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Update of the Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries
Chapter XX: Tax Incentives

Note by the Secretariat

Summary

This chapter provides a general framework on the design and use of tax incentives with a specific analysis of their use in the extractives sector in developing countries. The chapter attempts to define what qualifies as "tax incentive". At the simplest level, a tax incentive could be considered a difference between the default regime, and the one that is being examined that results in a reduction in the tax burden (whether in the quantum or timing of the tax liability of the taxpayer).

However, this definition may be too wide as it also captures differences to the default regime that are structural in nature and intended to reflect particular features of an industry.

In its subsequent sections the chapter describes the legal framework for an effective tax incentive policy before delving into its concrete application in general and within the extractive industries. The application is described in two different concepts, namely profit-based incentives and cost-based incentives. Before concluding, the chapter examines the interaction with investor and other tax regimes and how incentives in one country influences the beneficiary company and its tax planning for other activities in different jurisdictions.

Taking stock of comments and suggestions from the 19th session the chapter describes incentives in the context of BEPS and several of its implications in relation to tax challenges of the digital economy particularly with interaction with the pillar 2 of OECD which proposes, inter alia, a minimum effective tax rate for multinational companies to reduce profit shifting. Such rule will certainly have consequences on tax incentives a company may be seeking from its investment in a developing country.

The draft chapter is submitted for review and APPROVAL. At the same time the Subcommittee requests from Committee its view on the very brief description of the pillar 2 or if more details are necessary in the chapter. The Subcommittee was of the view that such a detailed description may be done elsewhere, in the work of the Subcommittee on taxation of the digital economy in particular.

CHAPTER XX: TAX INCENTIVES

Contents

Introduction

a) How to use this document

1. This chapter provides a general framework on the design and use of tax incentives (in Section 1-b) and c), as well as specific analysis of their use in the extractives sector in developing countries (in Section 3). It has been written as a reference document and is not intended to replicate the work undertaken by others. A bibliography of reference documents is included for further research.

b) What is a tax incentive?

2. The first challenge in writing a chapter on tax incentives is the definition of a tax incentive. At the simplest level, a tax incentive could be considered a difference between the default regime, and the one that is being examined that results in a reduction in the tax burden (whether in the quantum or timing of the tax liability of the taxpayer. These special provisions would clearly be captured by this definition.

3. However, this definition may be too wide as it captures differences to the default regime that are structural in nature and intended to reflect the particular features of an industry.

4. Consider, as is common in the extractives industry, a cash flow tax. This will seek to tax the taxpayer on a cash basis, rather than on an accruals basis as may be the normal (default) approach for other taxpayers. This is a structural choice of the government, which may create more progressivity in the fiscal regime and encourage investment. This may be achieved by providing immediate offsetting of capital expenditure against income (otherwise known as 100% tax depreciation or capital allowances) and then denying tax relief for the cost of funding (i.e. denying tax relief for interest incurred on debt which would normally be allowed under the default regime). Under the above definition, the 100% tax depreciation would be seen as a tax incentive despite the fact that it is a normal feature of a cash flow tax and may be partly offset by the denial of relief for funding costs. Therefore, it is important to consider the context of the whole tax regime and identify any related (and offsetting) elements of the tax regime.

5. Drawing on Norway's experience, Box X demonstrates the importance of considering incentives in the context of the fiscal regime as a whole.

Box 1

In Norway, under the special petroleum tax regime relating to extraction and transportation by pipeline of oil and gas on the Norwegian Continental Shelf (NCS), costs incurred to acquire relevant fixed assets for production, processing and transportation on the NCS may be depreciated at an annual rate of 16 2/3 per cent starting in the year of investment. Such straight-line depreciation over 6 years deviates from the general rules of the General Tax Act in that it will normally represent earlier depreciation and 'pay back' to the investor than following the trajectory of the economic life of the asset which is the principle underlying the depreciation rules of the General Tax Act.

The depreciation profile in the petroleum tax regime is one element among others intended to strike a balanced distribution of risks and rewards between the investors and the State. Front loading of recovery of investment costs is beneficial to the investor and contributes to the reduction of investment risks. However, the design of the petroleum tax system as a whole, including the timing aspects of the special tax base, should be understood in the context of a combined tax rate of 78 per cent (compared to the general corporation tax rate of 22 per cent). As the special petroleum tax regime is designed to capture as much as possible of the resource rent for the State and establishes a much higher level of taxation. The special rules on capital allowances should not be seen as a net tax incentive.

6. A potential definition for an incentive could therefore rest on the overall impact of the tax burden on the taxpayer for undertaking the activity. This would involve comparing the investment as a whole and identifying the total payments to government under the default regime and under the regime that is operating in practice. Such an approach will necessarily look beyond the tax system to all financial contributions. As noted in Chapter 7 – on government take, the extractives industry can be subject to commitments to make investment (such as in infrastructure) that goes beyond what they would need to operate.

7. Based on careful consideration and the above caveats, this chapter uses this more restricted definition of a tax incentive:

   "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 tax payer under the incentive regime, across the lifetime of the project."

c) What might be the role for tax incentives?

8. Tax incentives are generally used to attract investment or otherwise change behaviour. They represent a deviation from the default regime that is generally justified on the basis that such investment or behaviour would not have occurred under the default regime.

9. However, the effectiveness of tax incentives at attracting investment is not clear-cut. The UN Handbook on Protecting the Tax Base states that, on the one hand, the rise of the multinational enterprise, and capital being more mobile, has made tax incentives more important. However, while tax incentives may make an investment more attractive, in developing countries in particular, they generally will not compensate for deficiencies such as a lack of infrastructure, reliable power, or weak rule of law.[1] Moreover, where incentives have been found to have a positive impact on inducing investment, there has been no knock-on effect on increasing fixed assets such as machinery and buildings, which are more likely to generate structural economic growth than other forms of investment.[2] The conclusion is that tax incentives alone will not attract investment.

10. The effectiveness of tax incentives is examined further in relation to the extractives industry in Section 3 b). However, at this stage, it is sufficient to note that the empirical evidence of the effect of tax incentives is mixed. While there can be valid reasons for

[1] Zolt 527 to 528. Other relevant studies include Van Parys and James 2009; Rolf and White, 1991
[2] Klemm and Parys 2011

providing incentives, there are some instances where tax incentives have gone beyond that necessary to deliver the intended outcomes. It is therefore important to have a clear critical framework for considering the merits of tax incentives.

d) International initiatives on harmful tax incentives

11. Given that tax incentives deviate from the default regime, they can raise concerns from other governments that the resulting tax environment could be deemed to be harmful. Hence in addition to weighing the advantages and disadvantages of tax incentives from a domestic standpoint, countries should consider the international initiatives listed in Box X.

Box 2.

