

IGF-OECD PROGRAM TO ADDRESS BEPS IN MINING

LIMITING THE IMPACT OF EXCESSIVE INTEREST DEDUCTIONS ON MINING REVENUE



IGF

INTERGOVERNMENTAL FORUM
on Mining, Minerals, Metals and
Sustainable Development



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LIMITING THE IMPACT OF EXCESSIVE INTEREST DEDUCTIONS ON MINING REVENUE

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It complements action by the Platform for Collaboration on Tax and others to produce toolkits on top priority tax issues facing developing countries.

It reflects a broad consensus between the OECD and IGF but should not be regarded as the officially endorsed view of either organisation or of their member countries.

The lead organisation for this practice note was the OECD.

This programme builds on the OECD BEPS Actions to include other causes of revenue loss in the mining sector.

The programme will cover the following issues:

1. Excessive Interest Deductions
2. Abusive Transfer Pricing
3. Undervaluation of Mineral Exports
4. Tax Incentives
5. Tax Stabilisation
6. International Tax Treaties
7. Offshore Indirect Transfers of Mining Assets
8. Metals Streaming
9. Abusive Hedging Arrangements
10. Inadequate Ring-Fencing

OECD: <http://www.oecd.org/tax/beps/>

IGF: <http://igfmining.org/tax-avoidance-guidance-document/>

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Acronyms and Abbreviations

BEPS	base erosion and profit shifting
CIT	corporate income tax
DRM	domestic resource mobilization
EBITDA	earnings before deducting net interest expense, depreciation and amortization
IGF	Intergovernmental Forum on Mining, Minerals, Metals and Sustainable Development
IWT	interest withholding tax
MNE	multinational enterprise
OECD	Organisation for Economic Co-operation and Development



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1.0 Introduction

1.1 Domestic Resource Mobilisation in Developing Countries

Globally, there is a major change underway to combat tax base erosion under the base erosion and profit shifting (BEPS) process.

Raising tax revenue is especially important for developing countries. Strong tax systems are central to financing development, and there is increased recognition of the importance of external support in building those systems.

While real progress has been made on increasing tax revenues in low-income countries over the past two decades, in many countries revenue remains well below the levels needed to achieve the Sustainable Development Goals and secure robust and stable growth.

Like other sectors of the economy, there are tax base erosion risks in the mining sector that can hinder domestic resource mobilisation (DRM), particularly from the operations of multinational enterprises (MNEs).

About this practice note

Tax systems that provide income tax deductions for interest without making any similar provision for equity create an incentive for the use of debt.

While this is true of all industries, this note examines the particular base erosion risks from the use of debt by mining MNEs.

This note responds to a concern of many developing countries that MNEs use debt “excessively” in mineral-producing countries (called “host countries” in this note for brevity) as a mechanism to shift profits abroad.

This issue was one of the focus areas of the BEPS process. It was also identified as being of high priority for developing countries at an informal workshop on DRM from mining, hosted by the OECD in October 2016.

Who is this practice note for?

This note is for policy-makers and tax authorities in capacity-constrained developing countries where mining is occurring.

Its aim is to assist countries with very limited resources to combat tax BEPS. It prioritises simplicity and ease of administration as policy objectives.

It provides references to deeper analysis available to assist developing countries to navigate particular issues on interest deductibility wherever possible.

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For economic ministers and policy advisers, there is also a wider policy question of how countries strike a balance between tax base protection and encouraging inward investment. The decisions made on policies to limit base erosion have direct implications for the overall investment environment, and these policy issues are highlighted wherever possible.

How is it structured?

There are several issues around the use of interest deductions in developing countries that host country tax authorities are grappling with.

In particular:

- How *do* MNEs legitimately use debt finance within a corporate group?
- Where profit shifting is occurring, how can countries best set limitations on the use of interest?

The practice note does not argue that all mining MNEs are involved in aggressive tax planning. It focuses on where MNEs have been shown to be involved in practices that place significant pressure on the tax systems and the limited administrative capacity of host countries.

It is structured to examine these two questions, split into four main sections:

- Background on the financing needs of mining companies and how debt finance is used (Section 2).
- The base erosion behaviours and structures that developing countries have identified as being of concern (Section 3).
- How BEPS Action 4 operates to limit interest deductions, and other policy tools available, focusing on the mining sector (Section 4).
- Conclusions on best practices in limiting tax base erosion for developing countries (Section 5).



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2.0 Mining Businesses and the Use of Debt Financing

2.1 Introductory Briefing: The Capital-Intensive Nature of Mining

Mines require significant capital outlays over their life. Expenditure starts relatively modestly with exploration activities and development, before increasing substantially to build the mine and related facilities (see Figure 1).

These outlays—cumulatively hundreds of millions of dollars or more—include:

- Constructing the mine
- Facilities to process/beneficiate the ore (or extract valuable materials such as gemstones)
- Infrastructure such as power generators, worker accommodation, offices and transport (e.g., roads and pipelines).

Abstracting from other revenue sources for the MNE, these expenditures are made in advance of the company receiving revenue from the sale of mine production.

MNEs take considerable financial risk in undertaking mining (including through investments in exploration which may not yield a viable mineral discovery).

This means that there is considerable uncertainty when the investment is made that it will turn out as expected. For example, the yield from the ore, the actual costs of construction and operation, and/or the future market conditions for the products frequently change without warning.

These outlays may also be indirect, in the sense that substantial outlays are made to purchase mine assets from others (e.g., by purchasing an entity that owns those assets).

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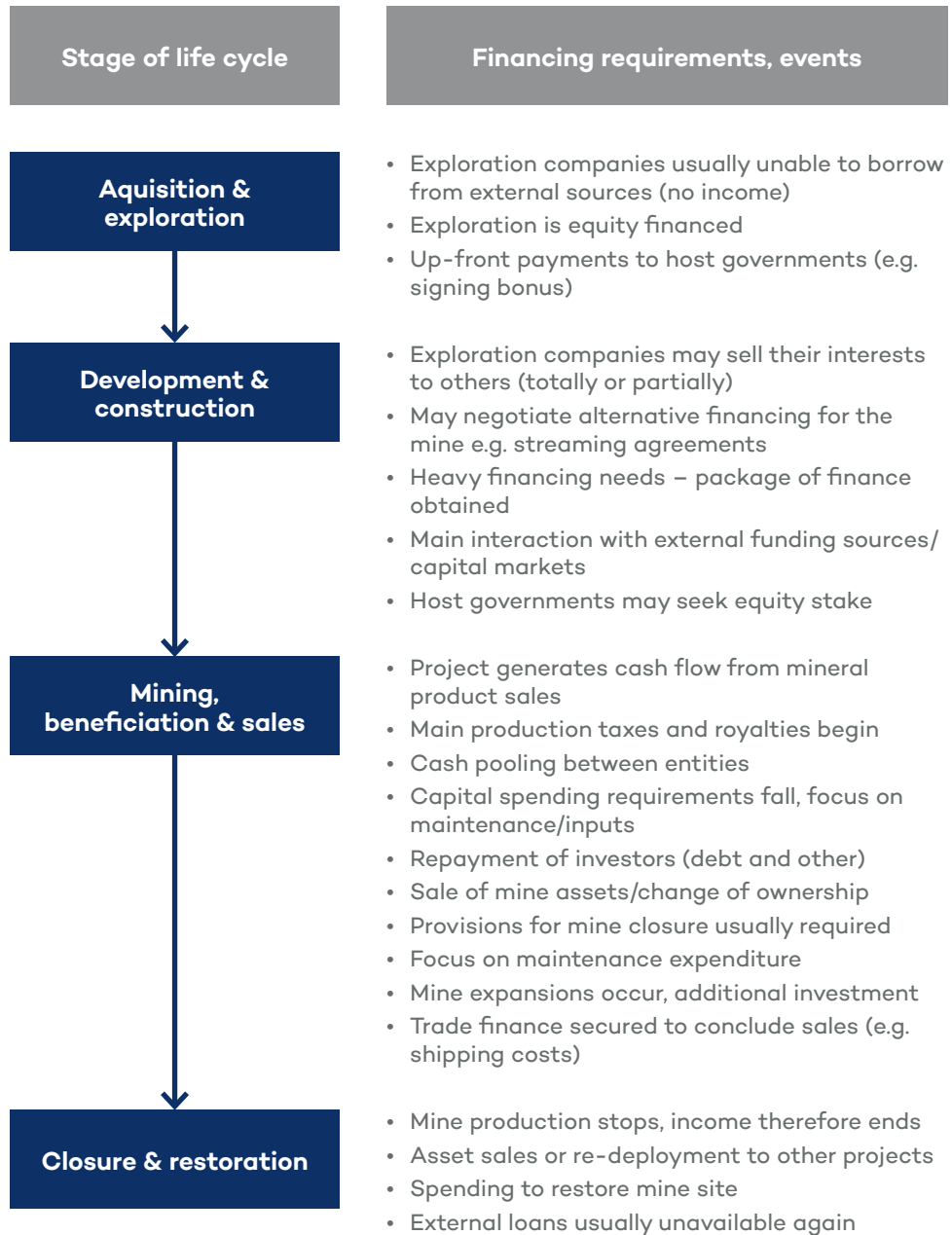
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Figure 1. Mining life cycle and financing requirements



