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"TAXATION IN THE MINING INDUSTRY: NOTES ON A DESIGN TO FACILITATE ITS APPLICATION"

AT THE

EXPERT GROUP MEETING ON EXTRACTIVE INDUSTRIES TAXATION

NEW YORK, MAY 28, 2013

UNITED NATIONS HQ, NEW YORK
(ECOSOC Chamber)

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TAXATION IN THE MINING INDUSTRY: NOTES ON A DESIGN TO FACILITATE ITS APPLICATION

I sincerely appreciate this invitation from the Department of Economic and Social Affairs - Financing for Development Office to speak on this subject to such a select group of professionals who are interested in governments having direct access to resources for social development.
I hope that by the end of my talk, we are better able to initiate a process of reflection on the expectations and responsibilities of governments and mining companies in order to establish win-win relationships in terms of tax revenue collection for the former and benefits for the latter, in hopes that addressing the issue from the perspective that the tax administration of insurance is an interesting tool for discussion. Thank you again.

1. Relevance of the topic

On other occasions we reported that social investment is also a tax issue, since tax revenues define the capacity of a state to spend. That is to say that every decision to spend means an implied decision to raise revenues. Hence each concession contract that will undoubtedly generate tax revenue is tied closely to increasing public spending.
In this context, the purpose of this paper is to present a vision of tax administration on the issue of contracts for mining concessions. This approach to the issue is usually ignored, because States are in a hurry to make investments in the sector, which undoubtedly create significant resources to promote or sustain public expenditures.
For any country, more so for the underdeveloped or developing countries, the benefits of exploiting natural resources are an essential source of revenue for states. Taxing the wealth properly obtained by the exploitation of these natural resources should be a priority in our nations, for more than one reason.
First, they are exhaustible resources and therefore we must "consume" them responsibly to obtain the maximum benefit; and second, because obtaining higher revenues from this sector could influence a decision to levy less taxes in other productive sectors within a country. An example of this is that in virtually all traditional mining countries, this sector is subject to a tax burden that duplicates that of the rest.

This last aspect is particularly important in countries seeking to increase their tax burden and tax systems that have highly fragile tax systems or high expenditures, because it allows the intended increase to be sustained, in an important part, from the proceeds of these companies producing non-renewable natural resources.
Another aspect is that revenues from natural resources are suitable for being administered according to a "fiscal rule". In this case it is the ability to create "counter-cyclical" funds; when this sector produces special or extraordinary short-term income, it is possible to maintain levels of social spending and emergency funding to meet unforeseen expenditures caused, for example, by natural phenomena or the effects of periods of economic decline.

We believe that Chile is a good example of countries seeking to allocate part of the funds raised in this way for the medium and long term, or to meet unforeseen contingencies. Very high copper prices have allowed it to save significant amounts of resources in "sovereign wealth" funds. This also shows its institutional strength.

In this respect it should be noted that there are several theses on the lack of correlation between countries that are rich in natural resources, economic growth and social development. There are many examples of countries rich in natural resources, but with very poor people. Excessive dependence and concentration of exports on these resources, especially with weak tax institutions, could fundamentally explain a large part of this reality.

In this context it is more important to focus on the approach from the perspective of the tax authorities, because it brings elements that allow States to show favorable results in obtaining revenues from its natural resources. There is no doubt that this is definitely an important topic, as it provides States the opportunity to show their long-term vision and capacity for planning.

Although our focus has to do with tax control, we must not fail to mention that in designing a tax system for the mining sector it should be remembered that this requires large investments, and that its revenues are cyclical. Therefore when deciding where to invest, investors must consider which country offers a better scenario in terms of geological potential and tax burden.

Consequently, it is a challenge for countries to design a tax system for the mining sector to provide sufficient resources, while also having a tax burden that maintains the attractiveness of investing and additionally ensures efficient monitoring and control by the tax administration.

Thus, since 1997 the Fraser institute has conducted a survey among officials of mining companies in order to assess how the natural mineral potential and public policy factors such as supervision and regulation affect investments in exploration.

For this there is an index called the Policy Potential Index (PPI) that takes into account various aspects including the following:

• Uncertainty concerning the administration, interpretation or application of existing regulations including environmental.

• Legal system (that legal processes are fair, transparent, non-corrupt, timely, efficiently managed, etc.)

