reduction in the value of the asset, particularly due to wear and tear;
- by paying a high mark-up on the cost of equipment and machinery purchased through a corporate services hub located in a low- or zero-tax jurisdiction.

5.2 Recommendations

Despite the risks, import duty relief is a common feature of the mining fiscal regime. It reduces input costs and risks for mining projects, which is especially important to investors given the substantial amount of capital investment required during the development of a mine.

While import duty relief may be necessary to attract mining investment, government should still protect its import duty base by adopting the following measures:

a) Levy a partial import duty (e.g., half the standard rate); this avoids raising the cost of investment to the level of a full import duty, whilst discouraging over-
invoicing. It also creates an incentive for customs authorities to verify the cost of mining imports, which they may not if there is no revenue to collect;

b) Issue a “mining list” which identifies goods intended for mining that are subject to duty concessions, versus goods for general use (e.g., photocopiers used incidentally by mining companies);

c) Require taxpayers to apply for an import permit for equipment and machinery on the mining list. Customs would verify the value of the import giving it the opportunity to make an adjustment upfront rather than when the item is re-exported. To avoid operational delays, taxpayers should be encouraged to engage customs in advance of the equipment and machinery arriving;

d) Assess the value of the duty as usual under customs legislation, and reduce the duty payable, or set it to zero, as required by the mining law. This allows the duty to be levied later if the item is exported or used for purposes other than those which attract the mining concession (e.g., 4WD sold to a non-mining company);

e) Revalue second hand equipment to determine the residual value, considering the wear and tear over time. It is common in the oil and gas sector for Production Sharing Agreements (PSAs) to contain standard rules for costing used equipment. E.g., in the case of materials purchased from affiliates, the price may be between 50 per cent to 75 per cent of the current international price of the material, depending on whether it requires reconditioning before it can be reused.

f) Ensure there is a legal basis for the tax authority to adjust the taxable income of the taxpayer in the event that an asset is transferred between related parties at a non-market price.
Example: Sale of Assets

MineCo operates an iron ore mine in Country A. According to the mine development agreement, the tax incentives given to MineCo also apply to its subcontractors. The relevant incentives are an exemption on import duties, and accelerated depreciation.

Three years ago, MineCo’s subcontractor, ServiceCo, imported a fleet of dump trucks to transport the ore from the mine site to the port of export. The total cost of the trucks was $1 million. ServiceCo was exempt from paying import duties (10 per cent), which means the government forewent $100,000 in tax revenue.

Over the next three years ServiceCo depreciated the capital costs of the trucks at a rate of 30 per cent. The table below sets out the value of the trucks each year minus depreciation (the “adjusted value”), and the depreciated cost, which is deducted as capital allowance.

<table>
<thead>
<tr>
<th>Year</th>
<th>Adjusted value</th>
<th>Capital allowance (30%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$1,000,000 (import value)</td>
<td>$300,000 (i.e. $1 million * 0.3)</td>
</tr>
<tr>
<td>Year 2</td>
<td>$700,000 (i.e. $1 million - $300,000)</td>
<td>$210,000</td>
</tr>
<tr>
<td>Year 3</td>
<td>$490,000</td>
<td>$147,000</td>
</tr>
<tr>
<td>Year 4</td>
<td>$343,000</td>
<td>Depreciation period ends</td>
</tr>
</tbody>
</table>

At the end of year three, ServiceCo had claimed a total of $657,000 in capital allowances, and the trucks had a remaining adjusted valued of $343,000. In year four, ServiceCo transferred the dump trucks to its affiliate company in neighbouring Country B.

During an audit in Country A, the tax authority discovered two problems.

1. The dump trucks had been second hand when brought into Country A, although ServiceCo assigned high market values to the trucks to increase their depreciable value, and hence the amount of capital deductions.

2. Instead of transferring the trucks to its affiliate at the adjusted value of $343,000 in year four, it used an inflated ‘fair market value’ of $850,000. (Note that the market value of the trucks as determined by ServiceCo was 85 per cent of the assets’ import value).

The tax authority’s response was to adjust ServiceCo’s chargeable income by adding back the inflated capital allowances it had deducted over the past three years. According to the law in Country A, the transfer of assets to affiliates must be at fair market value, and
the profits subject to tax. Because the tax authority lacked the expertise to determine the actual market value of the trucks, it deemed the sale of the trucks at ServiceCo’s own inflated ‘fair market value’ of $850,000.

The tax authority made the following adjustment:

\[
\text{Sale value ($850,000)} - \text{remaining adjusted value ($343,000)} = $507,000
\]

The $507,000 is the difference between the sale value, and the remaining adjusted value of the trucks after depreciation (i.e. the “balancing charge). The tax authority added the balancing charge back to ServiceCo’s taxable profits. The amount neutralised the excess capital allowances claimed (a total of $657,000 in the three years), except $150,000. A rate of 30 per cent corporate income tax was levied on the $507,000, resulting in $152,000 in additional tax revenue.
TAXES ON PRODUCTION

6. ROYALTY-BASED INCENTIVES

**Definition:** Royalties are charged on mineral sales, most commonly as a percentage of the sales value ("ad valorem"). Royalty-based incentives could be provided by:

- royalty holiday - the royalty is reduced (or waived) for a period; or
- royalty deferral - the payment date is extended (usually no more than three months);
- sliding-scale - the rate varies depending on sales, production, price, or cost.

Total exemption of royalties is generally infrequent (Otto, 2008).

6.1 Behavioural Responses

a) A royalty holiday or deferral provides an incentive to shift revenues into the tax-free period, like the response to an income tax holiday.

For most countries, royalties are applied at a constant rate, either to the value of production ("ad valorem"), or a physical unit of production (e.g., dollars per ton iron ore), thus imposing a fixed cost on investors regardless of their profitability. To increase the responsiveness of royalties to profitability, particularly during low commodity price periods, governments may offer a partial or complete royalty holiday for a period of years, or allow deferral of payment. Another reason governments might agree to reduce royalties is to prevent early termination of mineral production as the natural resource approaches exhaustion.

These may be reasonable trade-offs, depending on the circumstances, nevertheless, governments should be mindful that investors may respond by speeding up the rate of production, and extracting the highest value ore, to maximise sales revenue during the tax-free period. In this regard, the behavioural response to royalty-based incentives is like that for income tax holidays, but potentially more significant given the regressive nature of a royalty. There is also no guarantee they will make royalties more responsive to profit, but an increase in administrative complexity is guaranteed (IMF, 2014).
b) A sliding scale royalty may encourage taxpayers to adopt tax planning strategies to avoid falling into a higher royalty bracket.

There may be merits to sliding scale royalties insofar as they tax companies more in times of high profits and allows some relief in periods when gains are low. The intention is not to evaluate these merits here, but to highlight the potential behavioural responses to sliding scale royalties that may undermine government revenue.

Sliding-scale royalties can have a “slice” or a “slab” structure:

- **A slice structure** operates like progressive income tax regimes in many countries around the world, with a different marginal royalty rate applied to each “slice” of the mineral price.

- **A slab structure** applies the royalty rate to the entire price of the commodity depending on which “slab” of the rate table the commodity price is in.

A slab structure is easier to calculate and simpler to administer, but it can also distort investor behaviour due to the step-change in the average tax rate at each boundary of the royalty rate table.

