

16 March 2018

## THREE AFRICAN DIALOGUES ON FISCAL POLICIES AND CONTRACT NEGOTIATION IN THE EXTRACTIVE INDUSTRIES

### Introduction

This paper reports and reflects the experiences and voices of a wide group of African senior government officials (“**dialogue participants**”) heard at the three NEPAD “dialogues” held between 2015 and 2017 in Senegal, South Africa, and Cameroon.<sup>1</sup> Over 30 African countries were represented, as well as Regional Economic Communities.

The NEPAD Agency (“**NEPAD**”), in collaboration with ISLP and the CONNEX Support Unit, organized the dialogues in response to an African Union (“**AU**”) call to action. Indeed, at the 25th AU General Assembly in 2015 the AU requested NEPAD to build the technical capacity of Member States to design and implement tax policies and to negotiate complex contracts in the extractives industries. Following that request, the regional dialogues provided valuable opportunities for learning and sharing of experiences. The AU has also exercised leadership in this area by making one of the notable goals of Agenda 2063 building effective, transparent, and harmonized tax and revenue collection systems.<sup>2</sup>

The case for meeting this goal is urgent and the cost of failing very high. The Mbeki report on Illicit Financial flows estimates that total losses from “illicit” flows, including losses due to tax avoidance, poorly designed or lax tax regimes and weak tax administration, exceed \$50 billion annually. Support for stronger extractive sector fiscal regimes is a critical element in strengthening tax and revenue collection systems.

### Reporting the Themes and Priorities of African Officials

This paper reports across the range of the voices heard at the dialogues thematically. The views expressed herein are not necessarily consensus views of the dialogue participants as a whole and are not intended to be representative of the views of, or attributable to, any particular specified participants.

Here are some of the top priority issues raised and discussed by participants and expanded upon further below in the report below:

- Implementing concrete plans to improve transparency, knowledge, and involve a larger group of stakeholders in order to design more resilient tax policies related to extractives and to improve contract negotiation outcomes.

---

<sup>1</sup> The first dialogue and training session was organized in Dakar, from 9 to 11 September 2015, for the ECOWAS and ECCAS regions and the second dialogue was organized in Johannesburg, from 14 to 16 June 2016 for the Eastern and Southern regions. The third dialogue took place from 26 to 29 May 2017 in Yaoundé, Cameroon.

<sup>2</sup> Agenda 2063 is a strategic framework for the socio-economic transformation of the African continent over the next 50 years. More information is available here: <https://au.int/en/agenda2063>



- Apportioning clear roles and responsibilities within government to encourage greater engagement with citizens and taxpayers on tax matters.
- Promoting investment in better collection and sharing of tax data for Africa including through proportionate participation in international information exchange frameworks, the adoption of appropriate powers and frameworks to gather modelling data and other information from investors, and the effective deployment of ICT.
- Building the evidence base on regional cooperation to tackle harmful aspects of tax competition.
- Monitoring and strategically engaging with international initiatives such as BEPS with a view to ensuring that African concerns are properly addressed in international tax reforms.
- Investing in tax administrations and promoting the rule of law in tax and contract negotiation matters, including championing clarity and accessibility of the law and promoting its equal application.
- Building and share best practice on achieving and communicating community benefit flows in order to support country efforts to direct benefit flows in their particular contexts.
- Promoting sharing of good practice, engaging specialists to manage risks of revenue loss, and engaging, internationally, in reform processes to make transfer pricing work for Africa.
- Supporting tax reforms that enable African countries to fairly and effectively capture capital gains taxes on indirect stock sales (where the gains made reflect the value of mineral resources in those countries).
- Formulating and implementing robust double tax treaty policies based on cost/benefit analysis and reviewing existing treaties in light of such policies and recent developments in treaty norms.
- Analyzing the costs and benefits of stabilization clauses, limiting their use, scope and duration, and learning from international best practice to get them right up front.
- Checking and controlling the measurement and tax deductibility of early phase losses both from policy and administrative perspectives.
- Preventing significant tax avoidance through abuse of financing transactions and other complex financial instruments.

The remainder of this paper expands upon these key dialogue themes in two sections: (1) on the environment in which good tax policy and practice flourish; and (2) on specific tax law and policy and contractual issues that emerged from the dialogues as priorities for Africa.

