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Issues Concerning the Taxation of the Extractive Industries for Consideration by the Committee

Note by the Secretariat

Summary

Foreign direct investment issues and corporate taxation, including resource taxation issues for developing countries, is on the agenda for the ninth session of the Committee of Experts on International Cooperation in Tax Matters under agenda item 6(b)(iii). This paper is intended to assist discussion of that agenda item but should not be taken as representing concluded secretariat views.

INTRODUCTION & BACKGROUND

Foreign direct investment issues and corporate taxation, including resource taxation issues for developing countries, is on the agenda for the ninth session of the Committee of Experts on International Cooperation in Tax Matters under agenda item 6(b)(iii). This paper is intended to assist discussion of that agenda item but should not be taken as representing concluded secretariat views.

At the eight session, and building on a prior presentation on the use of tax incentives by Stefan van Parys (E/C.18/2010/CRP.13)[1], Robin Oliver (then a member of the Committee) gave a presentation[2] on how the taxation of foreign capital negatively affects the volume of investment, resulting in lower wages and/or higher unemployment. Issues of location-specific economic rents and their relevance to articles 5 and 7 of the United Nations Model Tax Convention on permanent establishment and business profits, article 6 on income from immovable property, article 9 on associated enterprises, article 10 on dividends, article 11 on interest and article 12 on royalties were discussed. Issues other than those related to the extractive industries are not addressed in the present note though many of the same issues are relevant to the taxation of natural resource exploitation more generally.

Following Mr. Oliver's presentation, the Committee discussed issues such as location-specific rents associated with natural resources and the need for appropriate tax policies for resource exploitation. According to a number of participants, many developing countries were losing out on such revenue. Those exploiting the resources were often provided with tax exemptions that could not be economically justified, while their activities led to externalities, for example environmental damage, that negatively affected local communities, which were often not appropriately compensated. The Committee decided to continue to work on this important issue and that a working group should be formed. However, as the membership of the Committee came to an end in June 2013, the formation of such a working group was deferred to the new membership.

Expert Group Meeting May 2013

With a view to assisting the Committee in addressing the agenda item, the Financing for Development Office of the Department of Economic and Social Affairs of the Secretariat organized a one-day Expert Group Meeting on 28 May 2013. The discussions focused on the issues that developing countries face when designing and administering an extractive industries fiscal regime with a view to ensuring that the United Nations tax cooperation work can further support developing countries in that important area of development.

During the meeting, participants from national tax authorities, international organizations, non-governmental organizations and the private sector considered the question of international tax cooperation in the extractive industries sector, including institutional arrangements to promote such cooperation. A detailed report of the meeting summarizing the presentations by

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[1] United Nations (2010). Use of Tax Incentives in Attracting Foreign Direct Investment. Retrieved from http://www.un.org/esa/ffd/tax/sixthsession/UseOfTaxIncentivesALL.pdf

[2] Oliver, R. (2013). Presentation on Foreign Direct Investment Issues and Corporate Taxation. Retrieved from http://www.un.org/esa/ffd/tax/eighthsession/PPTs/PPT_CRP11.pdf

participants and the ensuing discussions will be made available on the website of the Financing for Development Office before the ninth annual session.

Issues in Extractive Industries and their Taxation

The proper management of natural resources has set some countries on course for sustainable development and prosperity. However, in many others countries, the extraction of natural resources[3] has not resulted in growth but has, to the contrary, had some adverse impacts on the country's economic development. Natural resources and their extraction have implications for the macro-economic stability of a country. For example, the exploitation of natural resources often drives up the value of the local currency, thereby hurting the competitiveness of manufacturing exports, termed "Dutch disease". This is one of the reasons why resource-rich countries often struggle to diversify their economy, another being that the extractive industries manage to attract a large share of capital – financial and human. A strong focus on extractive industries can also have an adverse impact on other potential uses of the same geographical area or adjoining areas as well as on issues of land rights.[4]

Natural resource abundance is often associated with weak checks and balances because large rents motivate political elites and powerful private actors to capture these for the benefit of a few over the common economic interest. The World Bank's governance indicators suggest that, for example, oil-rich countries in Africa commonly perform worse than other country groups in terms of voice and accountability, political stability, rule of law and the control of corruption.[5] There is frequently a lack of transparency in the area of resource extraction. Addressing these issues is, however, not only a matter of technical knowledge but additionally requires sustained political will at the different levels of government, and the United Nations as well as other bodies can have an important role in helping focus and "institutionalise" that political will.

