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Base Erosion and Profit Shifting in the Extractive Industries *

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1. Introduction

Natural resources have a critical role for attaining sustainable development. By harnessing the profits generated from their extraction, governments can increase their revenues for financing public goods and social services. As per the World Bank, almost 3.5 billion people live in countries rich in oil, gas or minerals. Africa alone has 30% of the world's mineral reserves, 10% of the world's oil, and 8% of the world's natural gas[1]. While the benefits of rents deriving from the extraction of natural resources should allow resource rich countries to achieve high rates of economic development, many countries, especially those located in the South, are still counted among the least developed, despite having large amounts of viable natural resources.

Extractive industries and natural resources are intricately linked with the development of countries and indeed their very sovereignty. The United Nations (UN) General Assembly Resolution on 'Permanent sovereignty over natural resources'[2] was explicit in its recognition that "The right of peoples and nations to permanent sovereignty over

Abstract

Developing countries with significant natural resources have not fully utilised them for financing their development aspirations. Extractive industries and the revenue generated from their extractive activities need to constitute a larger share of domestic resource mobilisation. However, the sector remains beset with massive tax base erosion and profit shifting by large multinational companies. This policy brief therefore looks at the extractive industries, and the potential impact of their practices on the national policies and regulations in developing countries. It further also considers some current initiatives at the international level for enabling countries to obtain more revenue from natural resource extraction, and offers some observations on the policy options available to developing countries.

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Les pays en développement disposant d'importantes ressources naturelles ne les ont pas pleinement utilisées pour financer leurs aspirations en matière de développement. Les industries extractives et les revenus générés par leurs activités d'extraction doivent constituer une part plus importante de la mobilisation des ressources nationales. Toutefois, le secteur reste en proie à une érosion massive de la base d'imposition et à un transfert de bénéfices par les grandes entreprises multinationales. La présente note de synthèse examine ainsi les industries extractives et l'impact potentiel de leurs pratiques sur les politiques et réglementations nationales des pays en développement. Elle examine également certaines initiatives actuelles au niveau international visant à permettre aux pays d'obtenir davantage de revenus de l'extraction des ressources naturelles, et présente quelques observations sur les options politiques qui s'offrent aux pays en développement.

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Los países en desarrollo con importantes recursos naturales no los han utilizado plenamente para financiar sus aspiraciones de desarrollo. Las industrias extractivas y los ingresos generados por sus actividades de extracción deben constituir un elemento más importante para la movilización de recursos internos. Sin embargo, el sector sigue siendo afectado por la erosión masiva de la base impositiva y la transferencia de los beneficios por parte de las grandes empresas multinacionales. Por lo tanto, en este informe de políticas se examina el sector de las industrias extractivas y el posible impacto de sus prácticas en las políticas y regulación nacionales de los países en desarrollo. También se examinan algunas iniciativas actuales a nivel internacional para que los países puedan obtener más ingresos de la extracción de recursos naturales, y se ofrecen algunas observaciones sobre las opciones de política de que disponen los países en desarrollo.

* This policy brief considers some elements previously addressed in Manuel F. Montes, Daniel Uribe and Danish, *Stemming 'Commercial' Illicit Financial Flows & Developing Country Innovations in the Global Tax Reform Agenda*, Research Paper 87 (South Centre, November 2018). Available from https://www.southcentre.int/research-paper-87-november-2018/.

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their natural wealth and resources must be exercised in the interest of their national development and of the well-being of the people of the State concerned." However, it was also cognizant of the dynamics that accompany the use of natural resources, noting in its second paragraph that "The exploration, development and disposition of such resources, as well as the import of the foreign capital required for these purposes, should be in conformity with the rules and conditions which the peoples and nations freely consider to be necessary or desirable with regard to the authorization, restriction or prohibition of such activities."

Extractive industries can therefore have an important impact in the achievement of the 2030 Agenda for Sustainable Development and the Sustainable Development Goals (SDGs) by reducing inequalities through the creation and mobilization of resources through taxes, royalties and dividends[3]. The Addis Ababa Action Agenda (Addis Agenda) not only recognised extractive industries as a resource for financing for development in developing countries, but also encouraged countries to ensure corporate transparency and accountability in the extractive sector. It further recognised the need to limit excessive tax incentives; continue international tax cooperation through the sharing of best practices; and promote peer learning and capacity-building activities[4]. Similarly, during the 'Second Annual Developing Country Forum for Cooperation in International Tax Matters' organized by the South Centre, there were calls to consider the long term nature of contracts in the extractive sector and in particular, refraining from limiting State sovereignty and to retain control over the impact of these activities, which will require designing fiscal policies that support economic growth, while also addressing problems arising from commodity price volatility[5].

