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Committee of Experts on International Cooperation in Tax Matters Twenty-seventh Session

17-20 October 2023

Item 3(f) of the provisional agenda

Taxation of Extractive Industries

Co-Coordinator's Report

Summary

This paper is submitted to the Committee at the Twenty-seventh Session of the Committee for discussion, and comment. It reports on the progress of work by the Subcommittee on Taxation of Extractive Industries since the last Session. In particular, and considering the comments received, the Subcommittee has developed draft guidance on: (i) Tax Incentives and the Global Minimum Tax in the Extractive Industries, commonly referred to as Pillar 2 of the OECD/ Inclusive Framework BEPS Project (CRP.38) and (ii) Permanent Establishment (PE) and other Income Issues for the Extractive Industries (CRP.39). The two drafts are respectively presented to this Session for discussion as a first read. The progress on the other two workstreams namely; Trade Mispricing and Valuation of Mineral Content, and Energy Transition in the Extractive Industries, is also detailed in this report.

The paper on Permanent Establishment (PE) and Other Income Issues for the Extractives Sector, CRP.39, reviews various aspects of PE Article 5 of the UN Model as well as other Articles with a direct link to the PE concept. The paper puts forwards key issues and proposals on how to deal with them with the aim of protecting the tax base in extractive industries. One of the proposals made is to draft a standalone PE Article, a view shared with the Subcommittee on the UN Model Update.

The CRP.38 on tax incentives in extractive industries and Pillar 2 does not address the broad (and difficult) issue of tax incentive effectiveness as this topic has already been debated and addressed by the Committee in its previous sessions and in, for example the United Nations Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries. This paper instead describes the interaction between tax incentives and Pillar 2. It draws the attention of policy makers to the potential impact of Pillar 2 on tax incentives and tax collection in the extractive industries. The paper aims at shedding light on different key aspects governments in developing countries should pay attention to, to avoid or minimize any tax loss due to the pillar 2 or negative impact on foreign investments in some cases.

The two CRPs presented along with this report are submitted for **discussion as a first read** to obtain the Committee's suggestions, and guidance with the view to presenting a final draft for approval at the Twenty-Eighth Session.

1. Introduction

1. This report summarizes the work of the Subcommittee since the end of the last Session in March 2023. The Subcommittee held two meetings, one on 15-16 June and the second on 20 and 22 September 2023. In addition to those two formal meetings, more technical and shorter meetings were organized by workstreams, in particular the group working on trade mispricing and mineral valuation met online, with tax officials from Australia, a developed country endowed in natural resources including minerals. The purpose was to learn from an experienced tax administration on how monitoring and audit functions related to pricing of minerals and collection of tax are handled.

2. As recommended by the Committee at its last session, the Subcommittee on Taxation of Extractive Industries and Subcommittee on the UN Model Update (UN Model Subcommittee) exchanged views on the Permanent Establishment (PE) workstream, but due to conflicting schedules the two could not have a full meeting. The focal points from both Subcommittees along with available Co-Coordinator participated in each the other's Subcommittees meeting on topic related to PE and PE-related income provision. A full technical meeting between the two Subcommittees is planned in early November 2023.

3. As for collaboration with other Subcommittees working on similar workstreams, the stage at which the Subcommittee on Taxation of Extractive Industries is at did not call for a technical meeting with the Transfer Pricing Subcommittee or the Environmental Subcommittee. The Subcommittee on Taxation of Extractive Industries has among its participants, two active participants in addition to its focal point who regularly attend the Environmental SC meetings. This facilitates and maintains some level communication between the two. The Subcommittee on Taxation of Extractive Industries intends to continue to collaborate with relevant other Subcommittees, namely the UN Model Update Subcommittee on permanent establishment, Transfer Pricing on trade mispricing and mineral valuation, and Environmental Taxation on energy transition.

2. The Permanent Establishment (PE) Workstream

4. The Subcommittee on Taxation of Extractive Industries has prepared a draft proposal with a list of issues related to the PE concept and other PE-related provision in the UN Model. Concrete suggestions are made on how to amend and align the UN Model with continuously evolving global economy and new technologies in mineral, and oil and gas extraction. The Subcommittee on Taxation of Extractive Industries and the Subcommittee on UN Model Update share the view for a standalone Article on PE in the extractive sector and further meetings will be necessary for detailed and more in-depth discussion on various provisions of the UN Model.

