International Tax Issues for the Resources Sector

Peter Mullins

September 19, 2008

This presentation was prepared for the IMF conference on *Taxing Natural Resources: New Challenges, New Perspectives*, September 25-27, 2008. It is work in progress: please do not cite without permission. Views expressed here should not be attributed to the International Monetary Fund, its Executive Board, or its management.

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September 26, 2008

IMF Conference:
Taxing Natural Resources: New Challenges and New Perspectives

Why important?

Many investors in the resources sector likely to be foreign investors

…therefore governments need to consider international tax issues to ensure:

- The resource regime is competitive and attractive to foreign investors; and
- The state obtains an appropriate share of the economic rents from the natural resource

Key issues

- Double taxation/foreign tax credits
- Double tax treaties
- Transfer pricing
- Other tax design issues
- International trends in corporate tax

Double taxation/Foreign tax credits

- Source country (i.e., country in which profits are derived) usually has the first right of tax on resource profits
- Residence country (i.e., country in which taxpayer resides) may also tax profits but will usually provide relief to prevent double tax - two broad choices:
  - ***Worldwide basis*** - tax income from all sources and allow relief for foreign tax paid, usually by way of a credit (e.g., Japan, UK, US)
  - ***Territorial basis*** - exempt foreign source income (e..g., France, Germany, Canada)

Key for source country is to ensure its resource taxes (such as resource rent taxes or production sharing contracts) are creditable in the investors' residence country

…will depend on the law in the residence country, but a tax which in nature closely resembles a tax in the residence country is likely to qualify for a credit (e.g., Australia, Canada, UK, and US will recognize resource taxes with restrictions or under a double tax treaty (DTT))

For clarity specifically refer to such taxes in the double tax agreements (e.g., see Australian and UK DTTs)

Double tax treaties

DTTs have an important role in determining taxing rights of the source country as well as avoiding double tax

Use of DTTs in resource rich countries varies (e.g., for developing countries, Kazakhstan has 39 treaties but Venezuela less than 10)

DTTs for resource rich countries often contain resource specific clauses, usually to protect source taxing rights, including:

- Expanded definition of permanent establishment (PE) to cover exploration and exploitation activities
- General definition of a PE to include a mine, gas or oil well, quarry or any other place of extraction of natural resources
- Specifically mentioning resource taxes as being subject to the DTT
- Treating payments for rights to work natural resources as income from immovable property and hence taxed in the source country

DTTs also set withholding tax rates

... danger for a resource rich country if it has significant variation in withholding tax rates (such as for royalties) is that investors in negotiating resource agreements may seek to force lowest withholding rate under DTTs

Transfer pricing rules

A key concern for governments to protect the revenue base

Also a key concern for investors who want certainty of the tax treatment of cross-border transactions

What is transfer pricing? The misstatement of values and prices between related parties so as to shift profits to the taxpayer or jurisdiction which give the best tax outcome

- Transfer pricing rules aim to prevent income being shifted offshore through non-arm’s length pricing
  - Rules ensure profits for tax purposes are not derived in low tax jurisdictions/taxpayers

  …and ensure appropriate allocation of global income amongst jurisdictions
    - Minimise conflict between jurisdictions

Key principle: **Arm's length principle** (that is, transfer price set on the basis of what truly independent parties would reasonably have expected to pay)

- As a minimum each country should have an arm's length rule
- However, while world market price for tangible product flows in the resources sector may be available, not so clear for intangibles and services

Options to overcome uncertainties:

- Develop clear sequence of alternative transfer pricing methods
  - e.g., OECD transfer pricing guidelines which set out a sequence of acceptable methods for setting transfer prices
- Advance-pricing agreements
  - guarantees corporations advance approval of transfer pricing methodologies
- International co-operation through exchange of information

Other anti-avoidance rules

- **Thin capitalization**
  - Prevent profits being shifted offshore through a corporation being funded by a high level of debt and low equity
  - Rules may deny all or part of interest deduction based on substance of arrangement (i.e, debt or equity) or if level of debt to equity exceeds a fixed ratio (many countries apply a 3:1 ratio)
- **Controlled foreign corporation rules**
  - Prevent accumulation of income in controlled non-resident entities, especially in low tax countries
  - Usually only apply to passive income but this can include resource activities in some countries (e.g., US Subpart F rules)

