



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

Colombia: FAD Conference

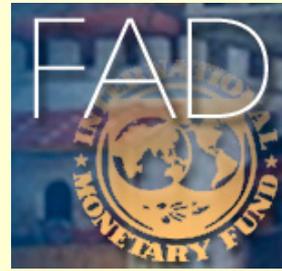
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International Monetary Fund

Income Tax Issues and Fiscal Stability

Bogotá, Colombia, September 30, 2015



Overview

- **Income Tax**

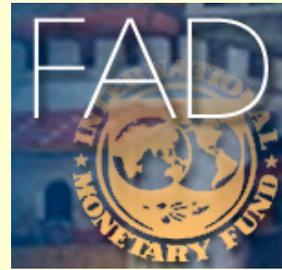
- Corporate tax rate
- Alternatives for additional progressivity
- Cost recovery rules
- Social infrastructure expenditure
- Deduction of royalty
- Loss carryforward
- Environment and abandonment costs
- Ring fencing

- **Fiscal Stability**



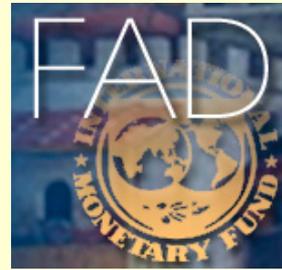
Corporate Tax Rate

- 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

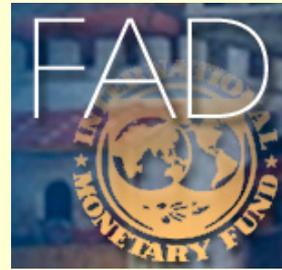
- 25%--Brazil, Jamaica
- 28%--Peru reducing to 27% in 2017 and 26% in 2019; rate 2 percentage points higher if fiscal stability elected
- 30%--Guyana (noncommercial), Mexico, Peru
- 34%--Colombia, including income tax for equality (CREE)
- 35%--Argentina



Corporate Tax Rate: Bolivia

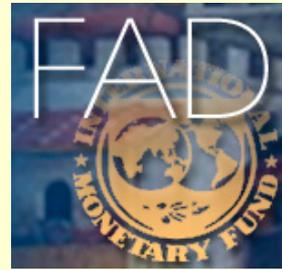
- Bolivia
 - 25% standard rate
 - 25% surtax for mining and petroleum companies
 - For mining companies the surcharge base is taxable income reduced by expenses related to qualifying investments and 45% of the income derived from extractive operations
 - For petroleum companies the surcharge base is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

Corporate Tax Rate: Chile



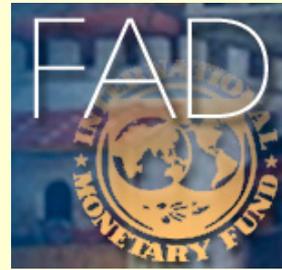
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- 22.5 % on taxable income (“first category income”), with an increase to 24% in 2016 and 25% in 2017
 - 35% final withholding on dividends paid to non-residents
 - However, the first category tax payment is creditable against the withholding tax; 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

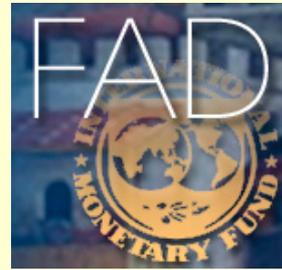


Variable Income Tax

- 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)

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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



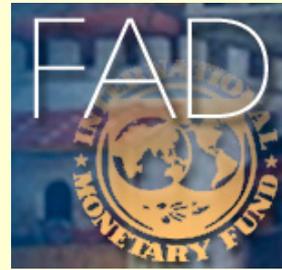
Resource Rent Tax

- 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”

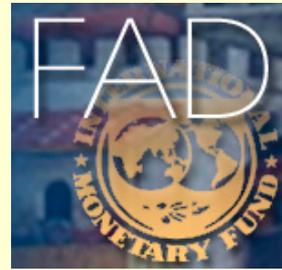


- The tax base would be taxable income for purposes the regular profit tax less the income tax liability
- The rate would depend on the R-Factor or payback ratio (i.e., the ratio of the company’s cumulative gross receipts to the company’s cumulative gross outlays (excluding interest expense)).
- The 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?



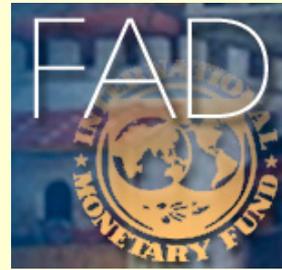
Capital Allowances

- 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

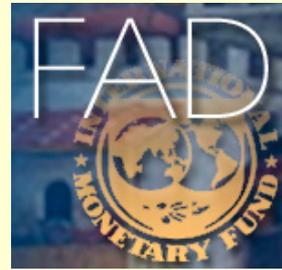
- Exploration expenditure—positive externality; therefore a strong case for expensing
- Mining exploration expenditure
 - Argentina: double deduction of costs
 - Brazil: amortized over the useful life of the mine
 - Chile: expensed
 - Colombia: amortized over at least five years, but expensing allowed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

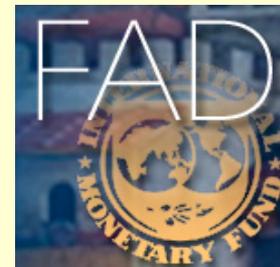


- If incurred in deriving business income—
deductible
 - Social infrastructure expenditure compulsory incurred under a petroleum or mining agreement should be deductible.
 - Over its useful life or the life of the project?
- If an application of business income after it has been derived—non-deductible



