

Expert Opinion on Mine Taxation

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prepared for the

Sheshinski Committee II

for the review of

Policy with Respect to Royalties on Natural Resources
formed by the Israeli Ministry of Finance

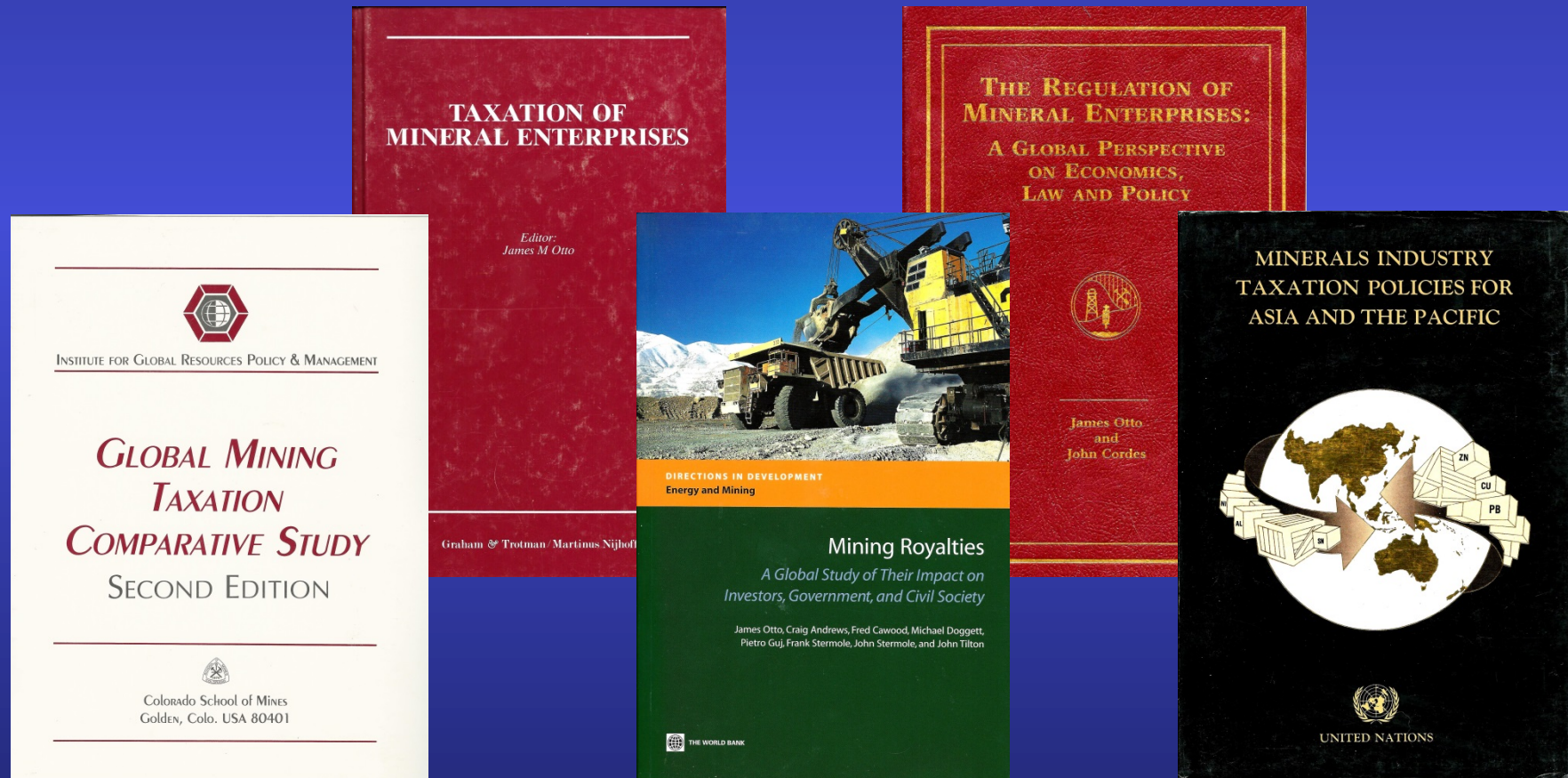
Structure of Presentation

- Credentials
- What is the definition of royalty?
- Is the cost accrued by DSW as a result of its undertakings in the Salt Harvesting Agreement with respect to the salt harvesting project considered "Government Take"?
- What types of additional or excess profits tax royalties are applied to mining, and what are their attributes?
- Concluding remarks

