August 2012
IMF Country Report No. 12/219

Philippines: Reform of the Fiscal Regimes for Mining and Petroleum

This Technical Assistance Report on Philippines was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed in June 2012. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the Government of Philippines or the Executive Board of the IMF.

The policy of publication of staff reports and other documents by the IMF allows for the deletion of market-sensitive information.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org Internet: http://www.imf.org

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

Fiscal Affairs Department

PHILIPPINES

REFORM OF THE FISCAL REGIMES FOR MINING AND PETROLEUM

Emil M. Sunley, Selcuk Caner, Richard Krever, and Oana Luca

June 2012

Contents **Page**

Appendix

ABBREVIATIONS AND ACRONYMS

AETR	Average Effective Tax Rate
ARMM	Autonomous Region of Muslim Mindanao
BIR	Bureau of Internal Revenue
CGT	Capital Gains Tax
CIF	Cost, insurance and freight
CIT	Corporate Income Tax
DENR	Department of Environment and Natural Resources
DOE	Department of Energy
DOF	Department of Finance
EITI	Extractive Industries Transparency Initiative
FAD	Fiscal Affairs Department
FARI	Fiscal Analysis of Resource Industries
FPIA	Filipino Participation Incentive Allowance
FTAA	Financial or Technical Assistance Agreement
GDP	Gross Domestic Product
IRA	Internal Revenue Allotment
IRR	Internal Rate of Return
LIBOR	London Interbank Offered Rate
LGC	Local Government Code
LGU	Local government unit
LME	London Metal Exchange
MA	Mining Act, 1995
METR	Marginal Effective Tax Rate
MGB	Mines and Geosciences Bureau
MPSA	Mining Production Sharing Agreement
NIRC	National Internal Revenue Code
NPV	Net Present Value
PNOC	Philippine National Oil Company
PSMA	People’s Small-Scale Mining Act of 1991
RRT	Resource Rent Tax
VAT	Value-added Tax

PREFACE

In response to a request from Mr. Cesar V. Purisima, Secretary of Finance, a technical assistance mission visited Manila, Philippines during the period April 10–April 23, 2012, to advise on the fiscal regimes for the mining and petroleum sectors. The mission was comprised of Emil M. Sunley (FAD Expert and head), Selcuk Caner and Oana Luca (FAD staff), and Richard Krever (LEG Expert).

The mission met with Mr. Purisima; Mr. Ramon J.P. Paje, Secretary of Environment and Natural Resources; Ms. Kim S. Jacinto-Henares, Commissioner of Internal Revenue; Mr. Rozanno Rufino Biazon, Commissioner, Bureau of Customs; Mr. Jeremias N. Paul, Jr. Undersecretary, Ms. Teresa S. Habitan, Assistant Secretary, Mr. Tomas R. Corillo, Acting Chief, Local Tax Division, Bureau of Local Government Finance, (all Department of Finance (DOF)); Ms. Carmencita N. Delantar, Budget and Management Bureau, Department of Budget and Management; Mr. Leo L Jasareno Acting Director, Mines and Geosciences Bureau, Department of Environment and Natural Resources (DENR); Zenaida Y. Monsada, Director, Oil Industry Management Bureau, Department of Energy (DOE); Mr. Manuel Q. Gotis, Director Bureau of Local Government Development, Department of Interior and Local Government; and Ms. Marjorie O. Ramos-Samaniego, Director, Legal Services Department, and Mr. Nestor P. Arcansalin, Director, Resource-Based Industries Department (both Board of Investments (BOI)).

The mission also met with senior officials of the Chamber of Mines, Indophil Resources, Lepanto Mining, Philex Mining Corporation, Sagittarius Mines, Xstrata, the Australian-New Zealand Chamber of Commerce, SGV&Co, the World Bank; and with representatives of civil society.

The mission appreciates the excellent cooperation and support of the authorities, especially Mr. Paul and Ms. Habitan. Mr. Dennis Botmann, the IMF's Resident Representative in Manila, provided excellent guidance and feedback for the mission. Thanks is also due to Ms. Febe J. Lim, who coordinated arrangements and follow up for the mission, and to Ms. Socorro Venturanza, in the IMF office for her kind cooperation and support.

EXECUTIVE SUMMARY

Philippines has long been a producer of minerals, but the mining and petroleum sectors account for only a small share of the economy, exports, and government revenue. In recent years the production of minerals has increased and several large mining projects, including one world-class project, are in the planning or development stage. The petroleum sector comprises only two fields—one producing natural gas and condensate and one producing crude oil. Both are located offshore west of Palawan.

The primary focus of the mission was the fiscal regime for the mining sector. The reason for this is the mining sector is much larger than the petroleum sector, and the concern, expressed in some quarters, that the mining sector is not paying its fair share. One indication of low contribution of the mining sector to government revenue is that mining sector's payments to government as a share of total taxes is less than the mining sector's share of GDP. The mining sector's low contribution to government revenue is, in part, due to the mining sector comprising mostly small-scale mines (with about 34 percent of total value mining production) do not pay a lot of tax, older mines that are in their twilight years, and a few new mines that are enjoying tax holidays.

The mission was asked to identify and provide advice on measures that would increase government revenue from the mining sector, but which would not require legislative action. The most likely measure would be to extend the 5 percent mineral royalty, which currently applies only to mines located in mineral reservations, to all mines by way of an administrative order. This could be problematic as the precedent used to justify the imposition of royalties explicitly provided only for royalties on minerals produced in a mineral reservation. An alternative that has been suggested by Senator Ralph Recto is to increase the mineral excise from 2 percent to 7 percent (S. No. 2754), a proposal that would require legislative amendment. Simply extending the royalty to mines outside a mineral reservation or increasing the rate of the mineral excise would increase production-based levies and would make the fiscal regime unattractive for mining projects of low profitability.

Legislative reforms of the mining fiscal regimes are needed. There are currently three fiscal regimes for large mines: mineral production sharing agreements (MPSAs) outside mineral reservations, MPSAs in mineral reservations, and financial and technical assistance agreements (FTAAs), which is the only fiscal regime that permits 100 percent foreign ownership. To date all FTAA agreements are for mines outside mineral reservations. Going forward, a modified version of the FTAA regime should be the only regime available for future large mining projects, as over-restricting foreign investment in the mining sector has likely held back investments in the mining sector. A modified version is needed as the FTAA regime imposes a heavy burden on low-profit projects, as it requires a 50 percent government share. The current FTAA regime is not competitive internationally.

The major reform of the FTAA fiscal regime would be to replace the current version of the additional government share, which serves as a minimum tax, with a 10 percent surcharge on cash flow after the corporate income tax but before financing. This would lower the government take on less profitable projects and make the overall fiscal regime less regressive.

The 5 percent royalty and the 2 percent excise on mineral production should be combined into a single royalty that applies to mines inside and out of mineral reservations, with the combined royalty to be collected by the Bureau of Internal Revenue. This would ensure early revenue to the national government to be shared with local governments. Recognizing that the high royalty rate, particularly when combined with other production-based levies, would make the fiscal regime uncompetitive, the mission proposes that the mining companies be allowed a tax credit against their income tax for the amount of royalty payment in excess of 5 percent.

Other reforms of the fiscal regime for mining are needed. First, the BOI and Mining Act tax incentives should be repealed. Second, all domestic tax rules should be consolidated in the NIRC, including the royalty, and all income tax measures affecting mining should be consolidated in a separate chapter of the income tax. Third, to foster sound environmental practices, mining companies should be allowed to deduct deposits to an approved mine rehabilitation fund. Fourth, a thin capitalization rule should be adopted to limit the excessive use of debt. Chapter II outlines additional reforms.

Local government units (LGUs) receive 40 percent of national revenue from the utilization and development of national wealth, including revenue from the 5 percent royalty and the 2 percent mineral excise. To improve the procedures for transferring funds under this program and to foster local support for large-scale mining, Congress should enact a continuous appropriation for the distribution of the LGUs share, and payments should be made to LGUs based on estimated amounts with adjustments when final amounts are known. A joint monitoring commission, with national and local representation, could be introduced to oversee the distribution of revenues to LGUs.

The Philippine petroleum fiscal regime, embodied in petroleum service contracts, is straight-forward and does not need a major overhaul. There was, however, insufficient time available for this mission to do a quantitative assessment of alternative fiscal regimes for the petroleum. The mission would recommend that for the next bid round, the government should consider replacing the 60/40 sharing of net proceeds with profit-based sharing under which the government share would increase as profitability increases.

I. INTRODUCTION AND OVERVIEW

1. **FAD provided tax policy advice on the Philippine tax system in 2011 and 2012.** The 2011 mission undertook a preliminary assessment of the fiscal regime for mining and recommended that a future FAD mission compare the current fiscal regime with alternative regimes**.**[1] The 2012 mission reviewed fiscal relations between the central and local governments, but did not review the sharing of mining taxes and royalties. This mission provides a fuller assessment of Philippines' fiscal regime for mining, with financial modeling of projects and international comparisons, and a preliminary assessment of the fiscal regime for petroleum. The mission also assesses the sharing of mining taxes and royalties.

A. Overview of the Mining Sector

2. **The Philippine Constitution limits foreign participation or ownership in most economic activities to no more than 40 percent of capital.**[2] This limitation has impeded foreign investment in the mining and other sectors of the economy. The Constitution, however, allows full foreign ownership if the President enters into technical or financial assistance agreements with foreign-owned corporation for large-scale exploration, development, and utilization of minerals and petroleum.[3]

3. **Responding to the constitutional and historical factors, Philippines has developed a three-track mining system.** Small-scale miners are subject to local license arrangements. Large mines were originally structured MPSAs with companies acquiring mineral extraction rights satisfying the constitutional requirement for a minimum 60 percent local ownership.[4] Mining reforms adopted in 1995 opened the door to full foreign ownership of mining operations through the adoption of financial and technical assistance agreements (FTAAs) that are a form of profit-sharing with the foreign-owned mining companies extracting the minerals. As of February 2012, there are 339 MPSAs and six FTAAs in place. There are only 99 MPSAs in the development or exploitation stages and two FTAAs in the development stage.

---

[1] Kiyoshi Nakayama, Selcuk Caner, and Peter Mullins, *The Philippines: Road Map for a Pro-Growth and Equitable Tax System* (November 2011).

[2] Constitution of 1987, Article XII, Section 10.

[3] Constitution of 1987, Article XII, Section 2.

[4] The ownership rules restricted the availability of investment capital, and attempts to circumvent the rule through ownership tiering arrangements proved ineffective as company securities administrators shifted from a first tier control test to full tracing through tiers (known as grandfathering in local terminology) to prevent majority foreign ownership.