Note: Cash pooling is explained under Section 2.3.

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Exploration and Risk

The exploration for new mineral deposits is an essential part of the mining industry, whereby specialist teams analyse country terrain and geology for signs of mineral deposits.

This phase is widely understood to be “high risk, high reward,” as frequently exploration efforts locate no new viable deposits.

As a consequence, investors typically provide capital to exploration companies in the form of equity, since these companies have no income source; in essence, they ask markets for funds, then progressively draw down those funds as they undertake their exploration.

Investors participate in the hope of the explorer making a discovery, since the value of the exploration entity can rapidly increase.

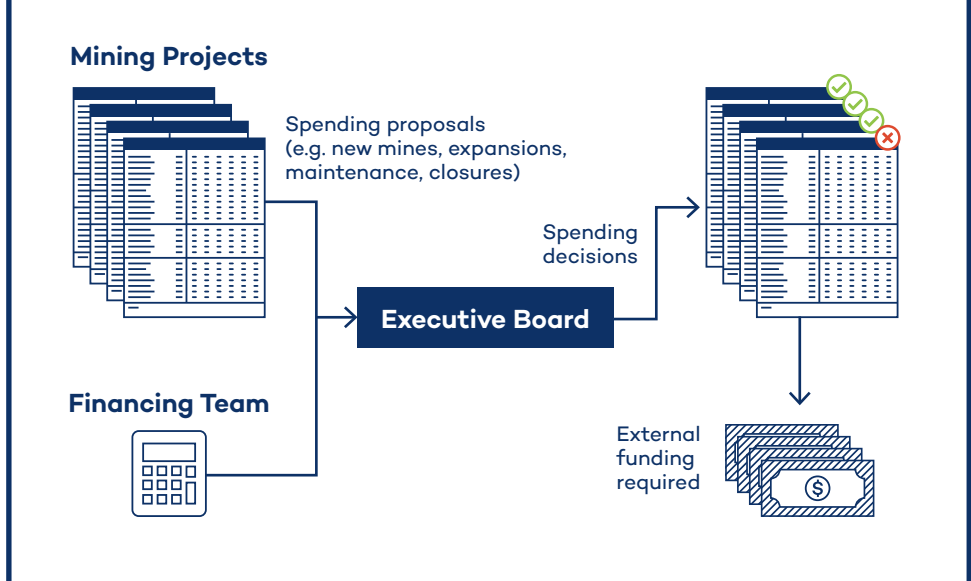
Box 1. The process of determining financing requirements

The figure below demonstrates a typical (but simplified) company process to arrive at its financing requirements. Spending proposals are prepared and weighed by decision-makers against funds available.

Those projects or expenditure items that are approved are tallied up and the company’s financing arm is tasked with obtaining the necessary funds.

While presented in the figure below as a linear process, it is better thought of as iterative, as information from within the company and from outside are brought together for decision-makers (e.g., the availability of funds both internally and externally informs the size of the company’s capital budget).

Figure 2. Stylised process of company decisions on financing



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2.2 Financing the Group

As financial markets have grown more diverse and complex, so too mining MNEs now fund their capital expenditures in numerous ways. Many of these arrangements are complex, requiring tax authorities to build their understanding of both the mining and financial industries.

MNEs can obtain funds from numerous sources.

“Traditional” sources

- External loans
- Bonds
- Capital raisings
- Internal funds (e.g., retained earnings, free cash flow from other projects)
- Asset sales (e.g., selling related infrastructure such as rail or energy assets where those assets can be used by third parties)

“Alternative” sources

- **Government support:** (e.g., equity investments, loans or guarantees) from host or foreign governments, or from international bodies such as the International Finance Corporation (part of the World Bank Group)
- **“Loan-to-own” agreements:** in general terms, loans that can be converted into stock in certain circumstances (also known as “convertible loans”)
- **Streaming agreements:** payments to a financier based on the sale of mine production to the financier at discounted prices
- **Private royalty agreements:** payment to a financier calculated as, for example, a percentage of the value of mine production

For large MNEs, external funds are routinely raised for more than one purpose (e.g., they may fund several projects at different stages of life and/or pay dividends to shareholders).

In contrast, medium and smaller MNEs will often seek ad hoc financing as new projects are developed.

Further reading - metals streaming

See an example of a streaming transaction in the *Supplementary Report – Addressing the Information Gaps on Prices of Minerals Sold in an Intermediate Form*, published by the Platform for Collaboration on Tax (p.169).

Available at: <https://www.oecd.org/tax/toolkit-on-comparability-and-mineral-pricing.pdf>

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2.3 Company Financing Decisions and Access to External Capital

A new project usually brings together a package of financing that may mix these traditional and alternative sources.

Medium and smaller MNEs will be generally more likely to use alternative sources, but this also depends on the stage of the commodity cycle and the overall attitude of traditional capital markets to mining investments.

Across companies, commodity price downturns and global macroeconomic instability can quickly tighten access to traditional funding sources and force MNEs to seek alternative sources of finance. In these circumstances, all funding arrangements could be expected to be on relatively onerous terms than what might have been available previously.

Alternatively, existing financial products may have components that adjust automatically to these changing circumstances. For example, finance might be connected to international financial reference prices such as the London Inter-Bank Offered Rate (LIBOR), much as occurs in other sectors.

Narrowing down to loan finance, the diversity of experience across mining companies makes it difficult to make universally applicable observations on the overall use of loans.

But some common factors are notable (see Table 1).