Harmful Tax Practices

The recent work on tackling Base Erosion and Profit Shifting ("BEPS") by the G20 and the OECD has focused attention on the potential for "harmful tax practices", which can include the use of incentives that are targeted purely at inbound investors. The Forum on Harmful Tax Practices ("FHTP") has refocused its attention to identify those tax practices, following the publication of BEPS Action Plan 5. Members of the Inclusive Framework have committed to ensuring that all new incentive regimes comply with the Action 5 requirements, and all regimes are actively peer reviewed.

EU Blacklist

The European Union has issued a list of non-cooperative tax jurisdictions. The review criteria include transparency and exchange of information; the existence of preferential tax regimes; and no corporate income tax or a zero corporate tax rate. Jurisdictions are selected for review based on the strength of their economic ties with the EU; level of financial activity; and whether they would be considered a safe place for tax avoiders to take their money.[3]

State Aid

'State aid' is defined as an advantage in any form whatsoever conferred on a selective basis to undertakings by national public authorities. The EU has agreed not to allow state aid that distorts competition and is likely to affect trade between member states. If an EU country granted a lower than normal tax rate for extractives, thus gaining an advantage with respect to attracting extractive industry investment compared to other EU countries, this could be considered state aid and may be disallowed unless it is subject to a specific exception or within certain specified limits.[4]

Exceptions to state aid rules may be granted where there is a clear need. For example, to enable Liquified Natural Gas (LNG)-related investments in the northernmost part of Norway, the government introduced an accelerated depreciation rate of 33 1/3 per cent, which was twice as fast as the standard depreciation rate for other petroleum investments. The measure was approved by state aid rules in 2002. It was a deliberate incentive to facilitate the development of the Snøhvit

[3] https://ec.europa.eu/taxation_customs/sites/taxation/files/2016-09-15_scoreboard-indicators.pdf
[4] The EU allows some level of state aid for example as regional state aid as a percentage of investment.

gas field in the Arctic, and the transportation system to bring the natural gas onshore and to the LNG plant at Melkøya.

A critical framework for considering tax incentives

12. As noted above, it is important to consider the role of tax incentives with a clear conceptual framework in mind. Tax incentives have been analysed by economists, academics, governments, NGOs, and industry, and the consensus conclusions are:

a) Governance

13. It is important that any deviations from the default tax regime are subject to an impact analysis so that government has a clear understanding of the costs and benefits before it decides to grant an incentive. Incentives should also be governed transparently, so that taxpayers understand the taxes they will pay, and the public can hold government accountable.

14. The following are considered best practice:

- **Prescribed in law.** Tax reliefs and incentives should be set out in the law with clear criteria for claiming them. Defining a range of possible incentives in law will limit the extent of any negotiation. Incentives should be based on clear, measurable policy objectives in order to enable monitoring and accountability. Should government choose to give decision-makers discretion with respect to granting incentives, these powers should be limited, transparent, and subject to checks and balances, to prevent the risk of corruption. Box X sets out the legislative system for granting tax incentives in South Africa.

- **Transparent.** Where incentives and reliefs are negotiated for individual projects as part of the investment agreement they should be disclosed. The best practice, according to the IMF transparency code, is when: "the revenue loss from tax expenditures is estimated by sector or policy area and is published at least annually. There is control on, or budgetary objectives for, the size of tax expenditures."[5] In addition, the B Team[6] responsible tax principles developed by a group of businesses states: "Ideally, tax exemptions and reliefs should be specified by law and generally available to all market participants. Where there are exceptions, we will work with relevant authorities to encourage publication of those incentives and contracts."

- **Monitored.** The value of tax incentives and reliefs should be reported annually by government as part of tax expenditure reports. The IMF and other international organisations provide detailed methodology and support to develop tax expenditure assessments.[7] There should be clear parameters for review, as well as sunset clauses to reduce the potential costs of badly designed tax incentive programmes. The revenue authority should also monitor the use of the incentives in its risk and audit programs.

5 https://blog-pfm.imf.org/files/ft-code.pdf
6 http://www.bteam.org
7 https://www.imf.org/en/Publications/Fiscal-Affairs-Department-How-To-Notes/Issues/2019/03/27/Tax-Expenditure-Reporting-and-Its-Use-in-Fiscal-Management-A-Guide-for-Developing-Economies-46676

Extractive companies should also report publicly on the incentives utilized in order to further strengthen transparency on both sides.

Box 3.

In South Africa, tax incentives are only granted through national legislation. According to section 77 of the Constitution, a money bill imposes national taxes, or reduces or grants exemptions from any national taxes. Furthermore, section 73(2) of the Constitution stipulates that only the Cabinet member responsible for national financial matters may introduce a money bill in the National Assembly; i.e. only the Minister of Finance may introduce a bill dealing with tax exemptions in Parliament, to be considered via the legislative process.

b) Effectiveness

15. Tax incentives are introduced for a purpose, namely, to influence a decision which may otherwise result in an answer that was less optimal than the alternative that the government wishes to encourage. This provides a natural framework for examining the effectiveness of the incentive – i.e. will the incentive change the behaviour in the way intended.

16. This evaluation needs to go beyond the question of whether the desired behaviour was achieved and question whether the desired behaviour has been stimulated by the incentive – if the behaviour would have happened in the absence of the incentive, then the incentive would be ineffective and a dead-weight cost to the budget.

17. The UN Handbook on Protecting the Tax Base notes that most surveys of business executives conclude that taxes were rarely a major consideration in deciding whether and where to invest. The primary question is the probability of recoverable mineral reserves and the factors in Box X that impact the ability to produce and market the reserves, after which the effective tax rate becomes relevant. Box X is a list of non-tax factors that influence investment decisions (source: UN Handbook on Protecting the Tax Base).

Box 4. Non-tax factors influencing investment decisions

1. Consistent and stable macroeconomic and fiscal policy.
2. Political stability.
3. Adequate physical, financial, legal and institutional infrastructure.
4. Effective, transparent and accountable public administration.
5. Skilled labour force and flexible labour code.
6. Availability of adequate dispute resolution mechanisms.
7. Foreign exchange rules and the ability to repatriate profits.
8. Language and cultural conditions.
9. Factor and product markets—size and efficiency.

18. Hence, there is no ‘one-size-fits-all’ framework to determine whether and which tax incentives will be effective. Tax incentives can be effective stimulants to long term investment and economic growth if used as part of a well-conceived and well-

implemented strategy to achieve certain development objectives, in addition to a predictable, and efficient tax regime.

19. It is best practice for tax incentives to be developed as part of clear, established objectives. The objective of a tax incentive and the decision to use it should be based on a broad economic assessment by the relevant country, including, for example, its financial, social or environmental requirements. The objective may be broad (e.g. to attract new investment) or narrow and examples include:

    - the creation of a set number of new jobs,
    - expansion of a facility,
    - the development of local skills, including those required for future jobs, or
    - investment in schools and hospitals.