Deduction of Royalty

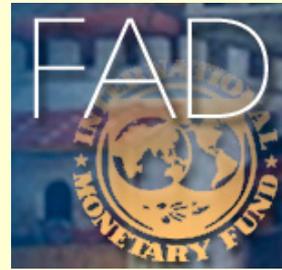
- In production sharing arrangements
 - There may be a share of production called “royalty” that goes to the government.
 - This payment is not a deductible expense as it is not paid out of the contractor’s gross income
- In tax/royalty fiscal regimes
 - Gross income = sales of the mineral product
 -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



Loss Carryforward

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

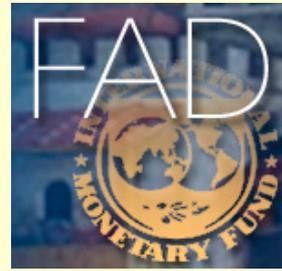
	Company A	Company B
Year 1 taxable income/loss	-100	+100
Year 2 taxable income	+300	+100
Total taxable income:		
With out carryforward	+300	+200
With carryforward	+200	+200



Loss Carryforward

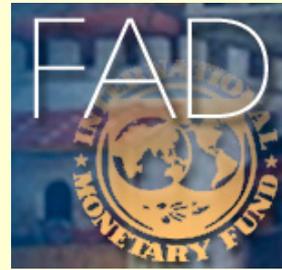
- Limiting the loss allowed in any year (e.g., an annual cap) adds complexity and works against achieving tax equality with companies without loss years.
- Given the long start-up period for resource projects, a long carryover period is needed.

Loss Carryforward in Latin American Countries

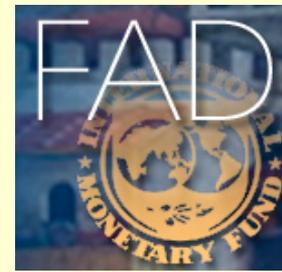


- No carryforward—Paraguay
- Limit on carryforward period—
 - Argentina 5 years;
 - Bolivia 3 years (5 years oil and mining companies)
- Limit on carryforward period with an annual cap
 - Ecuador—5 years; cap of 25% of taxable income
 - Jamaica—5 years; cap of 50% of taxable income

Loss Carryforward in Latin American Countries



- Unlimited carryforward—Trinidad and Tobago
- Unlimited carryforward 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

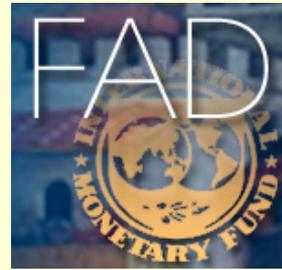
- Companies generally prefer provisioning for future costs, as money does not have to be set aside
- Escrow accounts can ensure that the money set aside will be there. However, insufficient money could be set aside and there is not guarantor of performance.



Ring Fencing

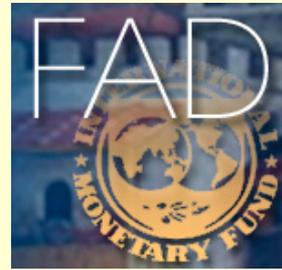
- Separation of taxable projects for purpose of calculation of tax liability and cost recovery
- Pros:
 - Avoids deferral of government revenue
 - Levels playing field for new entrants
 - Essential if impose additional profit tax
- Cons:
 - Limits incentive to invest in new activities

Ring Fencing Alternatives



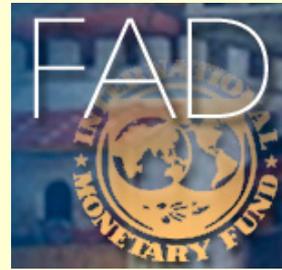
- Ring fencing can be:
 - License-by-license or
 - Project-by-project within the contract area
- There could be an exception to the general rule for:
 - “Failed” exploration on relinquished licenses
 - Adjacent licenses with joint operations

Fiscal Stability Assurances



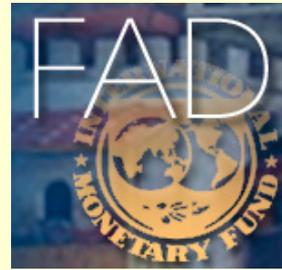
- The reason for:
 - The large size and the sunken nature of the initial investment
 - Long payback and profitability period
 - A lack of credibility that the host country will not change the fiscal rules—the “time inconsistency problem”
- But not all countries grant fiscal stability in their mining 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

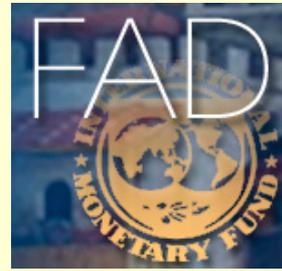


- Mining and petroleum companies may enter into an agreement with the government for a 10-year stabilization regime
- The income tax rate is that applicable at the time of the agreement plus two percentage points
- Companies can opt out at any time; opt-out is irrevocable
- Gives rise to planning opportunities

Two Approaches to Fiscal Stability



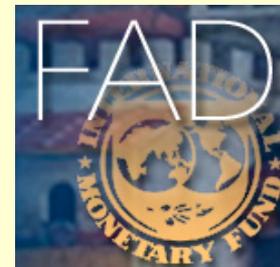
- Fiscal stability guaranteed by reference to laws in force on the effective date of the agreement (frozen law)
 - There should be legal authority to grant fiscal stability by contract as frozen law over-rides current law
- Maintain economic equilibrium if there are any adverse changes (agree to negotiate)
 - 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