### Box 6. Sliding scale royalties: “slice” versus “slab”

A sliding-scale royalty has the following rate table:

<table>
<thead>
<tr>
<th>Commodity price from...</th>
<th>...up to</th>
<th>Royalty rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>99.99</td>
<td>1%</td>
</tr>
<tr>
<td>100</td>
<td>199.99</td>
<td>2%</td>
</tr>
<tr>
<td>200</td>
<td>299.99</td>
<td>3%</td>
</tr>
<tr>
<td>300</td>
<td>unlimited</td>
<td>4%</td>
</tr>
</tbody>
</table>

Under a slice structure, the royalty on sales at a price of $250 would be calculated as 
\( ($100 \times \text{one per cent}) + ((200-100) \times \text{two per cent}) + ((250-200) \times \text{three per cent}) \)
\( = $4.50 \). The effective royalty rate is 1.8 per cent (calculated as $4.50 / $250).

Under a slab structure, the three per cent rate would be applied to the entire $250 price, giving a royalty of $7.50. The effective royalty rate, three per cent, is higher than the effective royalty rate of 1.8 per cent under the slice structure.

The average tax rates of the slice and slab structure royalties are shown in the chart below. The tax rate in the slice structure increases in a relatively smooth line, whereas the tax rate in the slab structure jumps at each price boundary. This creates an incentive to set prices just below the boundary, as set out below.
Unlike other tax incentives included in the toolkit, this incentive exists even in sales to unrelated parties, as both parties may be better off pricing just below the boundary, and not in the price bracket above (i.e. the seller pays less royalties, and the buyer gets a cheaper product).

6.2 Recommendations

Countries that would like to provide royalty-based incentives to mining investors should adopt the following complementary, or alternate measures to limit potential behavioural responses:

a) Establish clear and objective criteria, and procedures, for the deferral or waiver of royalty payments, including rules about interest on the deferred payment (IMF, 2014). Criteria may include:

- cash flows must negative;
- the mine does not have the funds to pay the royalty by the due date;
- the cash flow difficulties are temporary and capable of being overcome (i.e. periods of deferral should be short (a few months));
- the mine may have to close with job losses if royalties were demanded.
b) Offer a sliding scale royalty that uses a “slice structure”, which is less likely to lead to undercharging for mineral exports. Because the average tax rate increases gradually, taxpayers get less of a tax benefit from setting the mineral price just below the rate boundary, than under a slab structure (see Box 6).
7. STABILIZATION OF FISCAL INCENTIVES

**Definition:** Fiscal stabilization is intended to preserve the taxation, production-sharing, pricing, or state participation rules that govern the division of proceeds from a resource project at the time of contract. There are generally three approaches to stabilization:

- the laws (or contract terms) in force on the date of agreement are frozen,
- any future tax policy changes that would increase the tax burden on the project won’t apply, although the project can benefit from tax decreases, or
- there is an agreement to negotiate to maintain economic equilibrium if there are any adverse changes (Daniel et al 2008).

Fiscal stabilization is an incentive in and of itself, as well as having the potential to lock in any other incentives offered in the primary legislation, or the project-level contract.

7.1. Behavioural Response

Fiscal stabilisation may permanently freeze all tax incentives.

Fiscal stabilization clauses freeze the tax law, as well as any contract-level incentives. Most sectors of the economy are subject to changes in domestic law as they arise. But, for mining, oil and gas, because of the size and long-term nature of the investment, it is common for companies to request, and for governments to grant, a legal guarantee that fiscal terms won’t change adversely (or otherwise, in some cases) for the duration of the investment, or a shorter period depending on how the clause is designed.

In addition to locking in standard fiscal terms, stabilization will apply to tax incentives provided for in domestic law, and at the contract-level, as of the date the mining agreement is signed, or ratified by parliament, which is required by law in many developing countries (e.g., Liberia, and Sierra Leone).

If there is a significant change in circumstances, for example, commodity prices rise making it easier to attract investment, or a tax incentive is used in a way that government didn’t anticipate, unsustainable benefits may result. The tax risk is that fiscal stabilization locks in all the aforementioned behavioural responses linked to tax incentives.
7.2. Recommendations

Countries that want to include a fiscal stabilisation provision in their mining agreements should consider the following:

a) Limit the time limit and scope of the fiscal stabilisation provision.

Include a time-limited provision that would cover capital recovery rules, the income and withholding tax rates, royalty rates, and a maximum rate on import duties. However, any tax law change that affects businesses generally (e.g., transfer pricing rules, or a limit on debt relative to equity) and that does not discriminate against the mining sector would apply;

b) Explicitly charge an “insurance premium” for a fiscal stability assurance.

E.g., Peru charges a two per cent premium on the income tax rate where an investor takes a stability assurance. Papua New Guinea also introduced a premium on the income tax rate in 2002 (IMF, 2010).

For more information on the design and use of stabilisation clauses, see forthcoming IGF-OECD guidance on Stabilisation Clauses and Investment Treaties.
Example: Tax Stability Agreement Freezes Reinvested Profits Incentive

In the early 90s, the government of Country F granted mining investors a ‘reinvested profits incentive’ through the mining law. The incentive meant that mining companies did not have to pay income tax on the “retained profits” they reinvested, provided the reinvestment plan was first approved by the ministry of mines. The incentive was stabilised according to the Tax Stability Agreement in the mining law, which functioned to freeze the investor’s tax regime for the duration of the Agreement. In return for stabilisation, the government charged a two per cent premium on income tax.

To qualify for the incentive, retained profits could be reinvested in the following:

- installation or expansion of mineral processing facilities;
- works and acquisition of necessary equipment for the installation of new mechanized systems, for the development, exploitation and benefit of minerals;
- general work and mining transport;
- installation or expansion of power plants, whatever their source of energy;
- installation of distribution system and interconnection of electric power and construction of internal access and interconnection ways, among others.

The reinvested profits could not exceed 80 per cent of the company’s total profits.

In 2000, the government of Country F repealed the reinvested profits incentive. The main reason for repealing the incentive was Country F’s improved economic circumstances, which meant the perceived need to offer incentives to attract foreign direct investment was reduced. However, due to the Tax Stability Agreement, the incentive remained in force for most companies until the end of their agreements.

MineCo, one of the biggest producers of copper in Country F, entered into a Tax Stability Agreement in 1998. In 2004, four years after the incentive had been repealed, MineCo submitted a Reinvestment Program for the period October 2004 to February 2007 for the construction of a Concentrator Plant to process primary sulphide ore to produce copper concentrate. The budget for was around $800 million. The program was approved by the ministry in December that year.

Reinvested profits by MineCo ($USD millions):

<table>
<thead>
<tr>
<th>Year</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reinvested Profits</td>
<td>5</td>
<td>150</td>
<td>320</td>
<td>330</td>
<td>800</td>
</tr>
<tr>
<td>Income Tax Forgone (rate of 30%)</td>
<td>1.5</td>
<td>45</td>
<td>96</td>
<td>993</td>
<td>2403</td>
</tr>
</tbody>
</table>
MineCo was not the only mining company using the reinvested profits incentive. For the 14 mining companies benefiting from the incentive, a total amount of $3,643,000,000 was reinvested between 1993 and 2011. Consequently, despite the incentive having been removed from the statute books in 2000, by 2011, the government of Country F had forgone $1,093,000,000 in income tax due to tax stabilization.
Sources of Information for Reviewing Tax Incentives

This section sets out the information government needs to assess possible behavioural responses, and their impact on mining revenues. The availability of information, and its relevance, may vary depending on the stage of the project. During contract negotiation, the pre-feasibility study will be the basis for estimating the revenue cost of tax incentives. Once the mine is operational, additional information such as tax returns, transfer pricing documentation, and company reports can be used to monitor the revenue cost of tax incentives, as well as investor compliance with performance conditions (e.g., production targets, jobs).

