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South Centre Comments on Amount A: Extractives Exclusion

I. Background

The South Centre is the intergovernmental organization of developing countries that helps developing countries to combine their efforts and expertise to promote their common interests in the international arena. The South Centre has 54 Member States coming from the three developing country regions of Africa, Asia, and Latin America and the Caribbean. It was established by an Intergovernmental Agreement which came into force on 31 July 1995. Its headquarters are in Geneva, Switzerland.

The South Centre in 2016 launched the South Centre Tax Initiative (SCTI). This is the organisation's flagship program for promoting South-South cooperation among developing countries in international tax matters.

The South Centre offers its comments to the OECD Inclusive Framework's Task Force on Digital Economy (TFDE) on the Amount A: Extractives Exclusion.

II. Specific Comments

i. Re-application of revenue and profitability thresholds

Paras 2-10 of the document outline the seven steps that must be followed to apply the Extractives Exclusion. Steps 2 and 3 call for the re-application of the revenue and profitability thresholds to in-scope revenues and profits after the exclusion of revenues and profits from Extractive Activities. This would determine if the MNE is still in-scope.

Thus, if an MNE has revenues of EUR 22 billion (and a profitability of 11%) and revenues from Extractive Activities of EUR 3 billion, as per Step 1 it will be in-scope. However, after applying Step 2 its in-scope revenue will be only EUR 19 billion (subtracting the EUR 3 billion revenue from Extractives) and so the MNE will be out of scope as per the application of the scope thresholds.

The 8 October 2021 political Statement (henceforth 'Statement') said the following regarding scope and extractives exclusion:

> "In-scope companies are the multinational enterprises (MNEs) with global turnover above 20 billion euros and profitability above 10% (i.e. profit before tax/revenue) calculated using an averaging mechanism with the turnover threshold to be reduced to 10 billion euros, contingent on successful

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implementation including of tax certainty on Amount A, with the relevant review beginning 7 years after the agreement comes into force, and the review being completed in no more than one year.

Extractives and Regulated Financial Services are excluded."

The understanding is that once an MNE passes the scope test, it remains in-scope, and only the revenues from extractives are deducted from the tax the MNE must pay, which is Amount A. It was not supposed to act as another filter to remove companies from the scope.

However, as per Steps 2 and 3, the process now seems to mean that the exclusion of extractives would not only mean less taxes paid, but also a reduced number of taxpayers.

The design of the Extractives Exclusion was meant to prevent developing countries, especially resource-rich countries, from losing source taxing rights. Thus, *only the revenues* from Extractives were to be removed from the scope of Amount A, not the company/taxpayer itself.

It is possible for an MNE to have revenues from many sources, with Extractives being only one of them. As mentioned in the example above, an MNE which 'predominantly' derives in-scope revenues (19 out of 22 billion being in-scope), and has only a small portion of out of scope revenues (3 out of 22 billion) will nevertheless be out-of-scope as per this approach.

This is a completely misleading interpretation of the Statement. What was meant to be a policy measure to protect the taxing rights of developing countries has been used against them, by turning the Extractives Exclusion into another filter that would reduce the number of in-scope companies, which finally means a smaller amount of taxes to be redistributed to the developing countries.

The initial estimate by the OECD was that around 100 of the world's largest and most profitable MNEs would be in-scope. Independent estimates state this figure may actually be around 64. Applying more filters will reduce it further, and eventually the number may even end up being half of what was originally envisaged.

This raises a serious question of whether such a massive effort is worth it to tax only around 50 companies, who will then pay a minimal amount of taxes to the developing countries. The cost of compliance alone for tax administrations may exceed the revenue gains.

Recommendation: Steps 2 and 3 should be removed. Once an MNE is in-scope, it should remain in-scope, and should proceed directly to Step 4.

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ii. Definition of Extractive Product

Para 18 defines an 'extractive product' and d) includes 'Exploration and Development Assets'. The footnote elaborates that the forthcoming Commentary will mean this includes "licenses granted by the State, by a private person that owns the natural resource, or the transfer or rights between two companies."