20. These activities may also be tied to a particular region or locality in order to promote broader welfare benefits in that area. Irrespective of the contents, clearly defining the objective up-front is essential if effectiveness is to be assessed.

21. The application of this principle to the extractive industry is discussed further below (see Section 3), but, in general, studies to date have shown that although tax rates are a consideration for whether a project goes forward, they are less of a priority for locational decisions (security is usually first, and predictability second).[8]

c) Efficiency

22. A tax incentive is efficient when it achieves the policy objective at the minimum social cost. Such costs include net revenue losses for government, the cost of administering the incentive, as well as social costs such as the displacement of other investments.

23. Like effectiveness, efficiency is also a relative concept. The lower the cost of the incentive in meeting the policy objective, the more efficient it is, and vice versa. In this way, a tax incentive can be evaluated against alternative ways that the investment could be induced (e.g. a government grant for infrastructure costs). The option that best meets the policy goal at the lowest cost is considered the most efficient option. This requires a "joined up government" approach to avoid decisions that are optimal when considered in isolation resulting in an outcome that is sub-optimal when considered together.

24. The potential loss of tax revenue through the use of tax incentives should be considered on the basis of the full project, including other risk compensation, economic benefits to the broader economy, and negative externalities (e.g. environmental degradation, negative health impacts). For example, tax incentives that enable first entrants of foreign direct investment into a sector may increase economic growth and development through the broader development of the sector and associated skills and technology. The risk of these developments not occurring needs to be considered in the analysis. Any revenue

[8] The Fraser Institute's survey of mining and exploration companies (2017) lists the following factors in order of priority: (1) quality of the resource; (2) economic factors such as location of the resource, price outlook for target minerals and technology; and (3) policy climate such as enforcement of existing rules, taxation, security of tenure, infrastructure, and political stability etc.

impacts (positive and negative) should be considered over the life of the investment and this should be in the context of the overall fiscal package, not a standalone incentive. It is important to note, however, that governments may face annual budget cycles and hence may need to explain business cases for investments with a longer payback period.

Box 5 Analysing and monitoring the cost of incentives

Cost-benefit analysis is an assessment of the social costs and benefits of a proposed incentive, or package of incentives within an overall fiscal package. This should be done in advance of the granting of an incentive and then used in monitoring the incentive over its duration. It requires estimating the benefits generated by the investment, and the net costs in terms of lost revenues.

Given likely volatility in commodity prices throughout the life of an investment, as well as other uncertainties such as delays and cost increases, governments should model the value of an incentive at various price scenarios.

Tax expenditure analysis is also used to monitor the nominal value of incentives as they are used over time. Under 'Tax expenditure' analysis an amount of tax not collected is considered in the same way as an amount of revenue spent. This is important for transparency, and to periodically reassess the cost-benefit analysis of granted incentives. However, as the up-front cost benefit analysis highlights, the nominal cost of the tax relief in accounting terms is not the same as the net cost or benefit to public revenues, or the net cost or benefit overall.

Apparent tax expenditures may not be net incentives but structural features, where there is an offsetting tax collected. As noted above, the immediate expensing of capital investment within a cash flow tax that denies relief for funding cost (i.e. interest) can be seen to be structural rather than an incentive.

d) Ease of Administration

25. Incentives complicate tax administration, especially where they are granted on a discretionary basis, creating competing fiscal regimes.

26. Incentives should be carefully defined with clear rules about what type of activity or expenditure qualifies for the incentive. Poorly designed incentives may further expose governments to the risk of profit shifting and tax avoidance, and thus increase the administrative burden. Incentives that create parallel fiscal regimes, may give rise to concerns over the veracity of transfer prices.

27. The abrupt ending of a tax incentive may also create an incentive to accelerate profits to avoid paying taxes when the incentive ends.

Application to the extractive industry in developing countries

28. The extractive industry is different from other sectors. Mineral and petroleum resources are finite, and non-renewable, and generally owned by the state (or region) for the benefit of its citizens. There is also the prospect of substantial revenues, which, if managed well,

have the potential to create lasting development outcomes. Thus, any use of tax incentives should be considered carefully, to avoid forgoing government revenues unnecessarily.

29. If governments choose to offer tax incentives, these incentives should be carefully designed to align with the special features of the extractive industries:

- capital-intensive, with significant investment in exploration and development mostly sourced from the private sector;
- long periods of pre-production during which no revenue is earned;
- high risk because it depends on exploration being successful, and its profit is sensitive to commodity prices and exchange rates, which can be volatile.

30. These features may require a special fiscal regime, which diverges from the general tax system. In particular, incentives that enable resource companies to recoup their investment faster than other types of businesses: for example, a longer loss carry forward period, or accelerated depreciation. Or, incentives that mitigate environmental and social impacts by encouraging companies to procure supplies locally or restore mine sites, for example.

31. Designing resource tax policy may require certain trade-offs. In some cases, it may be worth forgoing some government revenue in order to attract productive investment. However, the benefits of the investment must outweigh the amount of revenue foregone, as well as other costs. Incentives that are too generous risk being politically unsustainable and may lead to a less stable and predictable fiscal regime.

i. Applying the Evaluative Framework

a) Governance

32. It is common for countries to have numerous laws that set out the extractive industry fiscal regime. Each of those laws may contain tax incentives.

1. The general income tax code, which may include special provisions for mining, oil and gas either in a separate schedule or chapter, or in the main part of the code. E.g., a different rate of corporate income tax.
2. The mining or petroleum law, which may contain more detail on the sector-specific fiscal regime. E.g., a reduced rate of tax or duty collected on imported goods for mining.
3. The production sharing contract providing for the payment of corporate taxes from the government share of profits on behalf of the extractive company.

33. The taxes paid by foreign investors are also often influenced by Double Taxation Agreements (DTAs), and national investment laws. DTAs are bilateral, or multilateral agreements between countries that set out which country has the right to collect tax on different types of income (see Chapter 2). DTAs are another aspect of the legal framework that interacts with tax incentives in the primary law, and project contracts.

34. As in all sectors, tax incentives granted to extractive companies should be publicly disclosed. This implies that governments should publish not only all the laws and international agreements mentioned above, but also any contractual agreement with oil,

gas and mining companies. This is in-line with the contract disclosure requirement under the Extractive Industry Transparency Initiative ("EITI") standard as of 2021.[9] By publishing all extractive industry contracts, any incentive granted to a specific project is disclosed to all relevant parties: government agencies, the legislature, audit institutions, other companies, and taxpayers in general. Such contract disclosure should also apply to tax incentives granted in addenda or appendices.

b) Effectiveness

35. Investment decisions are based on the net present value of cash flows (after tax) that the investor expects to generate from the investment over the life of the project. This will be impacted primarily by the quality of the resource and the price outlook for target minerals as well as the cost of constructing and operating the project. The upfront cost to develop the project will be impacted by where the resource is located, and the degree of technical risk related to extraction, as well as availability of existing transport infrastructure. The policy climate, including regulatory stability, security of tenure, the rule of law, also generally tend to play a key role. Once these key investment hurdles have been satisfied, the tax regime will be relevant to the decision to invest. In this regard, incentives may be a less important factor in attracting investment than other sectors, services, for example, that are more mobile and thus more responsive to preferential tax treatment.