General Information to be collected:

*Legal regime*

- Income tax law;
- Mining law;
- Mining contract;
- Investment promotion law;
- Double taxation agreements (DTAs).

*Company documentation*

- Mine feasibility study;
- Investor’s financial model, especially the internal rate of return (IRR);
- Production profile (e.g., tons of copper concentrate per year);
  - Prices: historical and future;
  - Quality adjustments;
- Costs: exploration, development, and operating;
- Financing (volume of debt, interest rate, repayment schedules);
- Company annual reports, filings to stock exchanges;
- Tax returns, and financial statements (e.g., turnover, earnings before income tax, depreciation, and amortization - EBITDA)
- Transfer pricing documentation (e.g., intercompany loan agreements, mine offtake agreements, service agreements).

Table 4. Information Checklist

<table>
<thead>
<tr>
<th>Tax Incentive</th>
<th>Specific Sources of Information</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax holiday</td>
<td>Mine feasibility study, information to pay attention to includes production and price forecasts, the mine planning process, specifically how the investor will mine the orebody to maximise</td>
</tr>
</tbody>
</table>
returns (i.e. “pit optimization”);  
- Price data, historical prices (e.g., World Bank Pink Sheets), as well as forecasted prices;  
- Depreciation schedule, and loss carry forward allowance, these provisions must be closely monitored to prevent investors from deducting accumulated costs once the tax holiday expire;  
- Ring-fencing rules, these may affect the extent to which costs, and income can be transferred between related mines in the same country.

**Withholding tax relief**  
- Thin capitalisation rules (e.g., debt-to-equity ratio, limit on interest deductions);  
- Intercompany loan agreement (key terms include the interest rate, the payment schedule, loan instalments, guarantees, financial or non-financial covenants);  
- Treasury policy documents;  
- Operational expenditure plan;  
- Management services agreement (key terms are the cost allocation method, and the mark-up);  
- Dividend policy.

**Cost-based incentives and import duty relief**  
- List of mining inputs eligible for cost deduction;  
- Capital and operating expenditure plan;  
- Depreciation schedule (i.e. what’s the rate of depreciation);  
- Import duty rates;  
- Loss carry forward (i.e. eligibility, and time limit);  
- Relevant intercompany service agreements, especially those relating to purchasing.

**EPZs**  
- Fiscal regime for export processing zone (EPZ), pay special attention to any relief or exemption on profit-based taxes (e.g., income tax, withholding tax), as this will significantly increase the risk of profit shifting;  
- Value chain analysis, which activities have EPZ status (e.g., downstream mineral beneficiation – smelting and refining);  
- Offtake agreement between the mine and the mineral beneficiation facility (key terms include price, volume, payment terms, quotation period, and quality);  
- Sales agreement between the smelter/ refinery and the next customer, if it is an independent customer (i.e. not related) the agreement may be a useful benchmark for the offtake.

**Royalty-based incentives**  
- Royalty regulations, including terms and conditions for incentives. This is especially relevant if the government is contemplating offering a sliding scale mechanism, where the different royalty rates will need to be applied to various price
| | scenarios to calculate the potential revenue loss, should the taxpayer deliberately under-price its mineral exports;  
| | - Royalty returns, including production volumes, grade, and quality adjustments;  
| | - Third party sales invoices;  
| | - Mine feasibility study, including production and price forecasts, the mine planning process, specifically how the investor will mine the orebody to maximise returns (i.e. “pit optimization”);  
| | - Price data, historical prices (e.g., World Bank Pink Sheets), as well as forecasted prices.  
| Fiscal stabilisation | - Specific wording of the fiscal stabilisation provision i.e. which fiscal terms it applies to, what it excludes the duration, and opportunities for review; |
Conclusion

Governments control the design and use of tax incentives to attract mining investment. If incentives are overly generous, or poorly drafted, governments should not be surprised to find that investors have maximized the tax benefit in ways they did not anticipate.

For this reason, careful thought must be given to how investors are likely to respond to incentives, and whether unintended revenue losses may ensue. These potential costs should be factored into an assessment of the efficiency and effectiveness of tax incentives in the mining sector.

However, policy choices about tax incentives are not solely technocratic. There will be trade-offs between securing revenues for public spending, and a competitive tax regime for mining investors. There are no easy answers to how to balance these goals. But at a minimum, governments should have clear, transparent, measurable policy objectives that are subject to public consultation, and regular monitoring.

The following conclusions are intended to help governments of developing countries make informed, well-grounded decisions about mining tax incentives, considering the unintended revenue losses that may flow from granting incentives.

1. **Before agreeing to any tax incentives governments should use a financial model to estimate the cost of incentives, and their impact on investment decisions.** Costs estimates should include potential behavioural responses. Combinations of incentives being considered should always be analysed together to determine the collective effect on revenues foregone. For example, reduced royalty rates will increase profits that go untaxed when combined with an income tax holiday.

2. **Avoid tax incentives that create parallel fiscal regimes side-by-side, which may lead to abusive transfer pricing.** Tax incentives that apply to one segment of the mining value chain, for example, processing, and exclude others, may create opportunities for profit shifting.

3. **Limit the most damaging incentives, notably tax holidays.** Tax holidays create an incentive to shift profits forward into the holiday to avoid paying taxes when it ends. They are poorly suited for mining given the location specific, and long-term nature of investments. A more efficient approach is to offer accelerated depreciation schemes, and investment allowances.

4. **Clearly define the investment expenses to which cost-based incentives apply.** Cost-based incentives lower the cost of capital, and thus make a great number of mining projects more profitable at the margin. However, it is necessary to clearly
specify the types of mining expenditure that are eligible for allowances, whether these expenses can be carried forward to future years, and for how long.

5. **Carefully consider the base erosion and profit shifting risks of incentives that lower the rate of tax on outbound payments to foreign entities.** Lowering, or exempting withholding taxes on outbound payments may motivate investors to artificially increase the volume, and price of related party debt, as well service fees, to erode the tax base of the host country, and shift profits offshore.

6. **Avoid tax incentives that create cliff edges.** Sliding scale royalties that use a “slab” structure may incentivise companies near to the boundary of a rate change to under-price sales, or defer sales when prices are falling, to benefit from the lower royalty rate. This also applies to tax holidays, as mentioned previously.

7. **Finally, tax incentives should not be open ended.** There should be opportunities for review, as well as “sunset” clauses (e.g., a limit to how long a tax credit can be carried forward) to reduce the potential costs of badly designed programmes.
Bibliography


Government Affairs Canada

Overall, we find the document to be well-organized and structured for ease of consultation. However, we feel that there are particular areas where more explanation can be given.