4. **The mining industry in the Philippines accounts for a small share of the economy even though minerals such as gold have been mined for a long time**. Mining production accounts for about 1.5 percent of GDP and mineral exports have averaged 3.7 percent of total exports since 2007. The main minerals mined in the Philippines are gold, copper, and nickel. Gold contributes about 50 percent of total value of mining industry's production. A consolidated Mining Act (RA 7942) enacted in 1995 provided a stimulus for investment in mining exploration and development.[5] However, the industry remained small due to low productivity and low world prices of minerals. However, the industry responded to high mineral prices in the past several years by increasing production and investment (Table 1).

Table 1. Philippines: Contribution of the Mining Industry 2007–10

	2007	2008	2009	2010
Value of Mining Production (in billions of pesos)	102.2	86.9	106.1	145.3
Metallic	81.4	63.4	79.6	112.0
Non-metallic	20.8	23.5	26.5	33.3
Share of GDP	1.5%	1.0%	1.3%	1.6%
Exports (in billions of pesos)	2,981.8	2,849.9	2,587.0	3,133.5
Exports of Minerals	130.5	125.0	75.0	93.8
Metallic	120.2	115.3	67.8	86.3
Non-metallic	10.3	9.7	7.2	7.5
Share of Total Exports	4.4%	4.4%	2.9%	3.0%
Gold Production (in billions of pesos)	39.9	43.0	52.8	70.5
Gold Production (in 000 kg)	38.8	35.7	37.1	40.9
Copper Concentrate (DMT)	88.1	92.8	203.4	236.8
Nickel Ore (DMT)	7,380.3	5,459.1	8,283.1	13,172.5
Nickel Concentrate (DMT)	17.9	18.5	30.3	33.5
Average World Prices				
Gold (per oz.)	696.4	871.5	973.0	1,222.0
Copper (per lb.)	3.2	3.2	2.3	3.4
Nickel (per lb.)	16.8	9.6	6.6	9.8
Exchange Rate (Pesos/USD)	46.2	44.5	47.6	45.1
GDP (in billions of pesos)	6,892.7	8,316.0	8,485.5	9,003.5

Source: DENR and staff calculations.

5. **For large mines, the fiscal regime depends on whether the mine is operating in a "mineral reservation" and whether the mine is operated under an MPSA or a FTAA.**[6] Only mines operating in a mineral reservation pay the royalty—5 percent of the market value of gross output, and the only companies currently mining in a mineral reservation are all operating under an MPSA. All mines pay the 2 percent mineral excise tax, which is also

[5] See, Rumolo, A. Virole, "*Can Gold Mining Revitalize the Mining Industry? Or, Should It*?" National Statistics Coordination Board, 2012.

[6] This report primarily addresses the fiscal issues relating to the large mines.

levied on the market value of gross output. In addition to the excise and possibly the royalty, MPSAs pay national taxes (including corporate income tax (CIT), withholding taxes, customs duties, and VAT) and various local taxes and fees). The most important local taxes are a business tax based on turnover and the property tax. The FTAA fiscal regime is structured in two components: the basic government share and the additional government share. The basic government share includes the same national taxes, local taxes, and fees paid by MPSAs. The additional government share, which is paid only after the recovery period (when net cash flows exceed the pre-operating expenses), is equal to 50 percent of net mining revenue in excess of the basic government share. The additional government share is, in effect, a minimum tax, after the cost recovery period, as it is paid only when the regular taxes and fees are less than 50 percent of net mining revenue. Investments in the mining sector are eligible for tax incentives provided in Omnibus Investment Code of 1987 and in the Mining Act of 1995. These incentives include tax holidays, customs duty and VAT exemptions on imports, and a longer loss carryover.

6. **The mining sector's contribution to government revenues in term of taxes, royalties and fees is small, but it has been increasing since 2008 (Table 2).** Total taxes[7] and royalties paid to national government and local government units (LGU) declined in 2008. However, they have recovered since then, mostly due to the increase in gold and copper prices and increased production in response to high prices. About 9 percent of the total taxes are payments to local government units (LGUs) in the form of local taxes and fees.

7. **Several factors account for the low contribution of the mining sector to government revenues.** Low tax revenues are due to the mining sector comprising mostly small-scale mines (with about 34 percent of total value of production) that do not pay a lot of tax, older mines that are in their twilight years, and a few new mines that are enjoying tax holidays. In addition, out of a total of 345 active large mining licenses, only 30 percent of the companies are in the development and production stages and the rest are in the exploration stage. As will be discussed in Chapter II, the low contribution of the mining sector to government revenue is not due to the Philippine fiscal regime for mining being generous to the contractors by international standards.

8. **The Tampakan project, if approved,[8] would substantially increase the size of the Philippine mining sector.** Sagittarius Mines,[9] which is the government's contractor for the development and operation of Tampakan, projects investment of US$5.9 billion to develop

[7] Total taxes include VAT, which should be refunded, as most mineral output is exported.

[8] The project is awaiting its environmental compliance certrificate.

[9] Xstrata Copper is the managing shareholder of Sagittarius Mines.

the mine. If developed, the mine could begin commercial production in 2016 and would become one of the top 10 copper mines in the world. The gross production from the mine could be US$2billion per year, which would add an additional 1 percent of GDP per year to the size of the mining sector. There are other large projects on the horizon, including the Far Southeast project (Goldfields/Lepanto), which is doing its definitive feasibility study. This project has a projected investment of US$2 billion.

Table 2. Philippines: Taxes, Royalties, and Fees Paid by the Mining Industry

	2007	2008	2009	2010	2011
Type of Tax	(In millions of pesos)	(In millions of pesos)	(In millions of pesos)	(In millions of pesos)	(In millions of pesos)
Taxes and Fees Paid to National Government 1/	8,371.7	5,949.5	10,272.5	10,736.3	7,339.9
Corporate Income Tax	2,806.5	4,102.9	1,119.5	1,971.3	
Minimum Corporate Income					4,202.8
Excise Tax	926.8	641.3	760.8	1,400.0	1,883.5
Royalty	589.8	414.8	305.3	675.0	1,099.5
Fees (MGB)	184.2	142.6	91.0	97.2	154.2
Customs on Imported Capital Equipment	130.3	221.1	326.5	336.2	
Waste and Tailing Fee					
Withholding Tax on Interest Payments	38.8	38.3	88.1	148.6	
Withholding Tax on Dividends	315.6	105.2	82.9	324.0	
Capital Gains Tax	111.7	49.2	3.9	13.9	
Royalties to Indigenous People (if applicable)					
Stamp Tax	30.0	35.0	52.3	68.7	
Other Taxes	3,238.0	199.2	7,442.3	5,701.4	
Local Government Taxes	359.8	522.1	992.9	1,112.4	986.7
Local Business Tax	68.5	92.2	167.7	181.9	
Real Property Tax	164.7	273.2	604.0	481.3	
Community Tax	0.4	0.3	0.5	0.5	
Residence Tax				N/A	
Occupation Fees	10.5	19.3	22.4	47.6	
Registration Fee	3.5	9.8	3.0	11.0	
Permit Fee	6.9	9.5	26.1	12.9	
Wharfage Fees	47.0	54.1	75.1	122.2	
Extraction Fee	20.2	24.7	44.8	20.5	
Other Local Taxes	38.1	39.0	49.3	234.5	
Total Mining Taxes (National +Local Governments)	8,731.5	6,471.6	11,265.4	11,848.7	8,326.6
As Share of Total Tax Revenues of National Government					
Total Mining Taxes (National)	0.90%	0.57%	1.04%	0.98%	0.61%
Corporate Income Tax	0.30%	0.39%	0.11%	0.18%	0.35%
Excise Tax	0.10%	0.06%	0.08%	0.13%	0.16%
Royalty	0.06%	0.04%	0.03%	0.06%	0.09%
As Share of Total Production					
Total Taxes (National +Local Governments)	8.5%	7.4%	10.6%	8.2%	5.1%
Corporate Income Tax	2.7%	4.7%	1.1%	1.4%	2.6%
Excise Tax	0.9%	0.7%	0.7%	1.0%	1.2%
Royalty	0.6%	0.5%	0.3%	0.5%	0.7%
Memorandum Items:					
GDP (in billions of pesos)	6,893	8,316	8,485	9,003	9,735
Total Tax Revenues (in billions of pesos)	933	1,049	988	1,094	1,202
Total Production (in billions of pesos)	102.2	86.9	106.1	145.3	162.8
Total Tax Revenues (billion pesos)	933	1,153	1,101	1,101	1,094
Growth in tax revenues		-28.9%	72.7%	4.5%	
Royalties		-30%	-26%	121%	
Excise		-31%	19%	84%	
Small scale gold	32.2	33.9	36.8	42.9	
Total Mining	102.2	87.1	106.1	145.3	
Small scale gold share	32%	39%	35%	30%	

1/ Includes all taxes collected by national agencies. Includes taxes not listed in the table.

Source: BIR, DENR and FAD staff calculations.

Source: DOF.

9. **New large mining projects have the potential to increase government revenue from the mining sector.** However, given Tampakan's fiscal regime, which is no longer available for new projects, national government revenue during the first five operating years (the recovery period) will be limited to royalty payments to host barangays and host indigenous peoples. The excise tax on minerals, corporate income tax and the withholding tax on dividends will be paid from the sixth operating year. Moreover, as a good fiscal practice, governments should not include projections of future mining revenue in government fiscal projections until the project has reached the development stage.

B. Overview of Sharing of Mineral Revenues

10. **Local government units (LGUs) are entitled to a 40 percent share of revenues collected from mining taxes (namely, the 2 percent excise) and royalties.** The mining taxes and royalties are shared with a lag of at least a year. The LGU revenues transferred from national government are shared by the provinces, cities, or municipalities and barangays. In addition to shared revenues, LGUs levy a local business tax, real estate taxes, and various fees and charges (Table 2). Own revenue sources of LGUs account for about 9 percent of total taxes and fees paid by the mining industry. LGUs also regulate the small-scale mining industry and quarrying by issuing permits and ordinances.