36. Bearing in mind the above, should governments choose to offer tax incentives, they should be effective – i.e. make a difference to the behaviour of the investor. This means that incentives will necessarily be targeted to marginal investors, such as those who would not have invested otherwise. There is no one-size-fits-all approach to determining when an incentive is necessary to attract investment; however as in the case of the tax holiday given in Box X, financial modelling can assist.

Box 6. Assessing the cost of a tax incentive – Yaoure gold mine

Cote D'Ivoire has sought to attract international investment to its gold mining sector, which is relatively undeveloped compared to established regional producers. As part of its new mining code developed in 2014, it gave a five-year tax holiday to new mining projects.

The government of Cote d'Ivoire developed a basic financial model of the Yaoure gold mine, to assess the potential cost of this incentive. The analysis, using information published by Amara Mining, estimated that the investor could achieve an internal rate of return without the tax incentive of between 15% to 34% for a gold price between $1000- $1,500/ oz.[10] The tax incentive was estimated to increase companies' IRR in its base scenario by around five percentage points. However, the government also noted that there is a three-percentage point difference between the IRR in their model and that given by the company, possibly due to different cost estimates, and other fiscal costs. The rate of return would also need to be adjusted for country risk.

[9] https://eiti.org/news/eiti-launches-2019-eiti-standard

[10] N'Guessan, Ernest Koudajo, and Esse, Bienvenu, (2017) Yaoure Gold Mine Project Financial Model, Open Oil, https://openoil.net/portfolio/yaoure-model-and-narrative-report/

The government concluded that the tax holiday in the case of the Yaoure mine was not necessary to provide an attractive enough investment prospect. The government has since removed the tax holiday from the mining code.

37. A core element for delivering an effective incentive is a predictable and stable tax. Tax incentives are more likely to be sustainable if they do not overreach in terms of time, and value. There should be clear parameters for review, as well as sunset clauses to reduce the potential costs of badly designed or inefficient tax incentives programmes. For example, government could specify that an investment tax credit be carried forward for the first three "profitable" years; thus, preventing the deferral of tax payments for long periods. Moreover, tax incentives should not exceed the time it takes to recover the investment (i.e. the pay-back period), unless there is a good reason according to the cost-benefit analysis.

Box 7. When a tax holiday starts: Rio Tinto Simfer – Guinea

One of the key elements of a tax holiday is its duration, which determines the total cost in lost revenue. Depending on how the tax holiday provision is drafted, it may start at the date when a mine enters into its production phase or from the year that in which 'first taxable profits' are generated. In this example from Guinea, in relation to the iron ore SIMFER project, Rio Tinto and the government of Guinea agreed in article 29.1 of the 2014 of the mining agreement that the eight-year tax holiday starts at the date of "first taxable profits". [11] This represented a departure from the applicable mining law at the time the contract was signed, according to which income tax holidays started in the year of the first production.[12]

From the investor's perspective, the start date of the tax holiday meant it could recover the carried forward tax losses, before getting the benefit from the tax holiday. However, from governments perspective, the first taxable profits may arise a number of years after first production, depending on the pace of production, mineral prices and amortisation rules; thus, extending the tax holiday further into the future, and deferring government revenues for a considerable time.

38. Incentives that depend on the achievement of certain goals (Box X, and X) or adapt with changing economic circumstances (Box X) are also more likely to be sustainable, although potentially harder to administer. If governments offer tax incentives and subsequent changes in circumstances make it uneconomic, or politically unfeasible to uphold these commitments, they may feel pressure to unilaterally change the terms, adversely affecting the predictability of the investment environment. If, however, they design incentives to automatically adapt to profitability, for example, to reduce the incentive when commodity prices rise, the result may be more acceptable to government and hence less susceptible to change.

Box 8. 'Pioneering status' in Singapore

The Government of Singapore offers a concessionary tax rate or complete exemption to "pioneering" investors for 5 to 15 years, provided they fulfil certain conditions on an annual basis, including total business expenditure, the creation of jobs, payments to local suppliers, and

11 https://www.contratsminiersguinee.org/contract/ocds-591adf-0925073922/view#/pdf
12 http://www.droit-afrique.com/upload/doc/guinee/Guinee-Code-1995-minier_Abroge.pdf

knowledge and technology transfer. The incentive in the law is available to all investors that fall into the category of "pioneering." If the conditions are not met, the tax rate steps up. Until the end of the incentive period, the investor may have their profits taxed at a concessional rate if certain conditions are met.

The incentive is monitored by the Economic Development Board (EDB). Investors that are granted the incentive must submit regular progress reports to the EDB for the evaluation of performance. If there is any breach of conditions, the incentive may be revoked, and associated benefits recovered.

Box 9.

Companies earning taxable income from mining for gold in South Africa are not taxed at the general corporate tax rate of 28 per cent, but (since 1936) are taxed at a rate determined by applying a formula. The formula is to be determined separately for each gold mine and is progressive in nature. It was designed to encourage the mining of marginal ore and ore at great depth.

In 2019, the formula that applied to all gold mines is: $y = 34 – (170 \div x)$, where y is the rate to be determined and x is the ratio, expressed as a percentage, of taxable income to income. The ratio is effectively profit over revenue. The effect of applying the formula is that the tax rate applying to gold mines can vary from 0 per cent to 32.3 per cent. An important feature of the formula is that the rate of 0 per cent is available for gold mines that are not profitable or have taxable income of not more than 5 per cent of gold mining income.

Box 10. Oil recovery tax credit linked to reference price

The United States provides an incentive to encourage enhanced oil recovery projects in the United States. This incentive allows a tax credit, enhanced oil recovery credit ("EOR credit"), of (generally) 15% of costs identified as qualified enhanced oil recovery costs. The credit percentage is reduced to the extent the reference price of oil is in excess of the base value (adjusted for inflation) of USD28. This credit is provided for in the U.S. Internal Revenue Code and as such, is available to any investor involved in a qualified enhanced oil recovery project that has qualified enhanced oil recovery costs for the year.

The credit can be viewed as a very effective targeted incentive, achieving the goals of the investor, the government and the public. The incentive is transparent, has certainty of application and can be viewed as equitable to both investor and the government.