Many countries have been unable to fully realize the revenues generated by natural resource extraction for a wide variety of reasons, which include issues such as limited administrative capacities, as well as legal and policy constraints. Another major factor is the behaviour of the enterprises involved in extractive activities. Since exploration and production are extremely capital intensive and highly volatile businesses, heavily dependent on international commodity prices[6], and require significant technical expertise, large scale extraction of natural resources is generally undertaken by large multinational enterprises (MNEs) and some state owned companies. The preponderance of MNEs in the extractive sector gives rise to its own unique set of challenges, which includes the heightened risk of base erosion and profit shifting activities which reduce the tax base and revenues of countries where these MNEs operate.

The well-known "resource curse" highlights that the generation of natural resource wealth is independent from other economic processes, but highly dependent on the interest and expertise of the private sector, and that resource-rich States have developed their economies and institutions on the basis of resource extraction. This ´resource dependence´ produces "further decay in critical arenas such as non-mineral–based revenue raising, expenditure patterns, fiscal accountability, and citizen participation."[7] Therefore, developing countries need to build strong institutions to face the various challenges in their dealings with MNEs operating in the extractive sector.

This brief is divided into 4 parts. After the introduction, Part 2 provides an overview of extractive industries and the commonly found tax base erosion and profit shifting activities in the sector. Part 3 looks at some of the practices of MNEs operating in the extractive industries, and their possible impacts on the national development plans, policies and regulations in developing countries. Part 4 looks at some of the current initiatives at the international level for enabling countries to obtain more revenue from natural resource extraction. The concluding part offers some observations on the options available to developing countries.

2. Base Erosion and Profit Shifting in the Extractive Sector

2.1 What are Extractive Industries?

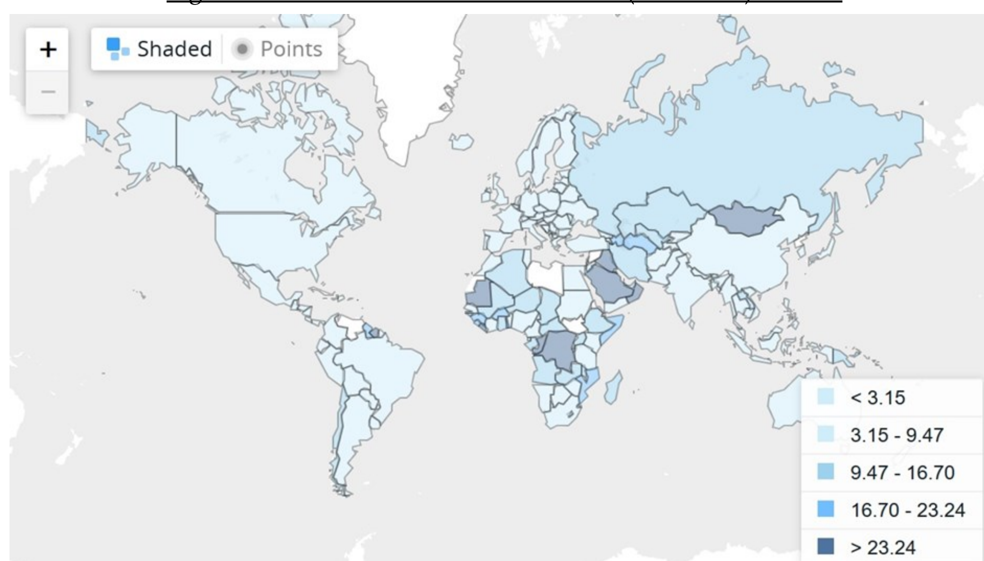
Extractive industries are entities engaged in activities of exploration, production, refining and marketing of non-renewable natural resources such as crude oil, natural gas and mining products[8]. In large scale mining, the extractive process is generally divided into *upstream* and *downstream* activities. The *upstream* activities relate to the exploration and production phases, which are the beginning stages of the life cycle of operations. The *downstream* activities correspond to a set of services related to transportation, refining, storage, distribution and marketing of these resources.[9]

The profits from the extraction and sale of those resources, commonly referred to as 'natural resource rents', can be quite large, and they form a significant part of the gross domestic product (GDP) of many countries (see Figure 1). As these activities are an important revenue base in many developing and least developed countries, the development of extractive industries can be a substantial factor contributing to sustainable development and therefore, they must design appropriate tax regimes that ensure a balance between sustainable economic growth and attracting foreign investment[10].

