

# Legislative Design of the Fiscal Regime for Seabed Mining

Lee Burns

# Taxation of Extractive Industries – Challenges for Government

- The reality is that most Governments do not have the financial resources to explore for and develop mineral and petroleum resources
  - Need to rely on foreign investors
- Challenge for Governments –
  - The design of the fiscal regime must balance (i) the need to attract foreign investors to explore and develop mineral and petroleum resources against (ii) ensuring that the Government (on behalf of the people) receives a fair share of the nation's resource wealth (meet the expectations of the people)

# Special Nature of Extractive Industries

- Two key features of the extractive industries sector impact on the design of the fiscal regime
  - Mineral and petroleum resources are non-renewable (taxation is a “one-shot deal”)
  - Possibility of earning economic rent
- Requires a mix of fiscal instruments –
  - Pay-as-you-produce (royalties)
  - Profit-based instruments to share in economic rent – income tax and resource rent tax

# Fiscal Instruments

- Main fiscal instruments used by governments in the resource sector –
  - Royalties
  - Production sharing
  - Income taxes
  - Withholding taxes
  - Import duties and VAT/GST
  - Rent-based taxes
  - Other charges – egs. auction bids, surface rent, bonuses
- State Participation

# I. Royalties

- Historically royalties have been the main fiscal instrument for extractive industries
- Pay-as-you-produce instrument
  - Royalties payable from first production
- Two main bases for calculation
  - Unit of production
  - Value
- Distinguished from income tax and resource rent tax (which are based on profitability)
- Trend to include an element of profitability in the royalty calculation
  - Effect = delay in royalty revenue
  - Overlap with profit-based instruments?

# What is a Royalty?

- Amount paid to the owner of a resource in the ground (usually the State) for the right to remove the resource
  - Right of access and removal
  - Ownership transferred on extraction of the resource
- Royalty is not a tax
  - Tax is a government imposte compulsorily imposed but not in return for any specific economic benefit not available to the general public
    - Royalty is paid in return for the right to take natural resources
  - Implications for foreign tax relief in the investor's home country
    - Royalty is not a creditable tax for foreign tax credit purposes
    - Profit-based royalties?

# Royalties and Profitability

- Royalties traditionally imposed on a unit or value basis
  - Does not take account of profitability
- Implications
  - Royalties can increase the marginal cost of extracting resources
    - Can lead to marginal projects not going ahead or early closure of projects
  - Government's revenue does not change with profitability
    - Government collects a greater share of returns when profitability is low and lower share when profitability high

# Base – Unit of Production

- Oldest form of royalty base
- Levied by reference to volume (\$x per cubic metre) or weight (\$x per tonne)
- Royalty can be determined at the point of extraction
- Trend is to weight-based measures as easier to monitor and assess
- Royalty revenue is constant regardless of the value of the resource



# Base – Value of Mineral

- Most common base but different approaches to determining value
- (1) Sales value – first sale or export value
  - Value should be at point of extraction but first sale usually downstream
    - Net back to point of extraction?
  - Vertical integration – transfer pricing
- (2) Reference prices
  - (i) work out weight of mineral sold by grade
  - (ii) apply a reference price to the amount e.g. London Metals Exchange daily quoted price for the metal
- (3) Market value at mine gate/delivery onto ship(?)
  - Based on notional arm's length transaction at mine gate/delivery onto ship

# Value – Profit-based Royalties

- Profit-based royalties take account of costs, including capital costs
- Northern Territory
  - 20% x net sales value for year
  - Net sales value = gross sales revenue - (operating costs + allowance for corporate capital)
    - Allowance for corporate capital is based on the depreciation rate uplifted for interest at a rate of two percentage points above the long-term bond rate
  - \$50,000 threshold

# Value – Profit-based Royalties

- Delay revenue to the Government
- Relationship with profit based instruments?
- Still a royalty
  - Not a creditable tax for foreign tax credit purposes

# Value – Hybrid Royalties

- Royalty has both *ad valorem* and profit based elements
- Tasmania – royalty has two components
  - 1.9% of sales revenue (*ad valorem* component)
  - profit component based on a formula under which the rate increases as the mine's profit increases
  - The maximum royalty payable - 5.35% of net sales

