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The IGF-OECD Program to Address BEPS in Mining

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LIMITING THE IMPACT OF EXCESSIVE INTEREST DEDUCTIONS ON MINING REVENUES

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

Business at OECD (BIAC) is pleased to have the opportunity to comment on the Consultation Draft: *Limiting the Impact of Excessive Interest Deductions on Mining Revenues* (the "Consultation Draft") issued 18 April 2018. As shown by Action 4 of the OECD's Base Erosion and Profit Shifting (BEPS) project, interest limitation rules are an important and difficult area, and we thank the IGF and OECD for the time and effort put into this Consultation Draft.

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. *Business at OECD* has been supportive of the OECD's BEPS project since its inception, as well as the OECD's Tax and Development work, and leads constructive and detailed input from the international business community to these initiatives.

Further, we support the recommendations that are consistent with OECD Standards that are included in the Consultation Draft, notably, Action 4 (Interest Deductions), the OECD Transfer Pricing Guidelines (TPG) and arm's length principle, and the OECD's efforts on Tax and Development. To this end, we continue to engage with developing countries and, back in 2013, developed the Best Practices for Engaging with Tax Authorities in Developing Countries. *Business at OECD* continues to believe these best practices will support responsible business tax management and enhance co-operation, trust, and confidence between tax authorities in developing countries and international business.

Business at OECD does have specific concerns and comments about certain aspects of the Consultation Draft described in our detailed attachment, which we've briefly summarized below:

- Mining is already a heavily regulated industry and ring-fencing, especially in a tax context, will result in negative economic effects;
- The ultimate conclusions of the Consultation Draft need to ensure that the principles behind Action 4 are taken into account without a simplified, blanket restriction (e.g., need to address commercial realities and also ensure that the set percentage of interest cost is allowed across the lifecycle rather than in just one year);

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- The 20-25 percent fixed ratio limit on deductibility may be overly simplified for many investments and projects because it disregards underlying economic factors. Entities of an affiliated group are going to have different borrowing risk factors (as acknowledged by the Consultation Draft in external borrowing), which should result in differing interest rates. With the blanket approach, these real economic factors are not taken into account and will likely impact investment decisions when MNEs are assessing respective business opportunities;
- The case studies as outlined in the Consultation Draft are not relevant for many businesses (and not more relevant for mining than any other businesses). Businesses have commercial requirements at the heart of their (funding) structures and even where debt is pushed down for tax reasons, this is often to ensure that it is equitably spread in line with objectives of Action 4 of the BEPS project, rather than to try and avoid local taxes (although this may not, in practice, result on consistent gearing in every year of each project due to their long lives, differing risk profiles, and local ownership conditions);
- Mining companies make significant contributions through tax and other means to local economies (illustrated by country-by-country reporting, public contribution reporting, etc.), which should be viewed holistically when considering corporate tax measures, especially when seeking to ring-fence them;
- The nature of the mining business requires risky, long-term investment and, as a result, is more sensitive to uncertainty and its potential impact to investment than other sectors;
- We do not support withholding taxes as a preferred alternative as they have the potential to lead to double taxation; but we do encourage treaties to ensure that countries get a fair share of tax base without double taxation; and
- A balance must be stuck between simplicity and business operating realities. The best approach for this balance should be alignment with international standards, including application of the OECD's TPG, transparency of operations, and education of tax administrations of traditional mining operating models.

Again, we thank you for the opportunity to comment on this subject, and look forward to working with you further. To that end, as the various papers are being developed for the subsequent nine (9) items, *Business at OECD* is fully prepared to engage in any capacity. Specifically, we would welcome the opportunity to be involved in dialog before papers are presented, during the working process, similar to our involvement in other OECD lead measures (e.g., the Technical Advisory Group on VAT/GST).

Sincerely,

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Chair BIAC Tax Committee

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General Comments

1. *Business at OECD* continues to endorse pro-growth tax systems that facilitate cross-border trade and investment, enhancing economic growth and efficiencies in the international market place. We believe the Consultation Draft appropriately identifies the policy questions of how countries strike a balance between tax base protection and encouraging inward investment. We agree that some measures would negatively impact investment, unless such measures are appropriately implemented, providing certainty and stability for taxpayers.