• Fiscal process (including personal tax, corporate, payroll, capital and others as well as the complexity of tax compliance);

• Political stability;

• Labor regulations/employment agreements and labor militancy/interruptions to work;

• Quality of the geological data base (includes quality and scale of maps, easy access to information, etc.);

• Level of security (includes physical security due to the threat of attacks by terrorists, criminals, guerrillas, etc.);

• Availability of labor/abilities (skills);

• Level of corruption (or honesty);

In the most recent survey conducted from October 9, 2012 to January 6, 2013 the top 10 most attractive jurisdictions for investment were Finland, Sweden, Alberta, New Brunswick, Wyoming, Ireland, Nevada, the Yukon, Utah and Norway. Chile, which had previously been the only jurisdiction outside North America consistently in the top 10 over the life of the survey, has continued to fall in the rankings to 23rd place.
Rather than the survey's results, its relevance here is to note the mining sector for its global influence, the resources invested while knowing the details of the environment in which to do business in each jurisdiction, and as an industry that requires making substantial investment, the decision to invest in one place or another will depend primarily on the returns investors can get, which is closely related to the mining potential of the country and its fiscal and institutional systems.
Thus the challenge is to achieve a balance between an appropriate tax regime for States and the countries owning natural resources with private capital that can turn them into revenue for sustainable development.

2. Essential components of the tax on mining

Unlike any other tax regime, what is applicable to mining concessions and others is based on contracts that may differ from each other. This in itself is a complexity for the tax administration, which adds to the degree of specialization on the subject of exploitation of natural resources.

In that sense, it is very healthy that contracts are uniform in the fiscal sense, yet also retain some differences arising from the mineral in question, the size of the investment, environmental remediation costs, etc. In this regard, States should define their fiscal policy on the issue of mines with some consistency in the treatments that are given to each licensee, regardless of how the individual negotiations may take place.

Put another way, a regulatory framework on the topic of mining (it could be called a Mining Act) should include a section on fiscal guidelines that details the duties applicable to the type of investment and other economic conditions or market situation, and even establish the necessary link with the Tax Code. Also, the issue of additional tax invariability or the stability of general rules about the use of resources can be part of this framework.

Regardless of the purpose of participation in the profits or revenues of the concessionaire, the components that should be part of a concession for mining with respect to taxation are of two types:

a) Of the taxes and fees to pay, which should indicate the taxes and contributions applicable to mining operations, to define the materials to be taxed, the taxable

income, in some cases clarify the operative event, establish exemptions and operating issues such as grants, debt, depreciation, etc.

The clarity with which these aspects are defined will determine the ease or difficulty of quantifying the tax and tax debt. In these contracts, it often happens that more is clarified than necessary, causing confusion, or explained to complicate.

b) Of the procedures, which are aspects that make possible the collection of taxes and fees established in the contracts.

We will go into detail on some of the major issues of this nature which definitively make a contract simpler or more complex from the point of view of what is possible for a tax administration management.

With the first of these components, mining operations have traditionally been taxed by the general systems for the sector usually in four categories, which are:

• Gross Revenue
• Benefits
• Extraordinary Gains
• Municipal contributions

The two first types of taxes exist in almost all countries, and they increasingly apply levies on profits proportionally to cyclical increases in prices.

The tax on gross income is assimilated with royalties. Although its origin and nature is different, the effect is usually the same. The most important thing is that this tax should be designed by defining a tax base or tax simply and very close to the business of extraction; that is, a percentage of gross income obtained without regard to costs or a specific value associated with the amount extracted, billed, etc.

Royalties may be deductible, or not, from the Income Tax depending on whether it is considered an advance, a minimum tax, or just another tax. The goal in this type of tax should be simplicity, as a guarantee of security in calculating the amount payable. This may be treated as specific taxes on the product exported or extracted, or ad-valorem on a reference price (sale of the mineral, for example).

Taking into consideration the existence of three widely used methods for calculating production costs - one of which is the lowest value and closer to the production, which excludes depreciation, amortization and interest expense; a second adds depreciation and amortization to the first items; and a third of higher value adds to the items already mentioned financial costs - it is vital that the contract clarifies when it is using either method of determining costs for each tax. This is particularly relevant for calculation of the Income Tax.

Royalties effectively become a minimum tax when a tax administration does not properly manage (or not strongly enough) the contract and other levies.

The other tax that applies is the Income Tax and its ancillary withholdings. This tax will be levied on the profits, and thus to be efficient the contract must clearly state how costs and deductible expenses are determined. This could mean the success or failure of this tax revenue collection.

Similarly, it is important to define the issue of withholding that applies to the various payments, especially abroad, as they help to avoid expensive fictitious expenses or transactions that make operations more costly and make it harder to reduce taxable income.

The third level of taxes applies to the extraordinary benefits that result from price changes and generate windfalls or faster payback on the investment. In this case it should be clearly defined what will happen with occasional or extraordinary profits that are generated by price increases, an agreed-on rate and when one considers that these profits are generated. These types of income are the most conducive in creating the “counter-cyclical” funds we have previously mentioned.

For its part, the taxes that apply on the state, provincial or municipal levels are common in decentralized countries. In many cases the same taxes apply at the central or decentralized levels.

