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Income Tax Issues and Fiscal Stability

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Overview

- **Income Tax**
  - Corporate tax rate
  - Alternatives for additional progressivity
  - Cost recovery rules
  - Social infrastructure expenditure
  - Deduction of royalty
  - Loss carryforward
  - Environment and abandonment costs
  - Ring fencing
- **Fiscal Stability**

Corporate Tax Rate

- Corporate tax rate be set higher for mining or petroleum companies (e.g., Trinidad & Tobago)
  – May be appropriate if the standard profit tax rate is low and the withholding tax on dividends reduced by tax treaties
  – Would make it clear that future reductions in the standard rate would not necessarily apply to mining or petroleum companies
  – Could lead to tax arbitrage with contractors

Corporate Tax Rates

- 25%--Brazil, Jamaica
- 28%--Peru reducing to 27% in 2017 and 26% in 2019; rate 2 percentage points higher if fiscal stability elected
- 30%--Guyana (noncommercial), Mexico, Peru
- 34%--Colombia, including income tax for equality (CREE)
- 35%--Argentina

Corporate Tax Rate: Bolivia

- Bolivia
  - 25% standard rate
  - 25% surtax for mining and petroleum companies
  - For mining companies the surcharge base is taxable income reduced by expenses related to qualifying investments and 45% of the income derived from extractive operations
  - For petroleum companies the surcharge base is taxable income reduced by accumulated investment costs and 45% of the amount of sales of oil output

Corporate Tax Rate: Chile

- 22.5 % on taxable income ("first category income"), with an increase to 24% in 2016 and 25% in 2017
- 35% final withholding on dividends paid to non-residents
- However, the first category tax payment is creditable against the withholding tax; therefore, the maximum rate is 35%
- Roughly equivalent to having a 35% corporate tax with no withholding on dividends

Corporate Tax Rates: Ecuador

- Ecuador
  - 22% general rate
  - A reduced rate of 12% on the amount profits that are reinvested by the end of the year of assessment
  - 25% rate for companies with shareholders registered in tax havens or low-tax jurisdictions if the shareholders own at least 50% of the company's capital. Otherwise, the 25% rate applies only to the proportion of shares owned by the shareholders.

Corporate Tax Rates: A Higher Rate for Petroleum

- Trinidad Tobago
  - 25% ordinary companies
  - 50% petroleum companies; 35% if deep water

Alternatives for Additional Progressivity

- Variable income tax
- Variable royalty
- Resource rent tax
- Excess profit tax based on R-factor

Variable Income Tax

- Gold mining regime in South Africa incorporated a variable income tax rate, with a floor and a ceiling
  - Lower than average rate in years of poor profitability
  - Higher than average rate in years of high profitability

All other features of regular tax retained.

Botswana: Variable income tax

$y = a – (b/c)$

where, minimum rate is 30%

y = tax rate to be applied per annum

a = 70%

b = 12%

c = the profitability ratio

(Note: if c = 100%, the maximum rate is 58%; if c = 30% (or lower) the minimum rate applies)

Ambrogio Lorenzetti; The Effects of Good Government on the City Life; Fresco; Palazzo Pubblico, Siena (Italy)

Peru: A Variable Royalty

- Royalties can be profit based and add progressivity to a fiscal regime.
- Peru's royalty rates increase from 1% to 12% based on a measure of operating margin
- In addition the special mining tax and the special mining contribution slide based on a measure of operating margin
- A variable income tax might be a simpler approach

Resource Rent Tax

- A tax on cash flow; all capital and operating expenditure (but not interest) is subtracted from revenues as soon as it is made
- Net negative cash outlays up lifted each year by the accumulation rate (annual uplift)
- Tax payable when the accumulated negative cash flows are offset by revenues; the positive balance of cash flow becomes taxable at the RRT rate.
- If the accumulation rate is 15 percent, the RRT is not paid until the project has yielded a 15 percent internal rate of return.

Excess Profit Tax Based on "R-Factor"

- The tax base would be taxable income for purposes the regular profit tax less the income tax liability
- The rate would depend on the R-Factor or payback ratio (i.e., the ratio of the company's cumulative gross receipts to the company's cumulative gross outlays (excluding interest expense).
- The time value of money is not taken into account

Capital Allowances

- To measure the profits of a company, gross revenue from sales must be reduced by the costs of producing the income
  - Operating costs expensed
  - Capital costs are depreciated
- Expensing or accelerated cost recovery of capital costs may be appropriate
  - To provide an incentive for investment
  - To offset the impact of inflation
- Should capital costs in resource sectors be treated more favorably than investments in other sectors?