The credit is designed to encourage investors to invest in projects to produce oil that might otherwise be less profitable to produce and thereby increase the supply of oil for the country. From the perspective of the government, the cost of the incentive is reduced or eliminated to the extent the value of the oil produced increases beyond a designated level, which might otherwise provide an unintended benefit to the investor.

c) Efficiency

39. Tax incentives should be evaluated against alternative ways that the mining investment could be induced (e.g., government paying for infrastructure to reduce mine costs). The

option that best meets the policy goal at the lowest cost is considered the most efficient option. In extractives, as in other sectors, redundancy is more likely to be avoided if incentives are targeted to marginal investors who would not have invested otherwise. Project-specific financial modelling is critical to such a determination.

40. Cost-benefit analysis is another way to assess the efficiency of potential tax incentives. The objective is to compare the costs and benefits of offering tax incentives to extractive industry investors. The latter must outweigh the former for the incentive to be efficient. The analysis should focus on direct impacts that are more easily measured, for example, jobs, and taxes; versus secondary impacts such as household consumption by mine employees.

41. Detailed consideration of the net benefits of a project is needed in order to make an informed decision. Table 1 sets out the main costs and benefits of tax incentives in the extractives sector.

Table 1. Costs and benefits

Costs	**Benefits**
• The amount of revenue foregone from the incentive, assuming the investment would have occurred without it • Environmental, economic and social costs • Administrative costs of implementing and monitoring incentives • Economic distortions introduced due to differential treatment of certain investments • Potential for corruption or abuse in the granting and administration of tax incentives	• The amount of economic value the extractive operation brings to the economy (including through the multiplier effect); • Employment: the number of jobs created by the extractive industry operation; • Skills development; • Government revenues: the amount of revenue generated for the host government by the extractive industry operation.

42. A cost-benefit analysis should be considered as part of the broader framework of the economic impact of investment. As such, it may factor the development of infrastructure, including ports, roads, airports, hospitals, schools, health and community centres, as well as social and environmental impacts, including displacement of communities, pollution of water resources, and potential conflict. These costs and benefits relate to evaluating extractive industry investment generally, not tax incentives specifically. Incentives may also be used to motivate companies to invest in practices that contribute to sustainable development, and, in this way, create additional benefits that could also feature in a cost benefit analysis.

43. Governments should use financial models to quantify the revenue impact of tax incentives both in terms of the cost (i.e. revenue forgone, non-fiscal costs of extraction), and the benefit (i.e. the amount of revenue and other economic benefits generated by the extractive industry operation).

Box 11. Excessive tax breaks: Rusal Compagnie des Bauxites de Kindia – Guinea

In many cases, tax incentives are granted on the basis of contributions made by an extractive company to the economy of the host country, which can be assessed and debated (see section on governance). In rarer cases, governments have granted large tax breaks without substantial evidence of their benefit to the host country.

For example, Guinea granted a mining concession for the producing Kindia bauxite mine to Rusal in 2000. In the accompanying mining agreement, the company was granted a complete exemption of most of the taxes normally applicable to the sector, including corporate income tax and withholding taxes on dividends. The agreement also replaced the ad valorem royalty on bauxite from the mining code with a fixed royalty of 1 USD per ton of bauxite, in effect lowering the royalty payable by the company. Without time limitation on these tax breaks, the company has enjoyed a very generous fiscal regime (compared to the default) for almost twenty years, resisting several government initiatives to review mining contracts.[13]

d) Ease of administration

44. Ease of administration relates to the cost and difficulty of tax enforcement and compliance. Incentives may complicate extractive tax administration, especially where they are granted on a discretionary basis, creating competing fiscal regimes. Moreover, specific types of tax incentives may increase the administrative burden. 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. Specifically, countries will need to rigorously apply additional base protection rules, particularly those relating to transfer pricing, and thin capitalisation.

45. Poorly designed incentives may further expose government to compliance risk, such as profit shifting, (see Box 12 for a list of the top ten abuses), and thus increase the need for administrative measures and compliance obligations. Administrative issues to consider include:

- Incentives that create parallel fiscal regimes may exacerbate transfer pricing risks. One such example would be if incentives apply to one segment of the value chain such as processing, but not the extractive activity.

- The abrupt ending of a tax incentive may also create an incentive to accelerate profits to avoid paying taxes when the incentive ends. For example, in the case of a time-limited income tax holiday, investors may increase the rate of extraction or preferentially extract high-grade ore compared to what they would otherwise do absent tax considerations.

13 https://www.itiedoc-guinee.org/document-archive/rapport-du-comite-technique-de-revue-des-titres-et-conventions-miniers-ctrtcm-19-avril-2016/
https://www.contratsminiersguinee.org/contract/ocds-591adf-9112931197/view#/pdf/page/24/annotation/2769

- Cost-based incentives should be carefully defined to prevent cost overstatement. For example, in the case of an investment allowance, it is necessary to clarify what type of expenditure is included; whether losses can be carried forward to be offset against income in future years, and if they can be added to deductible expenditure in the current tax year.

Box 12. Top ten abuses of tax incentive regimes

1. Existing firms transforming to new entities to qualify for incentives.
2. Domestic firms restructuring as foreign investors.
3. Transfer pricing schemes with related entities (sales, services, loans, royalties, management contracts).
4. Churning or fictitious investments (lack of recapture rules).
5. Schemes to accelerate income (or defer deductions) at the end of a tax holiday period.
6. Overvaluation of assets for depreciation, tax credit, or other purposes.
7. Employment and training credit (fictitious employees and phony training programmes).
8. Export zones (leakages into the domestic economy).
9. Diverting activities outside of regional and enterprise zones.
10. Disguising or burying of non-qualifying activities into qualifying activities.

Source: UN Handbook pg 550

ii. Typical tax incentives in the extractive sector

46. The multitude of factors and risks that exist underscore that there is no "one-size-fits-all" approach to tax incentives. Tax incentives that work in one country may not be effective in another, i.e., if an incentive does not work in one economy or sector, it does not mean it will be ineffective elsewhere. The next section sets out the different types of tax incentives commonly used in the resource sector, and the advantages and disadvantages of each.

47. In general, tax incentives may be grouped into two categories:
    - profit-based incentives, and
    - cost-based incentives.

a) Profit-based incentives

48. Profit-based incentives generally reduce the tax payable once the project is profitable, such as through tax holidays, tax sparing,[14] or preferential tax rates. These types of incentives will be less effective in encouraging investment compared to incentives that reduce the capital cost if profitability is low. When profits are earned due to location-specific factors such as natural resources, profit-based incentives tend to be associated with high redundancy rates and are ineffective at attracting investment.[15]

[14] Tax sparing is a provision usually in a tax treaty, where one state allows a credit for taxes "spared" (removed because of an incentive) in another country. The provision prevents the shifting of the benefit of an incentive from the taxpayer to whom it was intended, to another country in which the taxpayer is subject to tax.