## 1. FOSTERING A BETTER TAXATION ENVIRONMENT

The dialogues articulated a number of factors that influence the design and the implementation of the “right” fiscal regime for extractive operations. Some of those factors are detailed and country specific. For example, the fiscal regime should be linked with the kinds of commodities that are likely to be exploited. The regime should also be suitable for effective application to each



stage of the lifecycle of extractive projects (exploration, development, production, decommission). At the same time there are certain key issues, typically around information, transparency, and accountability frameworks, that are vital for fostering a better taxation environment for extractive industry projects.

### 1.1. Policy Making Environment

The dialogues further articulated concrete concerns and examples of good practice responses relating to the fostering of a positive tax policy making environment:

- At the political level: in some contexts investors are able to exercise influence at a high level and are able to have a disproportionate influence at the negotiation table or in influencing policy decisions. In response, participants shared experiences about how to build constructive forums for engagement and relationships between politicians, professional experts, and civil servants. It was commented that special interest lobbying that is not vetted with internal and external experts generally does not lead to good tax policy.
- Share best practices: as an example, the setting up of inter-ministerial committees to negotiate extractives agreements and make recommendations had positive outcomes in a few African countries. Having the responsible agencies in the room improves the likelihood of adherence to the rule of law. Further, increased transparency has also proved fruitful, by allowing for periods of advance parliamentary and public consultation and debate in relation to significant developments.
- Participants advocated reducing discretion in the granting of tax breaks (whether granted by law or contract) through articulating policy objectives in advance and ensuring that all incentives are published, open and consistent. The setting of maximum periods for tax "stabilization", for instance, sends signals to prospective investors that they need to have economically coherent reasons for justifying tax breaks.
- Following up by monitoring effects of incentives and implementing tight administration of incentives is important. More work could be done with Parliamentarians and other politicians and leaders to build understanding of tax policy issues and best taxation practices that are vital to domestic resource mobilization.

### 1.2. Citizens and Taxpayers

It is crucial to involve citizens and communities in tax matters. Taxpayer trust and cooperation is critical for state building and revenue raising. Participants cited examples where there was public loss of confidence in government based on perceptions that government and officials were too close to investors who were granted tax exemptions.

Voices coming out of the dialogues said:

- To foster trust of citizens and stakeholders, large sectors such as the extractives sector must be seen to contribute fairly to the state's resources.
- Realistic public expectations should be fostered to maintain a stable and constructive environment.
- Existing constructive initiatives, such as the African Mining Vision's compact with private sector leaders in the extractives sector, could be built upon to encourage a healthy and

informed public debate on tax issues in Africa. Such a debate should foster a sense of responsibility for both taxpayers and fiscal authorities.

### 1.3. Information

The dialogues discussed a major issue in the negotiation of extractive contracts: that is the unequal knowledge base of the contracting parties. Investors inevitably have more information at hand to make savvy investment decisions. Governments, on the other hand, often have difficulty getting evaluations of their mineral or hydrocarbon reserves from neutral third parties due to cost constraints, as they do not have easy access to the economic and financial experts needed to construct realistic tax, royalties, production sharing and other essential economic and financial projections.

From the dialogue discussions we learnt:

- Good policy is based on good data. The generation of good data requires investment.
- Dialogue participants observed that the private sector often tends to have an information advantage over government, including project financial modelling.
- African nations should collect data from internal sources and taxpayers to assist in the development and implementation of more effective and efficient tax policies, and more closely cooperate to share valuable data.

### 1.4. International Competition

The dialogues revealed some perceptions of harmful effects of tax competition between nations within Africa:

- Of particular concern is the use of costly tax incentives to attract investment in the context of perceived harmful competition for investment among African States. Countries should further explore the extent to which regional cooperation could address such concerns.
- Increased cooperation, integration, and/or sharing among African countries might help to address such concerns.
- The initiative of the AU Heads of State at their 2016 meeting in Kigali to commission a study on the harmonization of fiscal regimes in Africa is a valuable starting point for continued support for cooperation on tax matters in Africa.