Written report covers additional topics

James Otto: Credentials - Author

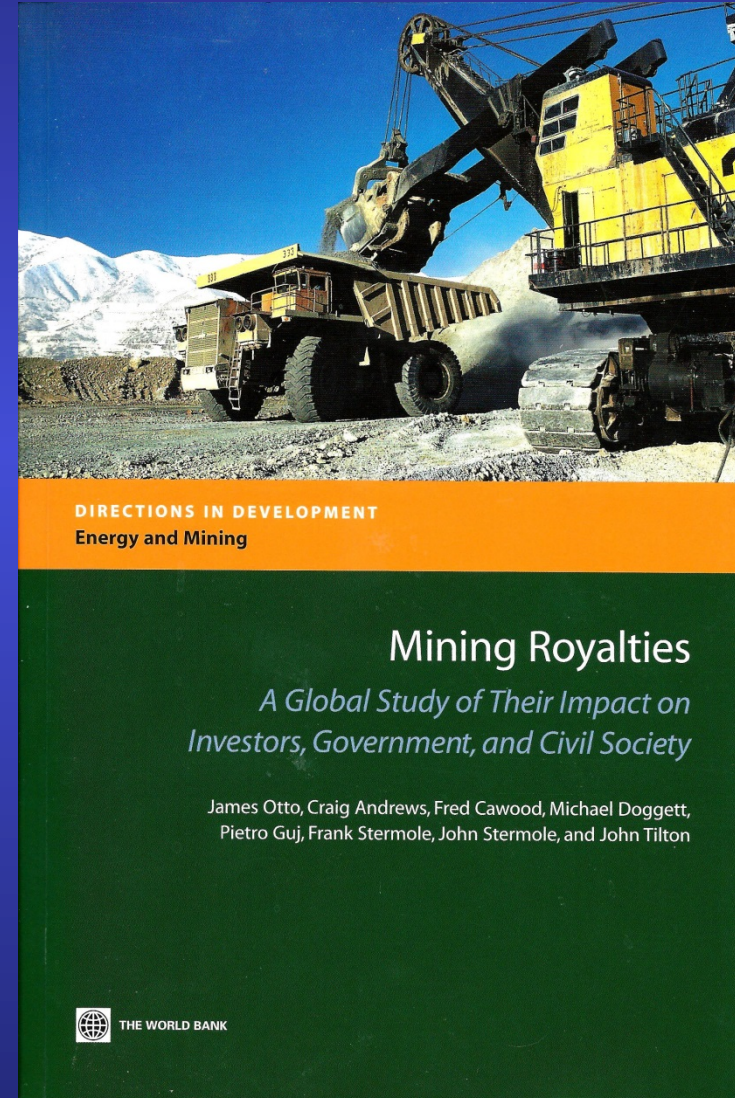
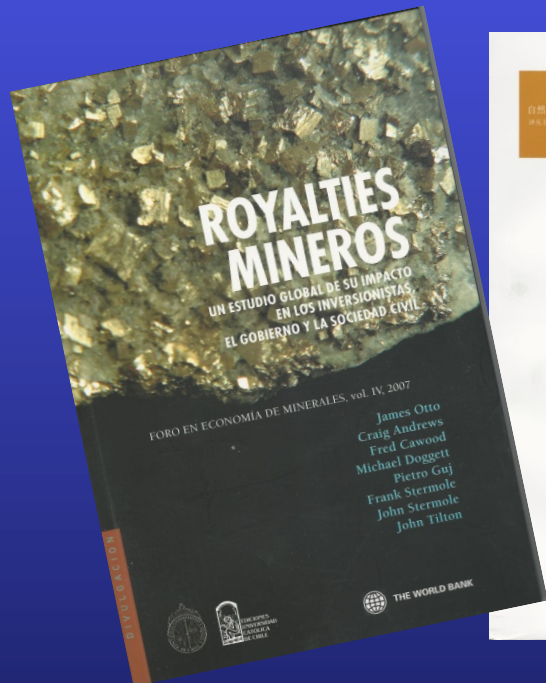
Author/Editor of reference texts on mineral sector taxation published by the United Nations, World Bank and academic presses