Revenues from the sales of extractive products will be excluded from scope and as per this definition it includes the sale of intangible property such as licenses and rights. As experience has shown, intangible property is more vulnerable to profit shifting and there have been cases of capital gains tax avoidance where tax havens have been used for offshore indirect transfer of such exploration and development assets.[1]

Recommendation: Safeguards are needed against tax avoidance schemes involving the sale of exploration and development assets.

iii. Definition of Qualifying Processing

This is defined as "processing undertaken to concentrate, isolate, purify, refine or liberate an Extractive Product as defined in paragraph 18a) from its natural state to produce a basic commodity."

A 'basic commodity' can be broadly interpreted, resulting in an unwarranted expansion of the Extractives Exclusion.

Recommendation: The term 'basic commodity' can be further elaborated or separately defined.

iv. Definition of Transportation

1) This is defined as the "physical movement and incidental storage of an Extractive Product to the delivery location to fulfil delivery terms set out in sales contracts and includes physical movement by airplane, automobile, helicopter, pipeline, ship, train, or truck."

[1] *Lamesa v. Commissioner of Taxation* in Australia. Page 161 of the UN Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries. https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2020-03/UN%20Handbook%20on%20Selected%20Issues%20for%20Taxation%20of%20the%20Extractive%20Industries%20by%20Developing%20Countries.pdf

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The attempt to exhaustively categorise may leave out some vehicle types used in developing countries, for example three-wheeler transport vehicles are used in many African, Asian and Latin American countries but may not fall into this definition.

Recommendation: A broader, open-ended definition is needed which will also be flexible enough to cover emerging modes of transport.

2) The footnote elaborates that the forthcoming Commentary will explain that where delivery is performed by the producer, the revenues earned for the transportation are included within the calculation of the extractive exclusion, notwithstanding that the Delineation Point may have been triggered.

This is problematic as it would mean revenues which actually should be in-scope of Amount A will be excluded. There is no rationale given as to why revenues beyond the Delineation Point should qualify for the exclusion.

Recommendation: As a matter of principle, no revenues beyond the Delineation Point should qualify for the exclusion.

v. Definition of Delineation Point

Para 27 b) states that revenues from intra-group transactions 'transferring' the Extractive Product from the State where Extraction takes place to another State will be within the Delineation Point. The term 'transfer' has been used to include transactions without a sales contract.

Such transactions may be more vulnerable to abuse and the absence of a sales contract may lead to audit difficulties.

Para 27 c) mentions the Internationally Recognised Reference Price.

Recommendation: The Commentary should develop safeguards to prevent 'index shopping', where MNEs may try to use those prices which will inflate the excluded revenues and hence shrink Amount A.

Para 27d) does not define 'market value' for the application of the deemed Revenue calculation.

Recommendation: The forthcoming draft Model Rules must define market value.

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vi. Initial Transition Period

Step 3 says work is underway "to consider whether an initial transition period is needed, while Groups adjust their systems to comply with the requirements."

The initial revenue threshold under consideration was EUR 750 million, which itself was seen as very high for many developing countries. Since it has now been raised to an astronomical EUR 20 billion to capture only the largest and most profitable MNEs, they should have no problem, given the huge resources at their disposal, to adapt to the compliance requirements.

Further, an initial transition period would mean yet another reason to delay and deny tax revenues to developing countries at a time when they are in sore need of it.

Recommendation: There must be no initial transition period.

vii. Cost Allocation

Step 3 takes the highly problematic approach of allocating the "unallocated costs" to in-scope revenues, both at the Disclosed Operating Segment and the Entity level. There is no rationale provided as to why unallocated costs should by default be allocated to in-scope revenues. This will reduce Amount A and the tax revenues for developing countries.

Recommendation: Unallocated costs should be allocated only to out of scope revenues.

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