

Mining sector – Impact of Interest deductions in developing countries

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A. Introduction:

In the current era, developing economies play an important role as they contribute to more than half of the global GDP. Global economy is moving at a slower pace and the growth is expected to stabilize at 2.7%[1] in FY 25-26. Although, the global financial conditions have eased slightly, the growing debt-service burdens continue to pose considerable threat to the economic activities in developing countries. Borrowing costs remain far higher than in the 2010s in developing countries ever since the impact of covid19. Further, concerns over trade relations with United States, policy rate cuts and increase in political uncertainty in developed economies are holding back investor optimism in the recent times.

In light of the above economic scenario, asset intensive industries face funding challenges due to high initial costs, long payback periods and the need for significant capital expenditures, making them vulnerable to economic slowdowns. Such industries face various challenges to secure finance since traditional lenders like banks are hesitant to provide large loans to these industries owing to high risk and long payback periods.

Mining industry is one such capital-intensive industry where requirement of funds during the acquisition & exploration stages is generally high. Due to uncertainty in the mining outcome, many resource-rich countries across the world face financial difficulties during the exploration phase since the chances of obtaining funds from external sources are remote.

Therefore, developing economies with rich mineral resources source funds from Parent/Group or Related parties ('RPs') in developed countries to fund their mining operations. Given that substantial funding is required for a mining company and given the fact that it could be primarily financed by an RP, the provisions limiting excessive interest deductions are likely to be an impediment.

This article discusses about mining sector and the impact of excessive interest deductions in mineral rich developing countries.

B. Funding Alternatives for MNE's in mining sector:

MNE's engaged in mining activity assume considerable risk as the investments in exploration may not yield a worthwhile discovery every time. There are various stages involved in the mining activity and the financing requirements for each stage is different. The following are the stages of mining life cycle:



High-risk activities are undertaken in mining industry since the investors might realise returns only if the exploration leads to profitable mining operations. However, if the exploration is unsuccessful, significant amount of capital to sustain the operations would be required till the realisation of revenue from mining operations. Considering the above factors, debt-based funding is often considered suitable because it allows the entities to access funds without diluting the ownership, offering a predictable repayment structure thus making it a valuable tool to manage cash flow and facilitate growth while maintaining control over the company. While large MNE's raise funds through external sources, small and medium MNE's seeking ad-hoc financing largely rely on the RPs .

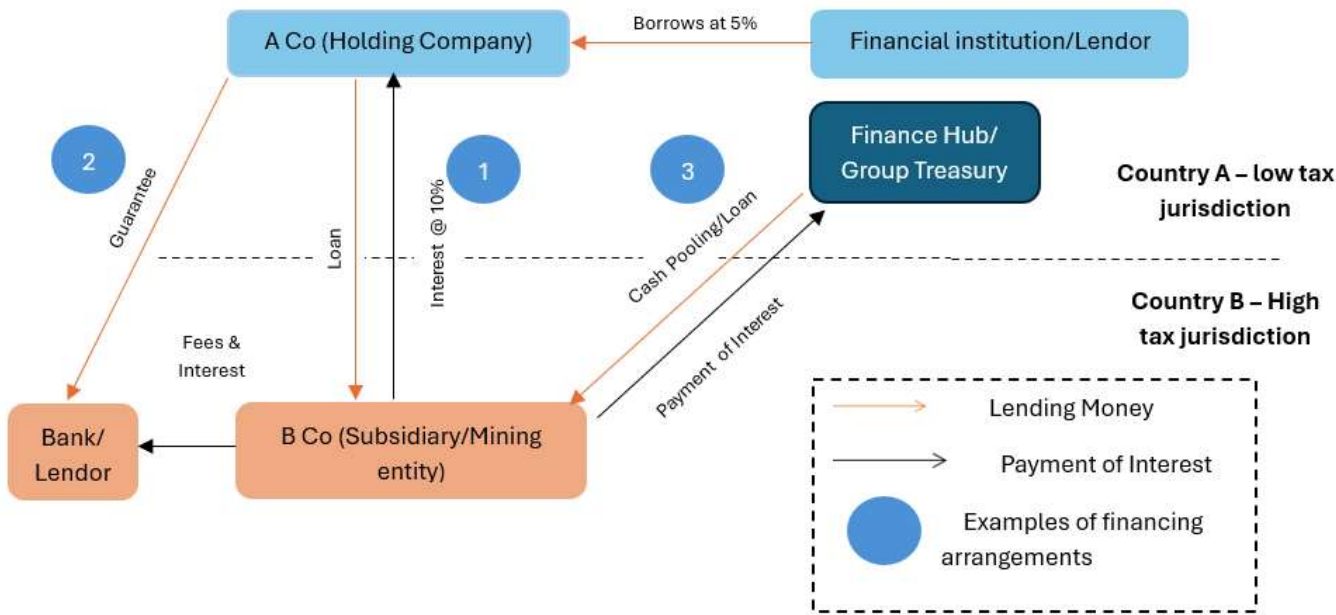
Various factors like credit rating, nature of minerals mined, level of risk, assets offered for security, requirement of ad-hoc finance, etc influence the external sourcing abilities of small and medium MNE's. Further, changing market conditions has a bearing on the existing financial products (i.e. change in the ARR/SOFR rates), thus, narrowing down the funding options for the large MNE's as well. Therefore, securing funds from the RPs is often considered as the most feasible option.