### 1.5. BEPS

“BEPS” or “Base Erosion Profit Shifting” refers to an OECD/G20 initiative to counter tax avoidance strategies. The Inclusive Framework on BEPS is a collaboration on BEPS implementation with non-OECD countries. Seventeen African countries have so far signed up to the OECD’s inclusive framework on BEPS.<sup>3</sup>

Approaches to engagement with BEPS were discussed at the dialogues:

- There may be benefits in speaking with a common African voice on issues of shared concern to increase influence at OECD level.
- The African Union and other international bodies may be able to play a valuable role engaging with such countries to build a common African voice. Such bodies may also

---

<sup>3</sup> More information is available here: <http://www.oecd.org/tax/beps/beps-about.htm>

consider whether it would be worthwhile to liaise directly with the G20, OECD and other international tax actors to support African countries in protecting source country taxing rights. For example, a switch to a destination-based corporation tax or a sales-based formulary apportionment tax system would be harmful for most African nations.

- One dialogue participant summed it up saying: each country in Africa should think about its own options for engagement with the OECD, however there is always something to learn from international engagement with countries having similar interests.

### 1.6. Tax Administration

It was generally agreed that even the best tax policies and laws will not be effective if they are not well administered. This means that tax administration should be sufficiently funded and staffed and should be well-structured.

Dialogue participants discussed:

- Tax policy-makers should consult with tax administrators in formulating policy. In some countries the policymakers and administrators are rivals when they need to be allies to succeed.
- Senior tax administrators should also be encouraged to resolve and explain unclear or uncertain laws and to publish interpretations. Self-assessment tax regimes place a responsibility on tax administrations to help taxpayers to understand the law.
- There must be equality before the law in tax matters or taxpayer morale, on which voluntary assessment rests, will be impaired. A rule of law culture in tax as well as other areas should be championed.

### 1.7. Benefit Flows

Several countries raised important issues around the treatment of communities and indigenous people affected by extractives projects.

Dialogue participants raised important points:

- When projects raise government revenues it can be difficult to choose between the money going to local or national level.
- Work is being done at national level in some countries on accountability processes to ensure money ends up in the appropriate place.
- Frameworks and initiatives at appropriate levels should be supported to ensure that extractive industry revenues are used optimally and in keeping with the aspirations of the Africa Mining Vision.

## 2. IDENTIFYING AND ADDRESSING PRIORITY TAX LAW AND POLICY ISSUES

During the discussions, African countries called upon the NEPAD Agency and its partners to improve their capacities to analyze and design fiscal models and negotiate contracts for extractives projects. In addition, high priority was given to the design and implementation of a range of specific fiscal and tax laws. Indeed, experts highlighted the fact that if the law and the fiscal regime are well designed, it reduces the need for negotiation and, by extension, for



renegotiation of specific deals. Here is a non-exhaustive selection of critical tax issues currently affecting governments seeking to raise a fair share of revenues from extractives projects.

## 2.1. Transfer Pricing

Transfer pricing rules are intended to prevent the shifting of taxable profits across borders through the off-market pricing of transactions between group companies. The rules require arm's length prices for tax purposes on related party transactions. This mechanism is intended to prevent manipulation of corporate groups to reduce overall tax bills and assure a level playing field for local providers. Transfer pricing rules can be difficult to enforce in complex cases such as those involving extractives. Absent scrutiny, transfer pricing can give rise to tax evasion and avoidance opportunities in all related party cases. Legislation and administrative rules designed for OECD countries may not be suitable or sufficient for some African countries which may lack the deep sophisticated administrative skills and resources of OECD country tax collectors.

The dialogues highlighted the importance and relevance of this issue:

- Many African countries report that the rules are difficult to police effectively in practice. Several, if not most, countries' dialogue participants reported live issues around transfer pricing in some form. Transfer pricing emerged as a top priority issue with the following points showing just a selection of the more specific transfer pricing issues causing concern.
  - o First, country participants report difficulties in identifying related party transactions.
  - o Second, it can be challenging to identify arm's length prices for certain minerals, especially those that are unique, rare, or unquoted.
  - o Third, intra-group debt financing can erode the tax base where operating companies are based. (The interest payments on the debt reduce the profits booked in the operating company, a double tax treaty may remove or reduce withholding tax on the interest payments and the interest is subject to tax only at a low rate or not at all in the financing company's jurisdiction.)<sup>4</sup>
  - o Fourth, off market hedging arrangements that can be difficult to find and to price on an arms' length basis were a concern.