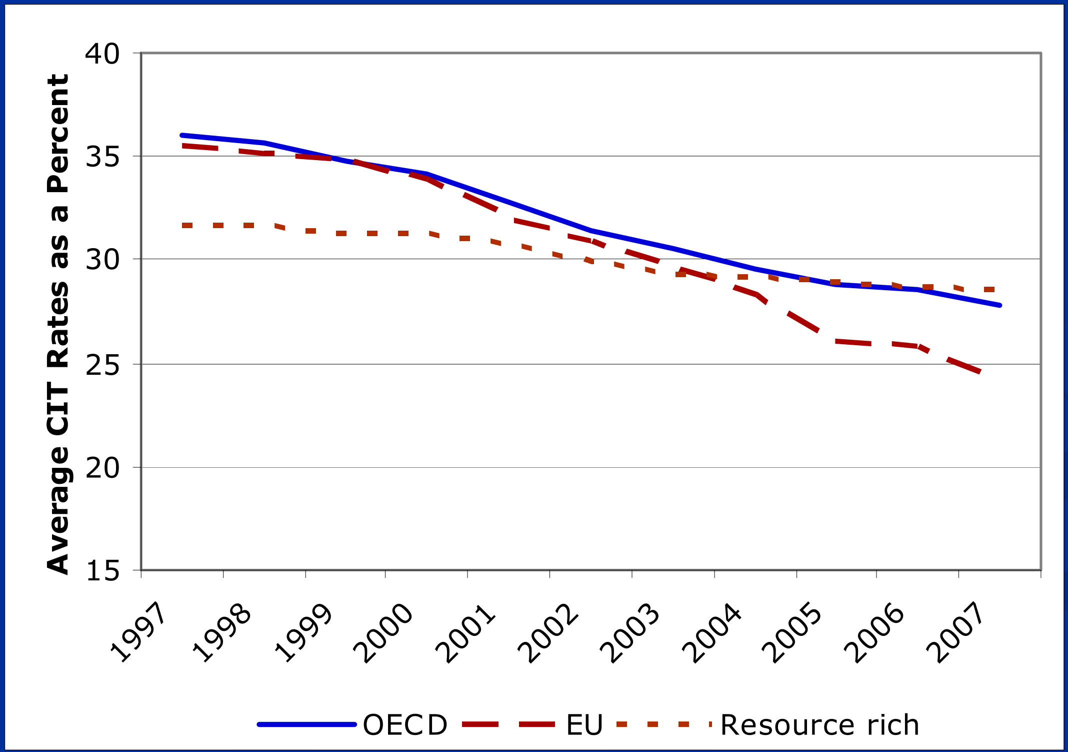
Other Tax Design Issues

- **Corporate reorganization rules**
  - Tax rules should not discourage such reorganizations (including in the resources sector) – tax rules should provide for tax neutral reorganizations
- **Special zones**
  - Are prone to abuse and may distort competition in the domestic market
  - If to apply, limit to indirect taxes
- **Labor taxes**
  - Sometimes resource sector expatriate employees are exempt to attract workers
  - Raises equity issues and could inhibit development of local expertise

- **VAT**
  - VAT refunds can be a problem for the resources sector as most of the output is likely to be exported (and hence zero-rated) and there are often significant costly imported capital goods
  - Many countries offer an exemption for such goods … while not preferred (because of potential for abuse, pro-import bias, administration complexities and revenue cost), if an exemption is to be offered it should be limited to capital goods specific to the sector and preferably not available in the domestic market
- **Export Taxes**
  - Preference is to remove export taxes and develop an appropriate domestic tax on resource rents

International corporate tax trends

1. **Tax competition**
   - Resource rich countries have reduced CIT rates, but possibly to a lesser extent than other countries



- Reasons for lower decline in rates:
  - Possibly less concerned about mobile capital due to natural resources being location specific
  - Non-CIT taxes on the resources sector may be more important so less need to compete
- Despite lower rates, revenues in resource rich countries have remained stable
- In the future, resource rent taxes can provide an alternative source of revenue to offset potential negative revenue effects of tax competition

2. **New CIT Regimes**

- Allowance for corporate equity (deduction for notional interest rate on equity)
- Zero-rate CIT on retained profits
- Restrictions on interest deductibility (e.g., Germany and Denmark)

Purpose of new regimes include:

- more neutral treatment of debt and equity - may have less impact on the resources sector than other sectors due to the apparent lower use of debt by resources companies
- move towards taxation of rents - a topic of interest to policymakers concerned with the resources sector