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Company size	Large, diversified miners usually have better access to a range of loan sources relative to mid- and small-sized firms and usually borrow on relatively better terms.
Credit rating	Credit ratings affect both the quantity of external borrowing possible and the terms for that borrowing (e.g., the interest rate): better credit rating means better terms.
Company age and maturity	Companies with a more established “track record” (including management) more able to borrow and on better terms.
Minerals mined	Some minerals provide companies better access to external capital than others (e.g., more liquid markets, better outlook for prices, more concentrated industrial structure of production—i.e., few producers or limited supply).
Level of risk taking	Companies with a reputation for higher risk taking provide a possibility of higher returns (e.g., mining in challenging geographical or political environments). This may affect the quantity of debt they can obtain, and entities perceived as more risky may face stricter/more expensive loan terms.
Security (assets) offered	Banks and other lenders lend to companies on terms influenced by the security offered and ability to acquire assets in the event of default—their primary objective is to ensure they recover the loan amount, interest payments and associated costs. Other financiers such as hedge funds or commodity traders may be more interested in acquiring strategically important mining assets.
Investor access to financial products	Financial products such as derivatives allow investors to hedge risk and more easily value mine production (e.g., by using transparent international reference prices) and therefore company value. That is, better access to derivatives for investors can mean better access to external debt sources. This is important to investors such as banks who must watch the asset values of the borrower (and potentially manage their risk exposure to price fluctuations).

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For larger MNEs, financing for the group will be arranged centrally, either in a stand-alone entity or functionally by allocating employees in several group companies—that may be in different locations—to perform that role. This function is known as the “group treasury.”

To organise their financing, MNEs often locate this group treasury in jurisdictions where the corporate income and withholding tax costs of raising finance are minimised or eliminated completely. And it may be the case that different forms of external capital are raised in different jurisdictions.

MNEs will usually look to locate the group treasury in jurisdictions with:

- Extensive treaty networks (thereby reducing withholding taxes)
- A labour force skilled in finance
- Low operating costs
- Strong legal frameworks
- Lightly taxed interest income

MNEs usually create a dedicated financial role that, under parameters set by the Board of Directors, manages their interaction with external lenders (as noted earlier). This role can include:

- Obtaining the best structure and term of funding to be raised
- Foreign exchange management for the group
- The hedging of currency and interest rate risks

Centralising financial functions can provide benefits to the group, lowering funding costs by relying on the credit rating of the group as a whole.

A group treasury function also means capital markets interact with one entity in the MNE that has financial experience and speaks the “language” of investors. These entities then fund (including on-lending to) other entities within the group, in accordance with approved spending plans.

The group treasury would also typically establish any cash pooling arrangements (see next page for explanation).

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Cash Pooling

In broad terms, cash pooling is a centralised short-term cash management arrangement between entities in the MNE, facilitating the efficient use of cash within the group.

They are usually a commercial arrangement, and not usually entered into for solely tax reasons.

Excess cash is moved to the cash pool routinely (e.g., at the end of the day) and can then be used by other entities on a short-term basis.

There are several potential benefits, including streamlining the banking arrangements of the group; that each entity depositing cash can earn a higher interest rate than it could obtain itself; and they can also facilitate group foreign exchange management.

Cash pool arrangements are headed by an entity (“cash pool leader”) that generally performs a co-ordination function that needs to be appropriately remunerated. The rest of the participants (“pool members”) will be depositing (borrowing) cash into (from) the pool and will be receiving (paying) an arm’s length interest rate for those deposits (withdrawals).

For more detail, see for example: UK HMRC Internal Manual, INTM503110, available at <https://www.gov.uk/hmrc-internal-manuals/international-manual>

2.4 Financing Decisions Within MNEs

Separate to resolving external financing, MNEs must also consider the allocation of that debt within the group’s entities.

Internal and external financing decisions typically do not “mirror” one another (i.e., different entities within the group will have different debt levels relative to their operations).

Commercial factors affecting internal MNE debt usage

The primary commercial driver is clearly the purchase and installation of mine assets and related infrastructure and the funds needed for those expenditures—essentially “when” and “how much.”

Commercial considerations also extend to the length of time that parts of the company need the funds for. For example, very short-term financing may be provided under group-wide cash management arrangements such as cash pooling (outlined in Section 2.1).

In addition, these commercial considerations also extend to loan terms and pricing, such as:

- Whether loans to host country entities are secured (which would typically reduce the interest rate charged, since risk of default is mitigated)

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- Whether performance conditions are imposed on the borrowing entity (also usually resulting in a lower interest rate, if they mandate decision making and/or management practices that lower the risk of the borrower getting into financial difficulties).

Tax factors affecting internal MNE debt levels

From a tax perspective, mining companies will seek to ensure that interest expenses are deducted against taxable income for corporate income tax (CIT) somewhere across the group's operations (or at a minimum, able to be carried forward).

Interest payments that are not deductible become a direct cost to the MNE.

Borrowing is more likely to occur in countries with higher tax rates relative to the lender, since this facilitates international profit shifting and reduces the overall taxation of the group.

This means that deductions are more “desirable” where the local tax rate is higher (e.g., where host countries are attempting to raise revenue from their natural resources) and in entities that are in a CIT paying position.

To ensure the benefit of interest deductions is maximised, MNEs will closely examine:

- Any limitations countries impose on the amount of interest they can deduct for tax purposes
- Ensuring the real value of interest deductions is maintained over time
- Whether deductions are transferrable to other mining projects (i.e., whether ring fencing provisions operate) or otherwise within the corporate group (e.g., through tax consolidation provisions)
- The strength and clarity of transfer pricing provisions
- Whether anti-avoidance rules impose any limits on the quantum or price of loans.

The process will often be advised by accounting or legal firms, which can also provide insight into structures other MNEs are using (and their relative tax advantages).

Ring-Fencing

These provisions isolate the tax position of each mining project, requiring each separate project within a country to maintain separate accounts and be taxed separately.

The intention is to prevent projects that are relatively more profitable from effectively cross-subsidising more marginal (or loss-making) projects by allowing deductions to be used against more profitable projects.

A photograph of a mining site. In the foreground, there is a large, rusted metal bucket on the ground. To the left, a yellow engine with a large flywheel is visible. In the center, a large, complex wooden structure, possibly a part of a mine's infrastructure, stands against a clear blue sky. The background shows a rocky, hilly landscape. The text "CHALLENGES FACED BY DEVELOPING COUNTRIES" is overlaid in the center of the image.

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3.0 Challenges Faced by Developing Countries

3.1 Introductory Briefing: Base Erosion Using Interest Deductions

The provision of loans to entities in host countries is of critical interest to tax authorities in those countries.

These tax authorities are increasingly alert to the disproportionate allocation of debt to operations in their jurisdictions relative to elsewhere in the group and the terms at which loans are provided to local entities.

In the absence of limitations on the extent of interest expenses, there is an elevated risk that companies will allocate higher debt levels to host countries.

Part of the challenge for some developing countries is that tax provisions are not sufficiently comprehensive (or targeted) to deal with the base erosion techniques that MNEs use.

And in many countries, there are acute capacity constraints in enforcing local tax laws—it may be that, for example, only 5–10 tax auditors must cover all companies operating locally.

For these tax authorities, this puts a premium on:

- Quickly understanding MNE structures and the legitimate ways MNEs organise their businesses, so that risks can be identified.
- Favouring tax measures that encourage simplicity in corporate structures and related-party financial transactions.

3.2 Current Issues for Developing Countries

There are three general categories of concern in the activities and structures used by MNEs, listed below.

Several case studies are provided to illustrate these challenges (some case studies illustrate concerns on more than one category).

They are not intended as definitive cases of tax base erosion—host countries would need to examine the actual facts and circumstances of transactions—but to highlight where there may be elevated risks.

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High debt levels

Companies allocate a disproportionately large amount of debt to the host country that raises questions about their ability to service that debt (and make a profit locally).

See: Case Study 1; Case Study 2; Case Study 5

Non-arm's length (high) interest rates

Related parties charge interest rates that are inconsistent with rates that would be charged between unrelated parties.

An excessive price of debt amplifies the effect of an excessive quantity.

