

Fiscal Affairs Department

International Taxation – Issues for Extractive Industries



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Presentation Outline

- Discuss key international issues:
 - Transfer pricing
 - Thin Capitalization
 - Treaties
 - Withholding Taxes
 - Transfers of Interests
- Recent international tax developments (i.e., Base Erosion and Profit Shifting Project – BEPS)

Part 1

KEY INTERNATIONAL TAX ISSUES FOR THE EXTRACTIVES SECTOR

Transfer Pricing

- Sector is vulnerable to transfer pricing (TP) abuse:
 - Special regimes ... higher/special taxes on EI upstream (so TP risk from cross border and domestic transactions)
 - Nature of EI company structures
 - International businesses
 - MNEs often vertically integrated (upstream + downstream activities)
 - Use of tax havens
- ... but other factors reduce TP risks:
 - Physical operations
 - Standards outputs/measures/prices
 - Joint venture structures (usually in petroleum)

Transfer Pricing – What to do?

- Important to have clear guidelines (preferably based on OECD guidelines) to provide certainty for investors and tax administrators
 - Draw on expertise of other tax administrations
- Use of advance pricing agreements can provide certainty

Thin Capitalization

- Many countries limit deductions for interest expenses due to concerns that profits are stripped from a country via interest deductions
 - Recent trend to tighten limitations to protect the revenue base
- Usual methods are :
 - Thin capitalization rules that limit deductions if the debt to equity ratio is higher than a certain percentage (e.g., Canada 1.5:1)
 - Earnings stripping rules (e.g., Germany limits deductions to 30% of Earnings before interest, tax, depreciation and amortization (EBITDA))

Bilateral Tax Treaties (BTT) - Aims and Provisions

General aims:

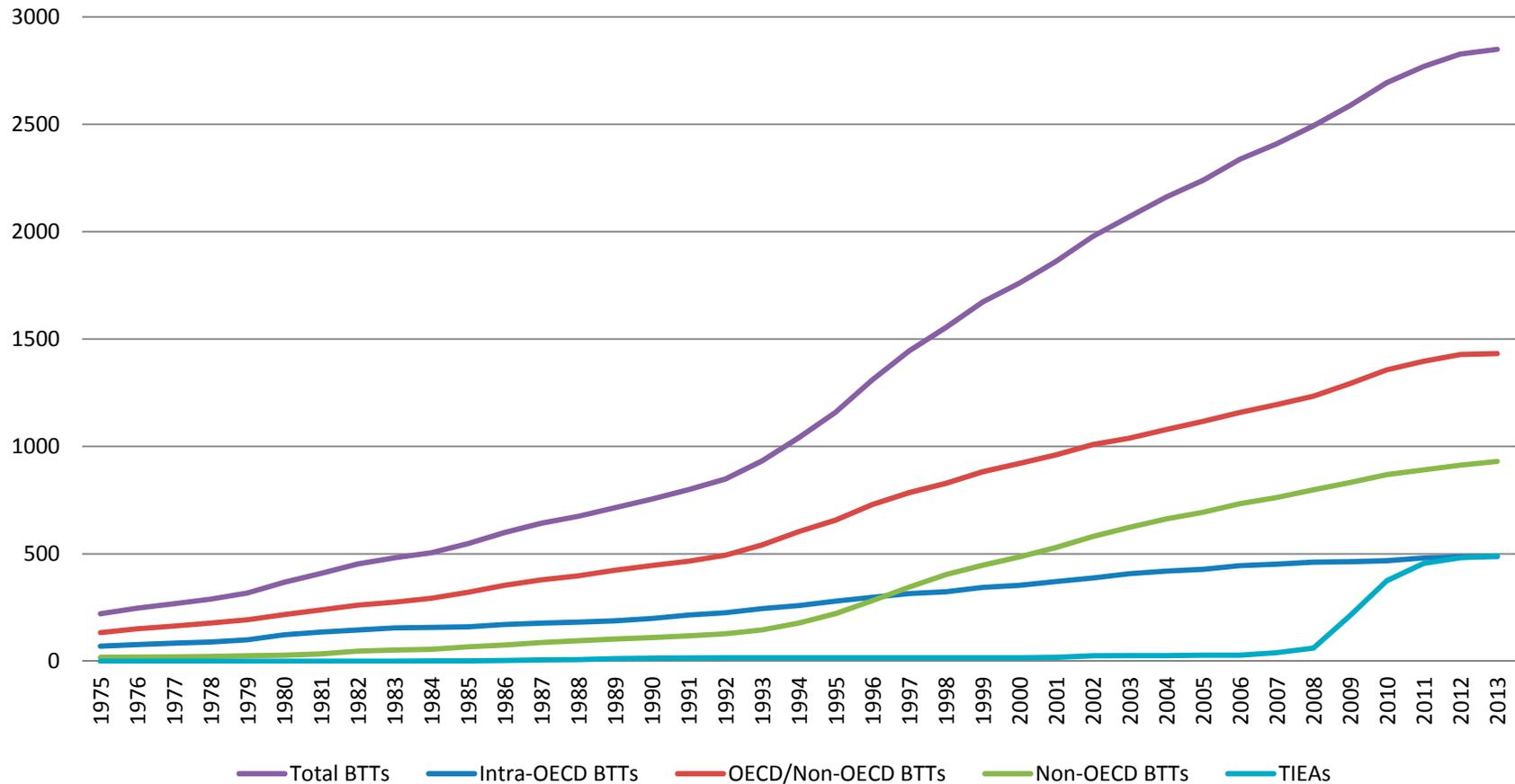
- Avoid double taxation
- Avoid no taxation—or at least counter evasion