## 2.2. Indirect Stock Sales

Participants discussed avoidance of tax on capital gains. Extractives projects in which significant resources are discovered can quickly and significantly rise in value. For many countries it may be important to prevent avoidance of taxation of gains when interests in such projects are sold offshore. The dialogues confirmed the interest of African countries in capturing capital gains tax from such offshore stock sales. This issue can arise, for example, when instead of selling a mineral concession directly, or a share in a local company that holds the mineral right directly, shares in a foreign parent company of the local company are sold by foreign shareholders. Any gain on the sale is therefore realized offshore and it can be difficult to find out about such gains or bring them within the charge to tax in the country where the extractives project is located.

- Countries should be encouraged to weigh the pros and cons of adopting legislation to tax such gains, and to review their tax treaty provisions to identify those that should be revised.

---

<sup>4</sup> The recent Chevron case in Australia shows that push back in this area can be successful.

Often sales are in non-treaty jurisdictions so treaties should not be a barrier to undertaking this process.

- While ISLP favors the approach of taxing sellers on their gains, African countries should reach their own view and seek as much conformity as possible among themselves to minimize distortions based on differences in approach.<sup>5</sup>

### 2.3. Double Tax Treaties

Double tax treaties apportion taxing rights between countries, ostensibly to prevent taxpayers from paying tax twice on the same income or gain. However, in doing so, treaties can limit the freedom of countries to impose taxes. That can be problematic for countries. For example, one weak treaty, such as one that forbids a country to impose withholding tax on interest payments made by its taxpayers to a low tax jurisdiction, can create considerable problems and be a major loophole for countries that are primarily importers of capital.

- Dialogue participants noted that reductions of various withholding taxes under treaties represent a significant cost to African nations. Furthermore, a weak treaty will likely attract investment routed through that jurisdiction such that it can effectively become a treaty with the world.
- It also can be a difficult problem to address once the weak treaty is in force, so getting a strong treaty policy in place that is implemented consistently is hugely valuable. A good treaty policy should promote careful consideration of costs and benefits of every proposed treaty, and take account of the economic and tax systems of the countries involved (including whether the other country imposes meaningful taxation). Countries should also consider the indirect costs of implementing and managing new treaties as part of the upfront cost/benefit analysis.
- Countries should be wary of promises of expanded direct foreign investment based on the existence of a tax convention, should consider adopting domestic law provisions regarding permanent establishments, information exchange, withholding taxes, and avoidance of double taxation which, in some way, mirror desirable treaty provisions thereby minimizing the need for treaties and the tremendous amount of time, effort, and skills required to negotiate them.
- This is another area where coordination among similarly situated and possibly competitive jurisdictions would be useful to prevent potential investors from making these countries compete with each other to the detriment of their countries revenues.
- Once a treaty policy is promulgated, existing treaties should be reviewed under the policy and a rigorous cost-benefit analysis. Treaties that are not in line with policy should be amended or even terminated, particularly if they result in material revenue loss uncompensated for by new investment.

### 2.4. Stabilization Clauses

Concession agreements and other contracts concerning extractives projects often contain terms that are vital to the fiscal regime governing those projects. Therefore, the regulation of such contracts is vital including, notably, the negotiation of the terms of any stabilization clause within

---

<sup>5</sup> Here is a paper from ISLP and CCSI providing some practical guidance on this issue: <http://islp.org/islp-and-ccsi-publish-new-offshore-stock-sales-paper/>



the contract. This is another priority area reflected in the Africa Mining Vision and it concerns the realization of that vision.

Concession agreements are almost always effective as law, and often have very long terms (e.g. 20-30 years). This means that very significant front end effort is justified and needed by governments in negotiating concession agreements. Concession agreement negotiations raise difficult issues because governments want to attract investors, and investors want long term certainty, or at least confidence that the long term economics will not change drastically. At the same time, governments want flexibility.

- The dialogues had a strong focus on the negotiation of fiscal stabilization clauses in contracts with investors (these clauses commit a government not to alter or maintain key tax rules favorable to the investor for a set duration). Some African countries do not give stabilization clauses, but most do.
- Investors may argue that in committing to a long term investment they need comfort that the fiscal regime will be stable. Governments could try to shift from providing such comfort through stabilization clauses towards providing it through increased and ongoing operational predictability, although some dialogue participants indicated that stabilization can be useful or necessary in some circumstances. It was clear from dialogue participants that unfavorable agreements can cause significant difficulties.
- These clauses should be subject to rigorous cost-benefit analysis along with the rest of the contractual provisions. If countries do agree to a stabilization clause, they should consider including limits to its duration, limits it to its scope (e.g. application only to a limited set of financial issues), and allowing such clauses only for very large contracts. Countries may also consider charging a premium tax rate for stabilized tax treatment.
- Some dialogue participants indicated that African countries should work together to set standards on stabilization clauses, another area of possible supranational engagement.