See: Case Study 3; Case Study 4

Complex structures

These may or may not be for legitimate business purposes, but they greatly increase the tax authority resources needed to analyse them.

See: Case Study 4; Case Study 5

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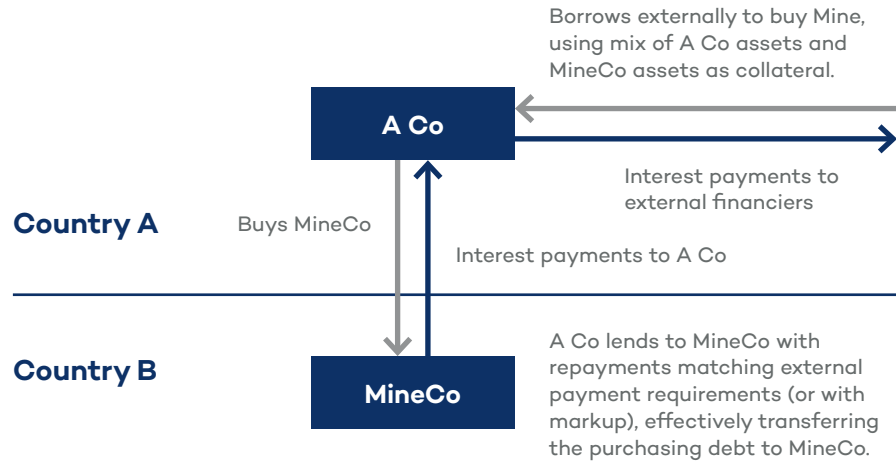
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Case Study 1 – Debt “Push Down”/Leveraged Buy-Out

Figure 3. Push-down structure



A Co is an offshore entity used to invest in the mine in Country B. MineCo operates the mine. The two entities are initially unrelated.

This technique is used by investors (A Co) to maximise the use of debt when purchasing a mine (or entity holding the mining assets, MineCo).

A Co borrows as much as it can from financiers to buy MineCo—often the entire purchase price—and uses MineCo’s assets as loan security.

Once A Co buys MineCo, it restructures the corporate group or, as in the figure above, A Co lends to MineCo, thereby generating interest payments back to A Co, which A Co then uses to repay external financiers.

Part of the strategy is to use the loans to reduce MineCo’s tax payments, thereby increasing its value.

A Co may sell MineCo later on to realise this gain.

What is the concern?

The main concerns with this arrangement are twofold:

- In the case where A Co is a foreign entity, Country B’s revenue is reduced by the heavily leveraged acquisition, via the interest deductions in MineCo.
- If A Co buys MineCo with none of its own money at risk, there is an investment policy question as to whether A Co will manage the mine in the best interests of MineCo (and by extension, Country B).

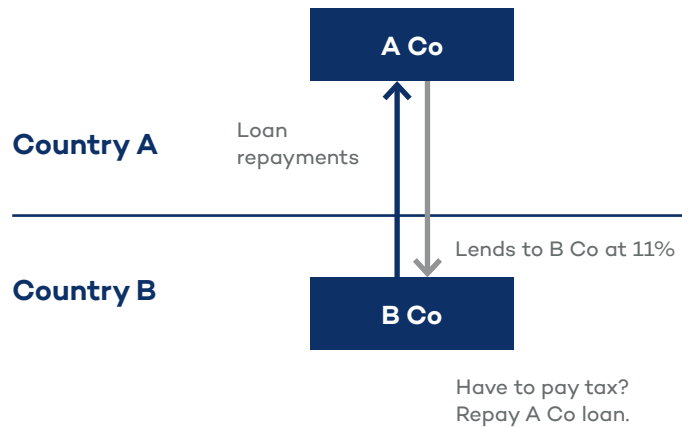
It may instead engage in practices to boost MineCo’s short-term value, which may be difficult for a later buyer of MineCo to observe pre-sale (e.g., environmental damage or restoration costs, increased overall risk or aggressive accounting valuation practices).

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Case Study 2 – Loan Terms Contingent on Host Country Tax Law

Figure 4. Loan terms contingent on host country tax law



A Co and B Co are related parties. B Co operates a mine in Country B.

In this example, A Co designs a loan arrangement for B Co whereby repayments of interest are only to be made if B Co must pay income tax in Country B.

If no income tax is payable, interest payments are deferred until such time as B Co does have to pay income tax, adjusted for this delay (i.e., the amount owing is “uplifted” or increased by an agreed percentage, or penalty interest rate is applied).

What is the concern?

Such an arrangement will need to be examined closely for its facts and circumstances, but there are two main concerns:

- The group has created an arrangement that looks less connected to the actual business of B Co than the tax system, since deductions only arise when there is a tax need.

It looks to be more in the nature of equity, since payments appear conditional on profitability.

- The terms of any uplift rate used between A Co and B Co may boost the amount of the interest deduction above what might have been afforded under Country B’s tax law (if the interest had been paid according to a fixed schedule).

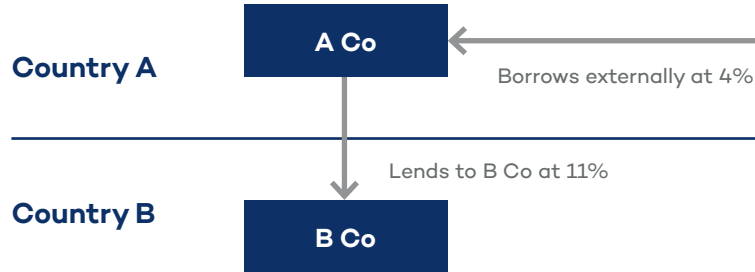
For example, if A Co uses an internal uplift rate of, say, 9 per cent, while Country B’s tax law allows a carry-forward of unused deductions, grown at say, 5 per cent, this creates higher deductions in the future.

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Case Study 3 – Interest Rate Markups

Figure 5. Interest rate markup arrangement



A Co and B Co are related parties. B Co operates a mine in Country B.

In this simple but still often-seen example, A Co borrows from independent financiers in Country A and then lends those funds on to B Co at a significantly inflated interest rate that independent parties would not enter into.

This generates increased interest deductions in Country B.

What is the concern?

A margin between the borrowing rate and the lending rate in A Co is not, of itself, a concern. But if the margin is set above what arm's length parties would have entered into, it becomes a straightforward profit shifting mechanism.

These arrangements require detailed analysis by Country B tax officials.

Further reading - interest rate markup risks

Transfer Pricing in Mining with a Focus on Africa: A Reference Guide for Practitioners

Available at: <http://documents.worldbank.org/curated/en/801771485941579048/Transfer-pricing-in-mining-with-a-focus-on-Africa-a-reference-guide-for-practitioners>

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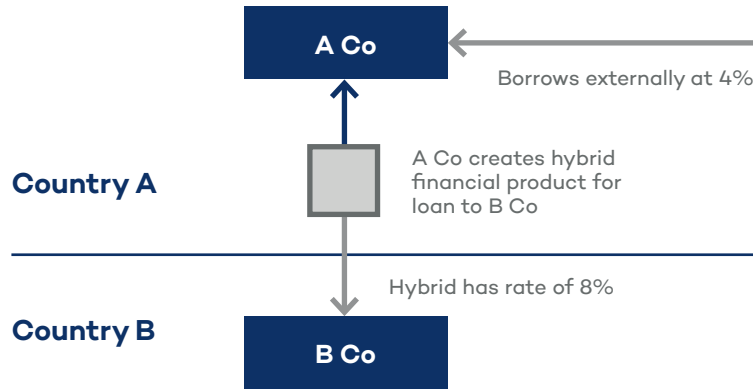
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Case Study 4 – Use of Hybrid Instruments

Figure 6. Arrangement using a hybrid instrument



A Co and B Co are related parties. B Co operates a mine in Country B.