C. Overview of the Petroleum Sector

11. **Philippines has only a modest level of petroleum production.** In 2011, the daily level of production was about 6,000 barrels of crude oil, 14,000 barrels of condensate, and 70,000 barrels of oil equivalent of natural gas. The condensate and gas are produced primarily from the Malampaya deep water gas field west of Palawan. Shell Philippines Exploration is the operator, and Chevron and the Philippine National Oil Company (PNOC) are joint venture partners in this gas to power project. A thin oil rim was discovered beneath the Malampaya gas field in 2001. Most of Philippines crude oil production is from the Galoc oil field offshore Palawan, which has two wells and is expected to produce oil through 2018. Galoc Production Company, a Singapore based company, which was formed in 2005 with the primary objective of developing the Galoc oil field, is the operator of the Galoc field, and Nido Petroleum, an Australian company, and various Philippine companies are joint venture partners. Philippines has a small amount of cyclic crude oil production from the Nido and Matinloc fields. Although Philippines' current production of crude oil and natural gas is quite modest, the Philippine petroleum industry may have significant potential in the disputed area of the South China Sea Basin, which is adjacent to the Northwest Palawan Basin.

12. **The Petroleum Exploration and Development Act of 1972[10] provides the legal basis for the exploration and development of petroleum resources**. The Act authorizes

[10] Conferred by Presidential Decree No. 87 and amended by Presidential Decree No. 1857.

the grant of service contracts entered into through public bidding, or through negotiations. There are currently 28 active petroleum contracts, mostly in the exploration stage and four contracts in the production or late-production stages.

13. **Philippines has a proceeds sharing fiscal regime for its petroleum sector similar to a production sharing fiscal regime.** Under this regime, the holder of the petroleum service contract bears all costs of exploration and development and all operating costs in return for a share of the gross income realized from any production that may result.[11] To encourage Philippine participation in the development of the petroleum sector, a Filipino Participation Incentive Allowance (FPIA) of up to 7.5 percent of gross proceeds is allowed, depending on the aggregate participation in the contract by Filipino citizens and corporations. The operating expense limit cannot exceed 70 percent and the contractor's share of net proceeds, after deducting operating expenses and FPIA, cannot exceed 40 percent.[12] There are signature and production bonuses, and the 30 percent CIT is paid out of the government share. There is no royalty. Other than the Philippine income tax, the contractor is exempt from all national taxes under the National Internal Revenue Code, including the minerals excise tax (Section 7.2 of the model). The contractor is also exempt, with some conditions, from levies, tariffs, duties, and value-added tax on imports of machinery, equipment, spare parts, and materials required for petroleum operations (Section 7.2 of the model). Finally, the model service contract includes a broad stabilization provision that applies to all Philippine laws or regulations without time limit.

D. Extractive Industries Transparency Initiative (EITI)

14. **The EITI supports improved governance in resource-rich countries through the full publication and reconciliation of company payments and government revenues from oil, gas, and mining.** Studies have shown that when governance is good, countries rich in oil, gas, and minerals can generate large revenues to foster economic growth and reduce poverty. However when governance is weak, oil, gas, and mineral resources may instead cause poverty, corruption, and conflict—the so called "resource curse." The EITI aims to work against this "curse" by improving transparency and accountability.

15. **Philippines is committed to becoming a candidate country for the EITI.** Once it has become a Candidate Country, EITI implementation will involve a range of activities to

---

[11] In contrast, under a production sharing regime, the contractor, and the government share production, once it is extracted.

[12] Sections 8 and 18 of the Petroleum Exploration and Development Act. In the model petroleum service contract, the operating expense limit is set at 70 percent and the contractor's share of proceeds is set at 40 percent. Because of confidentiality clauses, the mission was not able to see the actual service contracts, but the mission understands that the actual contracts contain slight modifications of the fiscal terms vis-à-vis the model contract.

strengthen resource revenue transparency. To achieve Compliant Status, a country must complete an EITI Validation within two and a half years of becoming a Candidate Country. If the EITI Board considers that the country meets all of the EITI Requirements, the country will be designated as EITI Compliant. There currently are 13 EITI compliant countries and 20 EITI candidate countries.

II. Reform of the Mining Fiscal Regime

A. Strategic Overview

16. **The State, as resource owner, has valuable assets in the ground that can only be exploited once.** In order to convert them into financial resources, Philippines must attract investment, both domestic and foreign, on terms that ensure Philippines gets the greatest possible value for its resources—in the context of uncertainty about what the value of the resources will eventually turn out to be. Once mineral resources are developed and sold, there is a need to balance the rights of the national and local governments for equitable shares of revenues. At the same time, but beyond the scope of this mission's work, Philippines needs to protect indigenous communities' rights, and through laws, regulations, and enforcement, safeguard the environment.

17. **Mining companies and governments have competing interests with respect to the division of risk and reward of mineral development.** Both want to maximize rewards and shift as much risk as possible to the other party. Given multiple objectives, multiple fiscal instruments may be needed to protect the interest of the government and the mineral companies over the life of the contracts. Product-based instruments, such as royalties, can ensure the government receives at least a minimum payment for its mineral resources. Profit-based instruments allow the government to share in the upside of highly profitable projects, but they also increase the government's share in the project's risk inasmuch as the government may receive no revenue if the project turns out to be unprofitable.

18. **Philippines should adopt a fiscal regime for the mining sector that is simple, predictable, and transparent.** This regime should ensure a fair distribution between mining companies and the government of the economic benefits from mining with fiscal rules that are complemented by an efficient and transparent tax administration.

19. **There is a market test for Philippines fiscal regime—can the country attract investments in its mining sector?** If not, the fiscal regime may be inappropriate for the country, given its exploration, development, and production costs; the size and quality of mineral deposits; and investor perception of commercial and political risk.

B. One or More Fiscal Regimes

20. **There are currently three fiscal regimes for large mines: MPSAs outside mineral reservations, MPSAs in mineral reservations, and FTAAs, which to date are all outside mineral reservations.** The multiple mining regimes and fiscal regimes can lead to inefficiencies and distortions and arbitrage opportunities. Company structures are designed to comply with complex ownership rules rather than optimal business structure choices while the array of fiscal regimes means investors may face collections of different levies by multiple agencies applying different taxes to virtually identical tax bases.

21. **Effective reform of the mining fiscal regime must establish mineral exploitation and fiscal systems appropriate for the Philippine nation's needs, achieving in particular three goals:**

- rationalization of the multiple mining fiscal regimes into a single regime that facilitates full foreign investment in large scale projects;

- rationalization of multiple mining fiscal regimes into a single progressive system that establishes a competitive base which provides investors with a fairer rate of return for their risk and investment while delivering a steady and predictable stream of revenue to the government for the sale of its resources, with the government's share rising appropriately as profits from the sale of its resources increase; and

- efficiently delivering a fair share of the rewards for the sale of natural resources to the LGUs hosting the exploited resources.

22. **As only the FTAA regime allows full foreign ownership and foreign investment will be critical to the growth and development of the mining sector, a modified version of the FTAA regime should be the only regime available for future large mining projects, whether foreign owned or operated by a local mining firm.** Mining companies with current FTAAs could be allowed to elect the modified FTAA fiscal regime. The details of the modified regime are discussed in later sections of this chapter. Small-scale mines, which are beyond the scope of this mission's work, would continue to be governed by Republic Act No. 7075 and other pertinent laws.

23. **Using a comprehensive financial model developed by FAD,[13] the mission compared four regimes (current and prior):** (1) the MPSA regime with no royalty (MPSA basic); (2) the MPSA regime with the 5 percent royalty; (3) the FTAA regime with Option B (the Tampakan project but no longer available for new investors),[14] and (4) the current FTAA

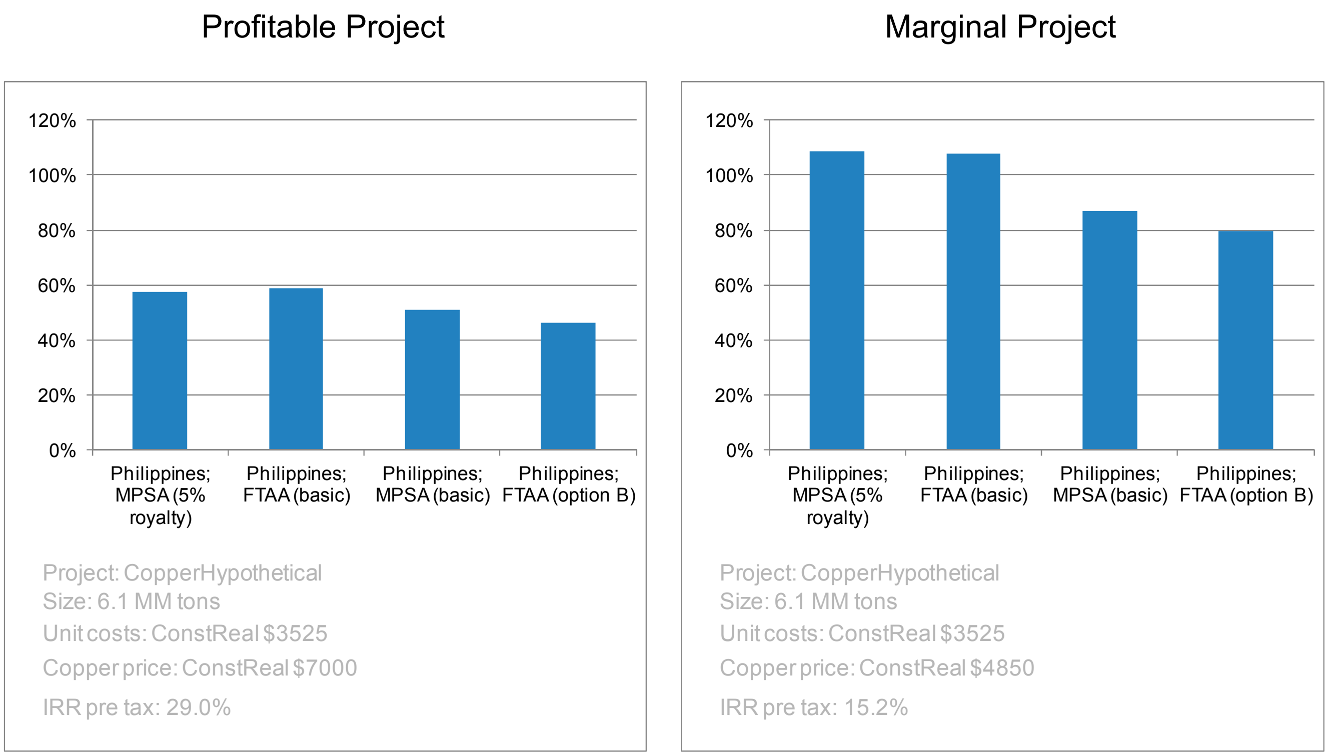
---

[13] Section H of this chapter contains a description of the model and more modeling results, including international comparisons.

