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IGF / OECD

Consultation Draft

IGF-OECD Program to address BEPS in Mining

The Hidden Cost of Tax Incentives in Mining

Subject: Comments on the Consultation Draft on The Hidden Cost of Tax Incentives in Mining

To whom it may concern:

The purpose of this letter is to present the Transfer Pricing Economists for Development (TPED)'s comments after the release by IGF/OECD of the Draft on the Hidden Cost of Tax Incentives in Mining ("the Draft" or "the Draft Report").

TPED is a Paris-based Association aiming to promote the development and sharing of business economics knowledge in transfer pricing as an enabler of development of emerging economies and developing countries.

In line with TPED's focus, our comments focus on the economic aspects of the Draft distinguished from, but in support of, the tax and legal considerations, which have been duly taken into account.

Given the limited amount of time allowed for more elaborated responses and comments, we have listed a number of points of attention, without necessarily elaborating them, which we would be happy to do if requested by the OECD/IGF.

We first provide some **general comments** on the Draft. We then expand on two aspects of the document: 1. **Reasons not to grant income tax holidays**; 2. **Management fees**.

1. General Comments

Overall, the Draft is useful and we hope it will help developing countries' governments to apprehend how important it is to assess the cost of tax holidays/incentives before granting them

so as to also make them consistent with their development needs: enhance access to education, develop modern hospitals and other medical facilities, build infrastructures etc.

We also compliment the authors for the detailed and clear articulation of the various concepts, definitions and the efforts to articulate such concepts and definitions together with examples. This allows a good and comprehensive read for the readers.

We encourage the authors to consider the following aspects in the next version of the Draft:

1. Tax holidays/incentives should be analyzed in the **broader frame** of the discussion on how developing countries, among which African countries, are going to organize their tax transition. This would be particularly relevant in the current context where their traditional revenue/income stemming from customs duties and other entry rights and duties, tends to be capped by the various customs agreements they are entering into at the regional/international levels.
2. Tax holidays/incentives should definitely pass the Effectiveness and Efficiency tests mentioned in the Draft. We would however like to point out that these Effectiveness and Efficiency tests should be run **both at the national level and the local level**. This is recommended given that any single investment implemented in a given country, whether or not in the mining sector, will impact, positively or negatively, the country but also a given local community, from an environmental, infrastructural etc. perspective. This is particularly true in the mining sector when it comes to negative impact on environment for example or improvement of transportation infrastructures.
3. **Tax holidays and tax incentives are not the same.** The Draft offers a broad generalization between tax incentives and tax holidays. Tax incentives may have a rationale for emerging and developing economies insofar as they have a clear (and limited) duration. The two should be distinguished, as they are conceptually different. In particular, we would encourage the adoption of a more neutral language in explaining to government officials the advantages and disadvantages of devising a tax policy which includes tax incentives as key features. In this respect, it is rather odd that in the description of tax incentives (see Step 1, at page 11) tax holidays are deemed as a special form of “tax incentives”, while we believe they should be kept separate. Moreover, ordinary features of any income tax system, which want to stimulate e.g. manufacturing activities, include measures such as “accelerated depreciation”, which are in the Draft presented with a negative tone.
4. **Transfer pricing is presented as abuse tax planning, almost by definition.** The Draft generally depicts Transfer Pricing as an abusive tax planning practice, and notes that such a phenomenon is strongly exacerbated by the existence of tax incentives. In our opinion, transfer pricing is necessitated by the fact that *operationally* local mining companies have access to foreign products, services and sometimes intangibles to operate their local business not only from external parties but also intra-group; so it is an operational must-have in the first instance. Only if such products, services, and intangibles are mis-priced, then this qualifies as base erosion. By associating transfer pricing and transfer mis-pricing, the Draft encourages local tax authorities, where mining activities take place, to exclusively

rely on transfer pricing measures to limit abusive phenomena, and discourage them from devising a comprehensive tax system. For instance, we do not understand the reference made at page 14, paragraph 1.1. b) of “abusive transfer pricing” when referring to tax holidays. The two concepts have to be differentiated and they are not limited to the mining sector only.