A Co borrows from third-party financiers in Country A with the intention of then providing the funds to B Co in Country B (the host country).

Rather than on-lend to B Co on the same terms as it received from financiers, it creates a hybrid financial product for B Co with debt and equity characteristics.

This is one example of profit shifting using hybrids, and there are other possible approaches that pose BEPS concerns.

What is the concern?

A Co has engineered a financial product that is more complex than is needed by B Co, with terms that, if transacted between independent parties, might allow it to charge a higher interest rate under transfer pricing rules, thereby reducing the tax payments of B Co (i.e., by selectively including terms that typically are associated with higher interest charges).

A Co may also attempt to take advantage of differences in treatment of the hybrid instrument in Country A and Country B, ideally having the instrument classified as debt in Country B (therefore with tax deductible interest payments) but as equity in Country A (which may exempt dividend receipts).

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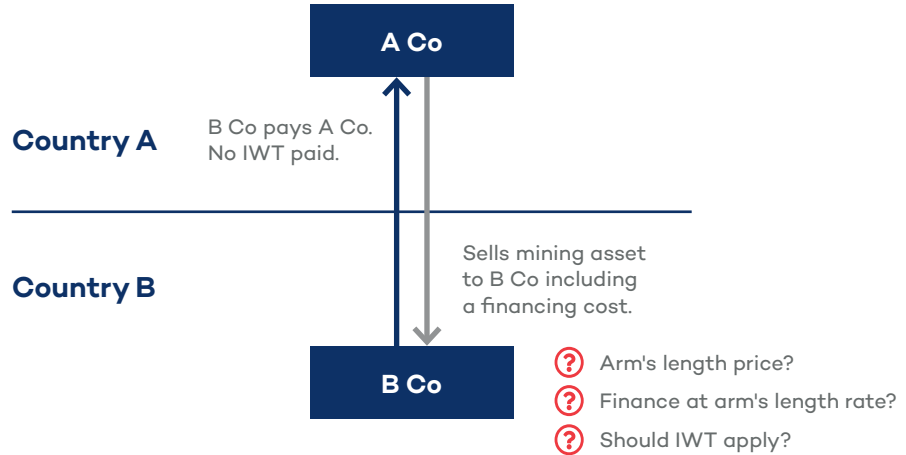
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Case Study 5 – Asset Purchases That Embed Financing

Figure 7. Asset purchase from related party



A Co and B Co are related parties.

A Co sells B Co an asset for use at the mine.

Within the purchase price is a financing cost, but this is not separately identified in invoicing.

What is the concern?

This kind of arrangement is quite common and is frequently a legitimate business transaction. But they can pose both base erosion and general complexity risks for developing countries.

- **Base erosion:** The asset might be over-valued by A Co relative to the terms that arm's length parties would have used, thereby increasing tax deductions for B Co in Country B.

This could be through an inflated price for the asset itself and/or inflated financing costs.

- **Base erosion:** By mixing financing payments into the asset price, the part of the purchase price that represents a financing payment (i.e., interest) would potentially avoid an interest withholding tax (IWT) that would have been payable had the loan been provided separately.
- **Complexity:** Tax officials must spend time disentangling the components of the transaction before they can be analysed separately under transfer pricing law.

For capacity-constrained countries, this draws resources away from tax analysis or auditing that could be done elsewhere.



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4.0 Interest Limitation Rules Including BEPS Action 4

4.1 Introductory Briefing

Abstracting from wider tax reforms of the treatment of debt relative to equity, there are a number of ways host countries can set a general expectation about the levels of interest deductions that are acceptable in their jurisdiction.

These tax measures can be organised into two groups:

1. Those that directly regulate or limit the use of interest deductions
2. Indirect measures that reinforce the intent of the direct provisions

This section begins with an examination of some of the key initial policy considerations countries must consider when examining interest limitation rules.

It then focuses on the recently developed Action 4 under the BEPS process, given its recent arrival as a common approach for policy-makers, before examining other direct approaches.

Additional supporting measures that reinforce limits on interest deductions are then outlined.

4.2 Initial Policy Considerations

How could limitations affect the investment climate?

Most countries implement some form of control over the level of interest used for tax purposes. Often this is to reassure citizens that the domestic tax base is not being abused and that companies are paying taxes when they are profitable.

But at the same time, most economies need foreign capital to help the economy grow. Foreign investors supply capital (and expertise), expanding the supply of capital and the production that is possible locally.

This allows investments to occur that otherwise would have to be funded at a higher cost or not undertaken at all. Economic growth would be lower without foreign funds being available.

Limitations on interest deductibility therefore need to be implemented carefully and in a consultative way that balances domestic considerations with the benefits that investors bring. This means implementing new interest limitation rules with a reasonable time period for companies to adjust to them.

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BEST PRACTICES**Is a mining-specific rule needed?**

Implementing an approach just for the mining sector is a crucial decision.

Tax policies implemented sector by sector are not usually encouraged, since treating sectors differently can drive resource allocation across the economy.

However, where extractive industries are a significant portion of the economy (and by extension, potentially a significant part of the revenue base), this can justify special interest limitation rules for the sector.

This would be especially the case if there is evidence of acute base erosion occurring. And in any case, mining companies often face separate fiscal arrangements and ring-fencing, meaning the decision to apply sectoral rules has already been made.

Interaction between laws

Setting the boundaries for a mining-specific rule requires detailed design (made more complex if there are also hydrocarbons), including how a sectoral approach interacts with tax provisions applying to all companies.

In particular, this requires consideration of whether limitations will apply to each MNE project-by-project or to the group of local entities as a whole (i.e., regardless of what other business activities it might engage in).

In practical terms, many countries resolve this design question by requiring each separate mining licence be held by a separate legal entity and/or by using project-by-project mineral development agreements which can include fiscal provisions that override the tax code.

How should the chance of substantial commodity price changes be addressed?

Falls in the price of mineral products mined can change the economic outlook for mining MNEs rapidly.

Within the company, earnings fall, and externally, share prices can fall as investors reassess the value of the company's mining assets in light of the changed price outlook.

Decreasing commodity prices can also tighten the lending conditions for mining MNEs, increasing external funding costs.

But how this plays out within MNEs very much depends on their loan agreements on intra-group borrowing.

- If interest rates are fixed in loan agreements, there may be little direct impact from the changed outlook.
- But if rates are linked in some way to an international financing index, interest payments may also increase (if movements in that index are affected by commodity price changes).

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This means there can be marked changes in the economic position of mining entities within the group. In particular, the accounting value of the entity can fall and the level of interest deductions for tax purposes can increase. These changes can occur without the MNE group taking any action to increase its debt levels.

This has implications for interest limitations and base protection measures, increasing the potential for denied deductions. Increased interest payments would also increase IWT obligations.

Where companies come under financial pressure, they may in turn seek better fiscal terms from government (e.g., weaker limits on interest or lower royalty rates). Setting limitations too strictly may lead companies to seek changes to their level of allowed interest deductions bilaterally, making tax administration more difficult and risking those changes becoming entrenched.

In the case of stronger commodity prices, the opposite forces are at work: earnings increase and interest costs can fall, increasing the level of debt that could be allowable (and thereby potentially encouraging MNEs to increase their debt levels to take advantage of any additional leeway).

In setting interest limitations, therefore, provision for this volatility is needed to ensure the rules operate without requiring ongoing change.

4.3 BEPS Action 4 on Interest Deductions

Prior to the BEPS process, many countries had realised that the existing tax tools to limit the use of interest by MNEs were complex to design, while still often being ineffective.

