

Refining IFRS Mining & Metals

Resource nationalism

The rise of special mining taxes - what are the accounting impacts?

What you need to know

- ▶ Classification of a government-imposed tax on a mining and metals project for financial reporting purposes will depend upon the specific terms and conditions of each tax
- ▶ If a mining tax represents an income tax under IFRS the related deferred tax balances will need to be recognised
- ▶ Deferred tax balances will need to be reflected in the financial statements from the point at which the relevant legislation is substantively enacted

The state of play...

As the mining and metals sector rebounded relatively quickly from the global financial crisis, it became an early target of national governments to help restore their treasuries. In a number of producer nations the ongoing boom in commodity prices has seen governments continue to assess the level of economic rent they are extracting from mining and metals projects in their countries via taxes, royalties and/or other levies.

From 2010, we have seen more than 25 countries change their fiscal environment (such as taxes and/or royalties) for mining and metals companies, and others have invoked 'use it or lose it' clauses (which require an entity to meet certain stated milestones otherwise risk losing the right to explore, mine etc). There is also a growing trend to increase local participation in projects.

Resource nationalism, the term used to describe situations where governments assert increased control over the natural resources located in their territories, places a large cost burden on mining and metals companies and increases risk of achieving long term project profitability. It can influence an entity's decision about whether to invest in a particular country.

While there are different forms of recent resource nationalism, this publication focuses on the following types and the consequential financial reporting implications:

- ▶ **Imposition of a new resource rent tax** - an example of this is the Australian Government's plan to implement the Minerals Resources Rent Tax (MRRT) for iron ore and coal mining in 2012
- ▶ **Amendments to royalty regimes or other tax rates/levies** - this may include modifications to current regimes that have been in place for some time. For example, Peru has recently enacted a new law which will modify the existing royalty regime to change the way in which the royalty is calculated

The different types of "government take"

The use of taxes, royalties and/or other levies to capture rents from natural resources is a longstanding phenomenon. The total payment to a government is often described as the "government take". This may include a range of fixed or variable payments that are based on physical production, revenue, or some type of net profit figure; and which may take the form of fees, bonuses, levies, duties, royalties and/or taxes.

Excise duties, production taxes and severance taxes

Excise duties, production taxes and severance taxes result in payments that are due upon production (or severance) of minerals from the earth. Depending on the jurisdiction and the type of mineral involved, they are generally calculated:

- ▶ As a fixed amount per unit produced
- ▶ As a percentage of the value of the minerals produced
- Or
- ▶ Based on revenue minus certain allowable costs

Resource Rent Taxes

The aim of a Resource Rent Tax (RRT) is to capture part of the resource rent of a mining project. While the specifics of a RRT may vary between jurisdictions, governments and/or mineral types, it is generally some form of profit-based tax, payable when a certain threshold rate of return on total cash flow has been realised.¹ The aim of a RRT is to levy tax on a project's positive Net Present Value (NPV).

RRT attaches taxation to the project's profitability; all expenditure is recovered first and a minimum return on the project should have been obtained, before the tax is due.

How we see it

While the overall objective of these arrangements is to help ensure a country receives an appropriate return on its natural resources, the specific nature and mechanics of each arrangement can (and do) vary - either subtly or substantially. Small shifts in government take can have a dramatic effect on risk sharing.

Assessing payments to government

One of the key financial reporting issues associated with payments to governments is determining whether the payment meets the definition of an income tax for financial reporting purposes. This will impact how and when such payments are accounted for and disclosed. This assessment is rarely straightforward.

IAS 12 *Income Taxes* should only be applied to account for "income taxes". These are considered to include:

- ▶ All domestic and foreign taxes which are based on taxable profits
- And
- ▶ Taxes, such as withholding taxes, which are payable by a subsidiary, associate or joint venture on distributions to the reporting entity

It is not completely clear what an income tax actually is, as the definition within the standard is somewhat circular. Income tax is defined as a tax based on "taxable profits", which are in turn defined as profits "upon which income taxes are payable". It does however seem clear that those taxes that take the total net profit or loss before appropriations as their starting profit are usually income taxes.

In assessing whether a mining tax is an income tax, the key aspects to be considered are whether it is:

- ▶ A tax based on taxable profit
- And
- ▶ Based on rules established by a taxation authority

In the mining and metals sector, challenges arise in applying the definition in IAS 12 when:

- ▶ A government raises taxes on sub-components of net profit (e.g., net profit before financing costs or revenue minus certain eligible costs)
- Or
- ▶ There is mandatory government participation in certain projects that entitle the government to a share of profits as defined in a joint venture agreement

Consequently, considerable judgement is required to determine whether or not a particular mining tax meets the definition of an income tax under IAS 12.

From a commercial perspective the overall share of the economic benefits a government takes is much more important than the distinction between its different forms. However, from a financial reporting perspective, the distinction is crucial given the considerable differences in accounting treatments and disclosures that apply to income taxes compared to other taxes, fees and government participations.

¹ Garnaut, R. and Ross, A.C., *Uncertainty, Risk Aversion and the Taxing of Natural Resource Projects*, in Vol. 85, No. 338 *Economic Journal* (1975) at <http://www.jstor.org/stable/2230992> p. 281.