The public revenues arising from the extraction and/or sale of natural resources in the form of profits from operating a state-owned enterprise, royalties, corporate income tax and higher tax receipts due to higher rates of employment and consumption can account for between 20 and 50 per cent of state income. It is thus pivotal that the fiscal arrangements governing the natural resources sector are balanced and ensure that a country's population benefits from economic gains.

An effective fiscal regime has to satisfy a country's specific needs for maximizing different goals, including government income over the whole project life cycle, securing early revenue, attracting investments, ensuring a "fair" share of the proceeds in case of rising prices and minimizing administrative burden and risks. The fiscal regime can additionally also be used to achieve other goals such as environmental protection, achieving the Millennium Development Goals and giving incentives to keep value-added activities in the country thereby moving the country and its economic actors up the global value chain. Building up funds to protect against potential shocks of the economic and financial system also represents a very important role for

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3 "Natural resources" denotes non-renewable natural resources such as crude oil, natural gas and mining products. The terms "natural resources" and "extractives" will be used interchangeably.

4 International Monetary Fund (2012). Macroeconomic Policy Frameworks for Resource-Rich Developing Countries. Retrieved from http://www.imf.org/external/np/pp/eng/2012/082412.pdf

5 World Bank Group (2013). Governance Indicators. Retrieved from http://data.worldbank.org/data-catalog/worldwide-governance-indicators

taxation. International tax issues range from potential double taxation, transfer pricing and indirect taxation to the taxation of cross-border fields.

Extractive Industries

The extractive industries produce crude oil, natural gas, traditional mining products as well as rare earth elements. While there are important differences between these sectors and sub-sectors in terms of exploration risks; environmental, labour and other concerns, value adding at source and commercial structures, the extractive industries have some common features, which in turn impact the business model of the industries and thus the way in which the industries should be taxed.

The sector is characterized by a high degree of uncertainty which equates to risk. Discoveries of extractives might not always lead to actual extraction due to cost or environmental reasons and because of highly volatile prices, which in turn influence the profitability of exploration. Exploration and appraisal activities may themselves be very expensive and some of the infrastructure is extremely costly. Exhaustibility issues, both at project level and overall add further unpredictability. The demand for extractives is strongly linked to the state of the world economy as well as to other developments, such as renewable energy sources and initiatives and legislation governing climate change.

Due to the technology and specialist expertise involved in extracting resources the industries are usually characterized by high sunk costs, which may not be easily recovered even if a project is terminated and, in turn, demands long production periods making stable fiscal regimes pivotal. The cost of the proposed offshore liquefied natural gas plant off the coast of Tanzania is estimated at $10 Billion or more. The construction of a coal mine in Central Queensland in Australia was recently estimated to cost between $900 Million to $1 Billion[6]. However, under favourable conditions, extractives have the potential of substantial earning in excess of a minimum return on investment, i.e. so-called rents.

Developing countries face special challenges when dealing with private companies from the extractive industries or joint ventures. Often, natural resources are extracted by foreign firms as local capital is scarce and FDI is much needed. Those producers often have substantive market power and are better informed than many governments as the process of discovery and appraisal is often driven by private companies. It is likely that those companies have more expertise and special knowledge in understanding an industry and in dealing with taxation issues than under-resourced tax administrations, which may not have the same expertise and information readily available.[7] There will also commonly be disparities in general negotiation experience.

Taxation of Natural Resources

There are different approaches a government can take to taxing the extractive industries.

State-owned enterprises

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[6] Daily Mercury,(2012). Retrieved from http://www.dailymercury.com.au/news/new-500m-coal-mine-could-create-400-jobs/1597495/

[7] Daniel, P., Keen, M. and McPherson, C. (2010). The Taxation of Petroleum and Minerals. Principles, problems and practice. London and Washington: IMF.