2. Reasons not to grant tax holidays

In the section of the report relating to *More reasons not to grant income tax holidays*, Table 3 indicates that *Mining is location specific*. The Draft seems to suggest that investors in any case have no choice but investing in a specific mine in a specific country. This location-specific characteristics is obvious (contrarily to other assets, such as intangibles) but oversees that investors are generally mobile and they may do arbitrage between various countries, notably for those minerals (most of them actually) that are present in not only one country. In addition, as further elaborated below, investors may simply not invest at all in a specific mine / in a specific mineral if the project is not expected to be profitable enough (see the discussion below on internal rate of return (IRR) and weighted average cost of capital (WACC)).

In the same section, Table 3 indicates that *Tax holidays have no impact on the cost of investing*. The explanation provided is that:

“Tax holidays are only relevant once a mine is profitable, and in a tax paying position, which may be years after the decision to invest”.

Tax holidays have an impact on the cost of investing.

Investors look at the IRR of investments. IRR is a cash flow measure directly impacted by all taxes involved – either withholding taxes, customs, or income taxes. The larger the tax holidays the higher the IRR of the project. Depending on the nature and timing of the tax holidays/incentives, the impact on the IRR will be greater or smaller. Investors generally have IRR thresholds (hurdle rates) to invest in a project, and compare the IRR of a specific project with their post- tax WACC. We also note that these projects typically involve, in the first years, a high probability of failure, and ultimately sunk costs and lost time and investments for investors, which makes tax holidays/incentives during this uncertain period even more welcomed.

Many countries, which have implemented favorable tax regimes for mining companies, usually have general tax codes and may enter into mining agreements providing for the following favorable tax provisions [non-exhaustive list]:

- exemption for a limited period of time of VAT on imports of specific equipment;

- exemption of customs duties on imports of equipment;
- import of equipment under the temporary admission regime;
- exemption of personal income taxes and/or payroll taxes due on remuneration paid to expatriates working on the project during the exploration phase, and as the case may be reduced tax rates during the exploitation phase.

Above are examples of particular tax holidays having a direct impact on mining companies' mobilization costs, either for their equipment shipped to the country where the mine is located or for the personnel to be assigned to the project. So tax holidays impact the cost of funding even during the first years of investments and when the mine is loss-making.

Assessing whether mining investors should benefit from tax holidays should, according to us, not be driven by the investor's needs or impact of tax holidays on their business only. This should rather be driven by the necessity and the cost of the investment, analyzed at both national and local government levels, with global Effectiveness and Efficiency tests run to achieve both national and local governments' objectives. In this respect, we recommend governments behaving like investors assessing their "return" from tax holidays (both financially, socially etc.) and having a holistic approach over the life time of a project.

3. Management fees as low-value services (page 20)

From our experience dealing with African governments, the reluctance to adopt the OECD low value-added services recommendation is that it is not always clear where the line lies. It is a sort of grey area for most tax authorities and accepting this generalization (of low-value services) is not feasible mainly due to information asymmetry. The taxpayer always knows more and has more information on the transaction at hand. Services may indeed qualify as low value adding but some of them may also qualify as core services. In some instances, services might not at all be needed in the first place if the services are already available in the local company ('duplicate' services). Although the information asymmetry limitation also greatly impacts the application of the benefit test, most administrations would be willing to struggle with this latter problem than the risk that high costs would be deducted in their jurisdiction without justification and in turn lose much needed tax revenues due to high deductions for costs that are not clearly defined or proved. In our experience, benefit tests prepared by the taxpayer should allow the tax administrations to confirm the reality and the value of such services - whether low or high value. We use this opportunity to recommend more guidance by the OECD on the benefit test matter.

Finally, we note that some services are sometimes rendered in parallel to the access of intangibles (such as specific know-how, knowledge, proprietary techniques etc.) which involve

a higher value, that a third-party would be willing to pay at arm's length, that may involve other transfer pricing methods, than cost plus. Specific services (core business) may also justify different remuneration schemes than the cost plus.

We thank you again for the opportunity of providing comments and remain at your disposal for further comments.

Best regards

On behalf of TPED¹

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