

## **West Africa Conference - Administering fiscal regimes for mining and petroleum: Issues and Challenges in West Africa**

Developing countries with significant natural resource endowments are presented with a remarkable opportunity to boost long term growth. This opportunity comes with enormous challenges. To maximize social and economic benefits, strong governance and institutional capacity are essential along the entire value chain that turns natural resource endowments into sustainable development and poverty reduction.<sup>1</sup>

This conference will attempt to address the nature of the risks that are faced by revenue administrations in sub-Saharan Africa due to the unique characteristics of the industry, the variations in regulatory and contractual fiscal regimes that exist and the administrative environment that governs the industry. It asks the question, what types of mitigation strategies are employed and/or could be employed and what knowledge and skill bases exist or are needed by administrations to deal with these risks.

The conference also considers how the fragmentation of regulatory responsibilities and risks that are inherent in a capital intensive global industry expose resource based fiscal regimes to revenue loss.

West African countries are at varying stages in developing the capacity to deal with these challenges. In theory, the administration of revenues from extractive industries involves the same principles, procedures and practices as other taxes. Therefore, the design and implementation of procedures for natural resource tax administration should accord with good practice in general tax administration.

### **I. Principles for Natural Resource Revenue Administration**

A primary goal of revenue administrations is to collect the taxes and duties payable in accordance with the applicable laws, regulations, policies and procedures through a facilitative compliance environment. This goal must be accomplished in a manner that will sustain confidence in the administration and the tax system as a whole. Revenue administrations have limited resources to address all risks and therefore need to develop targeted strategic and tactical responses in a manner, which maximizes compliance from taxpayers. This is best achieved through a balanced program of taxpayer assistance, simple laws and procedures and risk-based verification outlined as follows<sup>2</sup>:

- Taxpayer education and assistance helps taxpayers and their advisors understand their obligations (taxpayers cannot comply if they do not understand the tax laws);
- Simple laws and procedures make it easier and less expensive for taxpayers to comply (taxpayers will not voluntarily comply if the tax system itself makes it difficult or too expensive); and

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<sup>1</sup> *Revenue Administration: Administering Revenues from Natural Resources – A Short Primer*

<sup>2</sup> *Revenue Administration: Developing a Taxpayer Compliance Program*, Barrie Russell, IMF.

- Risk-based verification deters non-compliance (taxpayers are more likely to comply if they perceive a strong chance of detection and see blatant offenders penalized).

## II. **Effective Risk identification and Assessment Processes**

Enhancing voluntary compliance requires developing an objective risk-based verification processes. Increased automation and access to data is the direction that risk assessment is moving in. However, most risk assessment systems have a manual component, and some are principally manual systems. Each system has merits.

The first step in developing a risk assessment system is to segment the taxpayer population into groups that have similar attributes. Size and complexity of the taxpayer is a common basis for segmenting the tax base – small, medium and large taxpayers. Other factors that segmentation can be based on include economically important industries, the nature of the risk, such as, international, avoidance or domestic, or the type of tax, for example, income tax or VAT. Keep in mind that there is no ideal segmentation system. Instead, the goal is to identify groups that have similar tax compliance and business characteristics. Creating groups of similar taxpayers facilitate the revenue authority's ability to identify risks, the underlying causes of the risk, and develop tailored compliance strategies to mitigate those risk.

The next step is risk identification which concentrates on identifying taxpayer behavior that can lead to significant revenue losses. Various methods can be employed to identify risk including indirect methods such as sector-based tax gap analysis, direct methods such as a random audit program, economic modeling, and automated algorithms. The EI sector in most countries consists of a few large taxpayers who operates one or a few large-scale projects. These characteristic make the use of economic modeling feasible as a tool to identify tax gaps and risk indicators on a project by project basis. The risk assessment model recreates the fiscal regime and determines the tax outcomes on a yearly or life of project basis. The outputs from the model can be compared to the taxpayers filings for a taxation year resulting in indicators of compliance gaps, or that the taxpayer is compliant.

Regardless of the method employed to identify risk, the methodology should be objective and evidence-driven. Evidence to support risk identification comes from returns, forms, elections, and payment information submitted by the taxpayer to the revenue authority.

