STRENGTHENING EXTRACTIVE SECTOR MANAGEMENT IN MONGOLIA

Base Erosion Profit Shifting (B.E.P.S)

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17 -18 Janvier 2018

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Selected Topics

1. Excessive interest deductions
2. Abusive transfer pricing
3. Undervaluation of mineral exports
4. Indirect transfer of mining asset
5. Inadequate ring-fencing

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Overview

- Importance of the issue
- Examples of Transactions
- Political vs. Economics aspects
- Five Types of Transfer Transactions
- Not only an extractive industry issue

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Importance

- Became on the agenda of the overall G20/BEPS
- Huge transaction – Tullow vs. Heritage (1.5 B)
- Issues of Domestic Law and Bilateral Tax treaties
- Higher Profile in Extractive because of nature of resources sector

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Economic / Political

- Argument that efficiency in capital allocation requires ease and flexibility in corporate reorganisation
- If Resource right is obtained by bidding bonus, would capital gain tax be double-taxation ?
- Transfer price paid – tax deductible ?
- Not politically viable not to tax. Higher value is derived form resources value (rent)
- Effective taxation of gains may allow a shift in timing of receipts that addresses both concern.

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Examples of Transactions (1)

- Ghana--In 2011, Gold Field Ltd paid US$661 million to purchase the 18.9% interest held by AIMGOLD in two mining companies and reported in its books a US$403 million after-tax gain on the sale.
- Uganda—Heritage sold its Uganda interests to Tullow for US$1.45 billion; Tullow then sold two-thirds of its Uganda interests to CNOOC and Total for US$2.9 billion. Critical issue for Uganda is whether the gains realized by Heritage and Tullow are taxable

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Examples of Transactions (2)

- Papua New Guinea—Pacific Rubiales Energy agreed to acquire certain interests in PNG for an up-front payment of US$116 million and an agreed exploration work program.
- Ethiopia—Marathon acquired a 20% interest in the South Omo Block from Agriterra for:
  - $28 million payment to Agriterra
  - $12 million payment to the Government for Agriterra's tax on the sale (30% of net gain realized); any balance refunded to Agriterra
  - $10 million payable to Marathon (subject to applicable tax) on Marathon's participation in a commercial discovery in the Block

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Five Transactions That Transfer Interests

- Sale of assets (including the license) of the resource company
- Sale of shares (could be at an upper-tier level)
- Sale of new shares resulting in a change of control
- Farm-outs
- Overriding royalties

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Sale of Assets of a Domestic Company

- In some countries, a mining or petroleum license can be sold; or a company can sell all its assets to another company
- Domestic company has income
- Income is usually taxed

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Sale of Shares: Transactions

- Shares of a domestic company held by a non-resident could be sold.
- Shares of an upper-tier company could be sold
- If gain realized by a non-resident, gain may not be taxable under domestic law or under a country's tax treaties

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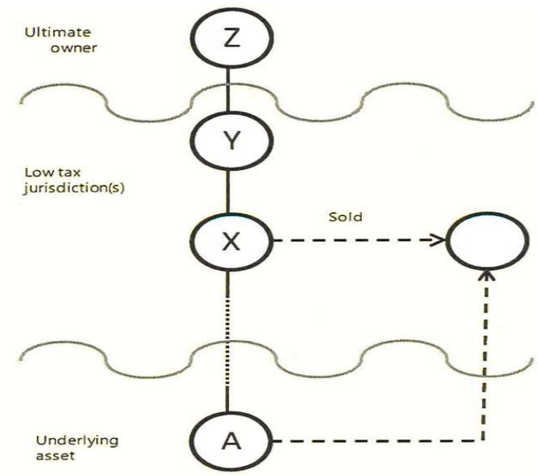
Sale of Shares: Transactions



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Sale of Shares by Non-Residents

- Domestic law could provide that a non-resident is taxable on the gain if 50% of the value of the shares is directly or indirectly attributable to immoveable assets in the resource country
- Note: this rule would reach non-residents holding shares of an upper-tier company

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Sale of Shares: Tax Treaty Considerations

- Under OECD Model Treaty:
  - Gains from alienation of immoveable property taxable in source country; immoveable property usually includes mineral deposits or the right to work mineral deposits
  - Gains from moveable property that is part of a PE taxable in source state
  - Special rule for ships and aircraft
  - Other gains from alienation of property taxable only by residence country
- New treaties often have special rule for gains on shares if:
  - the value of which is derived principally from immoveable property situated in the other state

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Change of Control without Sale or Exchange

- A company (including an upper-tier company) could issue new shares to the acquiring company in exchange for cash.
- New shares for cash usually treated as a capital contribution.
- If enough new shares are issued there can be a change of control. Should this be a taxable event?

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Farm-Outs (1)

- "Farmor" transfers an interest to the "farmee" for the farmee agreeing to undertake a portion of the famor's commitment/work program
- Most countries do not tax farm-outs
- Farm-outs may include a cash consideration
  - Transfer of interest may occur when the arrangement is agreed or once the work commitment is fulfilled

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Farm-Outs (2)

- Tax treatment of cash consideration could depend on how the farm out is structured
  - If the transfer of interest occurs when the arrangement agreed, the farmor could be required to recognize gain.
  - If the transfer occurs only once the work commitment if fulfilled, the cash could be treated as a bonus—revenue for the farmor and a deductible expense for the farmee

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Overriding Royalty (1)

- An interest could be transferred for $1 plus a 5 percent overriding royalty
  - The successor license holder is obliged to pay the original license holder 5 percent of the gross income realized from any commercial discovery.
- Difficult to put a value on the transfer at the time the transfer is made; the original holder has a contingent interest

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Overriding Royalty (2)

- Overriding royalty could be treated as an expense of the payor and income of the payee
- Payee is often a non-resident; therefore, no deduction for the payor and no income for the payee—two wrongs can make a right
- Could impose a withholding tax on payments to non-residents

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Challenges of collecting CGT

- Coherence between the tax code and license terms
- Stabilisation clauses
- Complex ownership structures
- Non-cash transactions
- Farm-ins and carried interests
- Direct vs. Indirect
  - Direct transfer: Transfer whole or part of the right itself.
  - Indirect transfer: owner of the entity owning the right may transfer interest in the entity.

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Challenges of collecting CGT

- Gains on transfers of real property usually taxable (whether separate CGT or general corporate income tax).
- What happens when real property is an asset held by foreign companies who sell shares to other non-residents?
- CGT then very difficult to enforce (and sometimes excluded by treaties).
- Presence of large gains suggests that fiscal regime is not expected to tax rents fully.
- Acquisition costs of a mineral right usually amortized – should treatment of gains and premiums be symmetrical?

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In Summary: Key Issues

- Is there a taxable event?
- If so, is the gain domestic source or foreign source?
- Is the gain taxed as ordinary income or a capital gain?
- Do treaties limit domestic law?
- If non-residents taxed, can the tax be enforced (and how)?