5. The Subcommittee on Taxation of Extractive Industries has focused on non-renewable resources which is its expertise. However, the Subcommittee on the UN Model is of the view that the new Article if so decided, should encompass renewable resources. The Subcommittee on Taxation of Extractive Industries did not consider that possibility, limiting its focus to its area of expertise, but after preliminary discussions, it is open to further discussion in that direction, especially given the role of renewable resources in energy transition policies.

6. The draft proposal the Subcommittee on Taxation of Extractive Industries presents to the Committee at this Session discusses, *inter alia*, the following issues:

- Lack of definition of “contracting states”. The UN Model recommends that the two states negotiating a tax treaty agree on what the terms means for the application of their treaty. However, the Subcommittee on Taxation of Extractive Industries suggested that the term should be defined in the UN Model, possibly in the Commentary, as the stand-alone Article will need to cover extraterritorial issues such as “continental shelf”.
- Article 5 of the UN Model requires a “fixed place of business” before a PE can be found. In the extractive industries the Article does not clearly cover exploration activities which may be carried out without a ‘fixed place of business”. This is necessary for a state to be able to tax income derived from such activities. The issue of immovable property needs to be fully developed for extractive industries as well as financing activities especially for payments directly linked to the value of the extracted material.
- The right to tax income derived from international transport of natural resources and the use of Article 8. As it currently stands, such rights are not guaranteed for the source country.
- The right to tax extractive industries’ income from administrative and technical services by the source country. Application of Articles 12A and 12B in the context of extractive industries given the emergence of services provided remotely.
- Taxation of capital gains. This concerns the sourcing rule of 50% in Article 13(4). Source countries may benefit from more flexibility to be able to tax capital gains.
- There is no explicit reference to alienation of extractive industries rights in Article 13(6).
- Employment in extractive industries where some specialized jobs may take place in the source country, but the income is taxed in another country. This is not sufficiently addressed under Article 15.
- The issue of compliance as related to a new stand-alone Article will also be discussed.

7. The Subcommittee on Taxation of Extractive Industries also discussed issues related to potential extra compliance work that the new standalone provision on PE may entail on companies, and on the expected product which may take the form of a standalone Article with commentary on provisions better aligned with other Articles.

8. In reviewing Article 14 on independent personal services in relation to subcontractors in extractives, it was suggested to also investigate Article 15 which contains provisions to counter base erosion in source countries.

9. The UN Model Update Subcommittee, in its comments, drew attention to Article 6 of the UN Model in relation to income arising from extraction activities. After discussions on this issue, it was decided to soften and refine the text under consideration and address this issue during the next subcommittee meeting following the Committee session, for Committee Review at the Twenty-eighth Session. The same approach will be taken concerning the rationale for excluding Article 13(7) from the scope of the proposal and extending the scope to cover renewable resources.

3. Tax Incentives and Pillar 2

10. The draft paper CRP.39 on tax incentives and OECD/IF Pillar 2 discusses the interaction between Pillar 2 and tax incentives regimes in the extractive industries. The Subcommittee on Taxation of Extractive Industries, during its meetings, worked on a paper that can give detailed explanation of the whole process the adherence to Pillar 2 would entail. The purpose of the paper is to give a summary of how the provision will be applied and whether and how it will affect countries whether members of the IF or not. It also attempts to discuss what developing countries can adjust or change in their domestic legislation to minimize the Pillar 2 impact on their tax and revenue collection in the extractive industries. The Subcommittee seeks the Committee's views on the possibility that a paper of the type attached - addressing the OECD /IF's Pillar 2 potential impact in the extractive industries - would be released, once finalized, as Committee guidance on the issues arising.

11. Another section addresses the difficulties of the application of Pillar 2 for countries which have signed a "stability clause" in the extractive contracts for their mineral resources. The section will also explore the role that the international community could play in the renegotiation of such contracts.

12. The Subcommittee on Taxation of Extractive Industries discussed the difficulties countries may encounter in trying to renegotiate extraction contracts containing the "stability agreement" so as to limit loss of tax revenue if and when the Pillar 2 comes into force across countries.