Firstly, the government can operate state-owned enterprises which transfer some or all of their profits to the treasury as "taxes" or "other revenues". While a deeper discussion is not within the scope of this paper, in weak governance contexts, such enterprises may be susceptible to low levels of productivity and low investment rates due to influential interest groups.

Joint venture structures
Secondly, a government can opt to form a joint venture with a private company, holding an equity stake. Here, the intention of the government is often the transfer of technology and knowledge. Depending on a country's financial strength and its risk profile, a joint venture is often chosen if a government wants to preserve control over its natural resources even though it is unable or unwilling to fully fund the exploration.

Production sharing
A third and similar option is production sharing. Here, the ownership of natural resources remains with the government throughout the exploitation period and a private company is tasked with the extraction of the resources. Such production sharing might take different forms, ranging from concession agreements to risk service contracts. Profits are usually derived from gross production minus allowable production costs and shared between government and investor and can be adjusted in favour of a government as production, volume, price or returns increase. As the government has all the information needed to determine the cost structure, taxation is deemed to be easier.

Options for corporate taxation
The fourth option is to tax private companies either on income, cash flows or profits. A resource rent tax would only tax the excess of income over a minimum rate of return needed to satisfy investors. Rents are linked to demand elasticity, the exclusiveness of a product and barriers to enter a certain market, such as very high investment needs. Determining what is in excess of an economic rent can be difficult, however, especially for resource-strained tax administrations. Windfall profit taxes try to capture sudden price hikes. As windfall gains are, by definition, unforeseen, taxing them is non-distortive. Due to this, windfall profit taxes may be relatively high and/or progressive.

Royalties
Lastly, royalties are usage-based payments made by the private company for the right to extract resources. These may be calculated ad valorem, i.e. according to the value of the sale of natural resource; per production volume, i.e. according to the amount extracted or using profit, i.e. according to after-cost profits from sale of natural resources.[8]

Tax Incentives
The use of tax incentives to attract foreign direct investment is often contentious. The note presented to the Committee in 2010 by Stefan van Parys on the use of tax incentives in attracting foreign direct investment finds that on their own such incentives have limited effects on investment and should be used minimally taking into account transparency issues. Their use should be linked to market failures or to generate multiplier effects. To the extent possible, it should be tax administrations that administer them and a sunset clause should be included in such agreements. They need to be kept under regular review also, to ensure that the original purpose of granting the resource is still being met. As in other areas, there is a general need

[8] International Monetary Fund (2012). Fiscal Regimes for Extractive Industries: Design and Implementation. Retrieved from http://www.imf.org/external/np/pp/eng/2012/081512.pdf

for clear and transparent legislation – administrable in practice, and with regular review of whether it continues to meet its policy objectives. This involves a process of engagement with stakeholders, including taxpayers and the interested citizenry.

The best way to counteract “harmful” tax competition, such as, but not limited to, the use of tax incentives, is to engage in regional cooperation. By coordinating their tax policies countries can circumvent a so-called “race to the bottom” and strengthen their negotiating position vis-à-vis private companies – this will help ensure that incentives are not given unless they are objectively needed to achieve that investment, and that they give away no more than necessary to achieve this.

Most countries have special tax regimes for the extractive industries to account for the abovementioned particularities of the sector. In fact, most countries make use of a combination of several instruments; that is a resource rent tax, a windfall profit tax and/or royalties. Governments should choose the fiscal regime governing the extractive industries that appropriately suits its risk profile, ensures appropriate government funding and can be administered by the country’s tax administration. There is clearly an issue of timing: Governments are likely to be rewarded with higher tax receipts if they forego some of their early taxing rights and bear some of the risks associated with the investment. The fiscal regime chosen should be clear, enforceable and non-discriminatory. Moreover, enough resources have to be made available for tax audits in order to ensure that tax evasion, if existing, is detected quickly and detected effectively.