- While the document cites other existing guidance on taxation principles and fairness, we feel more specific background information can be given here to the reader, including how to conduct analysis of costs and benefits of tax incentive policies and legislation, addressing principles like transparency (ie. disclosure of mining contract terms and commitments) and costing the tax burden of the mining sector against other economic sectors and/or rationales for and validation of anticipated social impacts through such tax policy approaches.

- Pg. 8: While quoted text, the second paragraph is strongly worded and emotive and as such not helpful. We would suggest citing evidence or specific examples of mineral tax policies that have not demonstrated intended social and/or economic benefits.

- The specific case of export processing zones is discussed, but there is no discussion on decentralized tax and resource governance and the internal complexity that can arise, even for a national government interacting with a single firm operating several mine sites in different subnational jurisdictions.

- There is no discussion of other instruments such as gender-based or local procurement incentives, where specific tax policies may be applied, ie. tax credits for female hires, VAT relief for local procurement, etc.

- Stronger red-line advice and/or provision of evidence for specific tax incentives that really should be avoided all costs. A red/orange/yellow/green coding approach.
Intergovernmental Forum Per Email: secretariat@igfmining.org

Submission in Regards to IGF Draft Tax Toolkit for Mining

Kinross Gold Corporation welcomes the opportunity to provide feedback on the recently published Intergovernmental Forum on Mining, Minerals, Metals and Sustainable Development (IGF) consultation draft paper “The Hidden Cost of Tax Incentives in Mining”. Kinross is committed to taking an active role in our industry community, and this includes participating in important public discourse impacting perceptions of our industry.

Kinross recently celebrated its 25-year anniversary on the Toronto Stock Exchange. Founded in 1993, Kinross Gold is a senior gold mining company with a diverse portfolio of mines and projects in the United States, Brazil, Chile, Ghana, Mauritania, and Russia. Headquartered in Toronto, Canada, Kinross employs approximately 9,000 people worldwide.

At Kinross, taking corporate citizenship seriously is one of our four core values. We are committed to the highest ethical and governance standards, vigilant in protecting the environment, and support sustainable initiatives focused on providing lasting benefits to the communities where we work. This was evidenced again earlier this year when Kinross received the ‘Industry Mover’ distinction from RobecoSAM’s Sustainability Award.

Understanding Mining Taxation in the Overall Context

We believe that there is significant value in improving the understanding of host governments about mining taxation regimes in the context of the economic and fiscal development in their countries. However, we believe it is crucial that this is framed in a manner that considers the total economic contribution of a mining project, of which direct taxation is but one part, as well as the commercial, technical and financial risks that the resources industry takes when it embarks on a new project.

In other words, it is impossible to make informed, well-grounded decisions regarding taxes applied to mining if the focus is only on potential impact on direct tax revenue, without adequate consideration to the other significant economic and social benefits generated by mining investment.

A brief review of the sources used in the draft paper suggest that the authors have primarily relied upon sources that are narrowly focused and dated (some sources were published over a decade ago). We encourage the IGF to take a broader view of the economic impact of mining, and consider some of the extensive modern literature that exists on this topic, including reports prepared by the International Council on Mining and Metals, the World Gold Council and the OECD.

In addition to these global and national-level reviews, Kinross has undertaken efforts to understand and measure the social and economic impact of its operations on our host communities. Recent research has demonstrated the significant positive impact of mining at this level. For example, in Brazil the UN Human Development Index of our host municipality of Paracatu has outperformed 1

Such as indirect tax income (e.g. payroll taxes), job creation, local procurement, development of associated and ancillary industries, etc.

See for example the comprehensive cost-benefit analysis referred to in: https://www.ghanaweb.com/GhanaHomePage/business/Parliament-grants-259m-tax-concession-deal-to-Anglogold-Ashanti-662667
both State and the National level statistics in Brazil. In Mauritania, the economic activity resulting from our mine has resulted in a dramatic reduction of poverty levels within a 50-mile radius of the operation since 2011.

Kinross can make our site-specific data available to you. We encourage the IGF to address these additional considerations in the report, perhaps by including an additional section exploring the broader economic impact of mining to a host country.

**Responsible Corporate Citizenship**

We note that one of the specific gaps that the toolkit seeks to address is to provide *'insights on how mining investors may change their behaviour in response to tax incentives to maximise the tax benefit beyond what government intended'*.

The draft paper seems to premise itself on the notion that tax incentives inherently encourage ‘bad behaviour’ by mining companies. We believe that the draft paper’s conclusions on likely ‘behavioural responses’ are inherently problematic, as they implicitly assume that mining companies, such as Kinross, are ‘bad actors’ who will seek to abuse any potential loopholes. In particular, the draft assumes that companies will take advantage of abusive transfer pricing, and overleveraging between subsidiaries to take advantage of interest rate deductions, affecting taxable income. As a matter of practice and principle, Kinross does not engage in the former, and adheres to all local requirements on the latter.

**Importance of Stability**

The suggestion that taxation structures are not linked to investment decisions is misleading and does not recognize the importance of fiscal stability to investors.

Mining companies base investment decisions on robust analysis of the technical complexity of the project, the quantum of the expected investment and the complete suite of short and long-term risks for the project versus the expected investment returns. At the time an investment decision is made, the taxation structure that applies to the project has a material impact on the economic analysis of the investment and is therefore a fundamental component of the investment decision-making process. In the case of large and financially material projects, this information is subsequently presented to the company’s shareholders and the investment business case becomes part of the company’s market valuation.

Stability and predictability of whatever fiscal terms were agreed at the time the investment decision was made is therefore critical for investment decisions and long-term planning. Jurisdictions which are not perceived to be fiscally stable and predictable will lose out on investment in the medium and long-term and/or pay a higher price to attract new investment. We urge the IGF and the OECD to highlight the importance of stability and predictability to the intended readers of this guide, for example, by including a case study of the impacts of instability and unpredictability of taxation regimes on value lost, for both investors and individual projects, and for host countries as a whole.

The draft paper also recommends against creating specific tax incentives through the ‘mining contract’ for individual projects, and recommends a consistent approach applied to all companies. We are of the view that any such consistent approach should account for substantial potential differences among project development plans such as the quality/size of the resource, geography and infrastructure needs, market conditions, etc. that may exist, even within one host country. For example—an open pit low-grade copper mine close to major power infrastructure may have entirely different economic parameters than a complex, underground, high-grade gold mine, and the potential impact of the tax structure on project economics may vary wildly between such projects.

**Examples and Industry Context**

Mining is a diverse industry—the economics and operational parameters of which vary enormously across countries, commodities, and the external economic environment. In fact, the economics and operational parameters will be different between two mines of the same commodity, in the same country, due to differences in geology and the maturity of the operation. It is our perception that
a number of the examples raised in the draft paper are not considered with sufficient context or nuance to be adequate indicators of potential behavioural responses. For example:

- ‘Gold plating’ of assets: The notion that mining companies will be induced to inflate capital expenditure above what is needed in order to maximise the tax benefits is not a realistic behaviour driver. Mining companies, such as Kinross, have robust tender policies in place for capital goods to ensure fiscal discipline, and are required to streamline purchases to maximize shareholder value. The example also does not consider higher operating standards or technical needs. We would encourage the IGF to avoid unintentionally encouraging government officials to question companies’ investments in best practices, such as social, environmental and safety investments or inadvertently advocate for the under-capitalization of mining projects.

