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Item 3(e) of the provisional agenda
Update of the Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries

Co-coordinators' Report

Summary

This note is presented to the Committee FOR INFORMATION at its 20th Session.

The main purpose of the note is to provide the Committee with a summary of the work the Subcommittee on Extractive Industries Issues for Developing Countries has carried out since the 19th session of the Committee. The note updates the Committee on the status of the ongoing work, topics already covered, and on how it intends to carry it forward for the remainder of the current membership's term. Four substantive papers are presented at the 20th Session, CRP.21 on Tax Incentives, CRP.22 on Tax Treatment of Subcontractors and Service Providers, CRP.23 on Production Sharing Contracts, and CRP.24 on Tax treatment of Financial Transactions. CRP.21 is presented for DISCUSSION and APPROVAL, while the 3 others are submitted for DISCUSSION.

This is a brief report of the work of the Subcommittee on Handbook on Issues for Taxation of Extractive Industries. At its 16th session the Committee was briefed on the Subcommittee's work and on its planned meeting in Madrid in June 2018 devoted to new topics to be included in the update of the handbook. The new topics included areas of priority for developing countries such as auditing mining and oil and gas activities, trade mispricing issues (to the extent that they were not transfer pricing issues), the tax treatment of service providers and subcontractors, the tax treatment of financial transactions related to extractive industries, environmental tax issues, and tax incentives. Below is a brief presentation of the state of work on four of these topics.

a. Tax Incentives

At its 19th session the Committee was invited to discuss the draft of the chapter on tax incentives in the extractive industries. Comments received from the Committee and other participants were considered new draft was prepared for the 20th session for review and APPROVAL. The Committee's attention is drawn on one particular issue briefly discussed last October concerning impact of other tax policies that could affect tax incentives, similar to the work done under action 5 of the Action Plan on Base Erosion and Profit Shifting and the “pillar one” and “pillar two” proposals of the Inclusive Framework. In particular the “pillar two” recommends a threshold on taxation of profit earned by an MNE in a jurisdiction for that profit to be eligible for tax exemption in another jurisdiction, generally the State of residence of that MNE. The paper discusses the issue but does not go in detail as the Subcommittee was of the view that other instances, including the Subcommittee on taxation of digitized economy, would study the issue further.

During its meeting hosted by the University of Nairobi in Nairobi, Kenya last December the Subcommittee discussed 3 more chapters, namely Tax Treatment of Subcontractors and Service Providers, the Tax Treatment of Financial Transactions in Extractive Industries, and Production Sharing Contracts. They are presented to the Committee for DISCUSSION and guidance with the view to considering the Committee's comments in updating the draft for another review and possible approval at the 21st session.

a. Production Sharing Contracts (PSCs)

The aim of this chapter is to describe the main tax and tax-related issues arising from upstream production sharing contracts. For this purpose, this chapter examines the concept and some of the mechanisms of Production Sharing Contracts or Agreements (PSC or PSA) in detail. PSCs are among the most common types of contractual arrangements for petroleum Exploration and Production (E&P). Under a PSC, the state as the owner of mineral resources, engages an oil company or a group of oil companies as a contractor to invest their technical and financial capabilities to explore and develop the country's hydrocarbon resources. The state is traditionally represented by the host government or one of its entities such as the national oil company (NOC).

To provide a general overview of PSCs, the chapter starts by considering how a PSC differs from other types of fiscal regimes; it explores some of the reasons why and when a country would choose a PSC driven fiscal regime as well as provide an overview of general terms and common tax clauses. When discussing terms, the chapter goes into a number of practical tax problems that are common in the interaction with PSCs and finally describes a number of current PSC systems around the world.

This chapter intends to improve understanding as to what PSCs are, including relevant terminology, what the tax mechanisms of the contracts are and what areas of attention are when applying a PSC. It intends to discuss aspects of interest to tax administration, investors and other stakeholders. PSCs have risen in popularity in recent years in many regions of the world, thus the need for such a chapter to inform governments, especially in developing countries, on what such arrangements entails for revenue collection purposes.

PSCs typically relate to the petroleum industry and are rarely seen in the mining industry. However, in recent years some countries (e.g. Senegal) have sought to apply PSCs in the mining sector. The subcommittee continues to seek concrete country examples of PSCs in mining that can be used for illustration. Committee members who may know of such country cases are invited to assist the Subcommittee.

b. Tax Treatment of Subcontractors and Service Providers

The increased complexity of extractive activities led to specialist businesses that are subcontracted by resource companies. Subcontractors open the market to more competitors, including local companies in developing countries. More competitors increase the number of bidders on projects and allows for new partnerships and operating models.

The use of subcontractors also gives rise to complex tax issues and some countries' tax administrations may have limited experience in administering these challenges. This chapter is focused on a limited range of key tax issues specific to subcontractors engaged directly by resource companies and that are not otherwise covered in the general discussions in this Handbook.

The chapter raises complex issues and gives concrete and applicable examples where possible. Because the chapter is a part of the Handbook and thus has to be of limited volume (number of pages), some examples have been cut from the main text and Subcommittee has proposed to publish them as an online annex or possibly partner with another institution to publish them with that institution, Intergovernmental Forum on Mining, Minerals, Metals and Sustainable Development (IGF) can be that institution. The Subcommittee is still pondering that option and the Committee's guidance on that would be appreciated. The preparation of several of such cases is expected to take a lot of time and may go beyond April-May 2021, expected date of completion for the Handbook.

d. Tax Treatment of Financial Transactions in the Extractives

There are a lot of crosscutting issues between financial transactions in extractive industries and intra-group transfer pricing within the same MNE. This chapter will focus on tax treatments of financial transactions that are not discussed in the United Nations Practical Manual on Transfer Pricing. The transfer pricing considerations related to the intra-group financial transactions along the value chain are not addressed as such in Chapter 9 of the United Nations Practical Manual on Transfer Pricing. In addition, because of the importance of intra-group financing in the extractive industries, beyond the market price compliance issues, thin-capitalisation and important financial expenses may constitute a risk of base erosion for local companies. Such issues will be discussed here.

Considering the importance of this issue for the extractive industries in developing countries, and in view of the difficulties encountered in applying the arm's length principle to financial transactions, particularly with regard to the comparability analysis, this chapter elaborates on the thin capitalization rule in the extractive industries, reviews current debate on interest limitation issues and provides concrete application examples in developing countries. Useful guidance is also provided in the United Nations Practical Portfolio, Protecting the Tax Base of Developing Countries against Base-eroding Payments: Interest and Other Financing Expenses.

This chapter addresses four important topics concerning financial transactions: financing mechanisms, hedging instruments, performance guarantees and farm-in/farm-out agreements. Financial transactions is a rapidly evolving topic in business around the globe and extractive industries sector is no exception. The Subcommittee has worked on concepts it judged are key and of interest for developing countries. The Committee is invited to give its comments and suggestions on any other subtopic the Subcommittee should include in this chapter.

e. Progress and steps going forward

It is the intention of the Subcommittee to finalize the 3 chapters presented here, considering the Committee comments and guidance, and submit them for discussion and approval at the 21st Session in October. After the Session, the Co-coordinators and the Secretariat will discuss possible dates for an online Subcommittee meeting for a debrief on the Committee discussion on Extractives work. It will also discuss the start of topics not touched so far. In this regard, the Co-coordinators would like to propose to deal with Trade Mispricing Issues within the chapter on Auditing and to make Environmental Tax Issue a section of the broader chapter on Decommissioning. This restructure is meant to refocus our work and make sure we finish different chapters within the remaining time.