[14] Option B is the additional government share that is equal to 25 percent of additional profits, defined as the difference between net income after tax and 40 percent of gross output, grossed up by the corporate income tax rate. Under DENR Administrative Order 99-56, mining companies were allowed to calculate the additional government share under three options. Option A requires a 50–50 sharing of the cumulative present value of the cashflows after the recovery period, if the cumulative present value of total government share from the previous years and the basic government share in the current year is at least 50 percent of the cumulative present value of the project cash flow. Under Option C, the additional government revenue is calculated as 50 percent of cumulative net mining revenue after the end of the recovery period minus the sum of cumulative basic government share and the additional government share. The three options for computing the additional government share allowed before 2007 are no longer allowed under DENR Administrative Order 2007–12. One or more mining projects, including the Tampakan project, are "grandfathered" under Option B.

regime with the 50 percent additional government share—a cash flow-based levy. The model calculates the average effective tax rate (AETR), also known as the "government take", using cash flows discounted at 10 percent. Figure 1 compares the AETR of the various regimes for a low and high profit project and Figure 2 compares the time profile of government revenue.

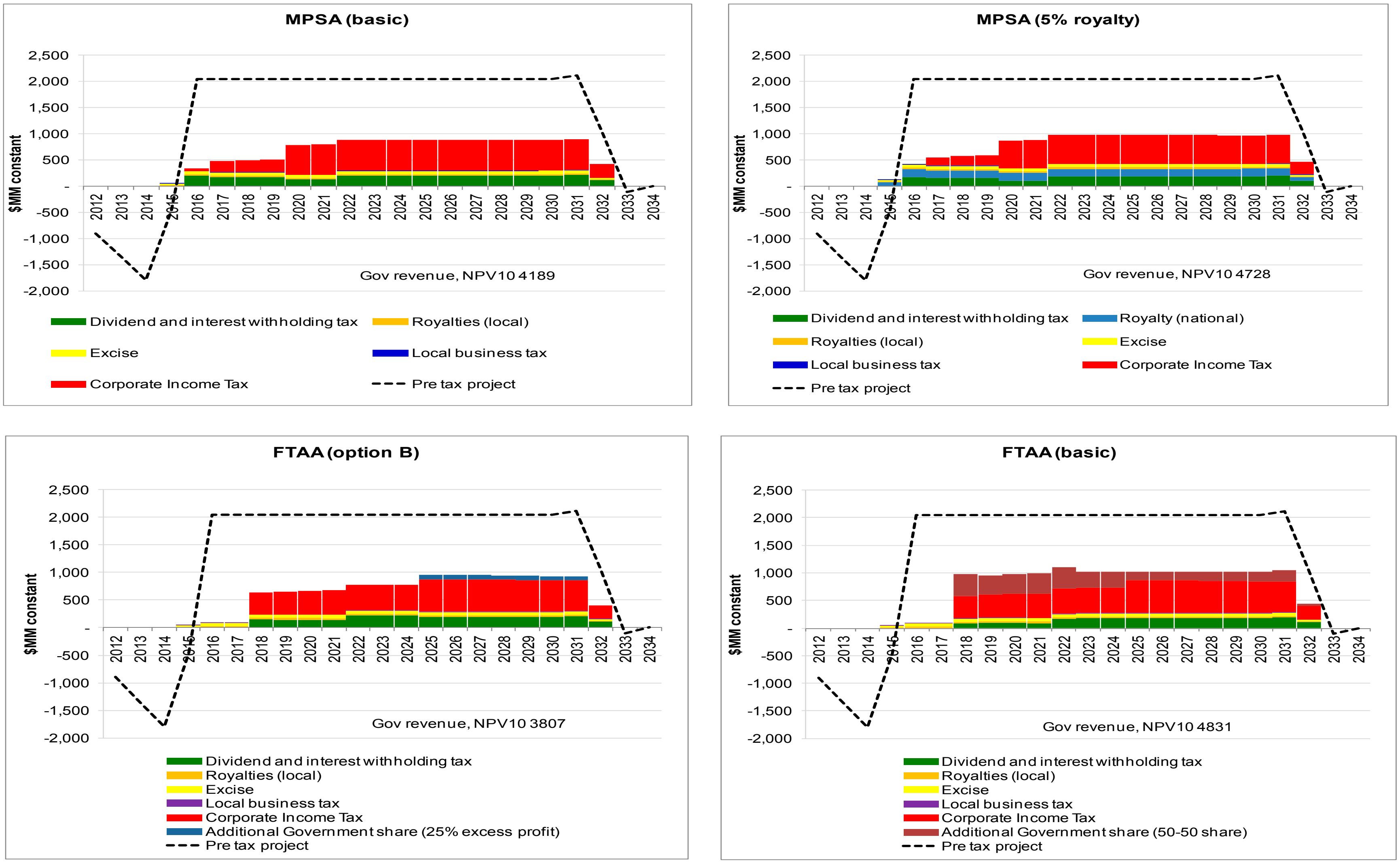
Figure 1. AETR NPV10



Source: IMF Staff estimates using FARI modeling platform.

24. **Some broad conclusions emerge from these comparisons**. First, each fiscal regime is regressive, in the sense that the AETR is lower for the more profitable project, and this is due to the reliance on production-based royalties in these fiscal regimes. Second, adding a 5 percent royalty to the MPSA basic regime, which applies to projects outside a mineral reservation, significantly increases the AETR. Third, the current FTAA has a much higher AETR than Option B's AETR. Fourth, the government revenue from the FTAA regime is more back-end loaded than the government revenue from the MPSA due to the exemptions during the recovery period. Although not shown in these figures, the current FTAA regime is a "tough" regime for investors compared to fiscal regimes of other countries. These figures suggest that the strategy for reform should be to modify the FTAA regime, to increase government revenue in the early years, lower the AETR for the marginal, low-profit project, and to make the fiscal regime competitive with the fiscal regimes offered by other countries.

Figure 2. Time Profile of Government Revenue



Source: IMF Staff estimates using FARI modeling platform.

25. **Two of the mission's recommendations, discussed later in the report, will address these concerns**. First, the proposed 7 percent royalty, discussed in Section C, will ensure early revenue to the national government. Allowing a tax credit for the royalty in excess of 5 percent will make the fiscal regime less regressive and more competitive. Second, replacing the current version of the additional government share with a 10 percent surcharge on cash flow (discussed in Section F) will reduce the government take on marginal, low-profit projects and increase the tax burden on the most profitable projects. Section H models the proposed fiscal regime and provides international comparisons.

Recommendation

- Use a modified version of the FTAA for all future mining projects other than small-scale mining.

C. Royalty and Mineral Excise

26. **Royalties secure revenue for the government as soon as production commences, are considerably easier to administer than most other fiscal instruments, and ensure that companies make a minimum payment for the minerals they extract.** Royalties, however, raise the marginal cost of extracting minerals, as they are based on the volume or value of production without deduction for cost. A royalty set too high may discourage development of marginal deposits and lead to high grading and early closure of productive mines, thus discouraging maximization of the value of the deposit. Nevertheless, a regular minimum payment is usually necessary to justify extraction of the resource in the public mind, to assure stability of the fiscal regime, and to broaden the tax base.

27. **While most countries apply royalties in order to secure a stream of early revenue from a project, the actual rates (and the type of royalty) vary widely (Appendix I).** The rates chosen will reflect the interaction with other taxes imposed on the mining operation (e.g., a high royalty rate may be offset by a low income tax rate), and higher rates may be assessed on more valuable minerals such as diamonds. The base for value-based royalties also varies widely across countries, and there is no best international practice. Value-based royalties can be levied on: (1) the mineral contained or the ore at the mine mouth; (2) the mineral contained in the first product sold (such as a concentrate); (3) recoverable mineral; (4) gross revenue derived from sales; (5) gross revenues derived from sales less certain allowable costs (such as transportation, insurance, and handling); and (6) the net smelter return.[15]

---

[15] For an excellent discussion of mineral royalties, see James Otto and others, (2006), *Mining Royalties: A Global Study of Their Impact on Investors, Government, and Civil Society*.

28. **Philippines imposes a variety of general and earmarked royalty and royalty-like payments on the market value of output or gross sales of mining companies.** The total burden of these production-based levies can be 10 percent of output value or higher for minerals mined in a mineral reservation (Table 3). By international standards a 10 percent royalty is quite high. Outside a mineral reservation the total is closer to 5 percent.

29. **The royalty rate is not prescribed in the Mining Act, but is prescribed in the implementing rules and regulations.**[16] The Act, however, provides that 10 percent of all royalties shall accrue to the Mines and Geosciences Bureau (MGB) of DENR.[17] There is an additional 1 percent royalty for indigenous people, collected by the indigenous peoples' councils or the barangays in which they live.

Table 3. Production-based Levies on Metallic Minerals Mined in a Mineral Reservation

Levy	Rate
Mineral excise	2%
Royalty 1/	5%
Royalty to indigenous peoples	1%
Local business tax on the extraction of minerals	2%
Local business tax on processing of extracted minerals to finished goods	0.38%

1/ Applies only to mines on mineral reservations.

Sources: DOF and DENR.

30. **It may be possible to extend the 5 percent mineral royalty, which currently applies only to mines located in mineral reservations, to all mines by way of an administrative order.** The Mining Act authorizes the President to establish mineral reservations when the national interest so requires[18] and if an area were declared to be a mineral reservation, the MGB would treat it as an area in which the mineral royalty is imposed. The process of declaring a mining site to be a mineral reservation is not simple,

[16] S 13, DENR Administrative Order No. 2010–21 (the Mining Act Implementing Rules and Regulations).

[17] Mining Act 1995 s 5. The MGB share goes to a special account in the General Fund, which is appropriated annually to DENR-MGB.

[18] Mining Act 1995, s. 5.

however, as extensive public consultation and notifications are needed first[19] and declarations might be challenged if the explanation of national interest varies significantly from precedents that consider the national interest in specific terms such as immediate land degradation threats. It is, therefore, uncertain if all mining areas outside existing reservations could be easily classified as mineral reservations. At the same time, extending the 5 percent royalty to all mineral production both inside and outside declared mining reservations is problematic as the precedent used to justify the imposition of royalties explicitly provided only for a royalty on minerals produced in a mineral reservation.[20] If it were not possible to declare all mining sites to be mineral reservations, extension of the 5 percent royalty would likely require legislative amendment of the Mining Act or NIRC. If this were done, revenue from the mining sector would increase by PHP 2.5 billion per year at current levels of production and prices.