13. The implementation of Pillar 2 provisions continues to evolve, and the Subcommittee on Taxation of Extractive Industries will continue to follow and monitor the situation so as to be able give an informed view of how the situation stands at any given moment and the likely corresponding impact, particularly on developing countries endowed in natural resources.

4. Trade mispricing and product content

14. The goal of this workstream has been to produce a report, which would be useful to developing-country tax administrations in developing and improving "best practices" for the complex process of auditing taxpayers' valuations of mineral product extracted for export. It has been anticipated that the report would primarily address technical elements of product valuation, including, for example, the proper use of index prices where they are available, as well as necessary adjustments to the index price for items like product quality, transport costs,

and contract duration. It should be noted that index prices are not available for some products like gemstones, for which valuation must rely heavily on item-by-item appraisal, or for some bulk-traded minerals, including lithium.

15. The Subcommittee on Taxation of Extractive Industries intends to do a review of the literature and then draft a compendium of 4 to 5 country studies: 2 developed and 3 developing countries. The cases will serve as examples of how countries (developed and developing) can go about improving or building their tax system in extractive industries to curb loss of tax revenue incurred due inefficient practices in pricing and valuation of content of extractive resources.

16. A meeting with officials of the Australian Tax Office (ATO) was very informative on several centrally important points:

- a. There are two basic approaches to audits of natural resource exporters; (i) valuation of the commodity being produced, and (ii) examination of the profitability of the “marketing hubs” that taxpayers usually establish in low-tax countries, which serve as conduits of product from the producing entity to unrelated purchasers.
- b. With respect to the first approach, many good written discussions are available of the technical aspects of direct product valuation. These include reports of the Intergovernmental Forum (IGF), the OECD, and the IMF. An recent treatment is the discussion of the “Sixth Method” in chapter 10 of the recent report of the IGF and the African Tax Administration Forum (ATAF) on the future of natural resource taxation (<https://www.igfmining.org/financial-benefits/the-future-of-resource-taxation/>); this report provides very useful information on the use (and potential mis-use) of index prices in natural-resource examinations. Another useful publication is Africa Centre for Energy Policy (with support from ATAF and IGF), “Improving the Monitoring of Quarry Production with Remote Monitoring Technologies” (Consultative Draft 2022), <https://storage.googleapis.com/stateless-acep-africa/2022/11/improving-the-monitoring-of-quarry-production-with-remote-monitoring-technologies.pdf>

17. The second approach focuses on the profitability of the low-tax “marketing hubs,” which typically purchase products from the mining company and then sell the product to unrelated customers. Focusing on the marketing hub generally requires less technical analysis than the attempt to directly value the product, but review of the marketing hub’s profitability generally requires access to sales contracts and other information that are in the custody of group members outside the country of the producing entity. Often, taxpayers may resist providing the out-of-country documentation, citing confidentiality concerns or administrative difficulties. This is a problem especially when the taxpayer group is headquartered outside the country in which the examination is conducted.

18. The Subcommittee on Taxation of Extractive Industries will use the materials above and information on the profitability of “marketing hubs” to better assess the existing information on country studies to be completed with meetings from tax officials in the selected countries. Some organizations such as OECD/UNDP Tax Inspectors Without Borders (TIWB), IGF, and possibly ATAF, will also be contacted.

1. Energy transition

19. The work on energy transition is divided into three main parts. The first part concerns the energy transition challenges especially the financing and de-risking investments in new technologies. The drafting team has started drafting this part in 4 different sections. The drafting group is working on the strengths and challenges for energy transition in a number of countries.

20. The second part will deal with some technical tax issues in relation to energy transition; tax regimes, direct and indirect taxes, as well as cross-border taxation will be the main focus. Finally, the last part will be devoted to recommendations regarding tax design and tax administration concerning energy transition.

Program of work April 2023 - April 2025

Dates/workstream	Energy Transition	Trade Mispricing	PE and UN Model	Tax Incentives
March 2023				
October 2023			1 st read	1 st read
April 2024	1 st read	1 st read ¹	2 nd read	2 nd read
October 2024	2 nd read	2 nd read		
April 2025				

¹ A change from the previous program of work presented in March 2023 at the Twenty-sixth Session.