- Differing commodities: The draft paper does not account for significant differences in the value chain and different fiscal treatment across commodities that create vastly different behavioural drivers. For example, the incentives around sliding scale royalties differ dramatically for precious metals producers that sell product at an internationally fixed ‘spot’ price, and commodities traded in less liquid or transparent markets.

- ‘High grading’: The draft paper provides an example of ‘MineCo’ extracting higher-grade ore during the first few years of production, and relies on the assumption that ‘MineCo’ is incentivized to high-grade ore in order to take advantage of a tax holiday, thereby stripping the host government of potential revenue later on. However, it is critical to understand that this practice is not primarily driven by tax avoidance, but is nearly always a reflection of the economic life cycle of a mine and the ‘time value of money.’ Mining projects require heavy capital expenditure (risk) up front, which must be recovered to recoup the significant initial investment and achieve profitability. Companies will seek to operate an asset as long as possible to generate the maximum value and returns on investment. Market conditions, negative public policy changes, technical problems or geological setbacks can all lead to suspension or closure of a mine earlier than initially planned.

We encourage the IGF to consider the above as it finalizes a toolkit that is both realistic and useful for host country governments, and reflective of the values of companies like Kinross and the broader mining industry.

Kinross would welcome the opportunity to further discuss our comments with the IGF. Please do not hesitate to contact undersigned at Mike.vanAkkooi@kinross.com should you have any questions.

Sincerely,

Mike van Akkooi
Senior Vice President, Government Relations
Disclaimer

The below comments reflect the perspective of Natural Resources Canada as the policy department on mining in Canada, and should not be taken to represent the entirety of the Government of Canada on this issue. Natural Resources Canada is not the tax authority for Canada, but possesses considerable expertise on the impacts of policymaking for the sector.

In the interests of context, a short overview of the roles and responsibilities of other Canadian federal departments follows:

- Finance Canada is responsible for tax policy and legislation at the federal level
- The Canada Revenue Agency (CRA) administers tax laws for the Government of Canada and for most provinces and territories, and administers various social and economic benefit and incentive programs delivered through the tax system. The Minister of Natural Resources is mentioned in the Income Tax Act and provides technical support to the CRA.
- Global Affairs Canada (GAC) is responsible for conducting Canada’s international relations.

The Hidden Cost of Tax Incentive for Mining

General Comments

The document is an excellent discussion of the types of incentives that can be used by a country to incentivize mining. However, how a country incentivizes mineral exploration, which can have a dramatic impact on the taxation of mining operations, is not discussed in the document. For instance, exploration deductions in many jurisdictions may be used to offset current or future taxable mining income in that country.

There is also no discussion of the pros and cons of ring fencing mining projects, nor is there mention of tax relief (tax incentive) associated with the additional legal obligations placed on mining companies that other industries are not required to undertake (e.g., environmental assessments and community consultations). Tax incentives related to mine reclamation are also not mentioned (e.g., in Canada, mine reclamation funds offer a company tax relief but ensures that funds will be available for reclamation purposes, if a company fails). This form of a tax incentive protects the Government from potential future environmental liabilities.

The decision to choose what types of tax incentives should be adopted should be based on not only the “cost to the government” and the associated potential behavioural responses but also the “benefit to the government” resulted from the tax incentive (and the resultant industry behavioural response, net of bad behaviour). The goal of any tax incentives should be the most effective and efficient, as indicated in the toolkit.

In addition, given that the toolkit claims to bridge the gaps to provide “guidance” on tax incentives in the mining sector specifically, the document should advise the audience that governments should consult with the industry as to what types of tax incentives the industry would prefer. It is often possible that with the same amount of government tax expenditure, different tax incentives could achieve very different level investment incentives.
Specific comments

Page 11 – Fiscal stabilisation assurances: The need for fiscal stabilisation is usually a result of a country's government changing the fiscal regime too often. Mining companies need stability to be able to make an informed financial decision and determine whether an investment is financially sound. While stabilisation agreements may result in “unintended consequences, by potentially cutting off government ability to correct mistakes”, a company making a multi-year, multi-million dollar investment needs a certain level of fiscal stability. The source of an “unexpectedly large revenue losses” is not articulated in the document. Lack of fiscal stability is a major deterrent to foreign investment. Government should not use fiscal incentives to attract investors only to change the rules once the investment has been made.

Page 12: Step 2 – Is the tax incentive open ended?: There is no real discussion of temporary tax incentives to compensate for market failure versus tax incentives designed to recognize the unique nature of the mining industry (high-risk nature of exploration, variable nature of deposits, public good nature of offsite infrastructure, etc.).

Page 13: Step 3 - What is the potential effect on government revenues?: The modelling required to do “Step 3” is not easy, and requires major assumptions concerning the number of potential mines, their size, the commodity mix, and future price, among other factors. Very few countries in the world have the capacity to undertake such an extensive calculation. Similarly, the report notes that “[t]he government should regularly calculate, and report publicly, the amount of revenue loss attributable to incentives.” Again, this is not an easy task if one tries to evaluate the net impact on government revenue from all revenue sources. An incentive may reduce revenue from corporate income tax but keeps the mine operating (royalty revenue, personal income tax revenue, sales tax revenue, etc.).

In addition, the impact on government revenue is only part of the equation. Governments may have other priorities such as regional development. Mining operations are often responsible for the development of infrastructure in remote regions.

Page 14-16 Income Tax Holidays: Excellent discussion surrounding tax holidays.

Page 16: The use of front-end incentives (exploration deductions, pre-development deductions, etc.) will allow a company to recoup its capital expenditures prior to the payment of taxes; the same effect as a time-based or tonnage-base tax holiday, but exposes the government to less risk and will not influence a company's mining plan (see page 17 – High-grading in the Gold Sector).

Page 21-23 Cost-Based Incentives: (Behavioural Responses) “Investors may artificially inflate the cost of investment to increase the tax benefit.” No proof is offered for this statement. Companies generally do not increase expenditures to get a bigger “tax break” unless it is based on a refundable tax credit.

It is true that transfer pricing may be an issue if purchases are made from non-arm's length companies.

Page 32-35 Royalty Based Incentives: There is no mention of the combination of profit-based royalties and cost-base incentives. Canada’s has profit-based royalties and cost-base incentives that reflect the high-risk nature of mineral exploration and development.

Page 36-39: Stabilization of Fiscal Incentives: This section fails to address that governments have used incentives in the past to attract investment only to change the rules once the investment is made. This
represents a significant deterrent to investment. International mineral capital is very mobile and will funnel funds into area, which have good geology and low-levels of investment uncertainty. Investors want to know what the tax burden will be before make substantial invests in a fix asset – a mine.

The recommendation section makes no mention that governments/countries should develop a reputation for fiscal stability and response governance. Fiscal stability will aid both investment in mining and all other sectors of a country’s economy. Fiscal stability should be the norm, not an incentive.
Les coûts cachés des incitations à l'Impôt Minier - Projet de consultation

1. Introduction

Au Niger, comme partout d’ailleurs dans les pays riches en ressources, les incitations fiscales sont l’objet de critiques amères et de contestations manifestes à cause des abus et avantages fiscaux instituer dans l'espoir d'attirer les investisseurs miniers.