## II. Income tax

- Location of income tax provisions
- Alignment with mining legislation
- Income tax base
- Corporate tax rate
- Tax treaties
- Exploration expenditure
- Development expenditure
- Rehabilitation expenditure
- Ring fencing
- Subcontractors
- Transfer of interest
- Tax Planning

# A. Location of Income Tax Provisions

- Should be in tax legislation and not sector legislation (such as Mining Act or Seabed Mining Act)
- One possibility is an Extractive Industries (Fiscal Provisions) Act
  - Includes all fiscal instruments – tax and non-tax
  - Transparent – makes it easier for the government to counter arguments that the sector is under-taxed
  - Facilitates the establishment of specialist tax administration unit for extractives
  - Common rules
    - Transfer pricing – income tax, rent tax and *ad valorem* royalties
    - Procedural rules

# Location of Income Tax Provisions

- If in Income Tax Act, then the specific rules for extractives should be collected together in a separate Part or Schedule
  - Advantage over an omnibus Extractive Industries Tax Law is that it involves the application of a single law
  - Transparent
  - Easier to comply with and administer

## B. Alignment of Terminology with Mining Legislation

- Income tax treatment differs depending on the stage that the project is at
- Exploration is tax sensitive so usual to include concessions to encourage exploration
- Commercial discovery made – development does not have the same tax sensitivity
- Ensure that the terminology used in income tax legislation aligns with the terminology used in the sector legislation to so that exploration concessions properly targetted



## C. Income Tax Base

- Taxable income = gross revenue – allowable deductions
- Allowable deductions – timing critical
  - Operating costs
    - Deducted outright
  - Capital costs (useful life of more than one year)
    - Depreciated/amortised
    - Straight-line
    - Declining balance
    - Accelerated depreciation/amortisation for tax purposes

# Life Cycle of an Extractives Project

- Three Phases
  - Exploration – high expenditures and no revenues
  - Development – potentially high profits (including possibly economic rent)
  - Rehabilitation – high expenditures and little or no revenues

## D. Corporate Tax Rate

- Corporate tax rate should be specified separately EI companies
  - Ensures fiscal stability for both the contractor and the government
  - Any change in the corporate tax rate (up or down) will impact on relative takes of the contractor and government
    - Increase in corporate tax rate reduces contractor's take
    - Decrease in corporate tax rate reduces the government's take
  - Corporate tax rate for EI companies must be specifically amended
  - Similar considerations for withholding tax rates

# E. Impact of Tax Treaties

- Tax treaty – international agreement between 2 countries (contracting states) –
- Purposes
  - Avoidance of double tax
  - Prevention of fiscal evasion – administrative assistance particularly information exchange
  - Non-discrimination
- Treaty partners
  - Residence country – home country of the investor
  - Source country – location of the investment

# Impact of Tax Treaties

- General pattern of taxation under tax treaties
  - Unlimited residence country taxation – but must provide relief from double tax
  - Limitation on source taxation
    - Exclusion of source liability because of modification of source basis of tax
      - Business profits (Article 7)
      - Capital gains (Article 13)
  - “Trading” source taxing rights for greater residence taxing Dividends, interest and royalties
    - Developed and developing country tax treaty – developing country is giving up taxing rights – why?

## F. Ring Fencing

- Norm is income and deductions are allowed on a global basis
  - Thus loss from one business activity can be deducted against profit from another business activity of the same taxpayer
  - However in extractive industries sector this can delay revenues for Government
  - Also act as a barrier to new entrants

# Ring Fencing

- Quarantine deductions on licence area basis
  - Exploration losses for a new licence area cannot be deducted against income from a mature licence area
  - Allocate general overheads if contractor has more than one licence area
    - Carefully policed
- Losses carried forward indefinitely
- Transition from exploration to development
- Terminal losses
  - Carried back
  - Transferred to another licence area
  - Not able to be used

# G. Exploration Expenditure

- Expenditure incurred before the decision to commence mining
  - Examples: Geological mapping; seismic survey, exploration drilling, feasibility studies; and environmental impact studies
- What is useful life of expenditure? What if there is no commercial discovery?
- High risk expenditure – may be a sunk cost - generates no income
  - Tax sensitive
  - Justifies accelerated depreciation including 100% write off