2.2 What is Base Erosion and Profit Shifting?

According to the UN, base erosion and profit shifting (BEPS) refers to "tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations, with the effect of reducing tax revenues available to governments for investment in sustainable development."[12] The abuse of tax planning strategies through BEPS generates a number of fiscal impacts, in particular increasing revenue loss from corporate income tax. According to estimates, the net revenue loss because of these practices is estimated to amount to be-

Figure 1 - Total Natural Resources Rents (% of GDP) - 2016[11]



Source: World Bank

tween US$100 billion and US$240 billion annually (in 2014 figures)[13].

The purpose of those corporate strategies is to use "regulatory arbitrage" to artificially shift profits to jurisdictions which apply little to no taxes, and where there is little or no economic activity being undertaken by the entity.[14] Corporate entities can therefore exploit the mismatches and gaps that exist between the tax rules of different jurisdictions, to minimise the taxes that they have to pay, either by making tax profits "disappear" or by shifting profits to low tax jurisdictions where there is little or no genuine economic activity. This means that they end up paying little to no taxes in the countries where their profits are being made.[15]

The idea of acting against BEPS gained significant traction with the endorsement of the Organisation for Economic Co-operation and Development Action Plan on Base Erosion and Profit Shifting (OECD BEPS Action Plan) by the Group of Twenty (G20) leaders in Saint Petersburg in September 2013[16]. Subsequently, in 2015, the G20/OECD Project on Base Erosion and Profit Shifting (BEPS Project) came out with its 15 Action Points comprising the 'OECD BEPS Package'.

Since its inception, the OECD BEPS project has failed to explicitly address base erosion and profit shifting in the extractive industries as part of its 15 Actions. However, some limited work such as the development of practice notes on the subject has been carried out by the OECD in cooperation with the Intergovernmental Forum on Mining, Minerals, Metals and Sustainable Development (IGF)[17].

3. Abusive Tax Planning and National Development Challenges

Developing countries have faced common challenges in harnessing the revenue potential of their natural resource extraction, as there are a number of mechanisms used by enterprises in the extractive sector to excessively reduce their tax liabilities. Some problems they have faced are related to transfer pricing methods, undervaluation, tax incentives, and tax stabilization strategies, among others.

The United Nations Committee of Experts on International Cooperation in Tax Matters (UN Committee) has identified some tax base erosion activities commonly encountered by developing countries while taxing extractive industries[18], which *inter alia* include:

- **fragmentation of the supply chain** allowing international companies to allocate profits to procurement and hedging companies;
- the **splitting of transactions** creating complex structures which allow the use of intermediaries for dividing functions and risk, and shifting profits;
- **thin capitalization** by indebting the subsidiaries to reduce its equity capital allowing for the allocation of tax deductions;
- **intra-group charges** allocating service fees to other companies in the corporate groups, generally located in low-tax jurisdictions, thereby reducing the taxable profit in the host State; and
- the use of **offshore marketing companies** to shift profits out of the countries where they are generated.

Other issues are raised by the various mechanisms used for the valuation of the exported resources as the pricing of minerals, oil and gas is not always straight forward, and variations of prices can and do exist during the different stages of production, refining, transporting and marketing; and will normally also consider the quality or grade of the product, as well as deductions for transport and insurance costs[19]. Similarly, splitting of transactions would also affect the value of the resources considering the different points in time where the sales price is set for

an intermediary, and the sales price charged by the intermediary to the end consumer.

In addition, the International Monetary Fund (IMF) notes that in the case of extractive industries, taxation potentially affects decisions at all stages, i.e. exploration, development and production, in complex ways[20]. While there is "no intrinsic reason for effective and transparent administration of extractive industry fiscal regimes to be harder than for other industries"[21], countries can and do experience high revenue volatility from oil and minerals[22] which requires fiscal adjustments and systems for managing them. Therefore administration of tax regimes in the extractive sector is faced with persistent challenges in the form of complex tax rules and inefficient royalty administration, while many countries lack the resources necessary to recruit, train and retain staff with the required experience and expertise[23].

This view is also echoed by the United Nations Conference on Trade and Development (UNCTAD), noting the difficulty in optimizing a fiscal system for the extractive industries: "if taxation is too low, it can result in foregone tax revenue for the host country; if it is too high, it may suffocate the industry and provide little incentive for companies to invest."[24] Although, it is usually left to the country to decide upon the appropriate level of rent they can capture from exploitation of their resources, this task presents many difficult challenges.

