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Possible update of the Extractive Industries Handbook

POSSIBLE UPDATE OF THE EXTRACTIVE INDUSTRIES HANDBOOK

Introduction

In 2013, during its ninth session, the UN Tax Committee established a subcommittee on taxation of extractive industries. The creation of the subcommittee followed a paper presented by a then member of the Committee Mr. Robin Oliver and another expert Mr. Stefan van Parys at the eighth session. The paper argued that many developing countries were losing out on such revenue from extractive industries. It pointed out that 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. Owing to the importance of the issue, the Committee decided that its work on it should continue and that a working group should be formed.

2. During the following four years the subcommittee worked on number of key topics dealt by the extractive industries in most developing countries, particularly those endowed in rich natural resources (minerals, oil and gas). The work of the subcommittee and the debates during the committee sessions led to the publication of a handbook on taxation of extractive industries which is the final (post approval) editing process.

3. The handbook is subdivided into nine chapters (the chapter numbering may change prior to final printing) as follows:

1) Overview Chapter

This Chapter gives a broad overview of tax issues relating to the extractive industries.

2) Tax Treaty Aspects

Bilateral tax treaties play an important role in coordinating rules for cross-border tax treatment and eliminating obstacles to cross-border trade and investment. Extractive activities usually have numerous cross-border elements. They are undertaken by investors, license holders, service providers and suppliers who are often not resident in the source country. Additionally, natural resources, once extracted, are typically exported.

These elements raise several tax treaty issues for the extractive industry, which are discussed in this chapter. In particular, the chapter includes commentary on which taxes are covered by a treaty, when activities of investors, contractors and subcontractors are taxable, how tax legislation may vary throughout the life cycle of a natural resource project, how the term “royalties” as used in tax treaties differs from mineral/oil and gas royalties, whether a tax or other levy is creditable in the resident state of the investor, aspects of non-discrimination, and the territorial scope of tax treaties.

3) Permanent Establishment Issues

This chapter examines the concept of permanent establishment (PE) in the extractive industries. In this respect, it focuses on the main PE taxation issues relating to the extractive industry taking into consideration the relevant provisions and Commentaries established in the United Nations Model Convention and other models.

While reference is made to the mining sector as required, the chapter mainly deals with the PE concept in the oil and gas (hereinafter referred to as O&G) sector where a wide array of taxation issues arise, and elaborates on the implications and existence of PE’s, distinguishing the contractor and subcontractors´ tax matters as a result of the particular business features and different activities performed in a country.

4) Indirect Asset Transfers

This chapter discusses whether and how a capital gains tax could be implemented for indirect asset transfers. Domestic legislation could tax gains on sales of capital assets as general ordinary income, as capital gains taxable under the corporate income tax law, or by a standalone capital gains tax law.

In cases where there is a capital gains tax on sales occurring within a country, the question of how indirect sales should be treated is examined. Instead of transferring an asset, e.g. a mine itself (direct transfer), the owner of an entity holding the asset may transfer its interest in that entity (thus "indirectly" transferring the underlying asset). In the case of a direct transfer of a mining or petroleum right, even by a non-resident, the source country can levy a tax under its domestic law on the gain from the sale of such property.

The chapter reviews issues and considerations a country may face in taxing or, in some circumstances, not taxing such direct transfers. Next, it considers indirect sales of mining or petroleum assets. For example, in order to protect the tax base of the source country in those cases, an indirect transfer tax rule could be implemented to tax indirect sales. The chapter reviews issues involved in making, implementing, and administering such a decision. An indirect transfer tax rule may involve both domestic law and applicable tax treaty issues, and the relationship of these is analyzed.

5) Selected transfer pricing issues in the extractive industries

The chapter is divided into two parts. Part I is a table reflecting the transfer pricing issues that often arise in the extractive industries in each phase of the value chain. The issues are categorized as relevant to the oil and gas industry, the mining industry or both, and comments are provided as to whether the identified issue is a tax issue that should be addressed by the tax administration of the relevant country, with advice on how to address and resolve the issue.

In part II several case studies are presented, some of which resulted from discussions with tax inspectors working in developing countries. The chapter is meant to serve as a useful summary and checklist of selected issues that commonly arise. It is recommended that the extractive industries chapter and the United Nations Practical Manual on Transfer Pricing for Developing Countries be consulted together.

