Mining Taxation – Overview of Recent Trends

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Agenda

1. Tax instruments commonly used in the mining sector
2. Country examples: Chile, Peru, Australia, and Canada
3. Conclusion

Tax instruments commonly used in the mining sector

Fiscal instruments used in the mining sector

In most countries mining projects are subject to specific taxation arrangements. While mining fiscal regimes vary across jurisdictions and minerals, they usually include some of the following fiscal instruments:

- **Royalties** (and windfall taxes)
- **Corporate income taxes (fixed or variable rate)**
- **Resource rent taxes**
- **State participation**
- **Local participation**
- Dividend and interest withholding taxes
- Other indirect taxes

Royalties: basic features

- Payment to the resource-owner (usually the state) for extracting the mineral
- Most common (and sometimes most important) levy on mineral extraction
- Attractive to governments because it ensures a constant stream of revenue from the start of production
- Relatively simple to administer
- Royalties don't take into account cost (except for profit-based ones), so they reduce the "cut-off" grade of the mineral
- Investors perceive it as an additional cost to mineral extraction
- Mining royalty rates usually vary between 1% and 13%, depending on the type of royalty and the type of mineral

Different types of royalties

Royalty	Description	Used in
Ad valorem	% of production value	Brazil, Argentina, Africa, some Australian and US states
Specific	Fixed charge ($) per unit of production	Indonesia, China, India
Profit-based	% of net income or other measure of profit	Chile (SMT), Peru, most Canadian provinces, Nevada (US), Northern Territory (Australia), Ghana, South Africa
Price-based (windfall tax)	% of production value based on a price scale	Zambia (repealed in 2009), Mongolia (repealed in 2010), Bolivia

Source: Hogan, Lindsay and Brenton Goldsworthy (2010), "International Mineral Taxation" in *The Taxation of Petroleum and Minerals: Principles, Problems and Practice* (IMF)

Resource rent taxes (RRT): basic features

- The idea is to tax only the mineral rent of a project without affecting the return required by the investor
- It is imposed on the net cash flow of a project once a specified pre-tax rate of return (e.g., 18%) is achieved
- It's supposed to be neutral (i.e., does not distort investment decisions)
- It's a progressive tax (i.e., the government take increases as the profitability of the project increases)
- Has been implemented in Papua New Guinea, Liberia, Kazakhstan and Australia for coal and iron ore

Corporate Income Tax (CIT): basic features relevant to mining

Standard CIT is usually applied to the mining sector, but with special provisions:

- Higher rates (for companies with fiscal stability contracts) or variable rates (in some African countries)
- Ring-fencing – limit loss deductibility to specific projects
- Loss carry forward provisions (e.g., unlimited, with uplift, etc)
- Depreciation allowances
  - Accelerated depreciation regimes
  - Full expensing of exploration (and development) costs.
- Full deductibility of royalties and other mining taxes
- Treatment of reclamation/rehabilitation costs

State Participation: basic features

- Political versus economic motives
- State participation usually occurs through a stated owned enterprise or a joint venture between the state and a private investor
- Historically has been also used for sovereignty issues and/or to “protect” the national interest
- Some governments also think of state participation as an economic development vehicle
- State participation is common in Latin America (most notable example is Codelco in Chile), Africa, Asia and the Middle East
- “National mining company” risks – government often does not realize the full value of the equity share

Country examples

Chile – specific mining tax (SMT)

- Only applicable to Mining companies with gross mineral sales greater than the value of 12,000 metric tones of fine copper (MTFC)/year
- The tax base for the SMT is taxable mining income (TMI), which results after adjusting taxable income for CIT purposes
- The SMT rate for companies that produce between 12,000 and 50,000 MTFC/year is based on incremental production
  - Marginal rates vary between 0.5% and 4.5% (effective rates between 0.04% and 1.93%)
- The SMT rate for companies that produce more than 50,000 MTFC/year is based on incremental mining operating margin
  - Marginal rates vary between 5% and 34.5% (effective rates between 5% and 14%)
- The SMT is deductible for CIT purposes

Chile – additional levies

- Corporate income tax (CIT):
  - 17% on undistributed profits (first category), plus an additional 35% on remitted or distributed profits (the first category is credited for the payment of additional CIT), constituting a maximum rate of 35%, (first category tax increased to 20% for 2011 and 18.5% for 2012) or
  - 42% with invariability regime (foreign companies that opted for a "tax invariability" regime have two options (1) a minimum of 20 years for investments of USD$50 million or higher; or (2) 10 years otherwise. Companies under this regime are not subject to SMT)
- Employee profit sharing:
  - Mining companies are required to distribute 35% of their pre-tax income to their employees. Alternatively, mining companies have the option to pay employees a 25% premium on employees base salary to a maximum of 4.75 minimum salaries