Il est alors temps de déterminer les avantages réels à bénéficier en introduisant les incitations fiscales pour le secteur minier (modifier les dispositions fiscales, promouvoir les infrastructures). C’est dire donc que les incitations fiscales doivent exister pour être efficaces (c'est-à-dire atteindre leur objectif politique) et efficientes (l'objectif politique est atteint au coût minimum pour les recettes publiques).

2. Incitations fiscales pour l'investissement minier

Alors que l'Etat détient la responsabilité des ressources minérales au profit de ses citoyens, il lui appartient de les transformer en résultats de développement durable. L'octroi abusif souvent exclusif d'avantages fiscaux à l'industrie minière encourage une évasion fiscale agressive des entreprises qui contribuent très peu aux recettes publiques et aggrave la pauvreté les citoyens.

Nonobstant la spécificité, il faudra opérer un choix d'incitatif moindre pouvant s'appliquer aussi bien à l'exploitation minière qu'à d'autres secteurs ou catégories d'investisseurs. En effet le traitement fiscal général d’un indice de référence dérivant du code général des impôts serait plus approprié pour appliquer la loi à tous les contribuables.

Sinon, quoi qu’on fasse, les pratiques BEPS (prix de transfert abusifs et la capitalisation restreinte) normalement soumis à une retenue à la source dans le pays où la mine est située, ne seraient pas payés en raison d'une incitation. Autrement dit, la partie liée va augmenter artificiellement les frais, privant ainsi les profits de la mine et les transférant à l'étranger. Ce genre de situation d'incitations fiscales fondées sur les coûts, les redevances, la retenue d'impôt à la source sur les intérêts et les services, les dépenses en capital, etc., augmente la motivation du groupe de sociétés à manipuler le prix de transfert.

Par le choix d’un incitatif fiscal pour tous les contribuables, l'exonération des droits d'importation peut être contrôlée, limitant ainsi le veut des investisseurs d’augmenter le coût
des machines et de l'équipement achetés auprès de parties liées afin d'augmenter leurs dépenses déductibles.

A défaut, il peut être proposé une liste de contrôle pour la bonne gouvernance et les incitations fiscales comprenant des :

- objectifs politiques clairs et mesurables pour le régime d'incitations qui sont annoncés publiquement, soumis à des consultations publiques, et un suivi régulier;
- incitations accordées seulement par la loi fiscale, plutôt que par des contrats miniers individuels ;
- incitations offertes à tous les investisseurs miniers sur la base de critères d'éligibilité clairement définis dans la loi ;
- calculs réguliers et déclarés publiquement du montant de la perte de revenus attribuable aux incitatifs afin d'examiner les risques liés aux incitatifs fiscaux miniers et aux mesures comportementales connexes.

3. Stabilisation des incitations fiscales

La stabilisation vise à préserver les règles en matière d'imposition, de partage de la production, de tarification ou de participation de l'État qui régissent la répartition des produits d'un projet de ressources au moment de la conclusion du contrat. Bien que la stabilisation apparaisse comme une incitation en soi, tout en ayant le potentiel de bloquer toute autre incitation offerte par la législation primaire ou par le contrat au niveau du projet, les approches suivantes sont déterminantes :

- Le gel des lois (ou les conditions contractuelles) en vigueur à la date de l'accord ;
- La non application des changements de politique fiscale futurs pouvant augmenter la charge fiscale sur le projet (bien que le projet puisse bénéficier d'une baisse des impôts), ou
- L'existence d'un accord de négociation pour maintenir l'équilibre économique en cas de changements défavorables selon Daniel et al 2008.
Overall: This is a useful piece, one of the most interesting in the series. We also appreciate the concise nature of the guidance note in discussing the sensitive issue of tax incentives. The comments that follow seek to add greater clarity, improve the cost benefit assessment around incentives (including related to effectiveness), and incorporate additional detail related to incentives that had been shared in earlier presentations by IGF-Mining, including public comments on the importance of transparency around tax incentives. We also encourage a stronger stance in opposition to ineffective and inefficient tax incentives (e.g. tax holidays perhaps being the most egregious among them) and those that are company- or project-specific.

Oxfam’s perspective
We note that Oxfam has also commented on the issue of tax incentives repeatedly, and we encourage you to review the recent publication Tax Incentives in the Global South: A business and civil society briefing (May 2018) published by Oxfam, Christian Aid, Action Aid, and the Confederation of British Industry.¹ In this document, we have stated that “incentives should only ever be granted following effective and transparent mechanisms for evaluating costs (environmental, fiscal, exacerbation of inequalities including gender inequality) and benefits.” We have also particularly noted that “tax-responsible companies should approach tax incentives by:

• Seeking equal treatment under a country’s tax regime and avoiding the use of company-specific incentives;
• Being transparent about the incentives that they use; and
• Regularly monitoring and evaluating their use of incentives to ensure that they are delivering their intended outcomes at the intended costs.”

General comments on the consultation draft:

A. Definitions and Structure: The broad definition of tax incentives, which includes incentives that are sector-wide and found in different sources of law, is helpful. The approach of looking at direct revenue costs, behavioral response and their unintended consequences (as perhaps indirect or additional costs) is a good one. The terms “revenue costs” could be defined though and the “costs” associated with behavioral responses could also be defined as “BEPS costs” or “secondary” or “additional” revenue costs.

B. Effectiveness: The paper starts from a framework to assess tax incentives based on their effectiveness and efficiency, but effectiveness then seems to be under-addressed in the document. Ultimately, effectiveness should be the key first test: if the tax incentive isn’t “effective” at attracting additional investment that would not have occurred but for the incentive offered, then it can’t be “efficient” at all, as any revenue cost is leaving money on the table. While Box 2 (p7) does attempt to explore this, it’s a less rich discussion than in past IGF presentations on this subject (which compared mining to manufacturing and assessed mining company investment decision criteria) and largely divorced from the recommendations.

¹ https://www.oxfam.org/en/research/tax-incentives-global-south
C. **Efficiency and social costs:** When looking at the efficiency of attracting that additional investment (that would not otherwise have proceeded) at limited cost, the guidance paper should also mention the social and environmental costs in addition to the revenue costs. While analysis of such costs may be beyond the scope of this paper, the IGF and OECD should encourage governments to undertake a more comprehensive assessment of costs and benefits before deciding to permit a project to proceed (particularly if the government may be less resourced to respond to environmental and social costs due to the tax incentives granted). (See at the end of Box 2 and throughout.)

D. **Infographics:** Those from past IGF presentations were helpful and may be beneficial to include in the text. For example, diagrams showing direct & BEPS costs were helpful and could be included.

E. **Quantifying costs:** While the paper is called “The Hidden Cost,” it would be helpful to have a bit more quantitative data (even anecdotal) in the document. Slides from past IGF presentations did illustrate the magnitude of the issue, including costs associated with behavioral risks.

F. **Comparison of risks of incentives:** The broad comparison of risk of different types of tax incentives included in past IGF presentations was also helpful. This could even help with the Recommendations throughout. For instance, it seems that the Investment Tax Credit is far more damaging than the other three cost-based incentives, so it would be helpful to recommend against this option.

