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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 their 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

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Chair BIAC Tax Committee

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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.

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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.

<u>Detailed Comments</u>

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.

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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.

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