In many countries, governance and administration in the EI, sector is fragmented among many government ministries, agencies, and in some cases the national oil company. A consequence of fragmentation is that data collected by the other regulating bodies is not available to the revenue authority. Access to this information would strengthen the revenue authorities ability to assess risks. One alternative to solve this problem is to store relevant data collected by the various regulating bodies in a central repository which all the regulating bodies have access. Keep in mind that there may be constraints on what information a regulator can share with other parties. Memorandums of understanding can overcome the problem, and information sharing constructs can be developed to respect taxpayers confidentiality rights.

A key consideration is that the revenue authority has to be able to assess the relative threat that each risk poses to its objectives. Assessing the threat involves a determination of the likelihood that risk will occur and the consequences that result if the risk occurs. The assessment of likelihood and consequences can involve a qualitative or quantitative measurement or combination of both. The scores for the two parameters can be brought together to produce a risk rating for each risk. The ratings are then used to produce a risk rating matrix.

Risk ranking is an important factor in selecting which risks the authority will mitigate. The selection also considers other factors including, expected recoveries from the mitigation strategy, the internal capacity to implement the strategy, public perceptions of the risk, and potential proliferation of the risk.

### **Other considerations**

1. Effective risk assessment must be carried out by a group of experienced officials who collectively have expertise in tax law, accounting, tax planning, and international and domestic transfer pricing. EI specialists are critical members of the team who can interpret the data and outcomes considering the EI's unique business processes, practices, and operating environment. The risk assessment group will also need to have access to expertise in economics, including economic modeling, information technology, and data management.
2. Countries are increasingly recognizing the value of sharing information to augment risk assessment and enhance voluntary compliance. The approach can be formal or informal. The traditional approach is to negotiate a bilateral or multilateral tax treaty with exchange of information provisions. Tax treaties are comprehensive, but the process of negotiating and ratifying the treaty can be lengthy. Alternative sources of information are:

Country by Country Reporting: For fiscal years commencing after January 1, 2016, multinational companies with revenues of more than 750 million euros will have to prepare a report that will be filed with the tax authority where the company is headquartered. The report has three parts and discloses by tax jurisdiction; total revenue, revenue from related and third parties, pretax income, taxes paid and accrued, employment, capital, retained earnings, assets and activities. Countries under unilateral or bilateral tax agreements, including information exchange agreements with the home country, will be entitled to receive the information.

The Convention on Mutual Administrative Assistance in Tax Matters: The convention was developed in 1988 and amended by Protocol in 2010. Approximately 116 jurisdictions participate in the Convention. Member states agree to assist each other through exchanges of information, a collection of tax assistance and service of documents.

### **III. Nature of Risks presented by the Sector**

Risks presented by the sector can generally be divided into three categories:

- ✓ **Nature of the industry**  
To properly identify and analyze the risks presented by the industry revenue administrations must understand the characteristics of the industry that drive business decisions and the consequences that those decisions have on revenue reporting. Though corporations will engage in tax arbitrage to minimize their tax costs, it is important to note that decisions made in the normal course of business can have significant tax effects. Effective mitigation strategies must be developed to address risks bearing in mind their underlying causes.
- ✓ **Complexity of nonstandard fiscal regimes that apply to the industry**  
The characteristics of the industry discussed previously prompt a range of tax policy responses from governments. The complexity of nonstandard fiscal regimes present unique challenges for revenue administrations worldwide.
- ✓ **Organizational structure of regulatory compliance by the country.**  
The involvement of numerous departments and agencies in the fiscal administration leads to fragmentation of responsibilities for fiscal policy and administration. This can lead to the development of uncoordinated and incoherent rules and processes. It is preferable that responsibility for fiscal administration is consolidated in the Revenue authority.

(See Appendix one for a more detailed discussion of EI specific industry and regulatory risks including industry characteristics that drive business behavior).

### **IV. Strategies to Address Taxpayer Compliance**

An effective compliance strategy for the extractive industries requires responses from front-line functional areas that educate, inform, verify and enforce. Piecemeal responses from front-line operations will be less effective than a coordinated strategy and response. Audit, filing enforcement, arrears management and taxpayer services each need to act and address risks in a coordinated fashion. For large corporations, the risks faced are more likely concentrated in under reporting using techniques such as transfer prices, cross-border transactions including those with tax havens and financing costs to name a few. Priority risks must be analyzed to identify the likelihood and impact of the risk, the drivers and attitudes underlying non-compliant behaviors and determine the appropriate mix of responses from the revenue administration. In addition, the system must be fair and be perceived to be fair for taxpayers to want to comply. This requires an operational, and robust dispute resolution system that provides for a timely second review of decisions.