Chile – Industry Reaction to New Mining Tax Regime

- Increased taxes in Chile did not result in widespread negative industry reaction
- Most mining companies in Chile agreed to pay higher taxes to fund post-earthquake reconstruction, even though the new royalty scheme was optional
  - The Chilean government offered a 6 year extension to companies with stability agreements to encourage participation in the new royalty regime
- Freeport McMoRan was "supportive" of the Chilean government's new mining royalty scheme, CEO Richard Adkerson :
  - "This is a special situation in Chile that is related to the country's recovery from the earthquake. It's been a matter of discussion for some time now, and there was a give-and-take between the government – the administration and the parliament – and the industry to come up with a structure that will provide some near-term cash to the government...and to do it in a way that would be acceptable to the miners there," he said. "We are supportive of it."

Peru- profit based royalty and special mining tax

Peruvian mining operations are subject to a three-tiered tax system:

1) **Mining royalty**, based on a measure of operating margin (progressive incremental marginal rates increase from 1% to 12%; mining royalty deductible for CIT purposes; the royalty does not apply to companies with fiscal stability contracts)
2) **Special mining tax (or special mining contribution for companies with fiscal stability contracts),** also based on a measure of operating margin (progressive incremental marginal rates go from 2% to 8.4%, and from 4% to 13.12% for the special mining contribution); both levies are deductible for CIT purposes)
3) **Standard corporate income tax**. The Standard rate is 30%; there is a 32% rate for companies with fiscal stability clauses, plus a 1.5% payment to Ingemmet.

In addition, Mining Companies with more than 20 employees are required to distribute 8% of pre-tax income to employees.

Peru – notable changes to the mining royalty

- **Mining royalties were based on gross minerals sales**, as follows :
  - 1% of the first US$60 million; 2% of the next US$60 million; and 3% of sales greater than US$120 million.
- **Royalties are now levied on a measure of operating profit**:
  - Operating profit is obtained by taking the income generated from sales of metallic and non-metallic minerals and deducting from it the cost of sales incurred to generate such income.
  - The cost of sales are determined according to standard accounting rules, <u>except for exploration expenditures</u> that now must be depreciated over the life of the mine.
  - An effective tax rate is then applied to the operating profit for each quarter. The basis to calculate the effective tax rate is the operating margin for each quarter and the corresponding marginal rates (i.e. 1%-12%).
  - The royalty payment in any particular quarter will never be less than 1% of mineral sales for that quarter.

Peru – new mining royalty

MINING ROYALTY:
PROGRESSIVE RATES

No.		Operating Margin			Marginal Rate
a		b			c
		Lower limit	Upper Limit		
1	[	0	10%	]	1.00%
2	[	10%	15%	]	1.75%
3	[	15%	20%	]	2.50%
4	[	20%	25%	]	3.25%
5	[	25%	30%	]	4.00%
6	[	30%	35%	]	4.75%
7	[	35%	40%	]	5.50%
8	[	40%	45%	]	6.25%
9	[	45%	50%	]	7.00%
10	[	50%	55%	]	7.75%
11	[	55%	60%	]	8.50%
12	[	60%	65%	]	9.25%
13	[	65%	70%	]	10.00%
14	[	70%	75%	]	10.75%
15	[	75%	80%	]	11.50%
16		More than 80%			12.00%

Peru – new special mining tax

- The tax is levied on operating profit from sales of metallic mineral resources, as well as from own consumption and unjustified withdrawals of those assets.
- Operating profit and cost of sales are calculated in the same manner as for mining royalty purposes. However, expenses and costs incurred for own consumption and unjustified withdrawals of mineral resources are not deductible.
- An effective tax rate is then applied to the operating profit for each quarter. The basis to calculate the effective tax rate is the operating margin for each quarter and the corresponding marginal rates (i.e., from 2% - 8.4%).
- The actual amount paid is deductible for CIT purposes. The expense shall be deducted in the year in which the special mining tax is paid.

Peru – new special mining contribution

- This contribution is only applicable to mining companies that currently have projects with fiscal stability contracts. The special mining contribution is voluntary.
- Operating profit and the cost of sales are calculated in the same manner as for mining royalty purposes.
- Companies may credit the amounts paid for mining royalties and contractual mining royalties, which expire after entering into the agreement with the Peruvian Government. Unused amounts can be carried forward to future quarters until they are fully exhausted.
- An effective tax rate is then applied to the operating profit for each quarter. The basis to calculate the effective tax rate is the operating margin for each quarter and the corresponding marginal rates (i.e., 4% - 13.12%).
- The actual amount paid is deductible for CIT purposes. The expense shall be deducted in the year in which the special mining tax is paid.