Key provisions:

- Clarify who can tax (and get a credit) for what
- Set maximum withholding tax rates
- Provide for information exchange
- Provide for dispute resolution (e.g. on transfer prices)

BTTs - Recent Proliferation

Numbers of BTTs and TIEAs, 1975–2013 (Source: IBFD)

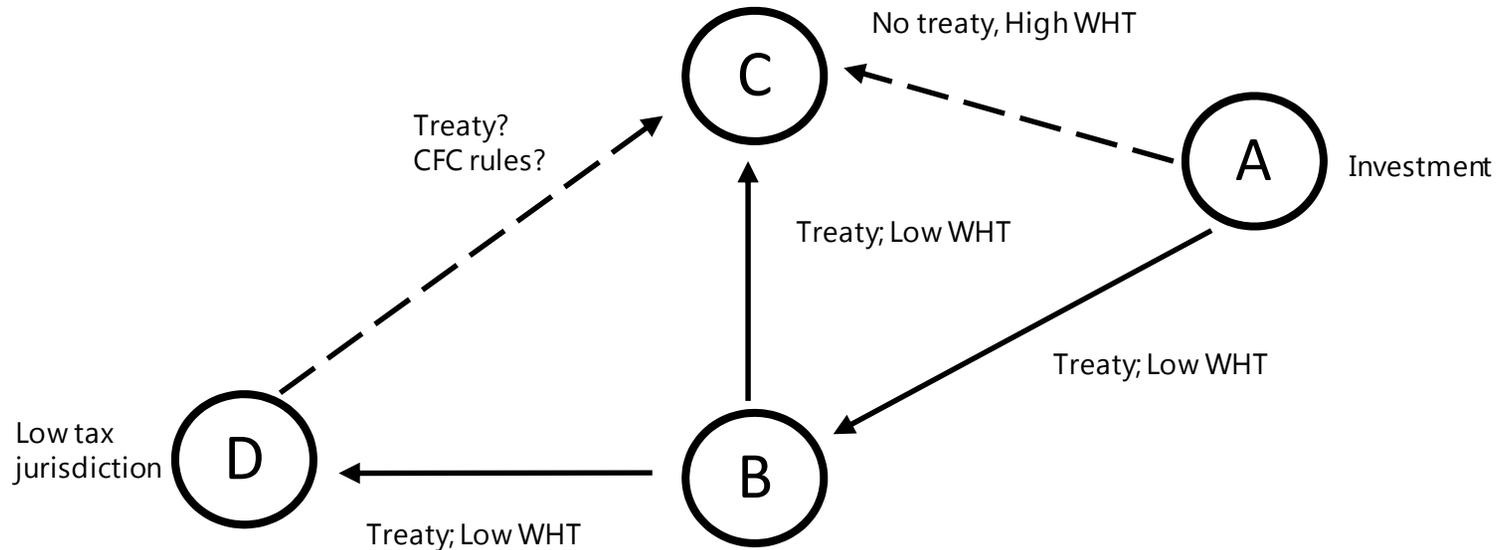


Why BTTs?

- Bilateralism seems highly inefficient (and each treaty is a treaty with the world)
- Do they encourage FDI? Evidence is mixed
- What can BTTs achieve that cannot be achieved by some mix of unilateral measures, tax information exchange agreements (TIEAs), investment agreements?
- Presumably something to do with either signaling and/or credibility?
 - High sunk costs mean this may be important for EIs

BTT Concerns

- Treaty shopping



- Erosion of withholding tax on dividends, interest, royalties, management fees and technical service payments – especially an issue for developing countries
- Exclusions of tax through narrow definitions of real property, or broad definitions of business profits

BTTs - What can be done?