# Exploration Expenditure

- Exploration right and exploration information
  - Include as exploration expenditure but only if there is uncertainty with the expenditure
    - Acquired from government
    - Acquired under a farm-out agreement
    - Exploration right and information acquired in other circumstances treated as development expenditure

# Exploration Expenditure

- Exploration expenditure generates losses as no income derived
- Loss carry forward rules
  - May take many years for investor to obtain benefit of exploration losses
  - Limitation on loss carry forward period

# H. Development Expenditure

- Expenditure incurred after approval of a development/mining plan in preparing a site for extraction, such as expenditure incurred on -
  - Mining right and information
    - Other than an exploration right or information treated as exploration expenditure
  - Drilling and completing production wells
  - Construction of production facilities

# Development Expenditure

- Amortise over life of the project – uncertainty
  - Legislative rule = lesser of, say, 10 years or expected life of the project
  - Self-assess the amortisation period
- Deductions commence when commercial production commences
  - When platform facilities are operating at full capacity
  - Regular shipments out of contract area
- Part year deduction rule in first year

# Border Between Exploration and Development Expenditure

- Border between exploration and development expenditure needs to be carefully defined to avoid development expenditure being expensed
- Exploration involves the search for minerals
- Exploration phase ends when: (i) existence or absence of minerals determined; (ii) feasibility of development carried out; and (iii) decision made to develop or not develop
  - Expenditure after this point is development expenditure
  - Treatment of the period covered by a retention licence?

# Plant and Equipment

- Definitions of “exploration expenditure” and “development expenditure” usually exclude plant and equipment
  - Confined to intangible expenditure
- For consistency, plant and equipment first used in exploration activities could be given the same treatment as exploration expenditure
- Normal depreciation rules apply to plant and equipment first used in development activities

# I. Rehabilitation Expenditure

- Costs incurred to rehabilitate a mine site at the end of operations
  - Little or no revenue
  - Possibility of terminal loss
  - Impact of ring fencing

# Rehabilitation Expenditure

- Options
  - Loss carry back
  - Tax-deductible contributions to rehabilitation fund
  - Tax-deductible provisioning



# Rehabilitation Expenditure

- Loss carry back
  - Terminal loss cannot be carried forward
  - Carry back to previous tax year(s)
  - Reopen assessment and deduct the loss carried back
  - Will result in a refund
  - Maximum carry back period – 3 years?

# Rehabilitation Expenditure

- Tax-deductible contributions to rehabilitation fund
  - Jointly managed by contractor and sector ministry
  - Contributions specified under an approved rehabilitation plan
  - Deduction allowed when contribution made
    - Avoids terminal loss and funds available to finance rehabilitation
  - No deduction for rehabilitation expenditure financed out of the fund
  - Any amounts returned to the contractor included in income
    - Rewriting the deduction

# Rehabilitation Expenditure

- Tax-deductible provisioning
  - Similar to contributions to a rehabilitation fund except that amounts are transferred to a reserve in the contractor's financial accounts
  - Amounts transferred in accordance with rehabilitation plan
  - Deduction when transferred – exception to the normal rule that no deduction for reserves
    - Avoids terminal loss
  - No deduction for rehabilitation expenditure financed out of the reserve
  - Any deducted amounts in reserve not used for rehabilitation included in income
  - Contractor to provide security to ensure that amounts in the reserve are available for finance rehabilitation costs

# J. Non-resident Subcontractors

- High level of subcontractors is a feature of the extractives sector
- Tax Treatment of subcontractors
  - Permanent establishment
    - Taxed on an ordinary assessment basis
  - No permanent establishment – problem of asymmetric treatment (service fees are deductible to contractor)
    - Untaxed?
    - Withholding tax – final tax
    - Tax treaties (Article 7 – no permanent establishment; no source tax)
      - Treaty shopping

# K. Transfer of Interest

- Overview of Issues
  - Types of transactions
    - Direct transfers
    - Indirect transfers
  - Domestic tax law must reach gains derived by non-residents
  - Impact of tax treaties
  - Enforcing compliance by non-residents

