



Mining duties and pre-operative expenses. Current tax situation for the Mining Industry in Mexico

After more than a decade of constant growth for the Mining Industry in Mexico, during 2013 the value of the mining-metallurgic production suffered a noticeable impact; it was a complicated year for the industry that included a combination of aspects like an adverse worldwide economic context as well as the price changes in some of the main metal commodities.

In previous years Mexico represented an attractive economic destination for foreign investors, not only due to the amount of potentially extractable minerals in the Mexican territory, the qualified labor force, or even the vast experience in exploration and extraction methods; but also due to the tax regime that used to be in force which generally comprised low effective tax rates. All these elements represented thoroughly an effective strategy to attract worldwide investment.



In 2014 before the need of increasing the federal budget, legislators viewed as a possible option evaluating the deletion of certain incentives and imposing new tax burdens for the participants of the Mining Sector.

Their analysis concluded in the enforcement of three new mining duties as well as in the elimination of the benefit of deducting (for income tax purposes) the pre-operative expenses in the year in which they were incurred. Both aspects became part of the measures adopted by the Tax Reform for fiscal year 2014.

Much has been discussed as to which will be the actual economic impact of these reforms: even though the government's collecting rates have increased significantly, the appetite for investors to run new projects may have decreased.

Due to these new challenges mining companies will require soon a restructure of their business operational model and inclusively of their administration, as well as a review of their growth strategies in the medium and long term. It will not be unreasonable as a consequence of these new challenges if some mining projects are suspended or totally abandoned.

Pre-operative expenses

Until December 31 2013, taxpayers dedicated to the exploration and exploitation of mineral deposits relied on the option of deducting the pre-operative expenses incurred during a year in the same fiscal year. Such option was eliminated in the 2014 Tax Reform. According to the Congress declaration of purpose, eliminating this incentive was based on the fact that it created inequality and reduced the collective potential with respect to the rest of the contributing economic sectors.

For 2014 and subsequent years, the Income Tax Law (ITL) foresees that taxpayers dedicated to the exploration and exploitation of mineral resources or any other extractive activities must consider the amortization of pre-operative expenses annually at a maximum of 10% rate, considering these to be the expenses performed related to the exploration stage for the localization and quantification of new deposits for development, in a similar manner to the rest of the taxpayers which perform different economic activities.

Derived from this it is worth mentioning as extremely recommendable to meticulously analyze the classification of expenses incurred for localization and quantification, and most importantly: what should be considered as a new deposit?

The previous will require a synergy of analysis from geologists, accountants and tax specialists in order to obtain an adequate segmentation and identification of the exploration expenses, with the purpose of creating a satisfactory classification according to the stated in the Mexican ITL.

Duties on mining concessions

One of the updates included in the 2014 reform package, specifically in the Federal Rights Law (FRL) was the creation of three new duties concepts, being the **Special Mining Duty** the most relevant.

Special Mining Duty – Applicable to mining concession holders; annual payments of a 7.5% rate on the profit resulting from subtracting the allowed deductions under ITL from the income on the sales of extractive activities with the exception of the annual inflation adjustment, interests and investments, aside from those performed for exploration and prospecting (similar to the previous recommendation it will be extremely

important to cautiously classify the expenses that are included in this concept).

Extraordinary Duty – Applicable to mining concession holders directly on the sales of gold, silver and platinum in a fiscal year at a 0.5% rate.

Additional Duty – Consists in a 50% increase on the rights per hectare currently being paid according to Article 263 from the FRL, for those concessions not explored nor exploited during two consecutive years during the first 11 years after having obtained the concession; an additional 100% increase in the rights per hectare mentioned will apply to concessions which have not been explored nor exploited in a two year period starting the twelfth year of holding the concession.

The intention of the **Special Mining Duty** appears as a concept similar to an already proven model on the Mining Sector applied in Peru and Chile; inclusively with a flavor of the Canadian regime characteristics.

Actually the legal wording and the clarity of object of the Mexican customization are aspects to improve in the short term. Besides it is extremely interesting the substantial effect of not considering its tax base expenses with significant relevance to the sector such as interests and deduction of investments, not mentioning the originally non-proceeding but now allowed deduction for expenses related to exploration and prospection.

Noteworthy is that even though the **Special Mining Duty** seems similar to a corporate tax due to its characteristics, it was catalogued as a federal contribution established in the FRL which is the legal frame that foresees the burdens to be established to those taxpayers who benefit from the use or enjoyment of the goods of the Nation's public domain. Moreover, due to its elements this right could even be interpreted as representing directly a payment of a Mining royalty, since it is straightly linked to a fixed percentage of a certain operating profit.

Conclusions

Even months after the enactment of the **Special Mining Duty**, several issues are still to be evaluated, such as:

- Is the person subject to the **Special Mining Duty** only the concession holder, as directly established in the law?
- This being said, in which situation are companies that exploit a concession under a contract titling them the exploration and extraction rights?
- Considering a change in the deduction / amortization under ITL regarding the definition of an exploration or pre-operative expense, what would be their treatment regarding jobs of such nature in a different vein but in the same deposit?
- What would happen to expenses incurred in an already mature deposit or when a new vein is found susceptible of being exploited with a similar extractable mineral which has already been found in the same concession?

- Under these assumptions, should the mining company continue to stick to immediate deduction or based on the annual 10% amortization rate for the income tax?

In addition, these matters as well as many others will have to be clarified by additional regulations or by modifications in the articles in the respective laws.

Mining is a very technical industry, and it is not negligible that certain concepts should be clarified by means of working in conjunction with other operative organs or departments experienced in the area seeking the correct implementation of the mentioned provisions.

As a conclusion, the Mexican Mining Industry has an important challenge to work on facing the mentioned circumstances. It is not easy to deal with the projections of metal prices nor with the imposition of additional tax burdens; unquestionably must the miners do an effort as never before in order to preserve and execute works in the mature and potential mineral deposits, and additionally comply with the duties and federal and local taxes.



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