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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Action Plan Description

- The BEPS project puts the issue of interest squarely into focus. Action Item 4 is titled "Limit base erosion via interest deductions and other financial payments."
- The description states, in part, that this action item will:

Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payment

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Thin Capitalization

- Funding a project with an excess of debt (versus equity financing) for tax purposes
- High interest payments to a related party—which are counted as a cost—dramatically reduce both:
  - Taxable profit
  - Profit available for distribution in the case of government equity

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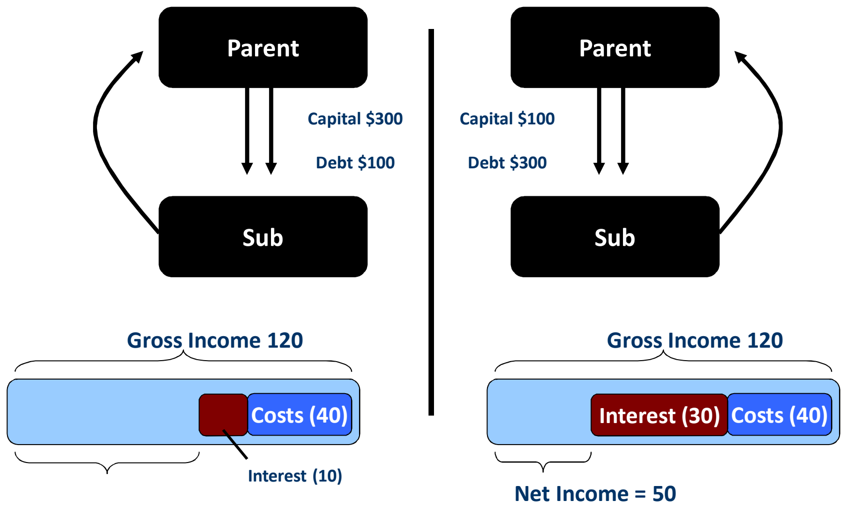
Simple Example



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Thin capitalization and five primary areas

Thin capitalization" is the preferred term for the condition in which a taxpayer is determined to have excessive debt and therefore excessive interest expense. In most cases – but not all cases – tax rules regarding thin capitalization focus on the debt owed and the interest paid to non-residents.

1. What is the best way to determine whether a taxpayer has "excessive" debt, such that some portion of the interest expense incurred should be disallowed either temporarily or permanently? This is the classic problem of defining "thin capitalization"
2. A deferred question is how to identify interest expense that arises in connection with exempt or deferred income. This issue most frequently occurs in connection with a taxpayer that earns foreign-source income that is taxed favorably in the taxpayer's home country. Although the interest expense may not be "excessive," allowing a current deduction for the interest expense may improperly erode the tax base.

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Thin capitalization and five primary areas

3. Should certain types of debt (and the associated interest expense) be treated differently from other types of debt with respect to tax deductibility? Or, should all of a taxpayer's debt and interest expense be considered as a single tax item for deductibility or limitation?
4. Is related-party debt particularly susceptible to abuse, so that related party debt and the associated interest expense should be subject to special limitations? If limitations are deemed appropriate, how could (and should) those limitations be designed?
5. What role can withholding taxes play in preventing erosion of a country's tax base in connection with cross-border payments of interest?

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Debt vs. Equity

- A debt instrument, classically a loan (from a bank, perhaps) or a bond (issued by a government or corporate borrower), entitles the holder to receive a fixed, periodic return, typically called interest.
- The holder does not have an ownership interest in the borrower, so the holder does not share in profits of the borrower. But, for the same reason, the holder ranks ahead of the owners of the borrower in the event of a default or bankruptcy.
- Equity, in whatever form issued, represents an ownership interest in the underlying entity.

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Debt OR Equity

- It should be clear that a particular instrument should be classified as debt or equity
- However, there are some instruments that are not clearly debt or equity.
- A most difficult issue for tax officials seeking to prevent improper tax base erosion and profit shifting is the proper treatment of hybrid instruments: financial instruments that are treated as debt by one taxing authority but as equity by another taxing authority.

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Tax vs. Non-Tax considerations

Example: Acme Corporation, a resident of Country X, seeks to create a subsidiary corporation, Beta Corporation, in Country Y. Beta requires initial funding of $1,000 in order to begin business.

Acme could provide that funding by

- Investing $1,000 of equity, or
- Investing $500 of equity and $500 of debt (or any other combination of debt and equity).

The choice of whether to use equity only, or a combination of debt and equity, generally will depend on a complex blend of both tax and non-tax considerations.

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Deductions – Tax Considerations

- Does Beta have sufficient taxable income against which to deduct the interest payments to Acme so that the deduction for interest is economically valuable?
- If no deduction is available in the current year, will the deduction be available in a future year?
- Does Country Y impose a withholding tax on interests to Acme, and, if so, at what is rate?
- How does the economic impact of that withholding tax compare to the potential economic benefit of the income tax deduction to Beta for the interest payment?
- What is the tax treatment of Acme in Country X?
- Is the interest taxable to Acme? At what rate?