# Types of Transactions

- Sale of licence
- Farm-outs
- Overriding royalties
- Sale of shares in the company/entity holding the licence, including the sale of an interest in an upper tier entity

# Sale of Mining Right (Licence)

- Simplest case
- Mining company sells its interest in a mining licence
- A mining licence is usually a depreciable asset so normal rules on recapture of depreciation apply
- Gain above cost
  - Maybe taxed under the depreciation rules
  - Gain on disposal of a business asset treated as income
  - Capital gains tax

# Sale of Mining Right

- If mining right is held by a non-resident, then source of the gain is an issue
- Non-resident taxed only if the gain has a source in the jurisdiction
- Tax treaties
  - Article 13 deals with capital gains
    - Source country can tax a gain on alienation of immovable property
    - “Immovable property” defined in Article 6
      - Has the meaning in domestic law – must ensure that it includes mining rights
      - Mining information?



# Sale of Mining Rights – Farm-out Agreement

- Farm-out agreement is a mechanism whereby the holder of a exploration licence (farmor) can reduce or share the risks of exploration by “farming out” some of its work commitments under the licence to another party (farmee) in return for an interest in the licence.
- There may be an immediate transfer of the interest in the licence or, more likely, transfer is deferred until the work commitments are completed
- Tax treatment, particularly for deferred interest farm-outs, can be complex involving characterisation, valuation and timing issues.

# Overriding Royalties

- An interest in an exploration licence could be transferred for \$1 plus a 5% overriding “royalty”.
  - The transferee is obliged to pay the transferor 5% of the gross income realised from any commercial discovery
- Difficult to put a value on the transfer at the time the transfer is made
  - The transferor has a contingent right to an income stream