However, even in countries with minimum decentralization, mechanisms must be established to meet the needs of municipalities and localities where the mines are located and which are directly affected by environmental issues. This can be clearly established in the concession contracts or established with rules governing extraordinary transfers from the central level to the municipalities.

Turning to the second component, which is the central concern for tax administrations, it is important that the contract clearly establishes rules and regulations to facilitate controls and auditing oversight. This aspect is often neglected due to the limited participation of the tax administration in the development or revision of mining contracts.

In this case, we want to highlight them because, once contracts are signed, states are unable to manage them properly due to a lack of instruments of control and administrative powers. This often occurs because of the existence of contracts that include control and tax auditing standards which are outside the general legal framework or respective tax codes, which clearly define the powers of determination and enforcement that tax administrations have.

One element to be evaluated is the impact of a kind of tax "cannibalism" that exists between countries to attract investment. This causes multinationals to worry about tax engineering to mobilize the resources of one or another jurisdiction from confusing corporate societal structures. In this context, it becomes more important that tax administrations be managed more efficiently. Deficiency or mismangement in the control over a concession contract will undoubtedly generate dissatisfactions in states and citizens, and ultimately produce challenges to the contract itself.

In this context, beyond the need for a tax on gross income, profits or extraordinary gains, it is essential to clearly define those elements that impact on the settlement of these, such as:

i. The form of compensation for losses generated in the first exercise.
ii. The method for determining depreciation of assets acquired by private investment but also those that the State has given.
iii. The methods and practices recommended for the calculation or use of comparable cases for transactions between entities, etc.
iv. The scope and powers for audits, in this case of the tax administration, the possibilities for running a risk analysis as a prelude to an audit.
v. The definition of obligations to report information to the tax administration.
vi. The treatment of future sales, for their impact on the calculation of a return on the investment and the need to analyze the relationship with the buyer.
vii. The rules for sub-capitalization or capitalization to avoid excessive debt charges that penalize earnings.

All of these provisions on procedures that impact the assessment of taxes under the contract become decisive when quantifying the payable tax.

Two other very important aspects are those concerning norms for Transfer Prices and regulations regarding the use of the International Accounting Standards and ample Financial Reporting.

While we recognize the difficulties in obtaining all of the necessary information for comparable transactions, we are convinced that you can obtain a proper assessment that allows tax administrations to settle or supervise the payment of taxes from mining companies. It is clear that one of the biggest risks from the point of view of tax administration in the auditing of multinational companies, is the establishment of an effective management system that is suitable for business structures which are as scattered and confusing as they are for this type of business.

To identify operations between related enterprises, to ask for reports on free price competition, to ensure that fiscal adjustments are made when the prices agreed between related enterprises differ from prices between those between independent parties, are vital procedures if you wish to determine that the amounts of tax payable will approach the ideal. This is even more notable in the case of companies which invest at higher levels of funding and penalize earnings and returns on investment.

In this context, it is more important to draw up contracts which provide the tax authorities broad powers of supervision to implement policies recognized for transfer pricing. Or better yet, they are always referred to as provisions applicable to ordinary taxpayers explicit in the Tax Code.

The other aspect to note is the use of international accounting standards and financial reporting which contribute greatly not just to obtain comparable information, but also to understand the transaction in the light of international standards. This proves to be a suitable complement to the understanding and appreciation of related operations.

No less important for the control scheme is signing agreements to exchange information, using OECD models, whether in the context of double taxation agreements (Article 26) or independently. This agreement model on information exchange for tax purposes within reach allows tax administrations to obtain relevant information about mining operations such as their exports, sales, etc. This is intended to combat the negative effects of "harmful tax competition" which occur so that many multinational companies end up in a low-tax country.

Information sharing is a way to verify data on exports, prices, asset ownership, corporate structure, ownership of shares, investment in the social sector in any kind of society etc. Also aspects such as the validation of real prices for machinery and equipment directly related to the business are easier when tools such as information exchange agreements are available.

From the point of view of tax control, we must recognize the importance of fiscal transparency of mining companies and therefore the tax authority should be concerned with the implementation of regulations for transferring information from operations that impact the settlement of taxes from mining companies.

In this regard, it is important to note that initiatives such as the IMF's Code of Good Practices on Fiscal Transparency and EITI Rules such as the first initiative of civil society (and in several countries led by the U.K.), which include principles on transparency for payments and revenues from the extractive sector. This latest initiative has criteria and standards that emphasize the accountability of companies regarding their income and taxes paid, and for governments regarding the use of resources from this industry.