It is, however, not only important to have a functioning fiscal regime for the extractive industries. Broader tax reform might also be needed. For example, countries may need to establish and properly administer a capital gains tax to ensure that in the case of *indirect* transfer of mines by sale of a foreign entity owning the mine, taxes are due and payable to an entity within the jurisdiction of the source country. There are obviously operational intelligence issues in terms of knowing when such a foreign sale, which represents an indirect sale of a local concession, is occurring. There are also legislative issues involved in ensuring any tax owing will be paid, such as by the new owner being responsible, with recourse against mine assets. Moreover, general or even specific anti-avoidance rules might be needed to deal with issues that are not necessarily confined to the extractive industries, but may be especially relevant to that sector because of its importance to a country’s economy.

International Tax Issues

One important international tax issue is transfer pricing, i.e. the pricing of intra-firm transactions between related parties involving the transfer of property or services as reflected in a “market” or “arm’s length” value, most of them across borders. Where the price does not reflect the true value of the property or service, this might be considered transfer ‘mis-pricing’ and issues of tax avoidance and evasion may potentially arise. Mis-pricing denies a country the ability to tax value created or added in that economy.[9]

Important points raised at the UN Expert Group Meeting of May 2014 were that natural resources are inherently local and cannot be moved, extraction is very capital intensive and financing issues including thin capitalization are a major issue in this transfer pricing context.

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[9] United Nations (2012). Practical Manual on Transfer Pricing for Developing Countries. Retrieved from http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf

Extracted resources need to be processed to be of value involving many different functions. In this case, one key transfer pricing risk arises where private companies enter in convoluted structures involving the inter-positioning of multiple companies, most often in low-tax or no-tax jurisdictions with little exchange of tax information possible, in order to apportion profits.

The issue of a fragmentation of the supply chain leads to serious transfer pricing issues through the use of offshore marketing or procurement entities and offshore hedging structures as well as in the provision of intra-group services. There is a risk that home-grown intellectual property used in the extractive operations will not be properly reflected in the estimation of profits because the legal rights to such intellectual property have been transferred offshore. Similarly, deductions for interest paid on offshore loans may artificially reduce or nullify profits. Many countries address this in the extractive industries and more generally by thin capitalization requirements, which limit the amount of debt funding in proportion to equity funding. Some deny deductions paid to entities in specified countries – so called "tax havens".

There is also the potential for double taxation which arises if taxes relating to the extractives are not being credited in the home country of an investor – often discussions during negotiations on tax treaties need to establish that a tax is within the "taxes covered" article of a treaty to prevent double taxation. In order for a taxpayer to obtain a credit against a tax already paid in a foreign country, the taxes that are levied in the source country have to correspond to taxes that would have otherwise been paid in the residence country. Especially resource rent taxes and windfall taxes are susceptible to double taxation as these fiscal instruments are not levied in many resident countries, but other taxes such as an income tax may be applied to the same profits. Some tax treaties also have specific treaty coverage of offshore extraction revenues.

Here, the limited treaty network that many developing countries have burdens the effective exchange of information and may thus further the possibility of double taxation or non-taxation. Even within limited treaty networks a combination of a treaty with a very low withholding tax rate and treaty shopping by taxpayers can deprive the source country of significant withholding tax revenues on dividends, interest or royalties for the use of intellectual property and the like – the effect can be especially detrimental to developing countries as, for many weaker administrations, such withholding taxes are an easily administrable, though imperfect, way of taxing profits made from engagement in the local economy.

Such transparency concerns are also addressed in a broader transparency context, such as the Extractive Industries Transparency Initiative (EITI), the US-American Dodd-Frank Act, the relevant European Accounting and Transparency Directives and the G20 efforts concerning country-by-country reporting. This level of focus on transparency in the extractive industries has been a positive development, but it also reflects that such issues were previously not adequately dealt with in the sector.

Indirect taxation, most often in the form of a value-added tax (VAT), represents a tax on final domestic consumption and should thus have little impact on the generally export oriented extractive industries. However, the export orientation could pose problems as there are large up-front costs involved in extracting resources and relief for VAT charged on inputs cannot be obtained by crediting them against that liabilities but must instead be refunded, which many developing country tax administrations have trouble doing in a timely manner. Where VAT

does apply, the opportunities for fraud are often great, and the administrative challenge of confronting VAT fraud is not always fully recognized.