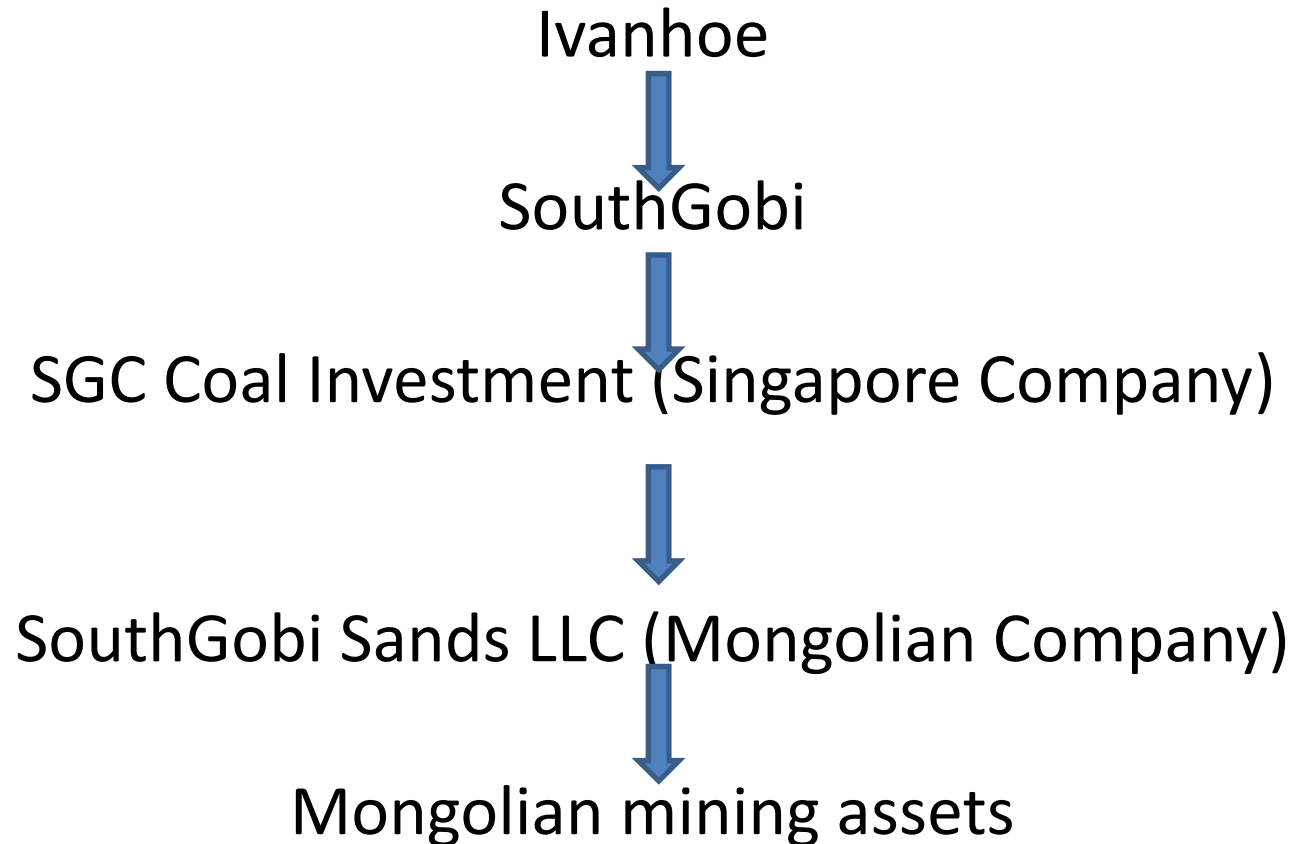
# Overriding Royalties

- The payment of the overriding royalty is income of the recipient and a deductible expense of the payer.
- What if recipient is a non-resident?
  - Payment may not come within the definition of “royalty” as there is no property right held by recipient
  - Recipient has no permanent establishment so potentially no taxing rights
  - Withholding tax – natural resource amount
  - Tax Treaties
    - Which article applies?
      - Article 7 (no permanent establishment)
      - Article 21 – OECD or UN Models

# Indirect Transfer of Interest

- Domestic company holds the mining right
- Value of the shares in a domestic company reflects the value of the mining right
- Sale of shares is an indirect way of realising the mining right
- Problem: transaction is between two non-residents taking place outside the jurisdiction
  - Is there jurisdiction to tax?

# Example Transactions



# Example Transaction

- Mongolia – CHALCO's takeover bid (April 2012) for SouthGobi Resources (Canadian company) (up to 60%).
- Shares in SouthGobi Resources held by a Canadian company – Ivanhoe Mines.
- Sales price US\$900m
- SouthGobi holds 100% of shares in SGQ Coal Investments (Singapore company)
- SGQ Coal Investments holds 100% of shares in SouthGobi Sands (Mongolian company)
- South Gobi Sands holds the mining licence for the Ovoot Tolgoi coal mine (and other Mongolian mining licences)

# Indirect Transfer of Interest

- Depends on source rule if normal income tax applies or jurisdictional rule under capital gains tax (e.g. taxable asset)
- Possible that source rule for casual gains of business assets is place of contract (outside jurisdiction)
- Possible that shares in a non-resident company are not taxable assets (only shares in a resident company)

# Indirect Transfer of Interest

- Special taxing rule – gain on disposal of shares is taxable if the value of the shares is principally derived, directly or indirectly, from immovable property situated in the State
  - Definition of “immovable property” important
    - Mining information?
  - Rule avoided by having the foreign company hold shares in contractors in several countries to avoid the “principally” threshold
    - Pro-rata taxing rule?
  - Consider non-corporate entities as intermediaries, such as trusts



# Indirect Transfers of Interest – Tax Treaties

- Modern tax treaties include a similar rule to preserve source taxing rights
- Article 13(4) of OECD Model and Article 13(5) of UN Model
- If the indirect disposal rule not included in Article 13, then no right to tax
- Article 13(4) of OECD Model is confined to shares in companies
  - Avoid by using a non-corporate intermediary

# L. Tax Planning

- Transfer Pricing
- Thin Capitalisation
- Treaty Shopping
- Management fees
- Finance leases
- Hedging costs

# III. Import Duties

- Used in the past as a method for governments to receive upfront revenue for mining operations
  - Substantial capital equipment needed for operations
- Global decline in level of import duties
  - Trade agreements
  - Countries often provide exemptions to encourage mining investment