[15] Platform for Collaboration on Tax, (2015) Options for Low Income Countries Effective and Efficient Use of Tax Incentives for investment, pg. 20

Notwithstanding, in other cases, the incentive can improve the project economics, thereby strengthening the justification for the investment.

49. Moreover, marginal mines are likely to benefit less than profitable mines from this kind of incentives, which is the opposite of what a pro-investment incentive should aim to achieve. For example, if a mine's gross income is $200, its operating costs are $50 and the tax rate that normally applies is 50%, a tax holiday means the taxpayer earns a profit of $150. Whereas for a mine that has the same gross income, but costs of $100, and pays tax at 50%, it earns a profit of $50. Government is effectively incurring higher tax losses on the mine that needs the least financial support.

i. Income tax holiday

50. A tax holiday applies during a specified tax-free period. The duration may vary from one year to the full term of the project. It may take the form of a complete exemption from profits tax, or a reduced rate, or a combination of the two (Zolt, 2017).

51. For the reasons highlighted above, income tax holidays may be a less efficient and effective incentive for the extractive industries.[16]

52. Income tax holidays for extractive projects tend to incentivise commercial behaviour which moves profitable activity into the time period covered by the incentive. Resource companies may increase the rate of extraction, or preferentially extract high-grade ore during tax free periods. Governments report the problem of high-grading as a potential response by mining companies to tax holidays. "High-grading" involves companies increasing the rate of extraction, or preferentially extracting high-grade ore, compared to what they would otherwise do absent tax considerations. Of course, tax may not be the only factor – companies will generally want to mine high value, easy to access ore first, to improve their cash flow. Nonetheless in estimating what the overall cost of a tax holiday will be, governments should anticipate behavioural responses that the tax incentive will generate.

53. From an investor point of view, a tax holiday which begins at the start of the project's development will be of uncertain value (and hence less effective as an incentive), since project delays will reduce the tax-free period. This is why investors may prefer tax holidays that commence from the first taxable year. However, in a project that requires massive amounts of investments, the first taxable profits could be years after the date of the first production, depending on the pace of production, mineral prices and amortization rules. Thus, from government's perspective, aligning a tax holiday to first taxable profits could extend the tax holiday further into the future than the government may expect.

54. If government chooses to offer a tax holiday, it should limit the incentive to the time anticipated for a specified tonnage to be extracted. Once the agreed tonnage has been extracted, the tax holiday expires; thus, limiting the risk of high-grading. In addition,

[16] "Tax holidays are widely regarded as a particularly ill-designed form of investment incentive, and one that poses considerable dangers to the wider tax system." Keen et al., Revenue Mobilisation in Sub-Saharan Africa: Challenges from Globalisation, (2009) pg.14

government should require that companies deduct depreciation allowances during the tax holiday (as if there were no incentive), so they cannot be offset after the holiday expires, reducing future revenue collection.

ii. Withholding taxes on income remitted abroad

55. Many developing countries favour withholding taxes on outbound services, interest and royalties. This is because withholding taxes are easier to collect than other taxes, and thus a reliable source of revenue, as well as discourage base erosion and profit shifting. By lowering or exempting withholding tax, developing countries become more vulnerable to cross-border tax planning by multinational companies.[17]

56. In the case of loans from foreign related parties, governments will end up with interest as a deductible expense, and no tax on the interest income received by the related party, unless they charge withholding tax.[18] Moreover, subject to thin capitalisation and transfer pricing rules, the group will have an added incentive to highly leverage its subsidiary in order to strip profits out via interest expense. The same risks arise for management service payments; although, this is lower in the context of Joint Venture arrangements, where shared costs (e.g. management fees) are reviewed by non-operating partners.[19] Additionally, it may be difficult for governments to determine the extent to which the services are performed offshore and are exempt from withholding tax versus services performed onshore (Article 12A of the UN Model imposes WHT on payments to non-residents for services performed irrespective of where the services were performed). Incentives relating to dividend withholding tax are less problematic because, unlike interest and management fees, dividends are not tax deductible. However, governments may wish to tax dividends for other reasons, including encouraging reinvestment or putting resident and non-resident investors on a level-playing field.[20]

57. 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. Similarly, with any large-scale project there may be significant project management and technical service expertise required from outside the country and the imposition of a withholding tax will increase the cost of such services to the project. Government should also consider that charging withholding tax on any dividends it receives from a project, may increase the overall share of distributed dividends it collects, beyond what was negotiated with the investor.

[17] OECD, *Measuring and Monitoring BEPS, Action 11—2015 Final Report*, supra note 23, 157, recognizes that withholding taxes "can influence cross-border tax planning opportunities" and can "discourage profit shifting via strategic allocation of debt and intangible assets."

[18] For more guidance on the level of withholding tax, see the UN Model commentary on Article 12A, paragraph 2, points 44 and 45.

[19] The risk of management fees being inflated should be reduced in the context of a Joint Venture arrangement where the operator is subject to the no-profit rule. For further information see [insert ITIC publication].

[20] See Chapter 2 of the UN Handbook on Protecting the Tax Base for a detailed discussion of taxation of income from services.

58. These trade-offs are important considerations. However, the administrative constraints, and base erosion and profit shifting risks, suggest that developing countries may find withholding taxes a necessary feature of the resource tax system.

iii. Export processing zone (EPZ)

59. A common characteristic of EPZs is the provision of special incentives to attract investment, mostly foreign, for export production. Incentives may include tax holidays, duty free export and import, and free repatriation of profits. In the mining sector, EPZ status is usually granted to a company's mineral processing operations. On the one hand, EPZ status may be an important factor in encouraging value addition in the host country, in which case governments should have clear criteria about what "processing" means. Notwithstanding, governments should be mindful that any tax differentiation between the mine and the processing facility may lead to domestic transfer pricing issues. Specifically, if the mine is subject to a higher tax rate, there may be an incentive to shift profits to the processing facility by under-pricing the intermediate mineral product transferred to the processing facility.[21] Tax authorities should ensure that audits also cover transactions with EPZs.

b) Cost-based incentives

60. Cost-based incentives include investment allowances, investment tax credits, accelerated depreciation and loss carry-forwards, all of which decrease the capital cost, and so make a greater number of investment projects more profitable at the margin—that is, generate investments that would not otherwise have been made.

61. The capital-intensive nature of resource investments makes cost-based incentives better suited than profit-based incentives.) This is because they allow taxpayers to recoup their investment through appropriate deductions from their taxable income or directly from their tax bill; and defer tax to later stages in a project's life and therefore do not reduce cash flows in the initial critical years when capital is most needed. From an administrative perspective, it is also easier to anticipate the revenue cost of cost-based incentives because it is based on the amount of investment.

i. Investment allowances and credits

62. Investment allowance: An investment allowance gives the taxpayer the right to offset a percentage of its capital expenditure against its taxable income in the year the expenditure is made, rather than spread over time through regular depreciation. E.g., If the taxpayer spends $200 and the allowance is 50 per cent, it can deduct $100 from its taxable income in the first year. Applying a 20 per cent corporate income tax rate means the taxpayer's tax liability is reduced by $20. This enables even quicker cost recovery than accelerated depreciation, depending on the rate, although standard depreciation would still apply for the remainder of the investment.