The precise design of any fiscal system for the extractive industries will vary according to the needs and priorities of each State. Certain policy objectives might have implications on the fiscal regime, for example ensuring steady revenue; limiting exposure to the risk of volatile fiscal flows; ensuring international competitiveness; minimizing opportunities for tax evasion; and having administrative procedures in line with the institutional capacity of the tax authority.[25]

The specific issues regarding taxation of extractive industries, especially in developing countries, go much beyond what has been envisaged under the BEPS Project. For instance, capital gains taxation, decommissioning of sites, tax treaty issues, and value added taxation are all relevant considerations when designing and administering fiscal regimes for extractive industries[26], but have not been given sufficient consideration under the BEPS Project. The following sections therefore look at some of the more common issues afflicting revenue collection from the extractive industries, and their impacts on developing countries.

3.1 Abusive Tax Planning Practices in the Extractive Industries

MNEs tend to internationalise their operations in the search for cheaply available natural resources globally, which is known as 'resource-seeking' behaviour. In addition, MNEs also employ a range of tax planning measures which substantially reduce their tax obligations in the territory where the extraction is taking place, without being *per se* illegal. This can include routing their investments through territories with preferential tax regimes to splitting up of transactions and overpricing of intangibles. However, it is often difficult to differentiate 'aggressive tax planning' from 'abusive tax planning' (though some suggestions have focused on an "intent based approach" for determining what would fall in the latter category[27]).

There is a widespread global perception that MNEs in the extractive industries do not pay their fair share of taxes to the states where they exploit the natural resources. For instance, according to an article in *The Guardian*, there were claims that the Zambian subsidiary of a Swiss company, Glencore, held through a holding company in the British Virgin Islands, avoided paying up to £76m a year in tax on profits from its copper mine in Zambia[28]. Thus, there is a need for countries to be able to clearly delineate the activities that are contributing to the erosion of their tax base in the extractive industries in order to combat them better.

3.1.1 Transfer pricing issues

Usually, whenever any goods, services or intangibles are traded between the group companies of a MNE located in two different jurisdictions, a 'transfer price' has to be calculated for tax purposes, based on the 'arm's length principle' (ALP). According to the UN, "Where the pricing does not accord with internationally applicable norms or with the arm's length principle under domestic law, the tax administration may consider this to be "mispricing", "incorrect pricing", "unjustified pricing" or non-arm's length pricing, and issues of tax avoidance and evasion may potentially arise."[29]

For the OECD, "abusive transfer pricing occurs when income and expenses are improperly allocated for the purpose of reducing taxable income"[30]. Thus, by engaging in abusive transfer pricing, MNEs can significantly erode the tax base of home states and shift their profits from the extractive industries to low tax jurisdictions. This can also cause severe economic distortions, as "it can enable companies to report higher earnings to appease stock markets and maximize executive remuneration, but the loss of tax revenues curtails the ability of the state to provide public goods and alleviate poverty."[31] This issue is generally covered under Article 9 of the model tax conventions (UN and OECD), which utilise ALP for fixing a transfer price in international transactions. However, ALP may not be applicable in all circumstances; and as the OECD notes "there are some significant cases in which the arm's length principle is difficult and complicated to apply, for example, in MNE groups dealing in the integrated production of highly specialised goods, in unique intangibles, and/or in the provision of specialised services."[32]

An abusive transfer pricing normally entails the underpricing of a sale, or overpricing of a purchase to shift the profits from the host State jurisdiction to a lower tax jurisdiction.[33] The risks of transfer pricing in the extractive

industry will depend on the stage of the value chain in which a country is.[34] For example, in the exploration and development phase, an extractive industry normally requires high capital investment and hiring of professional services which contribute to the costs of related parties or intra-firm transactions.[35] Such costs could be inflated in order to reduce the revenues of the extractive industry in the host State jurisdiction while not reducing the profit of the corporate group.[36]

Similarly, the UN Committee has illustrated the issue of transfer pricing with the use of intermediary distribution companies (IDC) within the same corporate group, generally located in a non-tax or low tax jurisdiction. In such cases, the operating extractive company (OEC) uses an intermediary distribution company to sell the product to the end customer, setting the price of shipping in two different time periods. First, the OEC uses the Index price previous to the date of actual shipment to the IDC with the objective of setting a lower selling price in the country where the extractive operations are done. This will reduce their profit rates and therefore tax rate allocation is lower. Secondly, the IDC sets its sales price to end customer at the Index price in the month of actual shipment, although the transfer of the product is direct from the OEC to the end customer, which means increasing profits through higher prices (see Figure 2).