Two EITI principles are particularly notable because they provide sustenance to those which often are claims from citizens to their governments and tax administrations, contract negotiators and mining companies:

1. "We affirm that it is within the domain of sovereign governments to proceed with the administration of wealth from natural resources for the benefit of the citizens of their countries, so as to promote the interests of their national development." This principle recognizes that there is a commitment to obtain and utilize the resources that come from the mining industry.

2. "We believe we need a broadly consistent and workable approach to the disclosure of payments and revenues, which is easy to introduce and to implement." This type of approach is based on a referral of information (usually electronic) with the aim to effectively exercise fiscal powers used by tax administrations.

Although of voluntary compliance these initiatives, once welcomed by governments and mining industries, can make a difference in the treasury-taxpayer relationship in this type of activity.

In this respect, there is an opportunity to structure a model of transparency to ensure, first, that taxes on this activity will be those expected in order to provide for the citizens of the countries which own the leveraged resources; second, that there are clear rules for action by governments through their fiscal authorities; and finally, accountability to the citizens will allow them to see that the industry and state oversight in defense of their interests is positive.

3. Some notes on the Dominican case

Although the Dominican Republic is far from being a mining country, expectations about the potential contribution of tax revenues are high. No doubt in the next few years we could be recording the mining sector's contribution to tax revenue at around 1.5% of GDP, when all mining companies are operating simultaneously.

Since the end of the input from Falconbridge (1957), which extracts minerals for the production of ferronickel and in 2007 contributed about 1% of GDP, the mining sector contributes almost nothing to the Dominican treasury.

Falconbridge's contract provides for the payment of income tax with a lower rate and a tax on what it calls Total Monthly Benefits, defined as the pounds exported by the value after subtracting the unit cost from the unit price. The expected payment cap reaches 50% of the profits obtained. The contract does not set an optimal tax control scheme.

In recent years they have signed two major contracts for the extraction of gold, which the State hopes will generate significant revenue.

One of these is with Barrick Gold (2002 and 2009), a company with which the Dominican government recently agreed to changes in the original contract that is expected to produce income bordering on 1% of GDP per year, according to official data.

This contract includes an integrated tax system for Income Tax at a lower rate than the overall tax, a royalty or tax on net sales or the cost of production resembling what we have defined as the lowest value and tax on the Participation Net Income (PUN in Spanish) which is subject to price variation. The complexity of the contract is the main opportunity for improvement.

The other major contract, signed with Laguna Limited (2004), provides a royalty called the Net Smelter Return or “NFR” and a similar tax on net profits called the Share of Net Profits or “PUN.” PUN payments begin at the start of the fiscal year in which the Cash Flows of Financial Management for the first time exceeds the “recovery amount,” which corresponds to the amounts invested to raise the project to the beginning of the period of operations, which is equivalent to the initial investment.

While this contract is simpler, it lacks a definition of tax control procedures to enable effective management, even granting the mining authority functions related to the tax issue. The tax regimes established in each contract are different, which, as already stated, generates additional complexity to the tax administration.

The challenge for this activity to become a solid contributor to Dominican public finances is to achieve, in general terms, a balanced and modern regulatory framework to encourage investment while under state control. More specifically it results in an important simplification of contracts, and strengthens administrative processes by introducing tax control procedures which, as mentioned, allow for the collection of taxes and fees established in the contracts.

Having a regulatory framework should be a priority, as it should ensure the fulfillment of the vision and objectives of the state and citizens, which, in our view, go through a tax system that facilitates control, creates transparency and strengthens technical institutions in mining materials and taxes.

4. In conclusion

We must recognize the great importance of the mining sector to provide tax revenue to the States. Hence the design of contracts in terms of the tax is a challenge for the authorities in each country as well as an opportunity to create an environment appropriate for transparency regarding the disclosure of information relating to the tax issue.

In this paper we have identified the issues which should be taken into account in the field of taxation when developing a mining concession, in order to make it feasible for the correct determination of taxes to be paid. Otherwise, even in the case of those taxes imposed as being necessary to meet the tax collection target, the risk of failure to achieve the expected results is high.

In this sense, tax administrations play a key role in the design of control mechanisms that enable the correct determination of taxes and the timely collection of tax debts.

Another aspect that should be highlighted is the importance of a legal framework to regulate the sector and to clearly define the roles of the governing authority for mining, but which also allows the tax authority to exercise its functions with all the necessary means. Achieving an appropriate regulatory framework, including mechanisms of control and transparency in contracts and to strengthen institutions, are the major challenges to achieve a way for natural resources to promote the development of the countries.

I will end here by quoting the number 1 principle of the EITI Standard, which seeks to understand the feelings of many, regardless of whether they are part of the state, civil society or the mining companies: “We share the view that the prudent use of the wealth of natural resources should be an important engine for sustainable economic growth that contributes to sustainable development and poverty reduction. However, if this wealth is not properly managed, it can create negative economic and social impacts.” Thank you very much