James Otto: Credentials - Author

Lead author of the “standard” royalty reference book--

“to provide a comprehensive, objective, and neutral analysis that can be used by governments and industry in deliberations concerning royalties”



James Otto: Credentials – Advisor to Governments



Experience in over 60 nations

- Heads teams to formulate national mining policies, draft mining laws, negotiate agreements, reform tax systems
- Headed UN project to train tax officers from over 75 nations
- Work in the region:

prepared mining laws/regulations and/or fiscal reviews for:

Egypt, Eritrea, Jordan, Saudi Arabia, S. Sudan, Yemen

James Otto: Credentials – Advisor to Investors

- Comparative country risk assessment systems
- Comparative tax studies
- In-house mining taxation workshops
- Negotiations with Governments
- Workshops for government JV partners / departments



What is the definition of royalty?

What is the Definition of Royalty?

“A royalty is any tax type that exhibits one or more of the following attributes:

- the law creating the tax calls that tax a royalty;*
- the intent of the tax is to make a payment to the owner of the mineral as compensation for transferring to the tax payer the ownership of that mineral or the right to sell that mineral;*
- the intent of the tax is to charge the producer of the mineral for the right to mine the minerals produced;*
- the tax is special to mines and is not imposed on other industries.”*

Source: Mining Royalties, World Bank

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- World Bank published book “Mining Royalties”:

“...the government can take its share of the wealth created by mining either in the form of taxes or in the form of non-pecuniary benefits. The latter are government imposed requirements on mining companies (or voluntary contributions) that raise production costs ... The more such requirements increase production costs, the smaller are the benefits the government can reap in the form of tax revenues, and hence the lower is the optimal level of taxation.”

- When a concession holder is requested, coerced to or forced by a government to carry out tasks, or bear costs, that would otherwise be the government's responsibility, or that are meant to advance public or social goals external to what would be necessary to the business of the holder, it can be argued that such costs are also deemed to be "government take" although they are not recorded as revenue by the government.

Are Salt Harvesting Costs Government Take?

- DSW planned to raise the dike surrounding the pond every five years, at an approximate annual cost of ten million dollars, to compensate for the rising water level.
- This solution – good enough for DSW, not good for hotels.
- Result: Israeli government adopts a salt harvesting plan intended to protect the hotels, at a cost much higher than that of raising the pond dikes every five years.
- DSW is strongly pressured by the government to assume the cost of the government's more expensive plan. Absent such pressure, DSW would have instituted, as would any for-profit company, the lower cost option “dike raising” option.

Is the cost accrued by DSW as a result of its undertakings in the Salt Harvesting Agreement with respect to the salt harvesting project considered "Government Take"?

- Had DSW not paid the costs of the salt harvesting, the Government would have probably provided direct relief to the hotels.
- In a dispute for damages, a court or arbiter, will likely find that the difference in cost between the dike solution and the salt harvesting solution is categorized as a government take or otherwise compensable cost.

What types of additional or excess profits tax royalties are applied to mining, and what are their attributes?

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- Types of Royalties -

Royalty can be based on a wide array of calculation methods:

- units of production
- value (*ad valorem*)
- net income
- price levels
- profit
- rate of return
- economic rent

...

Units of production and value-based systems are common, other methods are rare.

What types of additional or excess profits tax royalties are applied to mining, and what are their attributes?