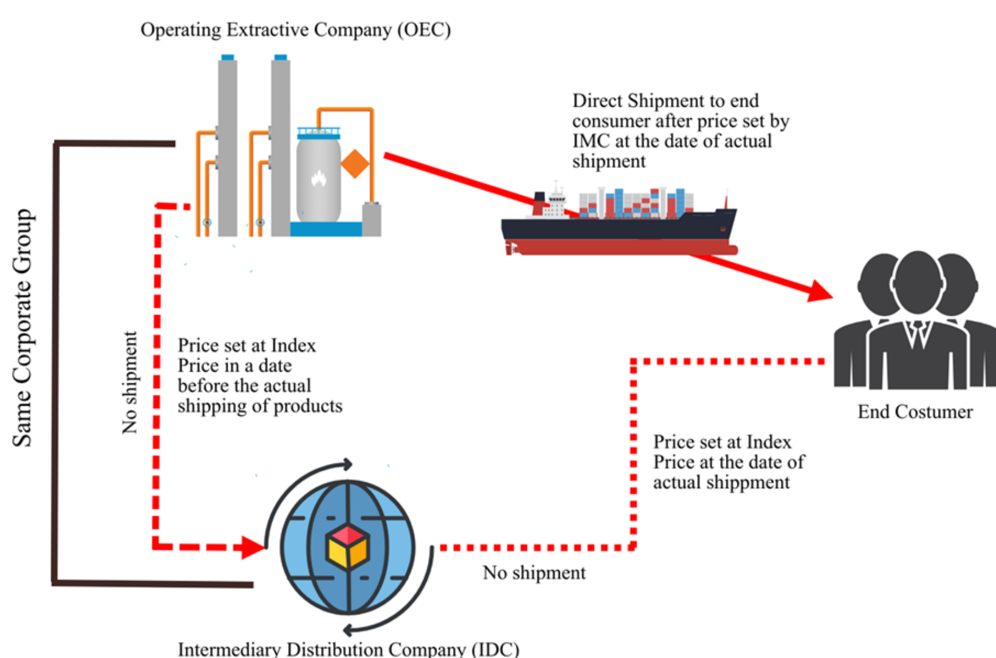
The relationship between the IDC and the OEC worsens the situation, given the fact that the IDC is a service provider (marketing and distribution), and therefore the OEC would be able not only to reduce its tax liability by setting a lower selling price, but also by using such costs as an expense to be deducted to reduce taxable profit. Similarly, as the taxable conduct in the case of the IDC is the provision of marketing and distribution services, setting Index price to such services is difficult and the ALP will only cover the transaction in the first tier of the commercial relationship.

3.1.2 Effects of double tax avoidance agreements (DTAAs)

The existence of multiple jurisdictions with simultaneous legitimate claims over the same source of taxable revenue is another source of pressure on the tax base of developing countries.[37] In conjunction with domestic laws, DTAAs are responsible for the allocation of taxing rights among their contracting parties. While this helps in preventing double taxation of the same income by two countries, recent experiences have shown that the abuse of such treaties frequently results in 'double non-taxation' instead[38]. Tax treaties have therefore come under severe criticism in recent years given that they were used by large MNEs to limit their tax liability in jurisdictions in which they operate.

DTAAs play a key role in extractive industries since the bulk of extracted commodities is generally exported to other countries. Given the large investments required to explore, initiate and maintain extractive operations, the possibility of abusing of intra-company debt shifting and deduction of interest charges is higher within a network of DTAAs. These treaties can include incentives such as "reduced dividend withholding tax; reduced interest withholding tax; crediting of income taxes paid by a home country taxable entity in the host country; and the recognition of deductions allowed in the host country as a valid deduction for host country crediting."[39] By opting for treaties providing the most preferential provisions and routing the investment through that contracting party (in a practice known as treaty-shopping), foreign investors and companies can substan-

Figure 2 – Example of Transfer Pricing through Intermediary



Source: The South Centre, based on the report prepared by the UN Committee of Experts on International Cooperation in Tax Matters on Transfer Pricing Issues in Extractive Industries, UN Doc. E/C.18/2017/CRP.9 (2017)

tially reduce their tax liabilities; especially if one of the parties is a preferential tax jurisdiction.

Therefore, while DTAAs could be important tools for tax competition among resource-rich countries, these treaties could also pose substantial risks for the attainment of policy objectives of host countries, particularly as they could limit their ability to gain from transactions like transfer of interests in mineral rights, payment of royalties and even managing fees. Similarly, DTAAs pose a limit to the exercise of taxing powers, which are an indispensable macroeconomic tool that governments use to regulate the economy of their country[40], not only because these treaties are difficult to change or terminate[41], but also because through the relationship of such treaties with other bilateral investment treaties or free trade agreements States could allow for tax measures to be scrutinized by international arbitral tribunals based on the rights granted to them through such international investment agreements.[42]

3.1.3 Indirect transfer of assets

Indirect transfer of assets can occur for avoiding capital gains tax by having the transfer of assets or interests in licenses or other exploration, extraction, and production facilities occur at the level of a company in a low or no-tax jurisdiction, rather than in the country where such assets or interests are located. By transferring the shares in a company owning the rights rather than engaging in a direct sale, the asset is said to be indirectly transferred. While vitally important to developing countries, this issue was not covered under the BEPS Project.