G. **Capital Allowance Uplift example:** is not at all clear in the figure or the text.

H. **Legal bases for tax incentives and discretion:** Note that tax incentives (and their inverse, subsidies) can also sometimes be found in surprising other legal texts, for example in environmental legislation, energy regulations, sanitation or water codes. Worse still, in some countries, incentives and exemptions can be granted on a discretionary basis by government officials (e.g. Republic of Congo / Brazzaville). This suggests that there’s a need to encourage, in the recommendations, the removal of discretion in granting tax incentives and the centralization of possible tax incentives within a single source (or explicitly listed and limited number of sources) of law. This which would improve accountability in the granting of incentives and facilitate monitoring of the incentives and of payments to governments.

I. **Tax administration:** Are there are opportunities to discuss innovative approaches to tax administration that may help to limit the unintended consequences of existing tax incentives?

J. **Related to tax incentives:**
   i. **Funds for Closure and Rehabilitation:** One under addressed potential tax incentive is funds for reconstitution of the deposit and rehabilitation of the mining site after closure (e.g. in DRC this can exempt 0.5% of gross revenues from profit tax; in Guinea, this can be 10% of the taxable profit). Is this a risk, and are there alternatives to consider (e.g. instead of a deduction from profit tax, allow for a contribution to an environmental trust as in Canada)?
   ii. **VAT exemptions:** It’s worth clarifying a bit about the role of VAT exemptions: while not a true tax incentive, they do create a behavioral risks of companies trying to exempt imports not directly related to mining activity. There are also questions about VAT refunding to subcontractors.
   iii. **Subsidies:** Mining companies are often granted subsidies (energy, fuel, water, etc.) that are not available to all companies/sectors and these subsidies have similar impacts to tax incentives; in many ways it’s the other side of the coin. These are not really mentioned in the document and perhaps worth integrating.
Specific comments on the consultation draft:

1. P4 “Effectiveness is when”: this could be unpacked a bit in terms of social benefits
2. P4 “Efficiency is when”: “low social costs” seems to be defined primarily by low “economic costs” to the host state. But social costs are also relevant here...
3. P7 Box 2: The points about “many drivers” and “no empirical evidence” in bold are really important points, that respond to one of the two main parameters articulated in the Introduction and “About this Toolkit” sections on P4-5, but they merit more detailed, stronger discussion in the text itself.
4. P8: In the first paragraph, it’s worth noting that mining requires substantial debt financing, and is also subject to interest rate volatility.
5. P9: worth highlighting reduced CIT rate as a common incentive in the sector
6. P10: At the end of sources of law and discussion of DTAs, it’s worth also discussing tax stabilization and international investment treaties/agreements
7. P10: “due to an incentive...” at bottom of page is unclear. Perhaps try “due to a withholding tax relief incentive, there is no withholding tax to be paid”
8. P11: Step 1: some discussion here might be helpful, and at some point a comparison of the potential risk involved in the different types listed in Table 2.
10. P12: “revenue cost”: here or elsewhere it’d be good to define this term as it is not necessarily intuitive at first glance (as it combines two terms often seen as opposites).
11. P12 re: fiscal limitations in time & scope: In some instances it extends to exonerating mining companies from paying local rates to local authorities.
12. P14 1.1b) Abusive Transfer Pricing: is it worth distinguishing this example from ringfencing for the reader?
13. P15 Table 3: This is really more about Effectiveness, but it only seems to be included for Income Tax Holidays not the other incentives. Does this merit a more general section elsewhere (earlier in the document)? The first item, at least seems generally relevant. Also, the second item’s explanation (last sentence) is not very clear. And “Mining companies are not well disposed to tax holidays” seems odd, as they certainly appreciate them, even if they don’t rank as highly as other items on the priority list.
15. P20: “Fixed Management Service Charges” and “fixed fee” ➔ “Fixed Percentage”
16. P21-23: In discussions of cost-based incentives, worth reiterating that the deductions are from taxable income (except for in the case of investment tax credits) wherever possible to help with clarity.
17. P20: b) investment allowances: note that the standard depreciation would apply for the other half of the investment.
18. P23: 3.2 Recommendations: can the document take a stronger stance against Investment Tax Credits relative to the others? It’s worth noting that they are not always limited to the first year and they could result in tax debts carried forward.
19. P24: Figure 1: The table here does not seem to fully make sense. Perhaps it’s worth double check this? Is there meant to be an Uplift in Year 1? If not, it seems that WITH uplift should include uplifts only for Year 3, not Year 2 for a second time. And shouldn’t the main difference
with compounding be that the uplift itself is compounded, rather than that there is an additional year of compounding (3 vs. 2?)

20. P24: the discussion that follows Figure 1 introduces numbers that do not correspond to the table. Is this meant to be a different example? If so, a better explanation is needed.

21. P25: EPZ’s…: It’s worth highlighting why “EPZ status is usually granted to a company’s mineral processing operations alone”: it’s a key item for encouraging value addition in country, which may be an additional “effectiveness” criterion.

22. P25: Box 5: It would be good to add a source or two here, especially for the last sentence (who requires?)

23. P26: Is “mining activities” here meant to include processing?

24. P27: 5.2 Includes a number of great recommendations (especially (d) ) that cover areas of tax administration. Is it worth synthesizing some of this into the key conclusions?

25. P31: last sentence “There is also no guarantee…” is unclear – what is it referring to?

26. P33: Chart 1: The fact that the slab approach in this example is ultimately generating MORE revenue is distracting from the larger point being made about the cliff edges. Would it be possible to include an example where the slice structure line is actually equivalent instead? (Even though this means higher rates for the slice structure vs the slab structure?)

27. P33: After the Chart, it would be good to note that this royalty incentive will also ultimately reduce CIT since a lower sale value is realized.

28. P35: “Fiscal stabilization…” doesn’t really seem to be a behavioral response. Perhaps it’s worth considering project expansion?

29. P36: 7.2 Recommendations a) Where it’s mentioned that the application of any tax should “not discriminate against the mining sector,” can you provide an example?

30. P36: 7.2 Recommendations: Consider a recommendation about stabilization clauses not being extended to subcontractors and affiliates, which can lead to significant revenue losses, difficulties in tax administration (e.g. as with VAT credit refunds)

31. P37: Reinvested profits table: Is the data for the 2007 and the Total column correct? Seems like there may be some errors (shouldn’t be possible for tax forgone from reinvested profits to exceed the reinvested profits).

32. P38: final example in this section: is there any evidence that the investments would or would not have proceeded absent the reinvested profits incentive? (Effectiveness question)

33. P39: Legal regime: relevance of BITs/IIAs for stabilization?

34. P42: The recommendations should include at least one related to the effectiveness of the incentives at achieving the policy goal.

35. P42 Recommendation 1: It would be good to also note the need to consider these revenues costs in addition to any social and environmental costs associated with the investments

36. P42 Recommendation 3: Avoiding the most damaging tax incentives: Rather than limit, the advice should rather be that countries abolish 'tax holidays'.

37. P43 Recommendation 7: In many old and even current mining contracts when you stretch them a bit you will find elements that can constitute reasons for review (even where there are stability clauses), so this can be a bit more clear to recommend for example that because the sector is turbulent/cyclical, a review could/should be carried out on annual/regular basis. More generally, it would be good to stress that governments should regularly assess the impact of tax incentives to better limit their harmful effects, which may be possible, in part, through tax administration efforts.
Dear Sir/Madam

Consultation Draft on The Hidden Cost of Tax Incentives in Mining

We wish to thank the IGF and the OECD for the work done to date in producing the current consultation draft and for providing South Africa the opportunity to submit its comments.