Coordinated compliance strategies should include:

- Taxpayer services provide a crucial role in providing summarized and understandable advice upon which taxpayers can rely. Targeted measures need to be developed to help taxpayers understand their obligations and consequences of noncompliance.

- Filing enforcement is a mainstay of compliance management given that filing is the first step in establishing tax liabilities. Monitoring filing behavior and enforcing filing of overdue returns is generally an automated process where returns filed are matched to the taxpayer register. Penalties should be applied consistently for all filing violations.
- Audit activity should include a range of audit types both comprehensive and issue oriented audits to ensure limited resources are engaged in activities which generate the maximum revenue and/or maximize coverage in a sensible manner given the availability of resources. Audit selection should be based on an automated risk assessment model.
- Arrears management requires early determination of collection risks and timely recovery actions to maximize returns.
- Dispute Resolution: which is equitable, accessible and timely for complex cases such as EI disputes is essential. Units separate from the functional areas that identified, calculated and processed the assessment should be set up to ensure a transparent and impartial review process.

## **V. Organization of Natural Resource Administration**

It is important to develop specialist expertise in the natural resource industry, to analyze and understand the fiscal rules that apply to the industry and the inherent risks that they present to compliance. Such specialization can be developed within a predominantly function based organization, taking advantage of international practice to segment taxpayers based on their characteristics and risks. Principles include:

- Ideally, revenue administration of natural resources companies should be managed within the Revenue Authority. If responsibilities for revenue administration are divided between various government departments and agencies, strong formalized information sharing and cooperation is required for effective revenue administration.
- In many cases government takes an equity interest in resource plays. Combining fiscal administration and managing the governments equity interest within in the same government entity presents a conflict of interest situation and should be avoided.
- Natural Resource companies, given their size and characteristics fit into the large taxpayer segment of the tax base and are best managed in a Large taxpayer office (LTO),
- A separate Natural Resource (NR) unit may exist for large NR companies within in a large taxpayer office (LTO), for functional areas which require specialized knowledge such as targeted client assistance, risk assessment, auditing and legal and policy matters.
- Where there is a significant artisanal mining sector, if necessary a specialized unit can be set up in a medium taxpayer office.

## **VI. Weak Governance, Corruption and Transparency**

In many countries with significant natural resource endowments the social and economic benefits that citizen expected to realize fail to materialize. The failure in large measure can be linked to a failure of national governance due to lack of capacity and accountability, and corruption.

The influx of natural resource wealth into tax administrations with low capacity, and weak internal control systems create an environment where integrity breaches can be concealed and never discovered. No single tool can minimize opportunities for corruption and address its occurrence. However, there are some steps that revenue administrations and government as a whole can take to minimize the risk in the tax administration including:

- Effective management and professional leadership throughout the organization instils a culture of integrity and honesty.
- Organizational structures that clearly define authority and responsibility, and recognize segregation of planning and monitoring functions from operational functions limit the opportunities for inappropriate behavior.
- Increased accountability through a code of conduct and asset disclosure requirements deter wrong doing.
- Reliable Information systems capable of recording audit trails
- An internal audit function to independently test and evaluate control systems and specific operations.
- Transparency of EI revenues and their utilization is a vital prerequisite for strengthening governance.

## **VII. Revenue Administration Frameworks in Selected West African countries**

A brief overview of revenue administration frameworks in West Africa reveals that:

- Liberia, Ghana, Sierra Leone and Nigeria have set up specialized natural resource teams to administer the Natural Resource sector
- Other specialized teams that have been introduced in various countries to deal with more generalized risks which are also prevalent in the natural resource sector include international transactions and transfer pricing, as well as a dedicated risk assessment team.
- Revenue administration of all facets of the natural resource fiscal regime is centralized within the revenue authority in Ghana, Sierra Leone and Liberia. In Sierra Leone, a strong formalized information sharing arrangement between the NRA, the Ministry of Mines and the National Minerals Agency is being pursued.
- Sierra Leone is developing resource project fiscal modeling skills to enhance its risk assessment, revenue projections and compliance gap analysis.
- Liberia is developing a risk assessment process and has begun to incorporate the results into operational planning