One of the ways that a government can gain revenue from extractive industry projects that will not generate a profit for years or even decades is to impose a tax on capital gains on the direct sale of local assets. However, if the assets are indirectly transferred, the country does not receive any revenues, as the 'sale' of the asset has been postponed. Thus "the longer the sale of the underlying asset is postponed, the lower in present value are country receipts (…) At six percent interest, for instance, a delay of ten years in receiving revenue of $1 billion reduces its present value by around $450 million."[43]

When such indirect transfers happen between offshore companies, there are also tax treaty implications. For treaties that contain Article 13(4) of the model conventions, they would allow for the "taxation of the entire gain attributable to the shares or comparable interests to which it applies even where part of the value of these shares or comparable interests is derived from property other than immovable property located in the source State."[44] However, the implementation of this would also depend on the domestic tax legislation of the State in question.

3.2 Challenges Faced by Developing Countries

The Addis Ababa Action Agenda clearly recognised that countries which rely significantly on natural resource exports face particular challenges. It therefore encouraged "investment in value addition and processing of natural resources and productive diversification, and commit(s) to addressing excessive tax incentives related to these investments, particularly in extractive industries."[45] This is of particular importance to those developing countries which are highly dependent on the export of commodities for raising revenues[46]. A recent UNCTAD report shows that more than half of all countries, and two-thirds of developing countries are commodity-dependent; with 102 out of 189 countries (54 per cent) being commodity-dependent in the period 2013–2017[47].

The commodity super-cycle of the early 2000s and the crash after the 2008 global financial crisis showed the effects of substantive commodity price fluctuations on national economies. The super-cycle also had significant effects on the fiscal regimes of countries which sought to take advantage of the high commodity prices by imposing increased royalties and rents from the extractive industries. These levies were however withdrawn in the aftermath of the crash, thus showing that "for commodity exporting countries, a downswing in the global commodity price super-cycle is usually associated with falling incomes, a decline in government revenues, currency depreciations, deteriorating current account balances, capital outflows and – last not least – rising borrowing costs."[48]

The reduction in the tax base is a vitally important issue for countries to tackle, since it directly affects their revenues. In the context of extractive industries, such tax base erosion can take place through several mechanisms, which usually involves the under-reporting of profits and over-reporting of costs. Other modalities can include the abuse of double tax treaties for shifting the profits outside the country. As this varies from country to country based on their specific national policies, legislations and treaties, it is important for States to conduct their own risk assessment for tax base erosion, which will help them identify the loopholes and risk areas for such activities.[49]

Thus, there are many challenges that developing countries must navigate in order to benefit from their natural resource wealth. The following section lists some illustrative challenges that are commonly faced by those countries.

3.2.1 Information and knowledge asymmetries

The primary step undertaken by MNEs for any potential projects is to assess their feasibility on a wide range of metrics using comprehensive financial models. MNEs also create extensive planning models for resource exploitation, which includes "specifically detailed technical information about the physical attributes of their resource and what is involved in producing it"[50].

Increasingly, developing countries are also adopting similar kinds of financial models, but gaps still persist.[51] This kind of modelling is extremely useful in the negotiation of contracts between the countries and the MNEs for the extraction activities. However, in cases where such information is not available to the States, it can lead to

them having a weaker negotiation position.

Another related element is the issue of transparency in the extractive industries. There have been global movements such as the Extractive Industries Transparency Initiative (EITI) and Publish What You Pay (PWYP) which seek to increase accountability and good governance in the extractive industry practices, particularly by making contracts public and having full disclosures about the payments involved, which can reduce the risks of bribery and corruption.

Furthermore, the requisite knowledge on the extractives industry encompasses not only technical knowledge about the operational processes, but also on how such corporations structure themselves and operate in the global context. Auditors and revenue authorities thus require extensive capacity building for tax auditing and knowledge of international law.[52]

In the case of mispricing and profit shifting in the extractive sector, another relevant factor is the lack of information on the cost of comparable transactions among non-related parties.[53] Even when the arms-length principle[54] should be applicable, revenue authorities face the challenge of identifying the prevailing market rate of the product sold or the cost of the service rendered, but revenue authorities will often depend on the comparable data from other sources rather than their own, and therefore is "time-consuming and expensive, and produces results that do not reflect the economic reality"[55] of companies operating in developing countries. For this, the domestic legal framework should clearly allow the tax authorities to request information and include an obligation of taxpayers to keep and provide such information when required.[56] Tax authorities also have other tools at their disposal to secure fair tax allocation of extractive industries when such information is not available. One such option is the establishment of rules allowing for presumptive taxation, by using the information available from other taxpayers in the sector as the indicative resale price or cost-plus method as benchmark rates, or establishing advance pricing agreement for any intra-firm transactions and limiting the total debt allowed for tax deductibility.