There are numerous benefits to be gained from the right kind of foreign investment in local resources. Different government agencies are affected by provisions of agreements generating charitable contributions, schooling, medical care, training, employment and of course tax revenues. These need to be coordinated and prioritized and the local concession negotiators must provide a united front.

## 2.5. Losses

Losses can be a valuable asset for taxpayers for corporate income tax purposes to the extent they can be offset against what would otherwise be taxable profits. The use of losses for tax purposes is an issue of particular importance to extractives projects because they typically have very high capital expenditure costs (and depreciation and amortization deductions) in exploration and development phases.

- Tax policy-makers should carefully consider whether to grant immediate tax deductions for such expenditure and the extent to which related tax losses can be carried forward and set off against future profits for tax purposes in future accounting periods.
- The deductibility of these types of early phase costs were major concerns for a number of the dialogue participants from a range of African jurisdictions who reported concerns about resulting delays in recognition of taxable profits.



- From a revenue perspective, royalties on sales generate host country revenue earlier in the project when sales commence, as compared with taxes on profits. The mineral royalty rate can be used to balance revenue flow so consider the use of royalties as part of a well-rounded fiscal regime.

## 2.6. Financing costs

Taxpayers are normally allowed to deduct interest payments on debt financing in calculating their profits for corporate income tax purposes. Excessive interest deductions due to the asymmetry in the treatment of debt and equity result in a significant loss of taxable income. This is a problem for all jurisdictions --not just Africa-- and has been addressed in the BEPS project (Action 4).

- BEPS proposed that deductible interest be limited to a percentage (e.g., 10 percent up to 30 percent) of taxable earnings before interest income and expense, depreciation and amortization (tax EBITDA). In addition, it would look at the worldwide group of affiliated companies (the "group") to allow an affiliated entity to claim a higher deduction.
- Participants discussed use of such maximum debt to equity ratios and various other limitations on interest deductibility to combat abuses. All African countries could benefit from the percentage limitation (some countries already have a percentage rule but at higher levels than BEPS recommends).
- Differing from BEPS and in part to address transfer pricing problems, African governments could also use the group ratio and the group borrowing rate to limit the affiliate's debt equity ratio and the interest rate on loans from affiliates.

## Conclusion

There are many important national factors relevant to the design of extractive industries fiscal regimes, such as those relating to local economy, geology and tax administration capacity. However, national electoral cycles may sometimes militate against long term thinking needed to design regimes suitable to govern extractives projects, which are typically long-term projects. The stakes and risks are high in such projects, prices can be volatile, and returns on investment take time. Governments need a balance of revenue sources to meet needs over a range of different business cycles. African leadership can support governments' development of progressive fiscal regimes that operate fairly and effectively in a range of scenarios, including very high or very low prices. This in turn is likely to create the kind of stable and predictable environment that is attractive to investors.



NEPAD is a technical body of the African Union (AU). NEPAD acts as the AU's implementing agency, mobilising resources and partners, leading knowledge sharing within the AU regarding development issues, monitoring and evaluating programmes and conducting advocacy connected with the vision of the AU.

ISLP is an independent non-profit organisation made up of affiliated entities in the US and UK charity that strategically deploys pro bono legal assistance to developing world governments and civil society organisations. ISLP's mission is to promote just and accountable development that is supportive of human rights and the rule of law. To that end ISLP focuses on selected issues where its network of specialist lawyers adds most value, including investment, trade, natural resource management, and international taxation.

The CONNEX Support Unit is the implementing body of the G7 CONNEX-Initiative with the objective to contribute to fairer, more sustainable investment deals as drivers of development. The CONNEX Support Unit assists developing and transition economies worldwide in complex contract (re-)negotiations in the extractive sector by providing high quality, independent, demand-oriented and ad-hoc advice for upcoming or ongoing negotiations. Selected experts are from a wide range of disciplines (law, fiscal analysis, industry analysis, environmental, etc.) to meet the individual requests from client governments.