6) Tax Treatment of Decommissioning for the Extractive Industries

This Chapter covers the tax treatment of decommissioning costs for mining and oil and gas projects. Such decommissioning may be required under a wide range of domestic laws, international agreements and voluntary guidelines. Decommissioning requirements may be mandated by law or by the agreement under which the extraction activity has taken place, and may be intended to meet a number of goals.

The Chapter first addresses the broad principles behind a government's regime for decommissioning and considers the actual work that needs to be done to achieve local, national and international requirements. It then discusses methods by which the assignment of responsibilities to carry out such work, and the different legal frameworks which govern the relationship between the host state/resource owner and the contractor involved with the extractive activity.

7) Tax Aspects of Negotiation and Renegotiation of Contracts

This chapter provides an overview of some of the tax and fiscal related issues developing countries face in the negotiation and possible renegotiation of long term natural resource contracts. It is intended to help developing country policy makers and administrators, and to provide information to other stakeholders, on both substantive and procedural approaches to agreements between such countries and the investors they seek to attract in the development of their potential oil, gas, and mineral resources.

8) Government Fiscal Take

A government's share from development of natural resources can include many components. Beside taxes and royalties applicable to the extractive industry, it also includes other requirements placed upon investors, such as making infrastructure investment, employing and/or training residents, and purchasing services and supplies from local businesses. It is this total contribution to a developing country's economy that should be considered.

Both business and government objectives should be clear, to create a framework for decisions in the design of a sustainable total contribution and tax policy. Ideally, the government should also form an idea of its potential resource revenues, what kind of return it expects, and how it wants to manage and use the funds generated by its resources.

Great variation in fiscal instruments is available and each one has differing implications for both governments and investors. Many combinations of such instruments exist on the road towards good fiscal policy for the extractive industry, and given the long term nature and scope of these projects, long term government objectives should drive the choice of instruments.

9) Value-Added Tax in the Extractive Industries

The value-added tax (VAT), also commonly referred to as the goods and services tax (GST), is the broad-based consumption tax of choice in more than 160 countries worldwide, including those countries with large extractive industries.

Due to their predominantly export orientated nature, governments should not expect large amounts of VAT revenue from the extractive industries operating in their country. The VAT treatment of the extractive industries could, however, be a barrier to investment which could ultimately lead to decreases in tax revenues from other taxes. There are also neutrality, efficiency and other potential costs to consider when deciding on the desired VAT system to apply to the extractive industries.

From an extractives industry perspective, the key issues to note therefore relate to:

- A stable, neutral and efficient VAT framework applicable to the industry.
- The timely recovery of input VAT, to i) mitigate opportunity costs on cash flow and ii) protect against exchange rate depreciation which would erode the value of the refunds due.
- Being allowed to register before making any taxable supplies and not being forced to deregister during the decommissioning/rehabilitation phase.
- Efficiency regarding the administrative requirements when exporting goods.

From a host country perspective, the key issues to note would relate to:

- A stable, neutral and efficient VAT framework which would ensure that VAT refunds due are administered in a timely manner and minimize distortions.
- Demonstrating that the host country is a suitable location for long term, stable investments.
- Developing the local economy as a result of the increased investment in the country.
- Limiting evasion under the VAT to the extent it applies to the extractive industry and industries supplying to this industry.

Work going forward?

4. Going forward the Committee may consider establishing a Subcommittee to revise the handbook to ensure it is as practically relevant to developing countries as possible, including proposing new areas where UN guidance may be beneficial. Examples might include:

- practical guidance on issues and best practice in auditing oil and gas or mining activities;
- "trade mispricing" issues insofar as they may differ from transfer pricing issues (this was an issue kept open for future consideration by the previous subcommittee);
- tax treatment of subcontractors and service providers;
- a specific chapter on Production Sharing Contracts;
- tax treatment of financial transactions that support the extractive and energy sector, such as hedging, finance leases, debt financing and thin capitalization issues;
- environmental tax issues; and
- tax incentives and the extractive industries.

5. Some of these items may need to be considered in conjunction with other subcommittees.

6. One suggestion put to the Secretariat is that the mandate of a possible new Subcommittee could be expanded to "Extractives and Energy". This would enable consideration of issues such as hydro power and other means of electricity generation, tax issues around renewables and carbon taxation.