In response, G20 nations and the OECD developed a new common approach, which was delivered under the BEPS Project as “Action 4.”

The recommended approach ensures that an entity’s net interest deductions (i.e., interest expense that exceeds any interest income) are directly linked to the taxable income generated by its economic activities, as measured by taxable earnings before deducting net interest expense, depreciation and amortisation (EBITDA).

This EBITDA calculation is a tax—not accounting—value.

Further reading - Action 4

OECD publication *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update*.

Available at: <http://www.oecd.org/tax/beps/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2016-update-9789264268333-en.htm>

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BEST PRACTICES**How does it work?**

The approach under Action 4 includes three parts:

- **A fixed ratio rule** (core) based on a benchmark net interest/EBITDA ratio
- **A group ratio rule** (optional), which allows an entity to deduct more interest expense in certain circumstances, based on the position of its worldwide group
- **Targeted rules** (optional) to address specific risks

To ensure that countries apply a fixed ratio low enough to tackle BEPS, while recognising that not all countries are in the same position, the approach includes a range of possible ratios of between 10 and 30 per cent.

As some groups may be highly leveraged with third-party debt for non-tax reasons, the recommended approach proposes, as an option, a group ratio rule alongside the fixed ratio.

This would allow an entity with net interest expense above a country's fixed ratio to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group (or other relevant financial ratio of its worldwide group, such as equity/total assets).

Under the group ratio rule, countries may also apply an uplift of up to 10 per cent to the group's net third-party interest to prevent double taxation.

In addition, other provisions can supplement the recommended approach to ensure the effect of any rule is targeted at MNE groups that pose the highest BEPS risks. These are:

- A "de minimis" threshold, whereby entities with a low level of net interest expense are excluded, should be added. Where there is more than one entity in the host country, the threshold may be applied to the total net interest expense of the local group.
- An exclusion for interest paid to third-party lenders on loans used to fund public benefit projects (with some conditions) could be adopted.
- The carryback/carryforward of disallowed interest expense or unused interest capacity could be provided, to reduce the impact of earnings volatility.

Action 4 also recommends that targeted rules are used to prevent circumvention, for example, by artificially reducing net interest expense levels.

It also recommends that countries consider introducing rules to tackle specific BEPS risks not addressed by the recommended approach.

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4.4 Implementing Action 4

The implementation of the BEPS approach raises several important design issues to ensure the rules operate without penalising legitimate business.

Which parts to use?

A key initial decision is which parts of Action 4 to implement.

Action 4 is designed to be applied flexibly, but there are elements that countries would be expected to adhere to (e.g., implementing the “core” of the measure, the fixed ratio rule—see Table 2).

Table 2. Components of Action 4

Component	Status	Comments
Fixed ratio rule	Recommended	<ul style="list-style-type: none"> This is the core element that countries adopt. If no group ratio rule is adopted, the fixed ratio rule should apply to both multinational and domestic groups, to avoid any commercial advantage to one over the other.
Group ratio rule	Optional	<ul style="list-style-type: none"> The group ratio rule addresses sectors that require high levels of net debt for non-tax reasons (e.g., banking). As a general proposition, mining MNEs do not typically have high levels of borrowing with external parties relative to most other sectors. It is reasonable that this should also be the case for entities in host countries. A simplified approach with no group ratio rule may be sufficient for developing countries facing acute capacity constraints. This would also make implementation easier, by limiting the changes in company filing and reporting requirements and information needed from offshore affiliated companies.

What percentage for the fixed ratio?

The 10-to-30 per cent corridor for the fixed ratio was chosen to facilitate international coordination and reduce the risk that some countries might set an unreasonably high ratio to make their tax settings more competitive.

The upper limit was set based on company analysis, as a balance between allowing the majority of MNEs to deduct an amount equivalent to their net third-party interest expenses and limiting the extent to which groups might be able to increase their intra-group interest deductions to exceed their actual net third-party interest expenses.

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Because there is diversity across mining MNEs, the fixed ratio needs to be set in a way that is tailored to the actual structure of the mining sector in each host country, particularly the minerals mined and types of MNEs operating (while remaining within the 10–30 per cent range).

Moreover, additional factors will influence setting the ratio, including whether the group ratio rule is used and whether excess interest can be carried forward.

Should the carryforward of excess deductions be permitted?

The carryforward of disallowed deductions under Action 4 or other measures is a policy choice, but one that is important to ensure mining companies can deduct legitimate expenses for tax purposes.

Carryforward is a standard arrangement in income tax law, and it is recommended to recognise the significant capital requirements of mining projects.

But there is an important qualifier, that carryforward only applies to interest that has a legitimate business rationale (e.g., borrowing from related parties during exploration should not be carried forward—see discussion under Section 4.5 on “arm’s length” transfer pricing rules).

The *carryback* of excess interest capacity (i.e., any gap between the actual level of interest deductions and what would be allowed under the fixed ratio) may be too generous however.

Additional design issues

Several additional design issues are presented based on feedback from mining MNEs.

Each issue and proposed response is provided in Table 3.

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Table 3. Issues and company concerns

Issue	Proposed Response
Large sunk costs associated with investments and risk of adverse changes in fiscal settings post-investment.	<ul style="list-style-type: none"> Planned changes be clearly explained and MNEs be given reasonable time to restructure financial arrangements before rules apply (transitional arrangements).
Exploration companies do not generate income, so will always have negative EBITDA.	<ul style="list-style-type: none"> Loans are not usually provided to these entities by external lenders, because they do not generate income. It may therefore be appropriate to not afford any special treatment that would allow these entities to borrow internally. Internal loans capitalised for deduction could be disregarded.
Timing mis-matches between when a mine is built and when production begins (income is received), resulting in entities with negative/no EBITDA.	<ul style="list-style-type: none"> Allowing the carryforward of excess interest expenses to later years is the most appropriate response (as long as the loans would have actually occurred at arm's length). Allowing the grouping of local entities could limit this effect, but that risks undermining the intent of ring-fencing provisions and any grouping would need to remain consistent with overall ring-fencing policy (i.e., to avoid highly profitable projects from being used to absorb interest deductions from other projects).
Mining company earnings fluctuate with commodity prices (reflected in reduced EBITDA).	<ul style="list-style-type: none"> Interest expenses exceeding the ratio can be used in subsequent years (integrity measures will be needed around any carryforward).
Relatively higher interest rates in developing countries.	<ul style="list-style-type: none"> No action proposed, but higher end of the corridor EBITDA ratio might be appropriate depending on local interest expense levels.
Use of joint venture arrangements and apportionment of earnings, expenses.	<ul style="list-style-type: none"> Depends on whether group taxation system is operating (consolidated taxation of all local entities); these rules may already cover this situation. Otherwise, simplest approach is apportionment based on ownership percentages or appropriate control test.
Use of shareholder debt to prioritise private investors where the host government has been afforded an equity stake in the mine without having to pay the MNE to finance that acquisition.	<ul style="list-style-type: none"> No action proposed, but further work is needed. (See Section 5).

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4.5 Other Measures to Regulate the Use of Interest

In addition to Action 4, there are several measures that directly impose limits on the use of interest that could reinforce (but not substitute for) Action 4.

These are outlined below and in more detail in Annex A.

Thin capitalisation rules

An established approach to limiting the quantity of debt used in host countries is legislation placing limits on the level of debt relative to equity in local entities, thereby preventing disproportionate debt funding or “thin capitalisation.”

These rules are often expressed as a ratio of the permitted level of debt relative to equity—for example, a 2:1 ratio would mean that, for local entities, interest deductions associated with \$2 of debt are permitted for every \$1 of equity.