2. Generally, the mining industry is a sector that is already highly regulated, including special legal regimes and disclosure requirements. We encourage local governments to utilize this information to quantify, in totality, the contribution made by local mining companies. This contribution expands outside of corporate income tax into other taxes, permits and licensing, local ownership/return, and significant direct investment (wages, etc.). Further, once a mine is opened, it cannot be moved, and, as a result, currently results in high levels of tax when compared to other industries.

3. Further, ring-fencing certain industries with different rules is traditionally cautioned against, as fragmentation of the rules across sector adds additional complexity and economic abnormalities. Accordingly, *Business at OECD* would generally suggest a comprehensive approach locally to interest deductibility, without certain focuses on industry sectors. As the economy develops, the traditional lines between sectors begin to blur, thus providing additional complexity of determining what rules may or may not apply.

4. The objective of simple and clearly designed measures is welcomed as it should reduce time and costs for both businesses and local tax administrations. Also, to further this goal, risk assessment tools should be developed to most efficiently utilise local, limited resources.

5. However, the Consultation Draft is generally focused on complication of arrangements and resulting misuse. We acknowledge that simplification is a noble aim. However, a balance must be stuck between simplicity and business operating realities. The best approach for this balance should be alignment with international standards, including application of the OECD's TPG and transparency and education of tax administrations of traditional operating models.

6. Nearly 5 years, ago *Business at OECD* developed the Best Practices for Engaging with Tax Authorities in Developing Countries. Busin*ess at OECD* continues to believe these best practices will support responsible business tax management and enhance co-operation, trust, and confidence between tax authorities in developing countries and international business.

7. The Consultation Draft acknowledges several factors impact the use of external debt and the interest rate at which a company can borrow (e.g., company size, credit rating, security, level of risk, etc.). These factors are then disregarded when determining its suggestion of a 20-25 percent fixed ratio limit on interest deductibility. The Consultation Draft simply reviews external group debt levels of certain publicly traded mining MNEs in order to determine a proper threshold for the industry as a whole. However, we believe such an analysis grossly oversimplifies the economic realities. A MNE's affiliate group will likely have a broad range of mining investments – with varying degrees of profitability, risk profit, credit rating and collateral/asset security – that should, on an arm's length basis, borrow at differing interest rates. By setting a general group level standard, which is then pushed down to the local affiliate, these real economic factors are not taken into account and may negatively impact investment decisions of MNEs when assessing the business opportunity.

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8. Investments in developing countries have greater risk than in developing mining countries (e.g., Australia, Canada, etc.). The increased investment risk in developing countries includes taxation risk, sovereign risk, and infrastructure challenges. As such, these issues should be included within any consideration related to this sector, and without, any provided guidance will be build on inaccurate economics.

Specific Commentary

Section 1 - Introduction

9. We agree that raising revenue is especially important for capacity-constrained, developing countries. Strong tax systems are central to financing development and achieve the SDGs to secure robust and stable future growth.

10. The Consultation Draft is focused on two specific questions:

    How do MNEs legitimately use debt finance within a corporate group; and

    How can countries protect themselves against base erosion that has little or no commercial justification?

11. *Business at OECD* strongly believes that a better understanding of the first question will facilitate answers and solutions to the second. However, on this point, the Consultation Draft uses very subjective language – "what is 'reasonable' and necessary for mining to occur." Generally, both of these aims are proper in this context. However, there is slight concern regarding the tone as it seems to divert from what is a sound commercial (non-tax) justification to what is arbitrarily reasonable. As discussed in more detail below, *Business at OECD* is of a strong opinion that existing metrics and guidelines should be followed, in lieu of creating additional, new rules that may impact investment.

Section 2 – Mining Businesses and the Use of Debt Financing

12. In the introduction to the capital intensive nature of mining, many of the comments are appropriate regarding the high level of capital required for building and constructing the mine. Further, the comments regarding the uncertainty of the investment are also proper. However, in this context it's worthwhile noting that these market conditions are constantly subject to change. For example, the note that "future market conditions for the products may change unexpectedly" – is somewhat misleading as this is all but a certainty per global markets and should appropriately say "will change."