31. **The 2 percent excise on mineral products applies to imported mineral products, domestic production, and exports.** Most excises (for example, on cigarettes) are intended to be destination-based taxes on domestic consumption. Imports and domestic production are excised and exports leave the country free of tax. The mineral excise, in contrast, is intended to be a tax on domestic production of minerals; that is, an origin-based tax. If mineral imports are excised as under current law, the burden of the excise could be shifted to domestic buyers of products that incorporate a mineral product when the domestic manufacturer or processor has a choice between buying the mineral product (for example, copper concentrate) domestically or importing it. By removing the mineral excise on imports, the government can ensure that the burden of this tax falls on the producer of the mineral product. Senator Ralph Recto proposes to increase the 2 percent excise on mineral products to 7 percent. If enacted by amending the NIRC, the total of royalty, mineral excise, and other production-based taxes would total close to 14 percent of gross output in mineral reservations. Senator Recto's proposal would increase government revenue by PHP 4.7 billion per year at current levels of production and prices.

32. **The excise tax is imposed on the "actual market value" of the gross output of minerals or mineral products at the time of removal.**[21] The latter is defined as minerals "produced and prepared in a marketable state by simple treatment processes such as washing

---

[19] Administrative Order 2010–21, s. 9 requires the Director of the Central Office of the Mines and Geosciences Bureau under the Department of Environment and Natural Resources to provide notification of and then conduct public hearings on proposals to extend or establish mineral reservations.

[20] Although there is no direct legislative authority for the current royalty applied in all mineral reservations, the validity of the royalty has not been challenged. The basis for the royalty is Presidential Decree 1001 (1976), which imposed a 5 percent royalty on mineral outputs from the Suragao Mineral Reservation. This law has been interpreted as creating a presumption that the executive could apply a similar levy in all mineral reservations.

[21] NIRC s. 151(A).

or drying, but without undergoing any chemical change or process or manufacturing by the lessee, concessionaire or owner of mineral lands".[22] Read literally, the tax could be imposed twice on minerals that are mined by one company and sold to another company (even a related company) for basic processing such as concentration. In practice, however, the Bureau of Internal Revenue (BIR) interprets the charging section as applying only once. While the tax applies "at the time of removal", administrative practice is to impose the tax at the time of sale, calculating the value of the output on the invoice price.

33. **The National Internal Revenue Code provides some guidance on the meaning of "actual market value" of outputs.** In the case of mineral concentrate, the actual market value is the "world price quotations" of the refined mineral product contained therein. In practice, the invoice price is used, but the contract price for copper and zinc concentrate is usually denominated against the London Metal Exchange price minus smelting and refining charges and any applicable penalties (for example for lead contained in the concentrate) or credits (for gold or silver contained in the concentrate).

34. **Though the base of the mineral excise and the royalty are the same, the mineral excise is collected by BIR and the royalty by the Mines and Geosciences Bureau.** This leads to unnecessary duplication of administration and extra costs on the mining company. The government should submit legislation to Congress amending Republic Act No. 7942 and the NIRC that would combine the two levies into a single levy collected by one agency. The mission would recommend that BIR collect the "royalty", in part, because the Internal Revenue Code contains appropriate enforcement and collection powers, and BIR could crosscheck royalty payments with income tax returns. Although collected by BIR, the new excise would be shared with local governments under Section 290 of the Local Government Code of 1991.[23]

35. **The rate for the new royalty should be set at 7 percent.** This will ensure early revenue to the national government to be shared with LGUs, as discussed in Chapter III. Recognizing that the high royalty rate, particularly when combined with other production-based levies, will make the fiscal regime uncompetitive for projects of low profitability, the mission proposes that the mining companies be allowed a tax credit against their income tax for the amount of royalty payment in excess of 5 percent. As the excess royalty would be refunded through the tax credit mechanism, the excess royalty would not be deductible for income tax purposes. To preserve the time value of money of the royalty credit, any unused credit at the end of the year could be uplifted, for example, at a rate of 10 percent or LIBOR

---

[22] NIRC s. 151(B)(3).

[23] The current 2 percent mineral excise, which is collected by BIR, is shared with local governments under Section 290.

plus 7 percent.[24] The higher royalty with a credit can ensure greater revenue to LGUs without making the fiscal regime uncompetitive.

Recommendations

- Combine the royalty and the mineral excise into a single levy known as the mineral royalty, which would apply only to domestic production and would be collected by BIR.

- Prescribe a 7 percent royalty rate for metallic minerals in the NIRC.

- Allow mining companies to claim a tax credit against income tax for royalty payments in excess of 5 percent of gross production with 10 percent uplift for any unused credits.

D. Concessions and Incentives

36. **Most, but not all, of the tax rules applicable to mining companies are found in the NIRC.** Other tax rules are set out in the Omnibus Investment Code of 1987, Mining Act of 1995, in mineral agreements, and in a range of other laws that provide concessions or holidays. Consolidating all domestic tax rules in the NIRC, including the royalty, will increase transparency and simplify administration and compliance. A separate section on mining taxation could be introduced in the income tax law (Title II of the NIRC).

Board of Investment incentives

37. **Investments in the mining sector are eligible for tax incentives provided in Omnibus Investment Code of 1987, which is administered by the Board of Investments (BOI).** Companies that are registered with the BOI and engaged in a preferred industry or service area and listed in the annual Investment Priorities Plan are eligible for a package of tax incentives. The Mining Act mandates that mining activities are always included in the Investment Priorities Plan, and the Omnibus Investment Code includes "mining activities" in the definition of a pioneer enterprise, making mining eligible for an income tax holiday of six years, which can be extended 8 years under fairly general qualifying criteria. The Board of the BOI, however, can restrict the availability of certain incentives, and in recent years the Board has used its administrative discretion to grant only non-pioneer income tax holidays to mining companies, reducing the holiday period to four to six years.

---

[24] Allowing the royalty to be a credit against tax was recently adopted in Australia. In computing taxable income for purposes of the cash flow surcharge, the full royalty paid would be deducted as a negative cash flow. In the year in which the credit is allowed, it would reduce the regular income tax payment and thus would reduce the net cash flow in that year.

38. **The BOI tax incentives include income tax holidays, an additional deduction for labor expense, tax and duty exemption on imported capital equipment and spare parts, and a tax credit on domestic capital equipment and spare parts equivalent to the taxes and duties that would have been waived had these items been imported.** In addition to the tax incentives, any registered enterprise (pioneer or non-pioneer) is entitled to certain nontax incentives, including access to bonded warehouses, simplified customs procedures, unrestricted period of use of consigned equipment, and the right to employ foreign nationals, subject to restrictions. Four mining projects, with projected costs of PHP 80 million to PHP 7 billion, were approved for BOI incentives in 2010, and seven projects, with projected costs of PHP 45 million to PHP 8 billion, were approved in 2011. Over the two years, PHP 22 billion (US$500 million) of mining investments were approved for BOI incentives.

39. **The income tax holiday is not needed.** Experience in other countries shows that income tax holidays or tax exemptions are a particularly inefficient way to promote investment in new enterprises, which typically are unprofitable in the early years and thus unlikely to benefit. The principal beneficiaries are more likely to be those foot-loose enterprises that seek low-cost labor, are profitable from the outset, and might not need incentives. Tax holidays are particularly inappropriate for mining companies, as it is the resource rents (the surplus value after all costs and normal returns have been accounted for) associated with mineral deposit in the ground, and not tax incentives, that attract investment into the mining sector. There is usually a gap between the amount of investment approved and the amount of actual investment that is made over the next several years.

Mining Act incentives

40. **The Mining Act incentives include property tax exemption for pollution control devices, a five-year net operating loss carryforward, accelerated depreciation, and various investment guarantees.** The accelerated depreciation and the loss carryover are discussed in the next section of this chapter.

Incentives in FTAA agreements

41. **Significant concessions are also provided in mining agreements taking the form of a FTAA.** The model FTAA provides a number of incentives not found in any law, and agreements based on the model contain concessions that appear not to be authorized by law. As there are no provisions in the relevant laws for private contracts between the government and mining companies to override the applicable laws, the legal basis for these extra-statutory concessions is unclear. It could be argued that the authorization in the Mining Act 1995 for the government to enter into FTAAs implicitly grants the government power to enter into private contracts that override national laws, though more transparent regimes normally recognize the power to override laws in the relevant legislation.

42. **Tax exemptions are the most important concessions included in FTAAs based on the model agreement.** There are exemptions from income tax, customs duties, and fees on imported capital equipment, value-added tax on imported goods and services, withholding tax on interest payments on foreign loans, withholding tax on dividends to foreign stockholders, documentary stamps taxes, and capital gains tax.[25] The exemptions are available for a period described as the shorter of five years and the miner's "recovery period" which is broadly equal to the period in which net receipts are less than the miner's expenditures. The recovery period can be extended beyond 5 years with agreement with approval of the Secretary of DENR. The exemptions do not include taxes based on mineral production including the mineral excise tax, local business tax, and royalties.

Incentive reform

43. **The need to rationalize Philippine's tax incentives is widely recognized and long overdue.** A serious effort is underway within the government and the Congress to harmonize and rationalize incentives. The House of Representatives passed H. No. 4935 in August 2011. This bill would provide a 6-year income tax holiday for mining companies that process minerals and export 70 percent of the output, followed by a 5 percent tax on gross income earned for the next 19 years, which would be paid in lieu of all national and local taxes except the real property tax. Alternatively, registered mining companies could elect a 50 percent reduction in the corporate tax rate for a period of 25 years. An alternative bill, prepared by DOF and which is being discussed within government, would eliminate tax holidays. The mission would strongly recommend elimination of tax holidays, at a minimum, for mining and remove the granting of incentives from BOI.[26]

Recommendation

- Repeal the BOI and Mining Act tax incentives for mining companies. If any of the incentives are considered appropriate for mining companies, they should be moved to the NIRC.

- Consolidate all domestic tax rules in the NIRC, including the royalty, and consolidate income tax measures affecting mining in a separate chapter of the income tax.

---

[25] Model FTAA clause 9.2(ii).

[26] For a further discussion of tax incentives, see the IMF technical assistance report, Kiyoshi Nakayama, Selcuk Caner, and Peter Mullins, *The Philippines: Road Map for a Pro-Growth and Equitable Tax System* (November 2011).

E. Income Taxation

44. **With few exceptions, the taxable income of mining companies is calculated in the same matter as the income of all businesses.** The three special rules for mining companies relate to depreciation, exploration and development expenses, and loss carryover. There are also gaps in the income tax, relating to mining reclamation, transfers of an interest, and ring fencing that need to be addressed. The mission's proposals for the loss carryover and thin capitalization could apply to all companies.[27] Also, the mission proposes in the royalty section an income tax credit for the royalty in excess of 5 percent.