## **Appendix One:**

### **Main Characteristics of the NR Sector and their impact on Revenue Administration**

**Capital Intensive with high risk and cost:** The finding and extracting of natural resources involve exceptional uncertainty and risk. Volatility of prices, cash flows, risk appetites and availability of capital make decisions on how to allocate capital complex. Expectations for rates of return and cost of debt and equity rise with the increase in risk. Business responses can include divesting of non-strategic assets, creation of joint ventures and partnerships to reduce exposure to risk and the use of innovative funding methods. Government responses can include tax incentives such as tax holidays to help attract investment, which can result in complex tax rules. Tax administrations need to be concerned about transfer pricing in business restructuring, allocation and classification of debt domestically, the application of thin capitalization rules, farm-in and farm-out arrangements and the taxation of profits from disposals.

**Cost Management:** Cost inflation in mining during the latest period of high commodity pricing was estimated to have been 15 to 20% annually. In the oil and gas sector skilled labor shortages, demand for equipment complemented by exploration and development that is focused on more difficult and less accessible locations such as deep water offshore has driven costs up steeply. Business responses can include divestiture of non-core and or low profit assets, outsourcing of non-revenue generating activities and the creation of joint ventures to have more effective use of shared services. Research costs on innovative methods to access these more difficult and/or remote mineral formations have increased. Tax administrations need to be concerned about farm-in and farm-out arrangements, research and development cost allocations, taxation of profits on disposals and classification of expenditures for write-off purposes.

**Price and currency Volatility:** Mineral commodity price volatility increases the risk associated with projects that have long development periods. Currency volatility increases the uncertainty around local operating costs and exchange-traded funds add to price volatility beyond pure supply and demand factors. Business responses generally include hedging strategies, prudent cost management. Tax administrations must be concerned about tax arbitrage arrangements including utilization of hedging and financial products.

**Multinational nature:** Large multinationals judge their return on capital investment based on net income net of all applicable domestic and international taxes required to repatriate this income to their home jurisdiction. They employ in house tax departments and sophisticated tax planning techniques to minimize their tax cost.

**Large artisanal mining sectors in some countries:** Artisanal miners consist of both licensed and unlicensed miners and generally operate outside of and have little understanding of the countries regulatory environment. This can be a significant portion of the economy that operates outside of the tax system. (In Ghana, artisanal miners mine approximately 32% of gold exported). A broad set of strategies are normally needed to address this shadow economy including regime and administrative simplification, education, out- reach, communication based initiatives, legislated tools to assist in detecting and deterring non-compliance complemented by audit and enforcement programs.

**Non-renewability:** Governments normally assert ownership of finite non-renewable Natural Resource (NR) and exert closer regulation and require a higher payment for their extraction. Special (NR) taxes—for example, royalties and Resource Rent Taxes—depart from the regular tax system and are sometimes administered by non-tax departments, fragmenting the administration of the NR fiscal regime and posing challenges for interagency coordination.

**Exceptional rent-generating potential:** To capture the resource rent, governments normally charge higher-than-normal taxes on NR. This practice creates exceptional transfer pricing (TP) risks, which governments may seek to mitigate by adopting benchmark-based pricing. Governments also need special ring-fencing tax rules so that higher taxes on NR extraction are not reduced by extraneous costs; however, countries generally do not want those higher taxes to apply to NR processing.

**Long development and operating periods:** Delays in reaching profitability provide an incentive to governments to impose royalties to secure early revenue. Special loss relief rules may be needed, as well as special returns and audit procedures for pre-profit periods. Specific rules are also needed for abandonment reserves or funds. Companies face major risks from changes to the NR tax regime once they have sunk costs. It is common for governments to provide assurances of stability and negotiate special tax arrangements governed by contract law, with rights to international arbitration. These types of arrangements pose considerable administrative challenges.

**High levels of exports and imports:** These contribute to TP risks and require effective customs control, a robust value-added tax (VAT) refund system, and a sound exchange of information between the tax and the customs administrations. In addition, the high level of foreign payments makes withholding taxes (WHT) important and complex as special rules may apply.

**Poor governance:** The association of poor governance with NR activities demands special measures to improve transparency of revenue administration and accounting

**State control and ownership:** State ownership is common but varies in nature and extent. Boundaries between commercial participation and taxation may be blurred. The fiscal role of national resource companies (NRCs) may be unclear, as may rules and responsibilities for revenues from state ownership.