Capital Allowances

- Capital allowances could fall into three simple categories
  - Exploration expenses expensed but only exploration expense incurred up to the time of the award of a development or mining license
  - Tangible capital costs (plant, machinery, industrial buildings, roads, power plants, depreciated under the general depreciation rules)
  - Other development expenses (that is, intangible costs) depreciated over 10 years

Exploration Expenditure

- Exploration expenditure—positive externality; therefore a strong case for expensing
- Mining exploration expenditure
  - Argentina: double deduction of costs
  - Brazil: amortized over the useful life of the mine
  - Chile: expensed
  - Colombia: amortized over at least five years, but expensing allowed for failed explorations
  - Peru: amortized over the useful life of the mine

Development Expenditure

- Development expenditure—no externality
- Mining development expenditure
  - Argentina: written off over three years; 60%, 20%, 20%
  - Brazil: amortized over the useful life of the mine
  - Chile: depreciated like fixed assets
  - Colombia: amortized over at least 5 years
  - Peru: amortized over the useful life of the mine

Social Infrastructure Expenditure

- If incurred in deriving business income—deductible
  - Social infrastructure expenditure compulsory incurred under a petroleum or mining agreement should be deductible.
  - Over its useful life or the life of the project?
- If an application of business income after it has been derived—non-deductible

Deduction of Royalty

- In production sharing arrangements
  - There may be a share of production called "royalty" that goes to the government.
  - This payment is not a deductible expense as it is not paid out of the contractor's gross income
- In tax/royalty fiscal regimes
  - Gross income = sales of the mineral product
  - Royalty is paid out of gross income and is a cost of doing business

Loss Carryforward

- The loss carryforward is an averaging devise that allows losses incurred in one year to offset income in a subsequent year.

	Company A	Company B
Year 1 taxable income/loss	-100	+100
Year 2 taxable income	+300	+100
Total taxable income:		
With out carryforward	+300	+200
With carryforward	+200	+200

Loss Carryforward

- Limiting the loss allowed in any year (e.g., an annual cap) adds complexity and works against achieving tax equality with companies without loss years.
- Given the long start-up period for resource projects, a long carryover period is needed.

Loss Carryforward in Latin American Countries

- No carryforward—Parguay
- Limit on carryforward period—
  - Argentina 5 years;
  - Bolivia 3 years (5 years oil and mining companies)
- Limit on carryforward period with an annual cap
  - Ecuador—5 years; cap of 25% of taxable income
  - Jamaica—5 years; cap of 50% of taxable income

Loss Carryforward in Latin American Countries

- Unlimited carryforward—Trinidad and Tobago
- Unlimited carryfoward with inflation adjustment
  - Chile & Colombia
- Unlimited carryforward with annual caps
  - Brazil—capped at 30% of taxable income
  - Guyana and Peru—capped at 50% of taxable income

Environment and Abandonment Costs

- Mining and petroleum companies are required to incur environmental, reclamation and abandonment costs
- If incurred at end of operations, may not be sufficient income to cover the costs thereby causing a tax loss
- Countries want to ensure that funds are available and companies perform
  - Escrow account
  - Tax deductible provisioning

Escrow Account

- Mining and petroleum companies allowed a deduction for payments to an approved escrow account for future environmental costs
- Environmental expenditures when incurred would be paid out of the escrow account and not tax deductible
- At the end of the project, any excess funds would be included in taxable income
- The mining or petroleum law would establish the rules for the escrow account

Tax Deductible Provisioning

- Company allowed to make a provision in its tax accounts for future environmental costs (no cash outlay)
- Company must put in place acceptable security (guarantee) for carrying out environmental obligations
- At the end of the project, any over-provision would be included in taxable income

Escrow or Provision

- Companies generally prefer provisioning for future costs, as money does not have to be set aside
- Escrow accounts can ensure that the money set aside will be there. However, insufficient money could be set aside and there is not guarantor of performance.

Ring Fencing

- Separation of taxable projects for purpose of calculation of tax liability and cost recovery
- Pros:
  - Avoids deferral of government revenue
  - Levels playing field for new entrants
  - Essential if impose additional profit tax
- Cons:
  - Limits incentive to invest in new activities

Ring Fencing Alternatives

- Ring fencing can be:
  - License-by-license or
  - Project-by-project within the contract area
- There could be an exception to the general rule for:
  - "Failed" exploration on relinquished licenses
  - Adjacent licenses with joint operations

Fiscal Stability Assurances

- The reason for:
  - The large size and the sunken nature of the initial investment
  - Long payback and profitability period
  - A lack of credibility that the host country will not change the fiscal rules—the “time inconsistency problem”
- But not all countries grant fiscal stability in their mining and petroleum agreements (e.g., Angola, Nigeria and Colombia from Jan 2013)

Trade-off for Contractor

- On the positive side:
  - Fiscal stability clauses can reduce the contractor's fiscal risk
- There is a cost:
  - Fiscal stability may come at the price of a lower take for the contractor, all other things equal

Fiscal Stability: Peru

- Mining and petroleum companies may enter into an agreement with the government for a 10-year stabilization regime
- The income tax rate is that applicable at the time of the agreement plus two percentage points
- Companies can opt out at any time; opt-out is irrevocable
- Gives rise to planning opportunities

Two Approaches to Fiscal Stability

- Fiscal stability guaranteed by reference to laws in force on the effective date of the agreement (frozen law)
  - There should be legal authority to grant fiscal stability by contract as frozen law over-rides current law
- Maintain economic equilibrium if there are any adverse changes (agree to negotiate)
  - The offsetting change need not override current law

Fiscal Stability Issues

- Unsustainable or unintended benefits
- Just what is the frozen law or reference law
- Determining the offsetting change
- The one-way bet

Fiscal Stability: A Way forward

- Fiscal stability should be time-limited
- Cover only the key features of the law: royalty rate, corporate income tax and withholding tax rates, maximum import duty, and the cost recovery rules for exploration and development expenditure