STRENGTHENING EXTRACTIVE SECTOR MANAGEMENT IN MONGOLIA

Base Erosion Profit Shifting (B.E.P.S) - an Overview

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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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Concept & Definition

- Ring fencing is the fiscal boundary within which costs and revenues of companies in common ownership may be consolidated for tax purposes (IMF, 2012).
- Some countries keep different resource projects separate for revenue purposes, because this means the profitability of each project is taxed on its own "merits"
- More profitable projects raise more revenue, as the costs of other projects cannot be used to reduce revenue charges.

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Ring-Fencing Concept

Ring-Fenced Project 1

- Gross Revenues: $200
- Total Costs: $100
- Net Revenues: $100
- Tax (@ 30%) = **$30**

Ring-Fenced Project 2

- Gross Revenues: $50
- Total Costs: $100
- Net Revenues: -$50
- Tax (@ 30%) = **$0**

Project 1+2 (No Ring-fencing)

- Gross Revenues: $250
- Total Costs: $200
- Net Revenues: $50
- Tax (@ 30%) = **$15**

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Concept & Definition

- Ring fencing creates incentives for domestic cost shifting wherever possible (such as where offshore project activities have a higher tax charge than onshore activities), requiring close scrutiny by revenue authorities.
- In addition, ring fencing can create administrative complexities where certain functions or services are centralised (for example, different mines owned by the same company may use the same beneficiation facilities),
- When infrastructure or equipment is shared across different projects, since authorities and companies must establish how much of each is to be apportioned to each project.

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Limiting Income Consolidation

- According to the International Monetary Fund (IMF), ring-fencing can broadly be defined as a "limitation on consolidation of income and deductions for tax purposes across different activities, or different projects, undertaken by the same taxpayer."
- This is particularly marked in the extractive industry where large amounts of capital expenditure are immediately deductible, making it possible to delay paying income tax for many years.
- Ring-fencing is one way of limiting income consolidation for tax purposes.
- This practice is common to resource-rich countries

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Caution about Ring-Fencing

- Despite widespread use, ring-fencing must be approached with caution.
- It has the potential to speed up the payment of corporate income tax, yet it may also deter further exploration and development, limiting the future tax base.
- May prevent existing operators from embarking on further exploration outside the ring-fenced area, thereby inhibiting industry growth and reducing revenue over time.
- Mainly Oil and Gas companies see ring-fencing as a major disincentive.
- Consequently, governments must balance early revenues, against increasing total revenue collection over the longer-term.

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What to Ring-Fence

- Operational: Definition of a “separate mineral operation” “mining area,” or license area
- Practicalities of ring-fencing mining
- A separate mineral operation is defined as a mineral operation pertaining to each mine and a mineral operation with a shared processing facility.

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Conclusion

1. Ring-fencing may limit investment
2. There are different ring-fences to choose from, some more restrictive than others.
3. There are trade-offs when deciding whether to ring-fence, and what form it should take:
   - On the one hand, ring-fencing may discourage exploration and investment, reducing total revenue over the longer-term.
   - On the other hand, the importance of early revenues, as well as difficulties administering corporate income tax, and the problem of aggressive tax planning by companies, may warrant a particularly demanding approach to ring-fencing.

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