3.2.2 Contract negotiations

In the absence of legal and regulatory provisions governing profit sharing in the extractive sector, many countries utilise contractual arrangements between the investors and governments for the extraction of natural resources (see Figure 3).

One of these contractual arrangements is production sharing contracts which govern all aspects of the extraction process, including taxation, and also provide for the mode of allocation of profits between the investors and the State. Under these contracts, an agreed formula between the government and the investor is used to divide the revenue of production which is not allocated to the recovery of project costs.

A second type of contractual arrangement consists of risk service contracts in which the investors assume risk and invest capital in the exploration phase of the undertaking. If no resources are found, the costs are only covered by the investor, but if there is commercial discovery and production starts, the State must reimburse and remunerate the invested capital and services provided. Under this contract, the State keeps sole proprietorship of the resource and is solely responsible for its production.

The ability of host governments to effectively negotiate

Figure 3 – Examples of Contractual Arrangements in the Sector of Extractive Industries

Production Sharing Contract	The contract sets out the legal framework for conducting operations in a specified area.
	The investor bears all contractual risk and costs involved in the exploration phase and the production phase (the State can also participate through a joint venture).
	The investor is given the right of exploration and production, but the produced resource and revenue belongs to the State, but it 'shares' it with the investors trough an agreed allocation formula.
Risk Service Contract	The investor assumes the risk and invests capital in the exploration phase of the undertaking. These costs are only covered by the investor.
	If there is commercial discovery, the production is only dependent on the State and it must reimburse and remunerate the invested capital and services provided to the contractor.
	The State keeps sole proprietorship of the resource and is solely responsible for its production, assuming all the risks.

Source: The South Centre, based on Kirsten Bindemann, "Production-Sharing Agreements: An Economic Analysis", Oxford Institute for Energy Studies, WPM 25, October 1999 and Michael Likosky, "Contracting and regulatory issues in the oil and gas and metallic minerals industries", *Transnational Corporations*, Vol. 18, No. 1 (2009). Available from https://unctad.org/en/docs/diaeiia20097a1_en.pdf.

with MNEs in the extractive industries depends on a variety of factors, such as commodity prices on the international and futures markets, its perceived scarcity and the presence of viable alternative locations for the extraction of the same commodity.

In cases where the State has limited resources to negotiate the contract, this might lead to asymmetric agreements being signed, which would severely disadvantage the State and limit their revenues. A specific example is the inclusion of tax stabilisation clauses which provide for the freezing of the tax rate for a set number of years, or the prohibition of taxing windfall profits.

The relationship between these contracts and other international agreements is also an issue of concern, as countries have struggled with the effects of including tax stabilisation clauses in their agreements with extractive industry MNEs. For instance, Zambia had introduced a 25 percent mining windfall tax in April 2008, but was subsequently forced to withdraw it in January 2010 after "some foreign investors threatened to take legal action, accusing authorities of breaching agreements they signed with the mining companies that promised lower taxes."[57] Similarly in Ecuador, the imposition of a windfall levy on foreign oil revenues led to an international arbitration under a bilateral investment treaty by the petroleum company Burlington, which resulted in an award of $379.80 million against the country[58].

4. Multilateral Initiatives on Tax in Extractive Industries

At the multilateral level, discussions on extractive industries taxation are primarily located at the UN Tax Subcommittee on Extractive Industries Taxation Issues for Developing Countries. Created in October 2013, the Subcommittee is mandated to "consider, report on and propose draft guidance on extractive industries taxation issues for developing countries".[59]

The Subcommittee has produced several Guidance Notes on the tax treatments that can be adopted by countries in relation to extractive industries. It has also produced the 'Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries', which aims to provide developing country governments with a "basic outline of the challenges they will encounter when seeking to compute the administrative, fiscal, environmental and other related costs of exploring natural resources, without affecting the quality of life of the citizens or the environment."[60]

In cooperation with the Intergovernmental Forum on Mining, Minerals, Metals and Sustainable Development (IGF), the OECD has developed draft toolkits on the hidden costs of tax incentives in mining[61], and limiting the impact of excessive interest deductions on mining revenues[62]. Part of this work has also contributed to the toolkit produced by the Platform for Collaboration on Tax on 'Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses'.[63] Beyond the limited scope of BEPS Action 4, it seems unlikely that the OECD would give much focus to the issue.