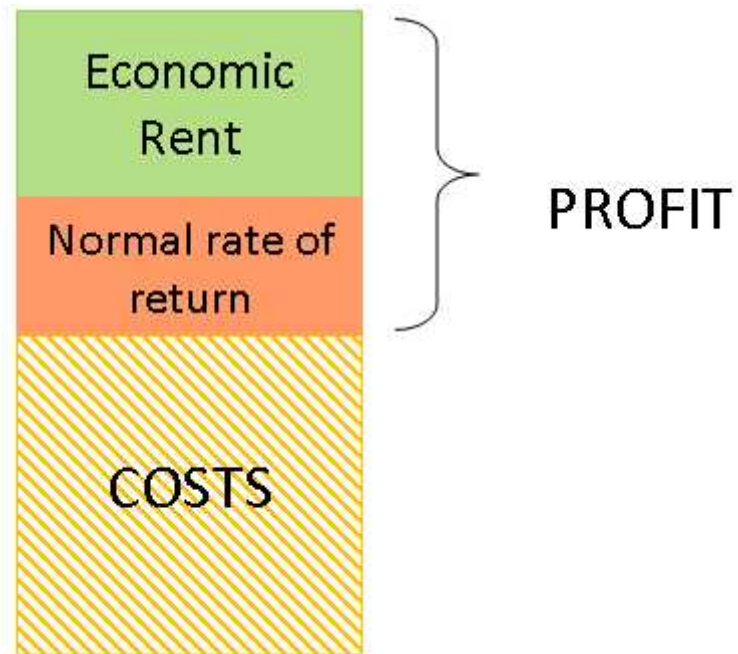
# IV. VAT/GST

- Basic VAT Model
  - Imports taxed – but, in natural resource sector, VAT treatment usually follows import duty treatment – so exemptions often apply
  - Exports zero-rated – significant percentage of the extracted resource (processed or unprocessed from) is exported so zero-rated, which means that input tax credits are refunded
    - SBM – processing offshore so all nodules exported
  - Thus little VAT revenue raised in the EI sector
  - Developing countries and the problem of timely VAT refunds
  - Registration during exploration phase?

# V. Taxing Resource Rent

- Resource rent taxation applies to extracted resource as it comes out of the ground/onto the ship without any value added by processing
  - Distinction between upstream and downstream activities in mining
    - Upstream activities = extraction of resource from ground and transportation & storage in a stockpile
      - SBM – scooping of resource off seabed and lifting onto ship(?)
    - Downstream activities = all activities transpiring after the mine gate/well head, including processing
      - SBM – all activities after lifting onto ship(?)

# Economic Rent



# Garnaut - Clunies Ross Model

- Developed in 1975 by Australian economists Garnaut & Clunies Ross
- The model currently used in oil & gas sector (e.g. Tmor Lesté) and the Mineral Resource Rent Tax in Australia
- Tax imposed annually on positive cash flow
  - Capital expenditure deducted rather than depreciated or amortised
  - Value revenue at the wellhead or mine gate
  - No deduction for interest
    - Avoids distortion of the financing decision to favour debt
  - Carrying forward of negative cash flow, uplifted by normal rate of return
  - Losses carried forward indefinitely (no refund of negative cash flows)
  - Positive net accumulated cash flow indicates an investor's internal rate of return for a project has been achieved (i.e. economic rent derived)

# Additional Profits Tax – Simplified Model for Resource Rent Taxation

- Simplified version of resource rent tax
- Start with taxable income
  - Add back depreciation + interest
  - Deduct new investment
  - Negative cash flow is carried forward at an uplift to equate to the investor's rate of return
    - 120% uplift under Cook islands APT
  - May be close proxy to the Garnaut - Clunies Ross model if all investor does is extract and sell resource
    - If investor does other things, such as processing, that do not involve economic rent, then those other activities will average down the level of economic rent taxable under the APT



# Key Messages

- Fiscal stability is important for both the Government and investor
  - Now is the time to put the fiscal regime for SBM in place
  - Once EI activity starts it is very hard to adjust the fiscal regime
- Rely on a mix of fiscal instruments
  - Simple royalty regime (pay-as-you-produce)
  - Profits-based taxes – income tax and resource rent taxation
- Prepare the income tax for extractive industries
- Tax is complex
  - Improve capacity, particularly in relation to international tax