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Deductions – Tax Considerations

- How does the tax treatment of the interest received by Acme in Country X compare to the tax treatment of a dividend received by Acme in Country X?
- If there is a withholding tax imposed by Country Y on dividends, or interest, or both ?
- Can that withholding tax be claimed as a credit against the Country X tax, or are there other considerations (e.g., excess foreign tax credits for Acme) that make the withholding tax imposed by Country Y a deadweight cost?
- If the debt investment to Beta is not made by Acme, but by an affiliate of Acme and Beta in a third country, Charlie Corporation in Country Z, then the analysis of the tax consequences of the interest payments will be made with respect to Charlie Corporation.

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Deductions – Non Tax Considerations

- Once made, difficult to reduce the level of equity investment in a corporation.
- Using debt as part of the capital for Beta allows Acme to withdraw the debt at a future time
- Accounting treatment for debt normally requires to recognize on a quarterly basis gain and loss from any currency fluctuations.
- Corporations do not have unlimited access to equity capital. Issuing additional capital is costly and dilutes of existing shareholders and may adversely impact share value.
- While there is flexibility in declaring and distributing dividends, debt service (debt repayment and interest payments) are mostly fixed.
- Higher debt means higher risks, especially in fluctuating and volatile cash flows environment.
- Finally, cost of debt is often lower that the cost of equity and using leverage maximize shareholder's value in the corporation.

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Two approaches: D/E or Limit of level of Interest

1. Debt/Equity Ratios:

- The most frequently adopted measure for whether an enterprise has a reasonable amount of debt is the debt:equity ratio of the enterprise.
- This is frequently expressed as a fixed ratio; for instance, an industrial company may be required to have a debt/equity ratio no higher than 3:1.

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Two approaches: D/E or Limit of level of Interest

1. Interest as a Share of a Prescribed Financial Ratio

- An alternative approach adopted by some countries is to disallow interest expense if the amount of interest exceeds some prescribed financial ratio.
- For instance, a taxpayer may be denied a deduction for the portion of interest expense (or, alternatively in some countries, net interest expense) that exceeds a fixed percentage (e.g., 50%, or 30%) of a prescribed financial measurement, such as gross income less certain expenses, or the familiar EBITDA.

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Additional points on measurements (1)

- Thin capitalisation rules setting a limit on the ratio of debt to equity, generally of 2:1 or 3:1, that is to say 66.67% or 75% of total funds respectively, both of which are, however, significantly higher than standard debt-to-equity ratios for mining.
- Any borrowing debt in excess of the allowed ratio is to be considered equity and the related interest charges dividends, and therefore no longer would they be deductible.
- Thin capitalisation rules generally avoid the need for the application of the ALP on a case-by case basis

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Additional points on measurements (2)

- In some countries with thin capitalisation rules, the arm's-length test is still applied
- Interest capping rules that limit the amount of interest that can be deducted by an entity for tax purposes in any one year as a proportion of their gross income or EBIT/EBITDA
- Some countries also use a maximum interest rate that can be used (Libor + x%)
- Group-wide rules that allocate interest expense as a function of the subsidiaries individual contributions to the MNE's consolidated revenue or earnings.
- Question: Do we consider all debts or only related party debt?

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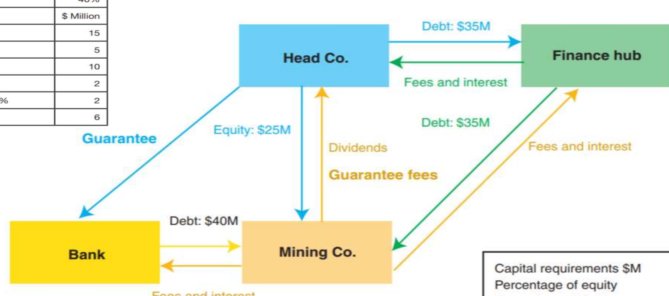
Example of Financial Structure

Independent Mining Company	
Capital requirements $M	100
Percentage of equity	60%
Percentage of debt	40%
	$ Million
Operating revenue	15
Operating cost	5
EBIT	10
Interest @ 5% p.a.	2
Corporate income tax @ 25%	2
Retained earnings $M	6



Calculation of tax payable by a company that borrows 75% of the required funds partly (40%) from an unrelated bank but subject to a guarantee by the MNE's Head office and part (35%) from the MNE's finance hub

Capital requirements $M	100
Percentage of equity	25%
Percentage of debt	75%
	$Million
Operating revenue	15
Operating cost	5
Guarantee fee	1
EBIT	9
Interest @ 5% p.a.	3.75
Corporate income tax @ 25%	1.31
Retained earnings $M	3.94

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Conclusion

- Structure can be extremely complex
- Companies will have argument why they need related-party debt
- If so, maybe better to have BOTH debt ratio rules AND interests level rules
- Debt and Equity vehicles may not be as obvious as one would wish (quasi-equity, convertible debt, etc.)

- Questions ?

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