Production-based tax

If the mining tax is based on a fixed amount per unit produced, or as a percentage of the value of the minerals produced, then it will likely not meet the definition of an income tax under IAS 12. In these circumstances, the normal principles of liability recognition under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* will apply in recognising the tax charge. That is, an entity will only recognise its obligation to pay the mining tax and the associated expense when it has either a legal or constructive obligation to pay. No deferred tax accounting in relation to future amounts payable in relation to the tax is applicable.

However, one issue that still arises is whether the mining tax should be presented as a cost of production or whether it should be deducted in arriving at revenue, i.e., gross versus net.

One view is that given excise duties, production taxes and severance taxes are aimed at taxing the production of minerals rather than the sale of minerals, they should be considered a tax on extractive activities rather than a tax collected by a mining company on behalf of the government. Based on this perspective, the tax should be presented as a production cost.

Another possible view is that these taxes should be netted against revenue. When considering royalty payments (to which these excise and production taxes could be likened), the current revenue standard, IAS 18, is not entirely clear whether or not revenue should be presented net of royalty payments. For those royalty payments in kind, i.e., settled in physical quantities, many entities do present revenue net of such amounts on the basis that they consider they never receive any inflow of economic benefits from these physical volumes. For similar reasons, excise duties, production taxes or severance taxes, payable in kind, would also generally be netted against revenue.

Resource Rent Tax

Determining whether a RRT is a production-based or profit-based tax is also often not a straightforward exercise. Some RRTs are similar to an income tax in that the tax is a percentage of revenue minus certain eligible costs. However, there can sometimes be other features not commonly found in other non-mining income taxes. For example:

- ▶ There may be an allowance relating to a physical quantity of the relevant commodity from each mine which is exempt from the particular RRT, subject to a cumulative maximum over the life of the mine.
- ▶ The tax may be levied on an individual mine rather than the entity owning the mine as a whole.

As noted earlier, an example of a RRT that has recently been announced is the Minerals Resource Rent Tax (MRRT) in Australia. For more details on the Australian MRRT, refer to the Mining & Metals section of Ernst & Young's Australian website.²

² <http://www.ey.com/AU/en/Industries/Mining---Metals>

How we see it

There are many different types of mining taxes around the world. Some of these are clearly not income taxes, while others have some of the characteristics of an income tax.

In determining whether a particular mining tax meets the definition of an income tax under IAS 12, an entity will need to assess whether or not the tax is based on (or closely enough linked to) net profit for the period and based on rules established by a taxation authority.

As IAS 12 provides only limited guidance on what is considered to be an income tax, this assessment may require significant judgement. It will also need to be determined for each individual tax based on the specific facts and circumstances.

Practical implications for entities

The mining tax is an income tax

There are several practical financial reporting implications for determining whether a mining tax is an income tax under IAS 12. These may arise both on the transition to a new regime and on an ongoing basis. These include:

- ▶ Determining when the impact of the new legislation is required to be reflected in the financial statements
- ▶ Recognition of deferred tax balances and disclosure of relevant information
- ▶ Volatility of future tax expense

Application of the legislation

IAS 12 requires taxes to be measured using tax rates or laws enacted or "substantively enacted" at the reporting date. In some jurisdictions, the announcement of tax rates (and tax laws) by the government, is sufficient to satisfy the "substantively enacted" requirement. This is possible even when actual enactment may not occur until several months after the announcement. In these circumstances, tax assets and liabilities are measured using the announced tax rate (and tax laws).

The standard provides no guidance on how this requirement is to be interpreted in different jurisdictions. Both the IASB and the IFRS Interpretations Committee have resisted various requests to provide further guidance. In most jurisdictions, however, a consensus has emerged as to the meaning of "substantive enactment" for that jurisdiction. Nevertheless, apparently similar legislative processes in different jurisdictions may give rise to different treatments under IAS 12.

Recognition of deferred tax balances

Once a new mining income tax is considered substantively enacted, an entity will then be required to measure and recognise its opening deferred tax assets or deferred tax liabilities, in relation to the new tax, on transition to the new regime, in the financial statements of that reporting period. The initial impact will be reflected through income tax expense.

This means that an entity will need to have formed a view in relation to the mining tax base of its assets and liabilities at or before the reporting date in accordance with the specific requirements of the new tax regime. As an example, this may be the use of cost or market value as the tax base.

If the legislation is substantively enacted, but there is insufficient time available for an entity to undertake or finish the necessary work to determine the impact of the new mining income tax, IFRS requires the entity to make an appropriate estimate of the amounts, disclosing any key assumptions. Revisions may be required at later reporting dates, depending on the materiality of any resultant differences to the original estimate. This would be analogous to reporting the impact of a major acquisition that occurred just before the reporting date.

For listed entities subject to continuous disclosure rules, any material impact would need to be communicated to the market as and when required - which may be in advance of a reporting period.

In addition to recognising the new deferred income tax balances, an entity will need to ensure it is capturing the appropriate information that will need to be disclosed in relation to such amounts.