Cost recovery

45. **Mining companies are allowed an immediate deduction for pollution equipment[28] and an accelerated depreciation regime for assets with an effective life exceeding 10 years.**[29] Exploration and development expenses can be expensed (deducted immediately) subject to an annual cap of 25 percent of net income from mining with indefinite carry-forward of unrecognized exploration and development expenses.[30] The rules are more generous than those found in some other jurisdictions, which provide accelerated cost recovery to encourage investment in the mining sector, but are not excessively generous. The incentive of accelerated depreciation and expensing of exploration and development expenses is directly related to the amount of investment and thus is a more efficient incentive than a tax holiday which is related to the level of profitability.

Loss carryover

46. **The NIRC allows a three-year loss carryover for most companies.** A longer loss carryover period is needed, however, for investments in the mining sector. Under the Mining Act, the loss carryover period is extended from three years to five years for expenses incurred in the first decade of a mine's operation.[31] This provision is incorporated in the NIRC.[32] The carryover period for mining should be removed from the Mining Act.

---

[27] A special rule for financial institutions would be needed if the thin capitalization rule were extended to all companies.

[28] Mining Act 1995 s. 91. This provision if retained should be moved to the NIRC.

[29] NIRC s. 34(F)(5). Assets with a life exceeding 10 years may be depreciated for any deemed life between five years and effective life, as nominated by the taxpayer. An identical provision is included in the Mining Act, s 93(b).

[30] NIRC s. 34(G)(2). The Mining Act also contains similar exploration and development cost recognition rules in Mining Acxt s 93(b).

[31] Mining Act 1995 s 92.e

Rehabilitation expenses

47. **The Mining Act requires mining companies to make deposits to a mine rehabilitation fund for the purpose of rehabilitating mine sites, as provided in the implementing rules for the Act.**[33] Pursuant to those rules, mining companies will make actual cash deposits into a trust fund in a government depository bank.[34] While the mining company retains legal title to the funds, the rules under which the accounts are established effectively quarantine the deposits so they can only be applied towards rehabilitation expenses.

48. **At present, the income tax law provides no recognition for deposits in mine rehabilitation funds required by the Mining Act and ancillary rules and regulations.** The deposits are currently treated for tax purposes as savings of a taxpayer akin to ordinary bank deposits rather than currently deductible business expenses. However, it is not unusual for income tax laws to allow a deduction for deposits to a mining rehabilitation fund where the funds are quarantined and protected for the purpose of mine site rehabilitation. The deposits are not pre-payments for services to be provided in the future that are related to future income. Rather, they are contributions to liabilities that accrue each year as mining takes place, giving rise to a rehabilitation obligation.

49. **A deduction for income tax purposes for deposits to approved rehabilitation accounts would enable mining companies to recognize these expenses as current costs of mining.** As mine closing costs can be quite high for an underground mine, allowing a deduction for deposits to a rehabilitation account would allow the company to claim the deduction earlier when it is likely to have taxable income against which to offset the expense. If a rehabilitation deduction were adopted, ancillary adjustment measures are needed to recognize as income any amounts returned to the mining company if the available funds exceed rehabilitation costs.

Thin capitalization

50. **Where a mining company is funded by equity, profits will be subject to Philippine's CIT when earned and a further dividend withholding tax of up to 15 percent when profits are repatriated, for a total tax burden of up to 40.5 percent.** In contrast, if foreign owners (or related parties) finance the Philippine company by way of debt, interest payments to the owners and lenders are deductible expenses to the Philippine

---

[32] NIRC s. 34(D)(3).

[33] Mining Act 1995 s. 71.

[34] Administrative Order 2010-21, chap.XVII.

company and subject to a withholding tax only ranging from 10 percent to 20 percent under tax treaties and domestic law.

51. **The different treatment of returns on debt funding and equity funding may encourage foreign investors to rely on excessive debt funding and little equity funding (an arrangement known as thin capitalization) to shift profits out of the Philippines subject only to low interest withholding tax.** Countries often adopt "thin capitalization" rules to counter such arrangements, denying resident companies deductions for some interest paid to the owners or related parties where the ratio of debt finance to equity finance appears excessive.

52. **The Philippines has no explicit thin capitalization rules.** Some control over debt to equity ratios is provided by the Board of Investment which can require certain ratios be met for a company to qualify for concessions administered by the Board. It was intended that thin capitalization measures would be incorporated into regulations establishing Philippines transfer pricing rules to apply to transactions between Philippine companies and related foreign firms. However, interim rules adopted the OECD transfer pricing guidelines for operation in the Philippines and these do not explicitly address the problem of thin capitalization. While they guidelines can be used to attack artificially high interest rates, they have little impact where interest rates are similar to arm's length rates but the business is funded mostly by debt.

53. **Given the potential for abuse, it would be preferable to adopt explicit thin capitalization rules.** Thin capitalization rules fall into two broad camps. One approach **is to prescribe** acceptable ratios by law or regulation and disallow a deduction for interest on debt payable to related persons to the extent the debt exceeds the approved ratio. An alternative approach is to limit the deduction for net interest expense (interest expense reduced by any interest income) to the extent that the net interest expense exceeds, say, 50 percent of profit before the interest deduction. Some countries apply a limit on excessive use of debt only in the case of debt supplied by a related party broadly defined. The mission suggests that it would be better for the limit on excessive debt to apply to all loans, as it is sometimes difficult to know whether the debt is from a related party, particularly when back-to-back loans are used or the parent company guarantees a loan by a third party to the subsidiary.

Supplies of services

54. **While mining companies have no net profits prior to commencement of commercial production, outside suppliers may derive significant profits from the provision of supervisory, construction, assembly and related services to the mining company in the Philippines.** It is important that the income tax law should apply to this income and that Philippines retains the right to tax this income when it enters into treaties with countries from which the service providers come. One possibility would be to amend the income tax law to provide that no payment for services is treated as a deductible expense

unless it gives rise to Philippine source income subject to Philippine income tax in the hands of the recipient.

55. **A non-resident service provider is taxable on income derived from sources in the Philippines.**[35] However, the definition of Philippine source income is ambiguous and does not clearly apply to business income derived for the provision of services such as exploration activities, project supervision or construction activities in the Philippines.[36] Even if an income tax liability can be established, collection and enforcement are problematic as there is no withholding tax liability on the mining company, the entity against which the tax liability could be enforced. The Philippines has retained the right to tax income from service providers in its double tax treaties, usually with the stipulation that the activities took place for at least six months. While some countries have negotiated shorter qualifying periods, the six-month period is in line with practice in comparable nations.

Transfers of exploration permits, mining agreements, and interests in mining companies

56. **Although there is little cost associated with the initial issuance of mining exploration permits, there have been instances of subsequent sales of these rights for significant amounts.** This has led to some discussion of the merits of issuing rights initially by way of auction or similar means to capture for the government some of the future value of the rights being granted. These proposals may confuse the gains that accrue after exploration permits are issued because of mineral finds on or near the permit area with the initial value of the permit. It may be the case, however, that even the initial issue of a license has a value well in excess of its nominal issuance price where the market is aware of likely mineral deposits in the region or nearby. Consideration could be given to simple tender auction system for the issuance of exploration permits. This is likely to work best if there is known geology.

57. **While the primary purpose of acquiring exploration permits is to enable the holder to explore for mineral resources, businesses may also acquire exploration permits for speculative purposes or to deny exploration rights to others.** Both types of behavior are inconsistent with the policy objectives behind issuing the permits. Reform of the licensing system could ensure licenses automatically expire if exploration to a defined level is not undertaken within a specified time.

---

[35] NIRC s 23(F), s 28(A(1).

[36] Section 42(A)(3) defines compensation for labor or personal services performed in the Philippines but exploration, supervisory, and other services provided by a corporation may not be considered personal services.

58. **The Mining Act allows for the assignment (transfer) of exploration permits to another person.**[37] Gains realized on the transfer of an exploration permit or mining agreement are subject to income tax as business income or capital gains, most likely as capital gains since a mining company will not hold permits as inventory. Any gain realized on the transfer by a company of an exploration permit or mining agreement will thus likely be subject to 30 percent tax. In contrast, if mining rights are held indirectly through an interposed company, the increased value of the rights could be realized by way of a sale of shares in the interposed company with the tax rate on this gain being 10 percent.[38]

59. **A non-resident company is liable to tax on gains realized on the sales of real property in the Philippines and sales of shares in a Philippine company as both are treated as Philippine-source income wherever the sale may be completed.[39]** There is no specific rule for mining interests, however, and a sale of mining interests by a non-resident might be able to escape tax if sold directly and almost certainly would escape tax if it were sold indirectly by way of a sale of shares in a foreign upper tier company that owned a Philippine company that owned the mining interests. A solution to this problem commonly used elsewhere is to expand the definition of real property for income tax purposes to include any mining interests or any interests in any trust, company, partnership or any other entity or arrangement where at least 50 percent of the value of the interest is attributable to direct or indirect interests in real property (included deemed real property in the form of mining rights). If this rule were adopted, gains from the sale of shares in companies that directly or indirectly owned mining rights would be taxed at 30 percent as gains from the sale of real property rather than at 10 percent as gains from the sale of shares.

60. **Unfortunately, Philippines has entered into a number of tax treaties that require it to give up its right to tax residents of the treaty partner country on gains from the sale of mining rights where those rights are held via a small chain of companies.** The Philippines has a very extensive tax treaty network and it will be almost impossible to renegotiate the treaties to extend Philippines taxing rights over gains related to Philippine mining interests. However, future treaties should adopt a broad definition of real property for purposes of the capital gains article to include all direct and indirect interests in mining rights. If there are opportunities to amend existing treaties, these should be used to address the definition of real property in existing treaties.

61. **Philippines authorities currently have no direct enforcement powers over nonresidents with respect to collection of income tax on gains from direct or indirect**

[37] Mining Acts s. 25.

[38] NIRC ss. (B)(5)(c), (A)(7)(c).

[39] NIRC s. 42(A)(5) for real property; NIRC s. 42(E) for shares.

sale of Philippine mining rights. However, it is likely that Philippine authorities only learn of any indirect transfers of Philippine mining rights (i.e., selling of interest in the company that owned the company with the mining rights) through international mining industry information channels and not through any government data collection. A simple enforcement mechanism to ensure collection of tax on both direct and indirect sales would be to provide an automatic security interest for the BIR in respect of any unpaid tax on gains on the direct or indirect sale of mining interests. If this rule were in place, the parties to the transaction itself would ensure tax is paid to protect the interest of the buyer and the sale price of the seller.