The Bretton Woods Institutions are also quite active on extractive industries taxation, with the World Bank issuing sourcebooks for 'Understanding the Extractive Industries'[64] and on 'How to Improve Mining Tax Administration and Collection Frameworks'[65]. Similarly, the IMF has also produced research[66] and a handbook[67] on developing and administering fiscal regimes for extractive industries. It has also produced an edited volume on 'International Taxation and the Extractive Industries'. While these publications are useful tools, there still remains a huge gap between the provided recommendations and their implementation in developing countries.

5. Conclusions and Observations

To achieve sustainable development, it is essential that countries receive the fair share of revenue from the extraction and exploitation of their own natural resources. MNEs can play a key role in realizing this by not indulging in tax base eroding activities and paying their fair share. The Addis Agenda has also underlined the importance of corporate transparency and accountability of all companies, notably in the extractive industries.

At the national level, countries can adopt a range of legal, fiscal and regulatory measures which can help them raise revenues from the extractive industries and prevent the erosion of their tax base. Given the unique characteristics of the extractive sector, it is useful for countries to be able to formulate their policies to capture their benefits most effectively, in line with their national policy objectives.

The fiscal policy for extractive industries often consists of a combination of different fiscal instruments given the long-term nature and scope of these projects. These instruments can also be specifically tailored to the different production processes, being applicable both upstream and downstream. The UN also recommends that the fiscal policy should be predictable, based on a long-term perspective and with high level of simplicity and clarity which would help in its administration. While there is no 'one size fits all' approach in the case of fiscal regimes, in general terms these policy instruments should be based on consultations with the various stakeholders and contribute to the overall development objectives of the host country where the natural resources are being exploited.[68]

A comprehensive legal and policy regime for governing the extractive industries should be put in place. Developing countries need to identify their priority areas for sustainable development of their natural resources and create long term policy objectives which would guide their extraction over their entire life cycle.

For improving regulatory predictability, States could increase their reliance on specific laws and regulations for the extractive industries instead of negotiating individual production and profit-sharing contracts with MNEs. This

will enable the creation of common outcomes from natural resource exploitation, as well as improve transparency in the sector.

In addition, by ring fencing the extractive industries from the rest of the economy and designing dedicated fiscal regimes for their management, countries could develop frameworks for greater realization of the potential rents generated from such activities, and their use for sustainable development.

For administering transfer pricing rules more effectively, countries should ensure that beyond passing a law, they have passed regulations or administrative guidance to clarify documentation requirements and methods for determining an acceptable transfer price.[69]

Importantly, there needs to be extensive capacity building for strengthening the auditing capacity of national tax and revenue authorities in the context of extractive industries, which pose unique challenges. By enhancing their administrative capacities, countries will be able to tackle tax base erosion activities more efficiently. This needs to be accompanied by a concurrent capacity building in the judicial and executive domains to deal with the issues that might arise from increased auditing, such as more judicial disputes at the domestic levels; possible investment arbitration claims arising from international investment agreement at the international level; and mutual agreement procedures under DTAAs.

The UN Committee also recommends that countries, especially developing countries, establish administrative measures to enable the tax authorities to pre-screen transactions prior to the application of tax treaties. Such measures could work as a natural deterrent to some of the most frequent treaty abuse practices.

In the context of extractive industries, it is also important to explore the possible systems of taxation that can be used by developing countries, such as a progressive taxation and a unitary method of taxation. The use of progressive taxation can be used by governments particularly in the extractives industry. In cases where there are windfall profits from the investment, the government should be able to capture a fair share of the profits without the need to resort to measures such as windfall taxes[70], which also bring along risks of investment disputes under international investment agreements.

At the international level, developing countries should utilise the modality of South-South cooperation to share their good practices and promote peer learning and capacity-building. By increasing exchanges among the revenue authorities among developing countries, tax administrators can share their experiences and good practices regarding issues such as contract negotiations for fair and transparent concession, revenue and royalty agreements, auditing practices etc. and learn from other countries who have already dealt with similar issues.

Further, by enhancing their cooperation and actively participating in the exchange of information on tax issues, developing countries can increase tax-related transparency, especially in the context of global value chains, and know more accurately whether or not MNEs are paying their fair share of taxes.

Finally, developing countries should also engage more extensively with the UN Tax Committee, which is mandated to give “special attention to developing countries and countries with economies in transition”[71]. In addition to its functions of making recommendations on capacity-building and the provision of technical assistance, the Committee should be empowered by the UN Member States to act as a forum where all developing countries can participate as equal members and be part of the agenda setting, rather than being brought in only at the implementation stage.

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