- Simple royalty schemes dominate:
 - Royalties based on units of production are commonly applied to low-value bulk commodities.
 - *Ad valorem* based royalties, such as those currently applied in Israel, are the most commonly applied royalty type.
- Royalties based on “taxable income” or “profits” are applied by few jurisdictions—mainly by sub-national governments in Australia and Canada.
- Royalties based on price levels are rare and subject to quick repeal (Mongolia)

What types of additional or excess profits tax royalties are applied to mining, and what are their attributes?

- Sliding scale “taxable income” based royalties have recently been introduced in Chile and Peru and remain experimental and untested
- Chile:
 - tax applied only to very large copper mines
 - Although Chile ranks in the top 10 countries producing potash, it has made the decision not to apply the tax to companies mining fertilizer minerals (economies of scale)
 - Mines with stabilization agreements do not have to pay (avoid reputational risk, avoid litigation)
 - No other royalty applies
 - The tax is deductible for corporate income tax purposes.

What types of additional or excess profits tax royalties are applied to mining, and what are their attributes?

- Peru:
 - Peru has a similar approach to the Chilean approach, developed in consultation with industry
 - With the introduction of its new mining tax, Peru repealed its ad valorem royalty
- Ghana:
 - pioneered sliding scale profit measure based royalty but repealed it and now uses an *ad valorem* royalty

What types of additional or excess profits tax royalties are applied to mining, and what are their attributes?

Rate-of-return triggered royalties are very rare

- Liberia and Australia recently introduced “rate-of-return” royalty
- Liberia is struggling to implement its “RRT-based surtax”:
 - Not based on the ups and downs of the commodity price from year to year, but instead looks to the project’s net cash flow over the mine life
 - Possibly too complex to implement

What types of additional or excess profits tax royalties are applied to mining, and what are their attributes?

- Australia (Mineral Resources Rent Tax)
 - Only applied to iron ore and coal mines (not to fertilizer mineral mines)
 - Royalties paid are credited against the Mineral Resources Rent Tax (MMRT)
 - Very complex to implement

MMRT is in the process of being repealed – a bill has been introduced for consideration in the next legislative session

What types of additional or excess profits tax royalties are applied to mining, and what are their attributes?

- Papua New Guinea, where the rate-of-return royalty concept was first introduced, repealed its “additional profits tax” in favor of a straight forward *ad valorem* royalty.
- Kazakhstan has a rate-of-return based tax in its statute but reportedly exempts mines (but not petroleum projects) from this tax in its negotiated mine agreements.

What types of additional or excess profits tax royalties are applied to mining, and what are their attributes?

Summary

Excess/additional profits tax can deter new investment and lead to premature closures of existing operations.

Special mining sector considerations to consider:

- mineral commodity prices fluctuate more than other commodities
- high capital costs with fixed repayment obligations
- high operating costs
- when commodity prices go up, costs also usually go up (supply, demand)
- alternative investment opportunities (capital flight: historically lower returns than many other sectors, lower tax jurisdictions)
- not applied to fertilizer minerals

What types of additional or excess profits tax royalties are applied to mining, and what are their attributes?

- Summary / Recommendations -

I urge the Committee to take into account:

- sliding scale royalties based on price level are quickly repealed
- rate of return based royalties:
 - rate-of-return triggered royalties are rare in mining countries
 - the track record of rate-of-return royalty in mining countries is poor
 - complex and difficult to administer
- additional profits taxes are complex and will pose a litigation risk when inevitable disputes arise over ambiguities in the law
- governments that revise their fiscal systems should exempt existing contract-based concessions