Most MNE's optimise their overall funding by carrying out centralised financing functions through a finance hub which provide various financial services to its group entities and which provides them with the best tax arbitrage. The financing entities of the Group aids its subsidiaries by:

- a) Providing internal loans;
- b) Cash Pooling;
- c) Supervision of cash flows;
- d) Collateral/Guarantee for loan;
- e) Hedging

Examples of various financing arrangements





C. Interest Deductions and BEPS Action Plan 4:

Financial services amongst the group entities are of relatively high transfer pricing vulnerability considering the volume of financing for a mining business and given the fact that minor mispricing could have a material impact on the profitability. The developing countries with high tax rates face higher risk since the MNE's tend to charge higher interest and shift profit legitimately.

BEPS Action Plan 4 sought to address such excessive interest deductions and counter profit shifting. This action plan recommended introducing provisions in the countries' domestic laws to address the following base issues:

- Dis-proportionate allocation of debt by MNE's amongst the group entities;
- Interest rates that are inconsistent with the market i.e. non-arm's length interest rates;

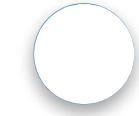
The BEPS recommended approach ensures that the entity's net interest is directly linked to the taxable income under three parts namely:

- Capping Interest deductions (Fixed Ratio Rule)- Allows a company to deduct interest upto a certain limit while computing taxable income.
- Group wide approach (Group Ratio Rule) - this allows an entity of the Group to deduct more interest based on the Group's worldwide position.
- Specific rules (Targeted rules) – specific rules targeted to prevent excessive interest payments

Considering the significance of the interest deductions in mining sector, OECD issued a practice note on 'Limiting the Impact of Excessive Interest deductions on Mining Revenue', to assist the tax authorities to identify MNE's who use debt as a tool to shift profits.

Several measures recommended by the OECD impose restrictions on excessive interest deductions such as below

Measures	OECD Guidelines/Recommendations
Thin Capitalisation	<ul style="list-style-type: none">• Directly set limits on capital structure of MNEs• Expressed as ratio of relative level of debt to equity. Any interest beyond the debt equity limits were denied;• Fixed Ratio Rule recommended 10-30 percent as benchmark net interest on EBITDA
Interest Rate Caps	<ul style="list-style-type: none">• Aimed to impose a cap on interest payments made to RPs (eg. LIBOR/SOFR plus 500 bps), to address unreasonably high interest rate mark-ups by MNE's.
Anti-abusive provisions	<ul style="list-style-type: none">• Provisions set to address specific areas in tax laws and assist tax authorities to identify and penalise complex business arrangements.• Introduced to prevent tax avoidance by evaluating the real economic effect of a transaction.
Proportionate Adjustment	<ul style="list-style-type: none">• Limitation on interest deductions based on differences between local and foreign rates, have been imposed by certain countries.