Volatility of future tax expense

There is the potential for an immediate and potentially material impact on tax expense/benefit on transition to a new mining income tax regime, as well as ongoing unpredictable future impacts.

As noted earlier, the immediate impact will arise from the initial recognition of the relevant deferred income tax balances, which will be recognised through income tax expense/benefit.

Ongoing volatility may arise from changes to the assumptions used in the tax model used to calculate the deferred tax balances and use thereof. This is because a change in the underlying assumptions may lead to a different profile for the use of any base deductions an entity may receive upon entry into the new regime. This may result in the future recognition or de-recognition of all or part of the related deferred income tax assets.

The mining tax is not an income tax

If the mining tax does not meet the definition of an income tax, an entity should develop an appropriate policy in accounting for such payments to governments, for example, under IAS 37.

How we see it

The financial reporting implications of determining that an arrangement is an income tax will have pervasive impacts on the financial statements, both upon initial application and on an ongoing basis. The impact of such changes may have to be reflected in the financial statements well in advance of the actual commencement of the new regime.

An entity should consider developing strategies to fully explain to boards, audit committees and the market the initial impact of a new regime and also anticipate and manage any potential uncertainty arising from ongoing income tax expense volatility.

Final thoughts

In these uncertain economic times, governments will continue to look to the mining and metals sector as a source of revenue. This means governments will continue to assess the fiscal terms of the economic rent they are receiving from the mining and metals projects in their countries in order to obtain their share of higher mineral prices via taxes and/or royalties.

As and when mining taxes and regimes are introduced or changed, an entity will need to analyse each new/changed mining tax to determine whether it meets the definition of an income tax as this will govern the required accounting. In some situations, this will require significant judgement and it will be a matter of facts and circumstances rather than an accounting policy choice.

IFRS contact

Tracey Waring
Global Mining & Metals IFRS Leader
Tel: +44 20 7980 0646
tracey.waring@uk.ey.com

Ernst & Young's Global Mining & Metals Center

With a strong but volatile outlook for the sector, the global mining and metals industry is focused on future growth through expanded production, without losing sight of operational efficiency and cost optimization. The sector is also faced with the increased challenges of changing expectations in the maintenance of its social license to operate, skills shortages, effectively executing capital projects and meeting government revenue expectations.

Ernst & Young's Global Mining & Metals Center brings together a worldwide team of professionals to help you achieve your potential - a team with deep technical experience in providing assurance, tax, transactions and advisory services to the mining and metals sector.

The Center is where people and ideas come together to help mining and metals companies meet the issues of today and anticipate those of tomorrow. Ultimately it enables us to help you meet your goals and compete more effectively. It's how Ernst & Young makes a difference.

Area contacts

Global Mining & Metals Leader

Mike Elliott
Tel: +61 2 9248 4588
michael.elliott@au.ey.com

Oceania

Scott Grimley
Tel: +61 3 9655 2509
scott.grimley@au.ey.com

China

Peter Markey
Tel: +86 21 2228 2616
peter.markey@cn.ey.com

Japan

Kentaro Nakamichi
Tel: + 81 3 5401 6407
kentaro.nakamichi@jp.ey.com

Europe, Middle East, India and Africa Leader

Mick Bardella
Tel: +44 20 795 16486
mbardella@uk.ey.com

Africa

Adrian Macartney
Tel: +27 11 772 3052
adrian.macartney@za.ey.com

Commonwealth of Independent States

Evgeni Khrustalev
Tel: +7 495 648 9624
evgeni.khrustalev@ru.ey.com

France and Luxemburg

Christian Mion
Tel: +33 1 46 93 65 47
christian.mion@fr.ey.com

India

Anjani Agrawal
Tel: +91 982 061 4141
anjani.agrawal@in.ey.com

United Kingdom & Ireland

Lee Downham
Tel: +44 20 7951 2178
ldownham@uk.ey.com

Americas and United States Leader

Andy Miller
Tel: +1 314 290 1205
andy.miller@ey.com

Canada

Tom Whelan
Tel: +1 604 891 8381
tom.s.whelan@ca.ey.com

South America and Brazil Leader

Carlos Assis
Tel: +55 21 2109 1606
carlos.assis@br.ey.com

Service line contacts

Global Advisory Leader

Paul Mitchell
Tel: +86 21 22282300
paul.mitchell@cn.ey.com

Global Assurance Leader

Tom Whelan
Tel: +1 604 891 8381
tom.s.whelan@ca.ey.com

Global IFRS Leader

Tracey Waring
Tel: +44 20 7980 0646
tracey.waring@uk.ey.com

Global Tax Leader

Andy Miller
Tel: +1 314 290 1205
andy.miller@ey.com

Global Transactions Leader

Lee Downham
Tel: +44 20 7951 2178
ldownham@uk.ey.com

Ernst & Young

Assurance | Tax | Transactions |
Advisory

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 152,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

Ernst & Young refers to the global organisation of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients.

For more information about our organization, please visit www.ey.com.

© 2011 EYGM Limited. All Rights Reserved.
SCORE Retrieval File AU1023

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither EYGM Limited nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.

www.ey.com/miningmetals