



COMMENTARY

UN Committee of Experts on International Cooperation in Tax – 20th Session Update on the Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries

Chapter XX”: Tax Incentives – E/C.18/2020/CRP.21

1. Summary

The Chapter provides a general framework on the design and use of tax incentives with a specific analysis of their use in the extractive sector in developing countries. The draft Chapter is submitted for review and approval

2. What is a tax incentive?

The Chapter attempts to define what qualifies as a “tax incentive”.

- Agree that the more restricted definition of a tax incentive set out below is appropriate to use for this Chapter.

“the net difference between the burden imposed under the default (or “counter-factual”) regime and the burden that is predicted to be borne by the taxpayer under the incentive regime, across the lifetime of the project.”

3. International initiatives on harmful tax incentives

While we agree that countries should consider the international initiatives listed in the Box 2 we think it is important to note that many African countries and we believe other developing countries have serious concerns about the EU approach to blacklisting particularly around forcing small economies to

implement the BEPS minimum standards. We think this is an issue that the paper should acknowledge and possibly give further consideration.

- We agree with the list of best practices set out in paragraph 14.
- Table 1 Costs and Benefits lists among the costs – the potential for corruption or abuse in the granting and administration of tax incentives. It would seem this will be extremely difficult to measure. It might be useful to provide some guidance on this issue.
- Paragraph 44. – We note and agree with the comment that *“Withholding tax incentives relating to deductible expenses, for example, whilst easier to administer, may lead to more tax base erosion, which may need to be countered with closer scrutiny of such deductions in the source country”*. However whilst transfer pricing and thin capitalisation rules might provide some base protection there are often very difficult and time consuming to apply and we think this point needs to be noted in the text as it would seem not granting withholding tax incentives might be a better base protection option.

Paragraph 57 states *“Despite the strong justification for retaining withholding taxes, developing countries should consider the potential impact on investment. For example, during the early stages of an extractives project, internal debt may be the only source of funding, in which case withholding tax will increase the overall of cost of the project. This cost may be passed onto the resident company in the form of a higher interest rate, thereby reducing its taxable income”*.

- We agree that withholding taxes may increase the cost of capital and may be passed on in a higher interest rate thorough for example grossing up clauses. However, we have concerns about the statement *during the early stages of an extractives project, internal debt may be the only source of funding*. In our experience in these early stages third party lenders are less likely to lend and will require greater equity investments. Internal debt should be within scope of a country’s transfer pricing legislation and therefore tested on the basis that it is a third party investor under the arm’s length principle.
- Paragraph 65 and 66 discuss customs duty reductions and exemption. We think there is a base erosion practice that should be include here. African countries often report that these exemptions lead to taxpayers overvaluing imported plant and machinery and claiming inflated capital allowances on that value. The exemptions facilitate this tax avoidance strategy.