Peru– Industry Reaction to Proposed Changes

- Election of leftwing candidate Ollanta Humala (who promised a windfall tax on the mining sector) rattled the nerves of investors and caused a sharp drop in the share prices of Peruvian mining companies
- Miners were confident that the proposed changes would not be too harsh as they threatened to pull $42 billion in planned investment over the next 5 years if the government imposed too harsh a rate
- Companies with stability agreements, which gave them immunity to the tax changes, had offered to pay the new tax on a voluntary basis
- Companies including Newmont, Xstrata Plc and Freeport-McMoRan have agreed to pay the new tax resulting in $1.1 billion per year of additional reserves to support public spending in Peru
- Ollanta Humala also gave up the ability to increase taxes without going to congress. This additional stability obtained a positive response from the industry

Peru– Industry Reaction to Proposed Changes cont'd

- The impact of Peru's new tax regime has had a positive response from market participants:
  - Canada's HudBay Minerals plans to invest at least $1 billion to develop its Constancia copper project in Peru
    - "We think that the approach that they are taking on reforming the tax is balanced," HudBay CEO David Garofalo
    - The International Monetary Fund ("IMF") said Peru's new mining tax scheme was favorable and suggested that resources be directed towards the industrialization of the country or toward promoting value-added production

[Kevin to add Colombia]

Australia: proposed mineral resource rent tax (MRRT) for coal and iron ore projects

- Corporate Income Tax – flat rate of 30% on income
- The MRRT rate is 30%
- Immediate write-off of new investments
- Unused losses are carried forward at the government long-term bond plus 7 percentage points
- Deductions can be transferred between projects
- Full credit for state royalties (uplift also applies to unused royalty credits, but can't be transferred)
- Recognizes past investment through a credit (option of market value (no uplift) or book value (with uplift))
- 25% extraction allowance

Australia– Industry Reaction to Proposed Changes

- Original proposal by then Prime Minister Kevin Rudd was a 40% Resource Super Profits Tax (“RSPT”) on profits derived from Australian mining operations
- BHP, Rio Tinto and Xstrata threatened to pull new projects and cut the value of existing ones
- Xstrata suspended projects in Australia when the RSPT was first proposed.
  - “Xstrata has suspended AUD586 million of expenditure to develop both the AUD6 billion Wandoan thermal coal project and a AUD600 million project to extend the life of the Ernest Henry copper mine, with immediate effect. Together these two projects in Queensland would have created 3,250 new jobs which are now at risk. The decisions represent the initial findings from Xstrata’s ongoing review of planned investment into its Australian operations and growth projects as a result of the Australian Government’s proposed Resource Super Profits Tax (“RSPT”). “

Australia– Industry Reaction to Proposed Changes cont’d

- Kevin Rudd was overthrown in June of 2010 and replaced by his deputy Julia Gillard
- After Gillard assumed power, and following discussions with the mining industry, the RSPT was replaced with the MRRT.
- The three largest companies in the Australian mining sector, BHP Billiton, Rio Tinto and Xstrata, issued a statement saying that they were encouraged by the government’s announcement that it proposed to replace the RSPT with the MRRT
    - “Xstrata Copper announces the resumption of full project activities at its AUD589 million Ernest Henry underground mine and the reinstatement of its AUD30 million north Queensland regional exploration program in light of the Federal Government’s decision to replace the Resource Super Profits Tax (“RSPT”) with a Mineral Resource Rent Tax (“MRRT”).”