Any interest associated with debt above this limit is denied.

These rules directly set limits on the capital structure of entities, by specifying the quantity of debt that is allowable (relative to equity), but do not set limits on interest rates (as an example, Australia and Canada have ratios currently set at 1.5:1).

They are complex to design, however, and have been found to be easily circumvented (a key driver as to why Action 4 was developed).

Interest withholding tax

A tax is imposed on payments of interest to foreign parties with the obligation to pay imposed on the payer (they must withhold the amount of tax). This may be all payments or targeted to payments to related parties.

These rules aim to tax interest income that has some connection to the host country, even though it is earned by a foreign person or entity.

IWT aims to reinforce the CIT, where there may not be enough of a local presence of the foreign entity that they would be taxed in another way (e.g., as a permanent establishment).

IWT can however be reduced by tax treaties, and MNEs may attempt to structure entities to take advantage of treaties with reduced IWT rates (so-called “treaty shopping”—see supporting provisions in Section 4.6 on how this can be addressed).

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Transfer pricing rules aim to ensure the transactions between related parties—including financing transactions such as loans—are on terms that accord with those that would have been undertaken with unrelated parties in those circumstances.

They provide a framework by which these transactions can be analysed, and, if necessary, provide tax authorities with the ability to modify features of the actual transaction that do not accord with what arm’s length parties would have done.

Strengthening the transfer pricing framework

To reinforce these transfer pricing rules, some countries have imposed additional requirements (sometimes called “would have” requirements) that limit deductions on debt that would not have happened if the entity had not been a member of an MNE group.

These rules target financing arrangements and capital structures with little or no commercial rationale.

This approach typically comprises two sequential questions:

1. **Could the MNE have borrowed** the amount, and at the terms provided, on an arm’s length basis?

If the answer is yes:

2. **Would they have?** That is, there should be commercial reasons why this borrowing would take place.

To explain the latter question: take the example of a company that had borrowed at, say, 8 per cent interest for two years from an unrelated party. During the period of the loan, where there has been no material change to the external operating environment, the company decides to repay that loan and instead borrow the same amount from a related party at 10 per cent.

In this example, clearly there is no commercial reason for this change to occur.

This is a particularly important element to prevent companies from restructuring their finances to increase debt levels up to the deductibility limits. Increased debt (or higher rates) must have some commercial justification.

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This measure would impose a maximum allowable interest rate on interest payments made to offshore related parties, with any interest amounts above this cap disallowed (e.g., the limit might be set at LIBOR plus, say, 500 basis points).

This is a simplification measure used to address unreasonably high interest rate markups to local entities and needs to be carefully considered. Setting these caps at fixed rates, for example, would mean they require continual monitoring and updating to ensure they operate as intended and do not unintentionally penalise companies should market rates rise. Alternatively, if an interest rate index is used, selecting the most appropriate benchmark becomes critical.

Given their punitive nature if implemented with no taxpayer recourse, such measures are best recommended as a “safe harbour,” whereby companies can avoid denied deductions if they are able to clearly demonstrate the arm’s length nature of their transaction.

Proportionate deductibility (“Uruguayan Rule”)

Some countries, such as Uruguay and Dominican Republic, have imposed limitations on interest deductions based on relative differences between the local and foreign rate of income taxation.¹ The intention is to negate the profit-shifting incentive caused by tax rate differentials.

For example, if the host country has a CIT rate of 25 per cent and a foreign affiliate has a rate of, say, 15 per cent, only 60 per cent of interest payments would be allowed (i.e., 15/25).

In this way, only foreign affiliates with a comparable tax rate or higher receive full deductions for interest payments.

This rule can also be tailored to include IWT in the calculation, if it applies to the interest payments.

One drawback of this approach is that it requires a country-by-country dissection of borrowing, increasing compliance costs for business.

Further reading - safe harbours, anti-abuse rules

See Section 4.3 Other Prescriptive Rules pp. 75–76 of *A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses*.

Available at: www.oecd.org/tax/toolkit-on-comparability-and-mineral-pricing.pdf

Natural Resource Governance Institute case study: *Preventing Base Erosion: South Africa’s Interest Limitation Rules*.

Available at: www.resourcegovernance.org/sites/default/files/documents/preventing-base-erosion-south-africa-limitation-rule.pdf

¹ In Uruguay, it also applies to other forms of payments.

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4.6 Supporting Provisions and Arrangements

To provide additional integrity to the domestic tax system, several measures that are not specific to interest deductions could be implemented.

Symmetrical treatment of denied interest expenses

Where an arm's length transfer pricing adjustment results in reduced interest deductions available to entities located in the host country, this may result in an MNE being double-taxed internationally. That is, the foreign country tax authority may tax the interest as income to the foreign related party, but the host country entity must also pay higher taxes because of the denied tax deduction.

This would place them at a disadvantage relative to parties operating independently, unless corresponding adjustments are made to the tax position of the related entity in the foreign jurisdiction.

Countries can use the Mutual Assistance Procedure provisions of tax treaties (e.g., Article 25 of the 2014 OECD Model Convention) to ensure this occurs. Under this procedure, the tax authorities in both jurisdictions agree whether any adjustments are appropriate and (in the case they agree on the approach of the host country) how the foreign tax authority will adjust its taxation of the MNE to achieve a symmetrical result.

Symmetry should also be applied to the treatment of hybrid financial instruments (as per the recommendations of BEPS Action 2).

Anti-abuse provisions

These provisions give tax authorities a tool to discourage and penalise arrangements found to have little economic or commercial substance. These could include additional penalties to deter particularly aggressive structures.

These provisions may be specific to particular areas of the tax law, such as the use of debt (often referred to as "targeted anti-avoidance rules") or apply more broadly to target artificial schemes and flagrant tax-avoidance practices ("general anti-avoidance schemes").

Practitioners caution that these provisions can be difficult to design and apply however.

Preventing treaty shopping to avoid IWT (BEPS Action 6)

To ensure international tax treaty networks cannot be used to artificially undermine local rules such as on withholding taxes, BEPS Action 6 ensures only true residents of countries undertaking substantive business will obtain treaty benefits.

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International networks and the Inclusive Framework on BEPS

Countries can improve their defences through direct participation in international and regional forums, such as the Inclusive Framework on BEPS.

The Inclusive Framework, established to implement the BEPS minimum standards and overall BEPS Actions, provides countries with access to a network of tax officials from other countries (currently there are 117 members, including resource-rich developing countries).

In addition to information exchange benefits under the minimum standards, joining the Inclusive Framework also provides access to OECD tax Working Party 11, which is the forum that monitors aggressive tax planning schemes and discusses policy responses. A sub-group of this Working Party manages a directory that contains over 400 tax planning schemes, including structures designed to use interest deductions aggressively.

Other international and regional groupings can also assist by connecting officials to counterparts that may be facing similar issues.

An aerial photograph of a large-scale construction or mining site. The terrain is heavily excavated, showing various levels and paths. A prominent feature is a large, semi-transparent rectangular box in the center, which contains the text 'CONCLUSIONS AND BEST PRACTICES'. The background shows a mix of grey earth, gravel, and some green vegetation. A body of water is visible on the right side of the image.

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5.0 Conclusions and Best Practices

Debt financing remains an important source of funds to build mines and finance their operation and expansion. Mines cost hundreds of millions of dollars to build (or more), and debt is a necessary part of the funding mix.

However, there are very real issues with the use of interest deductions to shift profits away from host countries, particularly when this occurs in highly capacity-constrained developing countries.

Responses to place limits on interest deductions involve policy choices that can affect the level of foreign investment into the host country. Very strict limitations on deductions can constrain economic growth, and policy-makers need to carefully evaluate the trade-off between tax base protection and what levels of debt financing are acceptable for mining to occur.