Cross-border fields raise revenue issues as well as international law (such as law of the sea) issues. Countries generally negotiate an agreement between them to determine the taxing rights of each country and to determine the tax regime chosen and how it will be administered.[10]

Issue of Contracts

The negotiation of contracts is a decisive stage that determines whether or not a country will be able to ensure a “fair” share of the revenues but also whether the project is worth proceeding with from the company perspective. It is thus of utmost importance that contracts are clear, concise and easily enforceable. In the Expert Group Meeting of May 2013, it was suggested that contracts should contain the following:

- A definition of the taxable income and tax base
- The taxation rules that apply to the extractive industries
- Underlying debt to equity and depreciation rules
- Applicable transfer pricing rules

An alternative is to keep taxation aspects separate from more general contract negotiations. While there is acknowledgement that having taxation rules as part of the contract might offer the taxpayer greater certainty, there are also benefits to keeping such issues separate. Firstly, this gives countries the opportunity to define the fiscal regime for extractive industries generally, which has obvious consistency advantages. Secondly, as contracts between the government and firms are usually not open to public scrutiny and evaluation, keeping such rules separate gives governments the opportunity to make them available to the general public thereby enhancing transparency and legitimacy. Thirdly, it gives governments the opportunity to change fiscal regimes that apply to the extractive industries when new circumstances arise thus offering more flexibility - though this entails a loss of security to investors and should not be a step lightly taken. Lastly, given that developing countries are often at a disadvantage when negotiating with private companies, especially multinational enterprises, there are obvious advantages to keeping these two processes separate.

This issue is closely linked to fiscal stability clauses (also called “equilibrium clauses” or “bespoke agreements”), which are legally binding commitments by the host country’s government and either guarantee the contract’s fiscal terms or guarantee investors a share of economic rents over an agreed upon period or for the length of the agreement. Given the high sunk costs, long production periods and thus the long time horizons needed to recuperate initial investment losses; such clauses are attractive to private companies. However, often such clauses do not offer the kind of flexibility needed to react to changing circumstances such as rising prices for extractives or new political realities. In fact, when the terms established are found to be untenable, contracts are sometimes re-negotiated despite a fiscal stability clause – at times as a result of strong public pressure.

[10] Daniel, P., Keen, M. and McPherson, C. (2010). The Taxation of Petroleum and Minerals. Principles, problems and practice. London and Washington: IMF.

There are also general issues of effective negotiation techniques when negotiating contracts, especially if developing countries are dealing with powerful private companies. There are, however, recognized techniques to maximize the effectiveness of bargaining power from apparently weak positions and ways of leveraging apparently small advantages. Capacity building efforts will need to address such negotiation techniques alongside more general efforts to raise knowledge and information on international tax issues surrounding the taxation of the extractive industries.

In all of these areas, some consideration to investment policy more broadly and to International Investment Agreements may be necessary, such as the potential issues arising under Fair and Equal Treatment Clauses, clauses relating to expropriation and "Umbrella" Clauses that are being interpreted as giving contractual provisions a treaty dimension.

Issues for consideration by the Committee – possible approach

The Committee might wish to consider:

1. Forming a multi-stakeholder Subcommittee tasked to confer in a way most conducive to effective developing country participation;

2. Mandate the Subcommittee to report back at the next annual session suggesting a work program, within the time frame of the current membership,
   a. that identifies, prioritizes and carries policy and administrative guidance for developing countries on taxation of extractive industries The issues at hand are many and often related to each other, so strong prioritization might be needed;
   b. that addresses how this can be achieved in a way that best utilizes the special characteristics of the Committee and the universality and convening power of the United Nations, while recognizing those activities of others in the field that support developing country efforts, address actual developing country cases and experience and respond very practically to their needs in this area;

3. The Coordinator for any such Subcommittee (traditionally chosen from among members of the Committee, when possible);

4. The extent to which the membership of any such Subcommittee should be determined at the annual session, or could be settled later at the discretion of the Coordinator, bearing in mind the need for broad and balanced representation in practical terms. Strong developing country involvement at the practical level would seem essential to a successful work programme despite the lack of Subcommittee funding and meeting in developing countries as far as possible may assist this; and

5. The need for consultation with other Subcommittees.

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