[21] Countries should also be mindful that export related tax incentives may contravene the OECD initiative on Harmful Tax Competition launched in 1998 and, more recently, BEPS Action 5, as well as World Trade Organisation (WTO) rules.

63. Investment tax credits: An investment tax credit enables a taxpayer to reduce the amount of tax payable by a portion of its investment expenditure in the first year, rather than reduce its taxable income, as with investment allowances. For example, if the investment is $200 and the investment credit is 20 per cent, the taxpayer can reduce its tax liability in that year by $40. If the tax payable is $40, the taxpayer can apply this $100 investment credit to reduce its tax liability to minus $60. This balance could be carried forward to offset tax liabilities in future years, or expire. Depending on the tax rate, the investment credit is four times more generous than the investment allowance.

64. Investment allowances and tax credits will only be relevant once the taxpayer is in a taxpaying position, unless loss carry forward is allowed.

ii. Customs duty reductions or exemptions

65. Import tax is usually based on the value of the good. For example, if import duty is 10 per cent on mining inputs, a company that brings in drilling equipment valued at $500,000 will have to pay $50,000 in duties.

66. Customs duty relief is often provided to enable the company investor to import specific plant and equipment duty free and to obtain refunds of excise paid in relation to fuel used to power machinery or in off road vehicles. These incentives are common in developed countries, where mining investments are very reliant on imported equipment, fuel and construction material. The major issue for developing countries is usually administering and policing of the relief to ensure it is targeted.

Box 13. Import duty exemptions target exploration and development phases

The Petroleum Code of Senegal from 1998 provides an exemption from Customs Duties and VAT during the exploration and development phase of an oil and gas project. Although the Petroleum Code from 1998 has been replaced by the Petroleum Code enacted in 2019, the 1998 Petroleum Code continues to apply to license holders granted prior to 2019. This incentive is provided in Articles 48 and 49 of the Petroleum Code and applies during the exploration and development stage of all oil and gas projects in Senegal. This incentive allows the import of materials during the relevant phases of the project free of customs duties and VAT. In addition, exports of petroleum products are not subject to export duties. After completion of the specified phases of the project the general rates of customs duties and VAT apply.

This type of incentive can be viewed from the perspective of the government as an enticement to investors to assume the risk of proving the existence and economic production of oil or gas in a new or unproven resource prospect. This position is reflected in the "Explanatory Statement" to the Draft Bill 98-05 establishing the Petroleum Code, which provides the following: "In order to be competitive, Senegal must not only take into account the evolution of the worldwide energy data, but also offer to prospective investors of the petroleum industry, conditions which are attractive and susceptible of promoting the development of petroleum investments in the exploration or production of our national territory.

This draft Petroleum Code takes into account the specific characteristics of the exploration and exploitation of hydrocarbons in our onshore and offshore sedimentary basin, the existing conditions, and the expected growth of the petroleum industry." From an investor’s perspective,

an incentive that provides a reduction of cost, especially during the exploration and development stages of a project before there is certainty of future income from the project, can be viewed as particularly beneficial to the project economics.

iii. VAT exemptions on imports

67. As described in Chapter 9 of this handbook, many resource-rich countries have difficulties with large VAT credits owed to export-oriented extractive industries. These industries pay VAT on inputs but do not collect VAT on exports. They are therefore owed large VAT refunds by the tax authorities. Delays in VAT refunds may become an impediment to investors. As the greatest proportion of input values subject to VAT tend to arise from imports into extractive operations, it is possible to simply exempt imported inputs used in oil and gas operations from VAT. This approach eliminates (or reduces) the churning created by imposing VAT with immediate refund, but creates two additional problems:

- First, VAT on domestic supplies is not exempt under this scheme and so an artificial import bias is created by exempting imports only. In effect, domestic suppliers are placed at a competitive disadvantage because of the import exemption. Such negative protection may hamper efforts to use the extractive industries to create downstream linkages to the rest of the economy.

- Second, an exemption for imports can be a source of leakage and fraud. Extractive companies and their employees import consumer and other goods not used in production and such imports should be subject to full VAT. In addition, if there is an exemption, there is an incentive to use the exemption to import goods that are resold into the domestic market free of VAT. Thus, the administrative requirements for monitoring an exemption system are largely the same as those required for monitoring the VAT in general.

Box 14. REPETRO – BRAZIL

REPETRO was a tax exemption scheme relating to upstream oil and gas imports in Brazil. It used to be the most important tax instrument in Brazilian oil legislation. It was a temporary admission regime with a tax holiday for rental or freight contracts until 2020, or until the end of these contracts. All equipment, parts, and tools were eligible for REPETRO.

On the one hand, REPETRO played a role in increasing Brazil's oil and gas reserves and production. When REPETRO was introduced in 1997, the oil price was not above US$ 20/bbl, and the Brazilian industry only had one oil company, Petrobras. REPETRO was a way that the Brazilian government enabled the oil companies to use the global market to supply their projects in Brazil, in an economical way. Brazilian oil proven reserves increased 80%, from 1997 until 2017. Oil production increased by 211% and gas production 306%, from 1997 to 2017.

Notwithstanding, there were some side effects. The way the regime was designed created a large assets accumulation abroad, creating many transfer pricing risks, as well as capital gains tax issues in farm out operations and in services supplied by related parties, especially on specialized vessels freights, such as Floating Production Storage and Offloading (FSPOs) and drill ships. The REPETRO fiscal waiver was an average of US$ 3.2 billion a year. This represented the amount of tax exempted for the importation of goods, which value is an average of US$ 13.7 billion per year (CIF values).

The other issue about REPETRO was the presence of different lists of products eligible to the tax incentives, for Federal Tax Administration and subnational States Tax Administrations (Customs duties X VAT), which create a problem of transparency in tax legislation.

Brazil's new tax legislation, enacted at the end of 2017, establishes that the ownership of production equipment and vessels (subsea and top side) must be accounted as Brazilian oil and gas company's assets. It recognizes the risk distribution between taxpayers and government and deals with it through import tax exemptions and a capital allowance, which includes a higher amortization rate, based on the fact that the technical and financial feasibility studies consider that the cash flow of enterprises, and the timing to charge the corporate tax, have a key role in the decision-making process of the investors.