13. The Consultation Draft outlines certain reasons why companies looking to use loans as part of their financing mix chose certain jurisdictions for their Group Treasury function – including extensive treaty networks, the ability to take advantage of hybrid mismatches, and low tax rates. However, we believe the emphasis is overly focused on certain tax considerations. In reality, there are significant other factors considered by companies during this evaluation, including, but not limited to, the potential finance talent locally, cost of operations, legal framework, and banking infrastructure. We strongly suggest that these additional factors, among others, be added to illustrate the entire story.

14. As acknowledged, financing decisions by MNEs are made for many reasons and regularly the internal and external financing decisions don't mirror each other. However, the Consultation draft appears more focused on the tax factors impacting this decision versus the actual commercial reasons. The minimal commercial factors addressed relate to "how much" and

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"when" expenditures are needed. However, there is not a thorough analysis of the specific factors noted earlier in the Consultation Draft (i.e., company size, credit rating, security, level of risk, etc.). Traditionally, a mining company will hold significant mining operating subsidiaries with different lending profiles. As such, these local operating entities will have differing loan profiles as well as different profiles from the parent entity or group financing entity. Consequently, there will be differing rates across the various profiles to reflect the economic circumstances of each respective party.

15. Lastly, another strong commercial reality for mining companies is that they often need to pay off the financiers first before the company or governments start seeing returns. This structure is not a choice; it's a commercial reality that exists in the industry.

Section 3 – Challenges Faced by Developing Countries

16. Generally, if the case study issues raise specific concerns, we believe those concerns should be addressed through targeted rule making. For example, through statutory changes targeted at hybrid mismatch arrangements, versus a separate, specific interest limitation regime for the mining industry.

17. An underlying assumption in Case Study 1 is that a "debt push-down," on its face, represents some manipulation of the local tax system. However, the final Action 4 Report encourages debt push-downs to underlying affiliates to equalize the debt levels across entities in the MNE as to not "trap" interest in an entity that is unable to pay. While there may be circumstances in which debt is overly "pushed" into an underlying subsidiary for tax purposes, we must distinguish such behavior from arm's length pricing and allocation of debt within the global group in accordance with Action 4 guidelines.

18. In Case Study 2, the loan terms between A Co (in country A) and B Co (in country B) are contingent on the tax deductibility (i.e., annual profitability) of B Co. Case Study 2 suggests the arrangement is pure financial engineering to reduce tax payments in Country B. However, even though such arrangement may be viewed as "structured," such may be the case for perfectly virtuous reasons (e.g., to increase the chance of success of the local mining company). By deferring interest payments if not profitable, the company is providing additional liquidity to invest in the success of the business of B Co. Further, the additional upside received by the lender on the foregone interest is purely an arm's length substitute for what it conceded in the earlier interest payments. As such, there should be a consorted effort to recognize where such arrangements may be driven by a commercial purpose versus pure tax engineering. If there are bona fide commercial reasons for the arrangement, the next question should be whether the arrangement is arm's length per the OECD TPG, not an immediate conclusion that the arrangement is improper.

19. Case Study 3 is focused on a discrepancy in interest rates charged between A Co and its related party, B Co. We acknowledge such an arrangement may be executed to "divert" income from B Co to A Co as a result of the interest rate charged, provided the structure is artificial. However, the Case Study completely disregards any economic factors that may be relevant for determining B Co's borrowing rate. In Table 2.1 of Section 2, the Consultation Draft outlines certain economic factors that impact the use of external debt (e.g., company size, credit rating, level of risk, security offered, etc.). These factors are similarly important in an affiliated group borrowing context and should be reviewed before instantly determining a difference in rates charged is abusive. For example, A Co may hold several, diverse investments, allowing it to

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borrow at a more friendly rate, whereas B Co may operate a single, risky business without much collateral. Consequently, these economics may fully support the interest rate charged.

20. We recognize the need to enact hybrid mismatch rules, as outlined in the Action 2 reports. However, one cautionary note regarding Case Study 4 is the tone regarding the general complexity and such being "more complex than what is needed." Alternatively, we believe the focus should first be on whether the arrangement gives rise to a hybrid mismatch, and if such is the case, domestic legislation as outlined in Action 2 could target such arrangement. From there, if the arrangement is not a hybrid arrangement, the focus should then be on whether or not the interest rate and arrangement meets the arm's length standard or is otherwise abusive.