Moreover, limits on interest deductions may not “end the story”—rather, policy-makers need to monitor for complex arrangements that re-characterise interest into other forms of payment.

The following conclusions and best practices for interest limitation rules are presented for highly capacity-constrained developing countries.

- **In capacity-constrained economies, simple and clearly designed measures should be prioritised.** They are easier to administer, meaning tax officials can focus on other tax risks, and where they reasonably approximate outcomes that are arm’s length, they will be accepted by business.
- **BEPS Action 4 has strengthened the policy toolkit available to countries and provides a simple response to limit interest deductions.** A simple headline rule on the overall level of debt permitted in the host country sends a clear message to investors.
- **Action 4 can accommodate the characteristics of the mining industry.** A sector-by-sector approach is not advised in implementing Action 4, but, given the capital-intensive nature of the industry, the carryforward of excess interest deductions addresses a key industry concern. In addition, transitional rules may be needed to provide MNEs time to financially re-structure before the new limitation applies.
- **Any limitation rule should be implemented transparently and consistently across projects and without administrative discretion.** This is to ensure businesses can easily understand the law and so that special deals are not afforded to particular projects (i.e., using a very generous interest limitation effectively as a tax incentive), which could facilitate resource allocation inefficiencies and corruption.

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- **However, no single measure will address all of the myriad ways interest deductions can be used for tax base erosion—several tools will be needed.** A coherent and well-coordinated set of measures is essential to ensuring each different approach to tax base erosion is addressed. Moreover, the design of measures—particularly their interactions with one another and implications for international double taxation—crucially determines their effectiveness. There is a lot of complexity in the details, and new base erosion risks can emerge in the design of new rules.
- **For capacity-constrained developing countries, a “package” of defences could comprise BEPS Action 4, IWT and transfer pricing provisions (emphasising the importance of substance in related-party dealings) as a starting point.** Where aggressive tax base erosion is encountered, blunter responses such as caps on interest rates or proportional disallowance of deductions based on the foreign tax rate on interest may be required. Countries must also be alert to the re-characterisation of income if new limitations on interest are implemented.
- **The wider BEPS package provides additional tools that cumulatively work to combat the aggressive use of interest, such as on hybrid financial instruments.** In addition, the Inclusive Framework on BEPS provides a forum for developing countries to help design the rules and monitor international developments in taxation.

5.1 Possible further work

One issue became apparent during consultation on this guidance note that could productively use deeper analysis. This is how the use of government equity stakes in projects that are paid for by the mining MNE (a “carried interest”) affects the use of debt in host countries (noted in Table 3).

Anecdotally, it appears these carried interests encourage MNEs to prioritise debt for two potential reasons:

- Practically, it may be easier to use debt to provide additional capital to finance the mine if funding requirements change, since the host country government’s equity stake is not diluted (that is, it affects the structure of incremental financing toward debt). But this raises the question of whether this is the only solution available to the partners—for example, what are the impediments to additional equity finance being provided by the host partners to keep the funding structure broadly unchanged?
- Some MNEs have stated that they prioritise the repayment of those financiers that have actually provided finance, and they are doing this via the use of debt (shifting profits offshore to repay them).

It may be that carried interests signal to MNEs that the host country government:

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- Does not want to share its financing burden when the project most needs it (in which case the MNE feels justified in prioritising those financiers who are)
- Accepts that other financiers will be paid first and company tax receipts will be delayed, as a trade-off for receiving the carried interest.

Further work to clarify the extent of this issue and the policy trade-offs involved could inform the policy choices around carried interests for developing countries.

Annex A. Relative Strengths of Interest Limitation Measures

	Strengths	Risks and Weaknesses	Design Issues
Debt-equity ratios (thin capitalisation)	<ul style="list-style-type: none"> • Sets a clear expectation of acceptable levels of debt. 	<ul style="list-style-type: none"> • Can be easy to avoid (e.g., by artificially injecting equity around measuring points). • Interest may be “embedded” into other transactions to thwart the rule (e.g., asset purchases), requiring careful monitoring. 	<ul style="list-style-type: none"> • Whether to apply to related parties only or also on arm’s length borrowing. • Needs a wide definition to include interest and payments economically equivalent to interest. • What ratio to set, having regard for the business needs of particular sectors (e.g., banking). • Transitional rules to provide for restructuring may be needed. • Whether denied deductions can be carried forward to use in subsequent years. • Whether to re-characterise disallowed interest as a distribution (dividend payment).
Transfer pricing laws and regulations	<ul style="list-style-type: none"> • Important defence against interest rate markups and excessive quantum of debt (above what arm’s length parties would negotiate). • Recognises that MNEs may have different levels of interest deductions depending on their circumstances. 	<ul style="list-style-type: none"> • Requires comparable transactions and tax staff trained in transfer pricing—difficulties in applying the arm’s length principle. • Company-by-company application can create uncertainty (but can provide guidance or consider advanced pricing arrangements to address this). • Groups may structure debt to have some equity-like features to justify interest rates significantly above the interest paid on third-party debt. • Does not prevent MNE from claiming deduction for investment in non-taxable asset or income stream. 	<ul style="list-style-type: none"> • Requires legislative provisions and then regulations to implement. • Documentation requirements for companies to explain related-party transactions. • How rules interact with interest limitation rules.

	Strengths	Risks and Weaknesses	Design Issues
Interest withholding tax	<ul style="list-style-type: none"> • Simplicity. Sets a clear tax on interest payments to foreign parties. • Acts as a “backstop” to the CIT system to tax income flows that may have a base erosion purpose. 	<ul style="list-style-type: none"> • Can increase the cost of capital for borrowers if they must compensate the lender. • Base erosion pressures remain unless rate set to equal the CIT rate (but tax treaties usually reduce significantly). • Can drive base erosion behaviour such as groups entering into structured arrangements to avoid imposition of tax or generate additional tax benefits. 	<ul style="list-style-type: none"> • Definition needs to include payments that are economically equivalent to interest. • May encourage interest to be re-characterised as another form (e.g., royalty). • Foreign country tax credit for the host country withholding tax needs to match actual (i.e., gross of withholding tax) payment.
Limits on interest rates (caps)	<ul style="list-style-type: none"> • Sets a clear limit, discouraging excessive local interest rates. • Could complement general transfer pricing rules as an anti-abuse provision. 	<ul style="list-style-type: none"> • Has no regard to actual circumstances of the taxpayer. Could penalise legitimate activity. • Requires ongoing review and updating as economic conditions change and market interest rates move. • May be circumvented by back-to-back loans if only applied to related-party transactions. 	<ul style="list-style-type: none"> • Could be used as a “safe harbour” to indicate interest rates that would not be examined by tax authorities (rather than a blanket restriction). • Whether denied deductions can be carried forward to use in subsequent years.
Proportional disallowance of deduction based on foreign tax rate (“Uruguayan Rule”)	<ul style="list-style-type: none"> • Directly targets the primary driver of base erosion, namely the differential between the host country and foreign country income tax rates. • Disallowance of deductions only occurs to the extent that there are international tax rate differentials. 	<ul style="list-style-type: none"> • Requires information on the actual foreign tax rate that applies (may differ from headline income tax rate). • Requires a country-by-country analysis. This adds compliance costs to business. • Tax reporting requirements would need to be changed. 	<ul style="list-style-type: none"> • Whether small tax rate differentials could be exempted from the application of the rules. • How to incorporate withholding taxes into the calculation of tax differentials. • Whether denied deductions can be carried forward.

Note: Action 4 not included pending feedback from countries that have implemented.



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