Concluding Remarks

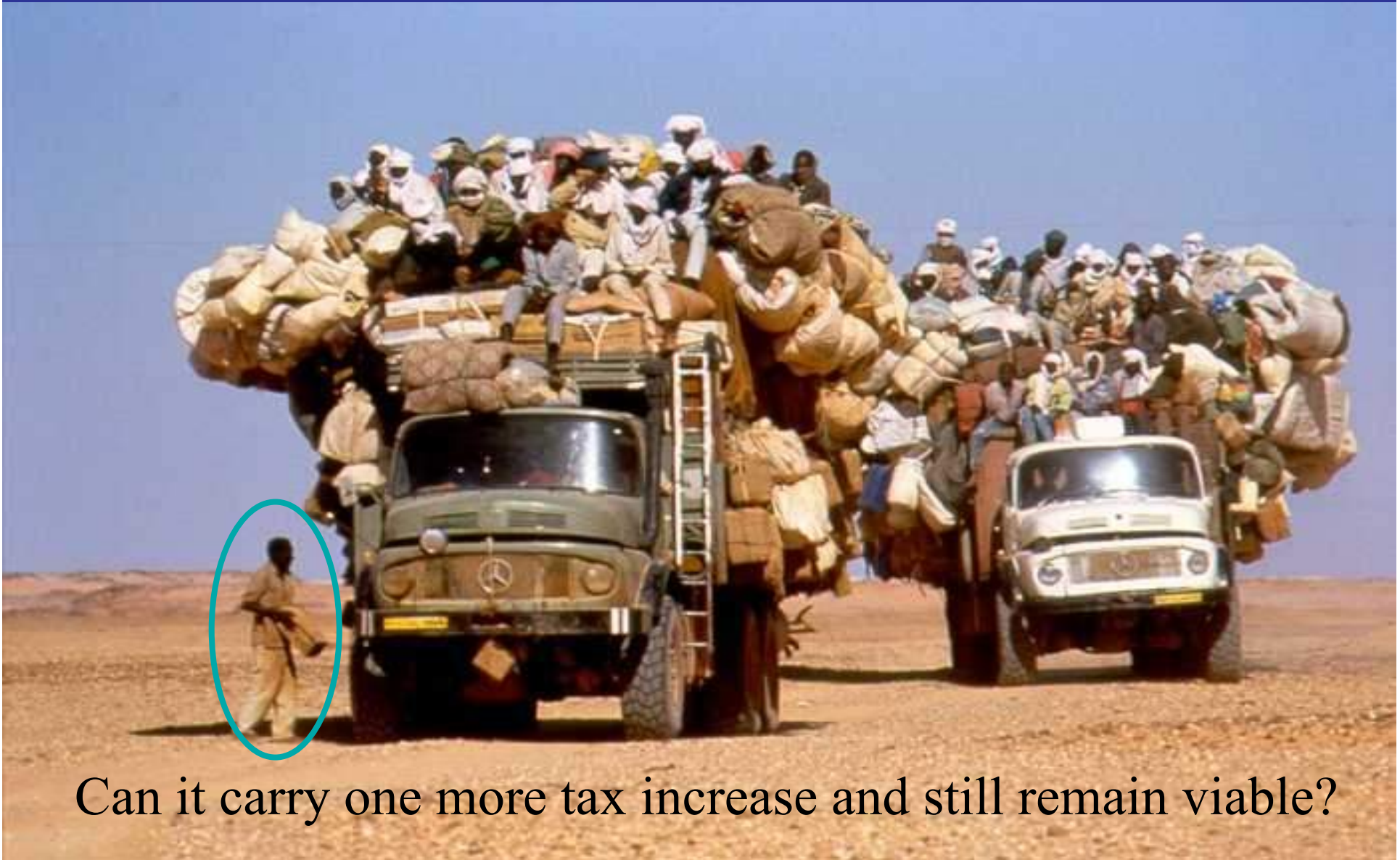
Recommendations

- When designing a royalty system, policy makers should take into account the cumulative impact that royalty, taxes, fees and “non-tax government imposed costs” will have on mine economics and potential levels of future investment.
- Immediate fiscal rewards to be gained from new taxes are less important than long-term benefits to be gained from a sustainable internationally competitive mining sector that will contribute to long-term development, infrastructure, and economic diversification.
- Royalty systems that are simple to calculate and administer have advantages over complex systems that may be quickly repealed.
- Honor contractual fiscal stabilization commitments.

Concluding Remarks

Recognize that the primary goal in mineral sector tax reform is to arrive at a win-win-win approach that satisfies Government's, investor's and societies' needs

Don't expect mines to carry too heavy a burden
- everyone wants a bigger piece of the pie -



Can it carry one more tax increase and still remain viable?