21. Case Study 5 implies the additional complexity makes it difficult for local countries to audit asset sales with embedded financing. However, similar to our prior comments, we believe the focus should be on educating capacity-constrained countries to traditional arrangements, so they have the knowledge and capacity to identify the potential issues raised (e.g., base erosion and withholding tax avoidance). The goal should be to identify misuse, while also providing an environment for normal and common business transactions.

22. In sum, there are noble aims regarding all the characteristics identified. Regarding non-arm's length rates, we fully support a consensus transfer pricing standard outlined by the OECD in their TPG. However, regarding the second two characteristics, we are concerned that the Consultation Draft's approach may be over simplified. High-debt levels should raise concern, but only when they aren't supportable by the underlying economics. Similarly, regarding complex structures, the fact an arrangement is complex should not provide prima facie evidence that there's misuse by the taxpayer. Business and governments should work together, on a transparent basis, to break-down common structures that may otherwise appear complicated.

Section 4 – Interest Limitation Rules Including BEPS Action 4

23. Our main concern with the Consultation Draft is the conclusion of the need for a 20-25 percent fixed ratio limit on deductibility of interest. The Consultation Draft reviews external group debt levels of certain publicly traded mining MNEs to determine this threshold. However, we have significant concerns that this approach dramatically oversimplifies the economic realities. A MNE's affiliate group likely has a broad range of mining investments. These investments have different risk factors as outlined in Table 2.1 (i.e., varying degrees of profitability, risk profit, credit rating and collateral/asset security, etc.) and should, on an arm's length basis, borrow at different interest rates.

24. Interestingly, even though the Consultation Draft acknowledges that developing countries have relatively higher interest rates, it does not then take it a step further that it is then reasonable that different subsidiaries (depending on the underlying economics) may need to pay a higher interest rates as a result.

25. Alternatively, by setting a general group level standard below the upper limit of the OECD Action 4 report (and without uplift mechanics built-in for highly leveraged global groups), a distortion in the economics may result. If these real economic factors are not taken into account, we would expect an impact to investment decisions when MNEs are assessing the business opportunity, as it may reduce the attractiveness of the investment.

26. For example, in a large-scale greenfield project in a developing country, there will always be a considerable time period where the project incurs interest charges but has no earnings (so no EBITDA). Further, very often the local jurisdiction has an unfunded equity stake in the project.

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As such, the need to charge interest on debt funding is required to ensure a fair outcome and such is completely in line with the standard commercial operations. Unfortunately, the Consultation Draft glosses over this issue by stating that the disallowed interest deductions might be able to be carried forward, subject to protections around quantum. Unless the interest deductions are available to be used when earnings flow, the after tax cost of the project will significantly increase to the detriment of it being viable. It will potentially build in a bias towards investment in developing countries where other income streams exist to shelter the interest deduction and reduce the risk and after tax cost.

27. We would alternatively suggest that the final report recommend a 30% threshold with some degree of group uplift. This approach would remain consistent with the final Action 4 guidance. Further, miners have portfolios of investment at different stages of their lifecycle and differing risk profiles. As such, we further endorse flexibility in carrying forward and back the interest capacity.

28. We are encouraged by the mention of the Mutual Agreement Procedure (MAP) being used to avoid conflict between jurisdictions. We also agree that anti-abuse provisions are traditionally difficult to design without resulting in significant uncertainty in the tax regime, and we would recommend against their introduction in this context. Similarly, we also caution against the use of interest rate caps. These caps have no connection to the underlying economics and are simply an arbitrary threshold, likely deterring investment by manipulating the underlying economics.

Section 5 – Conclusions and Best Practices

29. As noted above, we fully support the objective of simple and clearly designed measures, as such rules should reduce time and costs for both businesses and local tax administrations. Further, clear rules with additional transparency will strengthen relationships between government and taxpayer.

30. However, we strongly disagree with setting an arbitrary 20-25 percent fixed ratio limit as it oversimplifies and disregards underlying economics, while also creating a separate regime solely targeted at one business sector. Ring-fencing certain industries with different rules has been cautioned against for years, as the fragmentation of rules across sectors creates additional complexities and results in economic abnormities.

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