Comments:
Paragraph (b) of point 1.1

South Africa would like to suggest that more examples should be included in order to make it easy to understand and appreciate the issue addressed under this point.

Paragraph (b) of 2.2

Paragraph (b) of point 2.2 on page 19 states that “Governments are advised to adopt OECD BEPS Action Items 8-10 which states that in the case of routine services, for example, management services, the charge should be the cost of providing the service, plus a mark-up of 5%.”

The current wording is very prescriptive in stating that developing countries should adopt the simplification method for management services. We are of the opinion that developing countries are generally the recipients of
management services and the risk for developing countries is in the cost base and not in the mark-up. Therefore, South Africa would like to suggest alternative wording for the above statement by amending the statement to read “Governments should be made aware of the OECD BEPS Action Items 8-10 which states that in the case of routine services, for example, management services, the charge should be the cost of providing the service, plus a mark-up of 5%. ...”

We would also recommend an amendment to the heading of the paragraph to be in line with the change to the above statement: “Cost plus method for management fees”.

5. Import Duty Relief

Example: Sale of Equipment

When analysing the example, South Africa is of the opinion that it would be difficult gather information regarding how the assets are treated across so many jurisdictions. In practice we have found that obtaining such detailed information across so many jurisdictions is lengthy (if the relevant Double Taxation Agreement (“DTA”) is used) and in some instances you are unable to obtain such information because of the wording of the relevant provision in the DTA. It would therefore be useful if the Example provided a detailed approach relating to what information should be obtained and how the information can be obtained.

General comment

South Africa would like to suggest that actual amounts are included in the examples in order to make the document more practical.

Should you have any queries, please do not hesitate to contact me.

Yours faithfully

South African Revenue Service
Investigative Audit:
Operation Specialist/Specialist

ISSUED ON BEHALF OF THE COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE
Outlook on Tax Incentives in Respect of Mining Sector: Tanzanian Perspective

1. Brief Overview

In Tanzania, tax incentives are granted to both local and foreign investors provided they are registered by Tanzania Investment Centre (TIC) and/or Tanzania Revenue Authority (TRA).

Tax incentives are mainly in the form of capital deductions and allowances and are structured as according to the lead and priority sectors including mining; petroleum and gas (just to mention few).

Mining contracts (Mining Development Agreement "MDA") still have tax exemption provisions but did not have power to override the main Income Tax Act. Notably, most agreements and certificates of fiscal stability in relation to some mining companies prior to 2004 were stabilized under repealed act of 1973. However the Income Tax Act 2004 has cascaded continuity of such rights embedded in those binding agreements between the government and Investor, to exist for the duration of contract or the person relinquish those rights, whichever is earlier.

Note: The incentives are not automatic until Government Notice (GN) is issued or clearly indicated in the relevant tax laws.

2. Potential Tax Incentives available to MNEs in Mining Industry

2.1 Incentives offered under Income Tax

1. Accelerated Capital Allowance: A 100% capital deduction applies to equipment’s used for prospecting, exploration of minerals.

2. Indefinite carry-over of losses: There is no limit on the carry forward period for tax losses. However, there is ring-fencing of tax losses as follows:

- Losses from one mining license area can only be offset against profits from the same mining license area.
- Foreign-source losses can only be offset against foreign-source profits.
- Losses on investments can only be offset against investment income.
- Foreign-source losses on investments can only be offset against foreign-source investment income.
- Losses incurred on speculative transactions can only be offset against income derived from speculative transactions.
3. Newly listed companies

For a newly listed company on the Dar es Salaam Stock Exchange (DSE) get an incentive of a reduced corporate income tax (CIT) rate for the first three years from 30% to 25%, provided that at least 30% of shares are publicly listed.

4. Withholding tax on management and technical services 3%: This has been stabilized under relevant MDA between government and some of mining companies. This kind of incentive is open to mining companies which got MDA prior to 2004. Otherwise normal rates of 5% for technical services and 15% for management fees are applicable.

2.2 Incentives offered under Value Added Tax

1. Exempt from Value Added Tax on Imports: An import of goods by a registered and licensed explorer or prospector for the exclusive use in mineral exploration or prospection activities to the extent that those goods are eligible for relief from customs duties under the East African Customs Management Act, 2004.

2.3 Incentives offered under Mining Agreements (MDAs)

1) Fiscal stability provisions i.e Withholding tax

3. Comments on this draft toolkit

Our comments are centered on Risk Review of Mining Tax Incentives and Related Behavioral responses.

Taxes on Income

i. Income Tax Holiday

- **High Grading:** Tax holiday is not currently applicable in mining operations in Tanzania, Under Income Tax Act this tax holidays are for the taxpayers under Export processing zones (EPZ) and Special economic zones (SEZ).

- **Abusive Transfer Pricing:** No tax holiday in respect of mining operations as highlighted above.
  The general rule is, the ring fencing rules are applicable to prohibit offset of losses from one license to another.
ii. Withholding Tax Relief

- Our withholding tax regime is levied on management fees, dividends, IPs - royalties and interest on loan, imported services, and insurance premium paid to non-resident/foreign insurance company, and professional service.

In respect of Mining operations, the rate does not differ except if provided under MDA specifically under tax stabilization clauses. Some of MDAs entered prior to 2004 are stabilized under Income Tax Act 1973, where withholding tax rate has been stabilized at a rate of 3% in respect of technical services.

- Excessive Interest deductions
  We address this, by both thin cap rules and transfer pricing rules. Not only that but several tests are done to confirm actual incurrence, economic relevance and market conditions.

- Inflated Management Charges
  The general rule is all imported services (including management service) are charged withholding tax at 15%, but due to fiscal stability clauses in some MDAs, currently some mining companies' pays at the rate of 3%.

In cases where there is management charges which contravene the arm’s length price, the Commissioner is duty bound to quantify, apportion and allocate conditions resulting from a controlled transaction.

Therefore, transfer pricing rules aid to ensure the charges are not excessive and reflect market conditions

iii. Cost based Incentives

- Accelerated depreciation: Currently Income Tax Act, grants 100% capital deduction in respect of equipments used in prospection and exploration of minerals.

In case of Mining development Capital expenditure, only 20% capital deduction is allowable in respective year of income.

- Investment allowances: Currently not applicable in Tanzania

- Investment Tax Credits: Currently not applicable in Tanzania. In our case, only to the extent an investor or taxpayer having tax credit, this can either be refunded or used to offset current and future tax liabilities.
- **Longer loss carry forward:** In our case loss are carried forward indefinitely

iv. **Export Processing Zones**
Under Income Tax Act, Mining operation is out of scope of Export processing Zones (EPZ) and Special economic zones (SEZ).

v. **Import Duty Relief**
- Companies inflate the cost of imported equipments and machinery procured from related part
- Also wrong base will be used in computing capital allowance for wear and tear purpose.

**Question:**
Does the legislations which lack anti-treat shopping provisions offers indirect tax incentive in terms of misusing DTA available?