The new oil and gas federal tax legislation is aligned with the subnational States indirect taxation of VAT, since both the Union and the States now share the same list of goods exempted from Customs duties and subnational States' VAT (ICMS), making the legislation more transparent. Some VAT distortions were addressed by extending the exemption for two more layers of the domestic supply chain in order to avoid the credit refund problem for export companies in the extractive industry. The new scheme also gives Brazilian suppliers the same conditions of the foreign ones.

iv. Production royalty-based incentives

68. Royalty based incentives may be agreed to reduce the burden on the project during the first phase until recovery of sunk costs. They are sometimes offered in developed countries to incentivise new entrants and to prevent early termination of mineral production as the natural resource approaches exhaustion. These may be reasonable trade-offs, depending on the circumstances. Nevertheless, governments should be mindful that royalties are a payment for the right to extract a finite, non-renewable resource, and, as such, incentives should not be given lightly. Again, there is a risk that investors may speed up the rate of production, and extract the highest value ore, to maximise sales revenue during the royalty-free period.

69. Countries that choose to provide production royalty-based incentives to extractive industry investors should establish clear and objective criteria, and procedures to waive or exempt royalty payments.

70. Criteria may include:

- cash flows are negative in the short term;
- the cash flow difficulties are temporary and capable of being overcome (i.e. waiver or exemption should be for a short period (a few months));
- the mine may have to close with job losses if royalties were demanded.[22]

v. Fiscal stabilization

71. Fiscal stabilization is intended to preserve the taxation, production-sharing, pricing, or state participation rules that govern the division of proceeds from a resource project at the time of contract. The primary justification for this is to ensure the feasibility of projects

[22] World Bank, (2013) "How to Improve Mining Tax Administration", pg.44

in countries with higher levels of political risk. Therefore, fiscal stabilisation assists investors in reducing the relative risks of projects. There are generally three approaches to stabilization:

- The fiscal take laws (or contract terms) in force on the date of agreement are frozen.
- Any future tax policy changes that would increase the tax burden on the project will not apply, although the project can benefit from tax decreases.
- Changes in the tax regime will apply but the government is required to negotiate. There is an agreement with the company to negotiate to maintain the preceding economic equilibrium if there are any adverse changes (Daniel & Sunley, 2008).

72. For most businesses, stable rules are necessary to achieve the economic results that were anticipated when the investment was made, e.g. in order to maintain the necessary level of production, projected profit levels or to obtain the necessary maintenance and expansion of funds. The risk of instability will be factored into the overall cost of the investment. The bigger and more immovable the investment, the more relevant it will be. Consequently, from the investor viewpoint a well-designed stability agreement can remove a significant amount of tax and related profit risk and allow for more accurate forecasting of the future fiscal take impact on project cash flows.

73. However, where fiscal stabilisation is used, and depending on how the provisions are drafted, they may extend beyond standard fiscal terms, and also apply to tax incentives provided for in domestic law, or at the contract-level, as of the date the investment agreement is signed, or ratified by parliament when this is required by law (in many developing countries). If there is a significant change in circumstances, for example, commodity prices rise making it easier to attract investment, or a tax incentive is used in a way that government did not anticipate, unintended benefits to the company may result. The risk is that fiscal stabilization also locks in all the aforementioned behavioural responses linked to incentives.

74. If governments choose to offer fiscal stabilisation, such clauses can be designed to minimise the general tax policy impact, by limiting their scope to specific key fiscal terms (not all fiscal terms) for a specific period of time (not indefinitely), and possibly by applying a stability premium on tax rates.[23] Tax authorities should also be involved in negotiations with investors about possible stability clauses. Any agreement must be sustainable such that it does not lead to the host country being unable to address unintended outcomes or implement global reforms such as those championed by the OECD Base Erosion and Profit Shifting tax programme. In practice, long term stabilisation agreements that lock in unstainable benefits for investors, that do not allow for regular review by host country/company investor, and are not publicly available for scrutiny, often lead to dissatisfaction and dispute.

Interaction with investor and other tax regimes

75. The tax regime of the investor will impact on the attractiveness of the incentives. For example, an investor which operates a worldwide tax regime, such that foreign income

[23] Section 53, OECD, (2018) Guiding Principles for Durable Extractive Contracts available at http://www.oecd.org/dev/Guiding_Principles_for_durable_extractive_contracts.pdf

taxed below a minimum rate will result in additional tax (up to the minimum rate) in the investor location, is unlikely to be effective as an incentive. Instead it is likely to represent a shift in taxation from the investee country to the investor country.

76. At the time of writing, governments of the over 130 jurisdictions that are members of the Organisation for Economic Co-operation and Development (OECD)/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) (IF) are deliberating over possible actions to address the tax challenges arising from the digitalization of the economy. This process could have a significant impact on the effectiveness of incentives in all countries, regardless of the importance of digital businesses in their economies. Some of the proposals being considered would cover all sectors of the economy, including extractives. All of them could eventually be adopted globally.

77. In 2019, the IF agreed on a Programme of Work that adopted a two-pillar approach[24]. Of the two proposals, Pillar 2 is particularly relevant for tax incentives: it proposes setting a minimum rate of effective taxation for multinational companies to reduce profit shifting. The proposal contains four rules based on two country-based taxing rights:

    1. The right to tax any undertaxed foreign income of multinational companies in the jurisdiction where the shareholders of the low-taxed entity are located, with the so-called:

        a. "income inclusion rule" that would tax the income of a foreign branch or a controlled entity if that income was subject to tax at an effective rate that is below a minimum rate, and

        b. "switch-over rule" to be introduced into tax treaties that would permit a residence jurisdiction to switch from an exemption to a credit method where the profits attributable to a permanent establishment (PE) or derived from immovable property (which is not part of a PE) are subject to an effective rate below the minimum rate.

    2. The right to tax payments to foreign affiliated entities by companies operating within their jurisdiction when these payments are not taxed at a minimum level, with the:

        a. "undertaxed payment rule" that would operate by way of a denial of a deduction or imposition of source-based taxation (including withholding tax) for a payment to a related party if that payment was not subject to tax at or above a minimum rate and

        b. "subject to tax" rule that would complement the undertaxed payment rule by subjecting a payment to withholding or other taxes at source and adjusting eligibility for treaty benefits on certain items of income where the payment is not subject to tax at a minimum rate.

[24] OECD. (2019). *Programme of work to develop a consensus solution to the tax challenges arising from the digitalisation of the economy*. https://search.oecd.org/tax/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.htm

78. A minimum tax on multinational profits can be expected to impact the effectiveness of profit-based incentives. Should such a change be adopted in investor jurisdictions, governments should factor this in within their reviews of the cost and benefits of existing and future incentives.

Conclusions

79. Tax incentives can be used to encourage behaviour and, properly designed, managed and reviewed, may be a useful tool of social and economic policy. Experience in tax incentives has been varied and they should be used with care.

80. This paper recommends the adoption of an evaluative framework that covers:

- Governance
- Effectiveness
- Efficiency and
- Ease of Administration

81. It has then considered the most common incentives within the extractives sector, categorising them between profit-based and cost-based incentives.

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