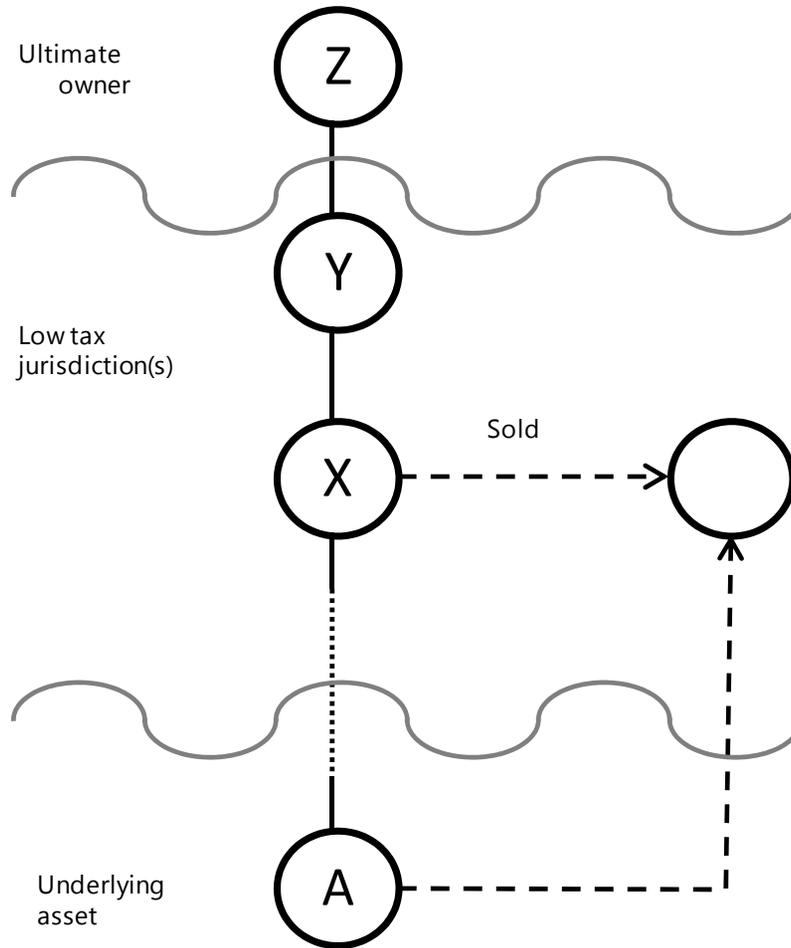
- Avoid negotiating a treaty simply because another country asks to do so , and integrate treaty-making with tax policy-making
- Limit new BTTs with potential intermediary countries, or countries with special holding company regimes
- Seek review of unfavorable BTTs, especially where created by inheritance from very old treaties
- Include a limitation of benefits (LOB) provision in domestic tax law preventing “treaty shopping”

- Ensure BTTs enshrine the broad right to levy WHT on payments to non-residents and, where relevant, ensure these are creditable in the partner country
- Aim for consistency in WHT provisions
- If this is not possible (and especially for resource companies) consider taxing the underlying business profits at a higher rate and forget about WHT
- Target some rules on tax havens
- Ensure that royalties, management fees, technical service payments do not get lost in “business profits” articles that exclude WHT by the host

Taxation of Transfers of Interest

- Taxation of transfers of interest in resource projects has become a big issue (Uganda, Ghana, Mozambique)
 - Different ways for indirect transfers of interests: domestic share sales; offshore share sales; farm outs
- Gains on transfers of real property usually taxable (whether separate capital gains tax (CGT) or general corporate tax)
- What happens when real property is an asset held by foreign companies who sell shares to other non-residents?
 - CGT then very difficult to enforce (and sometimes excluded by treaties)

Indirect Transfers of Interest



Taxation of Transfers of Interest

– What to do?

- Include EI rights and information in domestic law as “immovable property” making gains taxable under CIT for companies – and not to be over-ridden by treaties
- Tax the consideration received for the transfer - reduced by the undeducted cost of the transferred right
- Allow the acquirer to deduct the consideration paid for the right – rules differ on treatment of deduction

- To ensure payment of tax:
 - Some countries retain non-final withholding as a prepayment of the tax payable on the gain
 - Other countries deem the local entity to be the agent of the non-resident for payment of the tax due
- To ensure notification of the transfer:
 - Include a reporting mechanism under which the relevant Ministry informs the Revenue Authority of any substantial change in ownership (direct or indirect) of contractors or rights-holders

Part 2

RECENT DEVELOPMENTS IN INTERNATIONAL TAX - BEPS

BEPS – What is it?

- Base Erosion and Profit Shifting (BEPS) initiative – G20-OECD project to address major avoidance opportunities arising under international tax arrangements
- BEPS Action Plan 2013 – aim to make progress on 15 key areas by latter part of 2015
- Coverage includes:
 - Taxation of digital economy;
 - Strengthening domestic and BTT rules re: hybrid mismatches, CFCs, interest deductions, transfer pricing, permanent establishments, treaty abuse and BTT dispute resolution;
 - Disclosure of aggressive tax planning;
 - Consideration of multilateral instrument.

BEPS – Possible outcomes?

- Still too early to determine final outcomes of BEPs process and whether it will adequately address EI international tax concerns ... the impact on MNEs is also uncertain
- Strengthening domestic and BTT rules on transfer pricing etc. may have a significant impact for EI companies
... although disclosure rules may be less of an issue as EI companies already have major reporting obligations with EI transparency initiatives
- Question as to whether BEPs adequately covers interests of developing countries?