62. **An alternative approach that the authorities may want to consider would be taxing the deemed gain of the local company holding the mining rights.** Under this approach, if there is a 5 or 10 percent or more change in the underlying ownership of the entity holding the mining right, the entity is treated as: (1) disposing of its proportionate interest in its mining right and immediately reacquiring that interest; (2) receiving for the disposal consideration equal to the market value of the proportion of the mining right treated as disposed of; and (3) incurring a cost in respect of the reacquisition of an equal amount.

Ring fencing

63. **Ring fencing means a limitation on consolidation of income and deductions for tax purposes across different activities, or different projects, undertaken by the same taxpayer.** Some countries ring fence mining (and petroleum) activities, others ring fence individual license areas or projects.

64. **Ring-fencing rules matter for two main reasons.** First, absence of ring fencing can seriously postpone government tax revenue because an investor who undertakes a series of projects will be able to deduct exploration or development expenditures from each new project against the income of projects that are already generating taxable income. Second, as a mining (or petroleum) area matures, absence of ring fencing may discriminate against new investors who have no income against which to deduct exploration or development expenditures.

65. **Despite these points, a very restrictive ring fence is not necessarily in the government's interest.** More exploration and development may occur if taxpayers can obtain a deduction against current income, generating more government revenue over time by increasing the taxable base. The right choice is a matter of balance within the fiscal regime and the degree of government's preference for (modest) early revenues over (greater) revenues later on. Ring fencing—preventing losses from being transferred among projects—is particularly important if the government imposes a profit-based additional tax on highly profitable projects as a replacement for the windfall tax (see Chapter III).

66. **The mission would recommend that for tax purposes there should be a ring fence around the mining sector.** Losses from mining could not offset income from other business

activities and vice versa. Ring fencing around the sector is particularly important for the additional government share, discussed in the next section.

Minimum tax

67. **Mining companies are subject to a minimum corporate tax of 2 percent of gross income.**[40] Gross income is defined as sales revenue less the cost of goods sold. Depreciation and exploration and pre-production costs are not included in the cost of goods sold. On a case by case basis, the Secretary of Finance can suspend the imposition of the minimum tax on any company.[41] Consideration could be given to removing the minimum corporate tax for mining companies that are subject to a comprehensive mining tax regime as proposed in this report.

Recommendations

- Allow an income tax deduction for deposits to an approved mine rehabilitation fund.
- To limit excessive use of debt financing, adopt a 3:1 debt/equity limit or a limit equal to 50 percent of taxable income before the interest deduction, and apply the limit to all debt, not just related-party debt.
- Amend the NIRC to make it certain that income derived from exploration, supervisory, construction and assembly and similar services related to mining in the Philippines is treated as income with a source in the Philippines for tax purposes.
- Extend withholding tax measures and require mining companies to withhold income tax on exploration, supervisory, construction and assembly and similar services related to mining in the Philippines conducted by non-resident suppliers.
- Consider a bidding option for exploration permits.
- Include an automatic expiry of the exploration permit in the license conditions for exploration permits if specified exploration thresholds are not met within a timetable included in the permit.
- Define "real property" in the NIRC to include direct and indirect interests in mining rights; with indirect interests traced through any number of interposed entities provided at least 50 percent of the value of the seller's interests is attributable directly or indirectly to mining rights in Philippines.

[40] NIRC s. 27(E).

[41] NIRC s. 27(E)(3).

- In negotiating future tax treaties, define real property to include direct and indirect interests in mining rights in the Philippines.

- Amend the NICR to provide the government with a security interest in any mining right to the extent of any tax due on a direct or indirect sale of the right.

- Ring fence mining activities for purposes of the income tax and the additional government share.

- Remove mining companies from the 2 percent minimum tax.

F. Additional Government Share

68. **Mining countries use a variety of profit-based instruments, other than the regular profit tax, to secure a share of the resource rents.**[42] Each of the instruments has merit. Some require the specification of an uplift (interest) rate—not an easy process, and sometimes an invitation for companies to negotiate an inappropriately high rate. Some of the measures may be conceptually difficult to grasp when first encountered, but operationally are straightforward and only require simple adjustments to the profit tax and some arithmetic. Some instruments provide tax revenue in the early years of a profitable project and other instruments delay government revenue until a specified rate of return has been earned. Instruments that are in addition to the regular profit tax may or may not allow the regular tax to be deductible for purposes of determining base of the additional tax. For a given revenue target, the rate of the additional instrument can be lower if the regular income tax is not deductible for the additional tax or higher if it is a deductible expense. If an additional tax/surcharge is to be effective, it must be ring-fenced around the mining sector.[43]

69. **Profits generated by the sale of mineral resources are attributable to the efforts involved in winning the resources from the soil and market demand for the commodity.** The mining tax regime should ensure that both the mining company that has undertaken risk in investing to extract the resources and the Philippine nation which owns the resources being sold share in the profits from sale of resources. A key question in the design of a mining tax system is how additional profits should be shared if profits rise as a result of increases in market prices, or the discovery of an especially rich or low-cost deposit. Many countries have come to the conclusion that as the increased profits are attributable to the value of the commodity and it would be appropriate for the government's share of profit to rise as profits rise while ensuring that total profits rise, too, for the investor that assumed risk to bring the

---

[42] See Appendix I.

[43] The petroleum fiscal regimes in the U.K. and Norwegian continental shelf are ringfenced around the sector (that is, not ringfenced by project or license).

commodity to market. This can be achieved with a progressive mining tax regime that increases the government's share of profits as commodity prices and thus profits rise.

70. **Philippines' additional profit-based instrument, known as the additional government share, is a cash flow-based levy.**[44] It has the following features: First, the contractor commences to pay the additional government share only after the recovery period, which is a maximum of five years or at a date which the aggregate of the net cash flows from mining operations is equal to the aggregate of pre-operating expenses, whichever comes first. The recovery period, however, may be extended with approval by the Secretary of DENR.[45] Second, after the recovery period, the additional government share is paid if the basic government share, which consists of all direct taxes, royalties, fees, and related payments paid by the contractor, is less than 50 percent of the net mining revenue, which is equal to gross output less deductible expenses.

71. **The additional government share serves as a minimum tax after cost recovery.** It ensures that the government take, after the recovery period, is equal to at least 50 percent of net mining income determined on a cash-flow basis. The additional government share is paid only if 50 percent of net mining income is greater than the sum of all direct taxes, royalties, fees, and related payments. Thus, the additional government share when added to the basic share can bring the government share up to 50 percent of net mining income. If the basic government share is above 50 percent of net mining income, the contractor's liability for the additional government share is nil.

72. **The design of the additional government share as conceived is problematic in several respects.** First, it offers investors that finance operations through debt the opportunity to in effect recognize costs twice. Loan amortization is treated as a negative cash flow. This results, in effect, in a double deduction, which will extend the recovery period. The double deduction occurs because the recovery period lasts until the pre-operating expenses, financed by the loan, are recovered (the first deduction), and loan amortization reduces net cash flow, as defined for purposes of determining the recovery period (the second deduction). Loan amortization should not be allowed as a deduction in determining net cash flow. Second, many of the taxes, royalties, fees and other payments included in the basic share are also operating expenses therefore recoverable costs. For example, royalties are treated as a deductible expense in determining net mining income and it is also included in the basic government share and therefore can reduce the additional government share that would otherwise be due. Similarly, the withholding tax on interest is included in interest

---

[44] The current formulation of the additional government share is prescribed in DENR Administrative Order No. 2007–12.

[45] For financial modeling the mission assumed that the recovery period was equal to the period over which pre-operating expenses were recovered on cash-flow basis.

expense and therefore deductible in determining net mining income and also included in the basic government share.

73. **As the financial modeling in Section H of this chapter shows, the additional government share as currently structured is not progressive relative to profitability.** Together with excises taxes it operates as a minimum tax that can impose very high levels of taxation relative to profits on low profit investments while failing to capture for the government a greater share of profits as profits rise due to an increase in the value of the state's natural mineral resources. To improve the competitiveness of Philippines' fiscal regime for mining, the mission considered various alternatives.

74. **The most promising alternative that retains a cash-flow based levy would be a cash flow surcharge, which could be known as the new additional government share (NAGS).** The tax base for the surcharge would be determined by adding back depreciation and interest and other financing charges to regular taxable income before the loss carryover, and deducting any capital expenditure and the regular CIT. This yields a tax base of net cash flow in the year after the regular income tax but before any financing. Instead of permitting an annual uplift for losses carried forward, as under a resource rent tax or the earlier options A and C for the additional government share,[46] the surcharge tax rate could be set sufficiently low to imply such compensation, or a simple uplift (investment allowance) could be added to the capital costs at the start. If taxable income for purposes of the surcharge is negative one year, the surcharge loss is carried forward to subsequent years so the surcharge would not be charged until the project has positive cash flow.[47] A version of this surcharge is used in the U.K. sector of the North Sea on petroleum projects and the surcharge rate from 2011/12 is 32 percent, in addition to the normal profit tax rate.

75. **The mission considers a rate of surcharge on cash flow in the range of 10 percent to be appropriate.** A rate at this level removes the need to specify uplift, as under the RRT. The surcharge does give companies a choice in periods of high profits: invest more (and, thus, increase the tax base for the future) or pay extra tax.

Recommendation

- Replace the current version of the additional government share with a 10 percent surcharge on cash flow after the corporate income tax but before financing.

---

[46] Prior to 2007, companies could choose one of three options for computing the additional government share. See, DENR Administrative Order No. 99–565.

[47] The surcharge loss carryover eliminates the need to define a recovery period, as under the current additional government share.

G. Indirect Taxation on Mining

76. **The principal indirect tax burden born by mining companies is the customs tariff and VAT imposed on imported supplies used in mining operations.** In theory, the latter should be recoverable when a mining company commences production and makes zero-rated export sales of mineral output.[48] Even if administrative procedures were adopted to process refunds, in the case of new mining operation, recovery will be many years after the expense is incurred.

77. **The impact of the indirect tax burden is mitigated by tax holidays.** The Mining Act designates mining operations as investment priorities for the purpose of legislation offering investment incentives, thus qualifying them for tax holidays.[49] Mining companies that opt to enjoy a tax holiday will be exempt from VAT and customs duties on imports for the holiday period, which ranges from four to six years.