Transfer Pricing Rules

- Transfer Pricing Rules targeted to ensure that the international transactions between RPs are at arm’s length.

D. Introduction of Thin-cap rules in developing countries:

In line with the guidelines issued by the OECD, India introduced thin-cap rules vide section 94B of the Income Tax Act, 1961. Section 94B specifically **targets** excessive interest deductions by **limiting the deductibility of interest** paid by an Indian company to its RPs. The deduction is **restricted to 30%** of the earnings before interest, tax, depreciation and amortisation of the Indian entity and the provisions are applicable for payments exceeding INR 10 million. This aligns India’s tax regime with the BEPS guidelines and ensures that the Indian tax system does not fall prey to MNE’s aggressive tax avoidance strategies.

Similarly, most of the countries (both developed and developing countries) introduced thin-capitalisation rules, which, not only limit international debt-shifting but could also impact their real economic activity. Most European countries have pre-tax interest limits in place i.e. limit set to 30% of EBITDA. In Srilanka, the interest in relation to debt exceeding 3 times the equity is disallowed while computing taxable income. Likewise, the African country has set benchmark debt-equity ratio as 3:1. Similarly, interest payments for debts exceeding the debt-equity ratio of 3:1 limit is disallowed in Japan.

E. Impact on Mining Sector in developing countries:

The developing countries, in an endeavour to attract FDI in mineral exploration, have formulated various fiscal incentives and tax holidays, however, excessively restrict certain financing arrangements. MNE’s therefore, continuously optimise their businesses on global scale resulting in significant restructuring and restricting flow of FDI into the country.

Mineral rich developing countries are therefore in the process of rephrasing their local regulations adhering to OECD’s recommendations and also carefully considering the benefits and costs of entering into DTAA’s with developed countries.

Furthermore, the following critical factors also needs to be considered by MNE’s while entering into financing arrangements:

- a) Debt-equity ratio – Companies with disproportionate debt-equity levels are prone to high financial risks, which might be viewed as a red-flag from investors perspective;
- b) Non-arm’s length interest rates – Related party interest rates, if inconsistent with the market rates might lead to potential transfer pricing issues;
- c) Complex structures – MNE’s tend to formulate complex structures to finance the group entities – this might lead to tax issues in case any revenue leakages/base erosion issues are identified by the tax authorities.

F. Key Takeaways for MNE’s:

Though sector-wise tax policies are usually not being implemented by the policy-makers because of its limited applicability, if mining industry contributes to a significant portion of the country’s economy, special rules relating to such sector might be introduced in such countries in line with OECD’s recommendations. Provisions favourable to mining industry are often embedded in the corporate tax systems in various countries. Such sector specific incentives might be in the form of:

- Waiving/deferral of mineral royalties
- Tax holidays for a specified period/based on quantity extracted basis
- Special capital allowances
- Indirect tax exemptions

MNE’s should consider the following points while evaluating on the region/location to set-up/expand its mining operations:

- Although TP legislation exists in all developing countries, tax authorities might lack knowledge of mining industry , and as a consequence, certain issues may not be fully addressed. Therefore, maintenance of appropriate documentation is the key;
- The transfer pricing documentation should clearly differentiate between the routine and unique services to ensure that appropriate transfer pricing methods have been applied for substantiating the intra-group transactions;
- Consider understanding the regional tax laws to determine whether adequate carry forward provisions are available for mining entities to mitigate cash flow issues due to timing mis-match between development & production stage of mining life-cycle;
- Be aware of the country’s thin cap rules to understand the maximum allowable level of debt;
- Drop in the prices of the commodity might have a major impact on mining industry which could hinder the lending/ borrowing conditions of MNE’s. Therefore, risk-mitigated approach should be adopted while drafting inter-company financing agreements, for eg: interest rates should be linked to market conditions/commodity prices; and
- Ensure that the inter-company pricing policies are consistent with the arm’s length principles i.e. whether the terms & conditions of related party transactions are similar to those entered under uncontrolled circumstances with unrelated parties in the absence of MNE’s influence.



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