Canada– profit-based royalties

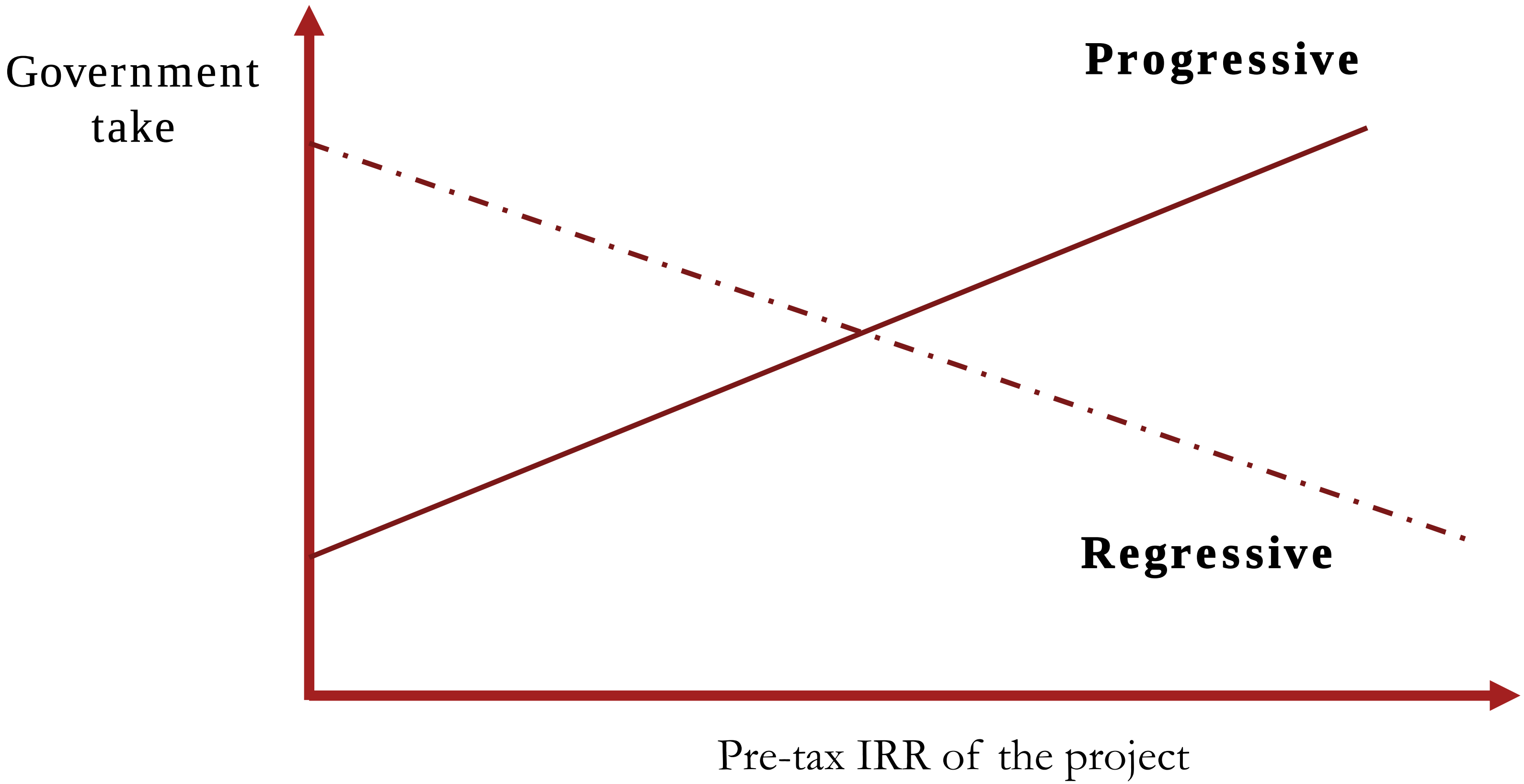
Canadian mining operations are subject to a three-tiered tax system:

1) **Provincial and territorial mining taxes and royalties, which are levied on a measure of production profits or revenues** (deductible for CIT purposes)
2) Federal income tax levied on a mining operation’s taxable income (generally being net of operating expenses, depreciation on capital asset and the deduction of exploration and pre-production development costs; 2012 rate 15%)
3) Provincial and territorial income taxes, which are based on a similar taxable income as for Federal income tax (rates between 10% and 16%).

Canada– British Columbia mining tax

- Mining taxes in BC are imposed on a mine-by-mine (ring-fenced) basis in two stages:
  - A 2% tax on “net current proceeds” and;
  - A 13% tax on “net revenue”
- The 2% tax is creditable against the 13% net revenue tax of the current or future years, with notional interest at 125% of the prevailing federal bank rate (can’t be carried back and is ring fenced)
- If net revenue is negative in a particular year, the result is added to a cumulative expenditure account (CEA) of the mine, which can be carried forward indefinitely.
- An investment allowance (using a notional interest rate) is applied to the CEA balance

Progressivity: payments to the government as a proportion of pre-tax cash flow (i.e., Government Take)



Conclusion

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- Mining taxation varies between jurisdictions and between minerals (no two fiscal regimes are alike)
- Governments' objective is to capture the mineral rent
- However, investor's perception of risk has to be taken into account
- Governments, based on their unique characteristics and needs, need to strike a balance between attracting investment into the sector and securing a fair share for the state
- The fiscal regime of a particular country has to be evaluated as whole, including royalties, CIT, RRT and state participation
- Recent trends in mining taxation in Latin America are providing mixed signals. While Chile and Peru (and probably Colombia) have moved towards profit-based royalties, Brazil and Argentina are currently threatening to increase their royalty rates

Thank you!