78. **The impact of the indirect tax burden is also mitigated or eliminated in mining agreements structured as FTAAs.** Large foreign investments are most likely to be structured using the FTAA system. Under the model FTAA, the mining company is exempt from customs duties and VAT on imported supplies from the date of approval of the Declaration of Mining Project Feasibility until the end of the recovery period,[50] which can extend up to five years or longer after the commencement of commercial production.[51] After this exemption period, customs duties and VAT are payable on imported equipment but are completely absorbed in the calculation of the basic government share, meaning they are in effect creditable against the total payment due to the government once the project generates a profit.

79. **Mining companies importing equipment outside a tax holiday or FTAA recovery period will incur an indirect tax burden that can affect the viability of projects.** The number of affected companies would increase if tax holidays were ended.

80. **Two legislative solutions and one administrative solution to the problem of unrecovered VAT are possible.** The first possible statutory solution is modification of the law to allow for refunds of VAT input tax credits within a short period after a mining company files a return, with no need to wait until zero-rated exports commence. For this solution to work effectively, administrative practices would have to be altered significantly to

---

[48] NIRC s. 112.

[49] Mining Act 1995 s. 90.

[50] Model FTAA s. 9.2.

[51] Model FTAA s. 9.7.

ensure prompt processing of tax returns and tax refunds. This solution addresses the problem of VAT on imports but does not provide relief for customs duties on imported equipment. The second possible statutory response is adoption of an exemption from VAT and customs duties on equipment that will be used directly in the extraction of minerals and preparation of the output for sale. The exemption would be limited to items imported directly by the holder of a mineral agreement for use in the importer's mining operation and the definition of qualifying equipment would ensure ancillary items that can be applied to other purposes would not be included in the exemption. An administrative solution for the VAT would be to adopt an Executive Order that suspends the VAT on imports by deeming it to have been paid until such time as the mining company has incurred a VAT liability on sales. If the mining company only exports its output by way of zero-rated export sales, the VAT on imported equipment is suspended indefinitely. If the company sells into the domestic market, the suspension of VAT on imports would be progressively lifted as it is offset against VAT payable on domestic sales. Once again, this solution does not address the question of customs duty imposed on imported mining equipment.

Recommendations

- Seek to suspend VAT on imported mining equipment using an administrative order to deem payment of VAT on these items pending enactment of a statutory exemption

- Adopt statutory amendments to the NIRC and the Tariff and Customs Code to exempt equipment and spare parts that will be used directly in the extraction of minerals and preparation of the output for sale from VAT and customs duties

H. Financial Modeling

81. **The mission modeled the current FTAA and the alternative new cash flow surcharge, and compared them against the fiscal regimes of several international copper producers**. The quantitative simulations were run using FAD's Fiscal Analysis of Resource Industries (FARI) modeling system and database.[52] In practice, investment decisions depend on a variety of factors that go beyond the fiscal regime—such as perceived potential of reserve in the ground, stability of institutions, and companies' diversification strategy. This analysis focuses exclusively on the characteristics of the fiscal regime and thus assumes all other factors constant and neutral on the investment decision.

---

[52] For a detailed exposition of the FARI modeling framework and evaluation criteria for fiscal regimes see Daniel, P., and others, *Evaluating Fiscal Regimes for Resource Projects: An Example from Oil Development 2010, in The Taxation of Petroleum and Minerals: Principles, Problems and Practices*, ed. by Philip Daniel, Michael Keen, and Charles McPherson (London and New York, Routledge and IMF). FARI is an Excel-based cash flow model frequently used by FAD's technical assistance missions on extractive industries tax policy.

82. **Using data from the companies, the mission built a stylized project example representative of a large-scale mine producing copper and gold concentrate**. Except for a couple of projects which still await beginning of development, most mining projects in the Philippines are relatively small. It is expected though that the country will attract more large-scale investment and the results presented in this section are for such a scenario. The production profile and cost structure are similar in scale to the Tampakan project, but are not the same. Table 4 lays out the basic project economics and gives summary project results before any fiscal imposition for both a high and a low price scenario.

Table 4. Project Economics: Stylized Project Example

[Costs in constant 2012 US dollars]		
Project duration: 2010-2032		
Production copper	000 tons	6,076
Production gold	000 ounces	5,800
Production	years	18
Exploration costs	$mm	200
Exploration costs per unit	$/ton copper	-
Development costs	$mm	7,498
Development costs per unit	$/ton copper	1,234
Operating costs	$mm	11,249
Operating costs per unit	$/ton copper	1,851
Decommissioning costs	$mm	108

Pre-tax Net Cash Flows			
Scenario	**Units**	**High price**	**Low price**
Copper Price	$/ton	7,000	4,850
Gold Price	$/ounce	1,400	700
Pre-tax NCF (NPV0)	$mm	29,291	12,168
Pre-tax NCF (NPV10)	$mm	8,238	1,864
Pre-tax IRR	%	29.0%	15.2%

Source: IMF Staff Estimates.

83. **The modeling is sensitive to the assumption regarding copper prices, which have been on the rise over the last decade, except for a temporary dip in 2009.** The high price scenario assumes a fixed sales price of US$7,000 per ton (in constant 2012 terms), which is consistent with current World Economic Outlook (WEO) projections for the medium term (Figure 3).[53] With this price assumption, the project yields a rate of return of 29 percent before tax and a net present value of US$29 billion undiscounted (US$8.2 billion when discounted at10 percent). The low price scenario assumes a copper price of US$4,850. Such a price generates a marginal project with 15 percent return and US$12 billion in undiscounted net present value (US$1.8 billion when discounted at 10 percent).

Evaluation of the alternative regime

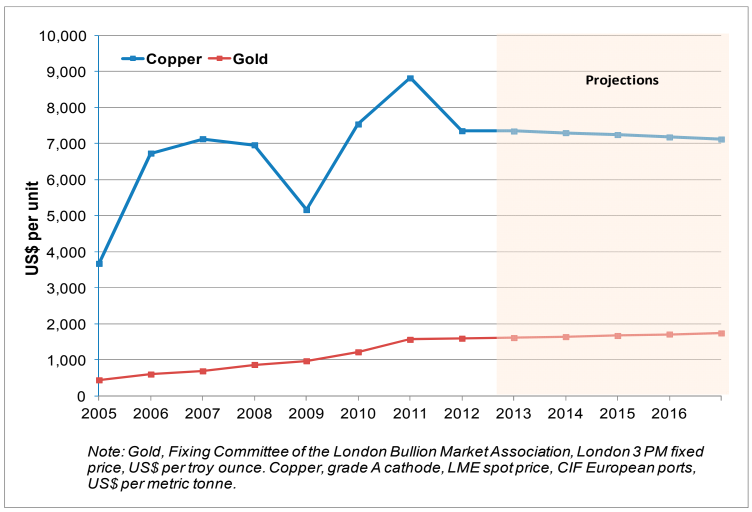
84. **The previous sections have discussed in detail the terms under the current FTAA.** Several simplifying assumptions were made in the model. Fiscal payments under the FTAA include: 2 percent excise tax, 1 percent royalty to the indigenous people, and local business

[53] WEO reports the LME spot price CIF European ports for refined copper, and requires adjustments for freight and for treatment and refining charges. In this case, an adjustment of USD379 per ton was made to the price.

tax of 0.375 percent—all applied on gross sales value. Income tax is charged at 30 percent, with capital assets depreciated over a period of 10 years,[54] while cumulated pre-production exploration and development (intangible) costs are expensed up to 25 percent of net mining income starting in the first year of production. Excess unrecovered pre-operating costs are carried forward until fully offset. The recovery period under the FTAA is allowed to vary between one and five years, depending on how fast the project pays back the initial investment. Loss carry forward is limited to five years. The additional government share is computed as the difference between 50 percent of net mining revenue and the basic government share (see Section F above). Interest and dividend withholding tax are modeled at 15 percent. A variation of this regime is the FTAA with a 5 percent additional royalty.

85. **The alternative new cash flow surcharge diverges from the standard FTAA 50 percent sharing.** The model assumes the same basic production charges (excise, local royalty, and local business tax) and income tax as for FTAA, but with an additional 5 percent royalty on gross sales payable to the national government. Any production charge in excess of 5 percent is creditable against income tax and any unused credits are uplifted at a rate of roughly 10 percent.[55] In the calculation of income tax, depreciation of capital assets is shortened to five years (in the absence of a recovery period that exempts income tax, the investor would seek to front-load the capital depreciation to defer tax payment). The new additional government share is in the

Figure 3. IMF WEO Copper and Gold Price Projections



Source: IMF, World Economic Outlook.

---

[54] Capital assets can be depreciated over a period of 5 to 10 years. Since the FTAA allows for tax exemption during recovery (up to 5 years from commencement of production), the model assumes that investors would chose the maximum depreciation period. In this way, deductions are spread out to the post-recovery period when the project is subject to income tax.

[55] The uplift factor should reflect the normal or a minimum rate of return. According to one published study based on a survey of 20 companies, mining companies use a 12.5 percent real after-tax discount rate or rate of return in evaluating potential projects. See, Ross R. Bhappu and Jamie Guzman, "Mineral Investment Decision Making: A Sutdy of Mining Company Practices," *Engineering and Mining Journal*, July 1995. The 10 percent rate of return is similar to a required return on equity of 7 percent over LIBOR assuming inflation of 2 percent.

form of a 10 percent tax surcharge on cash flows after tax but before financing. A simple adjustment to the tax base of accounting profit is made by adding back depreciation and interest and other financing costs, and deducting capital expenditure and income tax in full.

86. **The new cash flow surcharge offers a good middle-way alternative to currently available options**. The regimes are compared using a measure of government take called AETR and calculated as the ratio of the NPV of tax collections (royalty, income tax, additional profit tax, withholding taxes, etc.) to the NPV of the project pre-tax net cash flows. Compared to the current FTAA regime, the proposed regime would reduce the AETR (or government take) on a marginal project (Figure 4.A), but increase the AETR on a more profitable project (Figure 4.B). Similarly, if an FTAA under current law were to mine in a mineral reservation or if the authorities decided to extend the 5 percent royalty to all FTAAs, the current FTAA regime plus 5 percent royalty would impose a high burden on marginal projects risking a considerable reduction of the investment base.

87. **The proposed cash flow surcharge and other changes recommended by the mission ensure earlier revenue to the government compared to the current regime.** Figure 5 compares the revenue streams under the two regimes. The alternative regime derives early revenue not only from the additional 5 percent royalty (creditable in later years against income tax), but also from withholding taxes on interest and dividends. The current FTAA exempts withholding until recovery and hence creates a deeper revenue gap during the first years of production.

International comparison

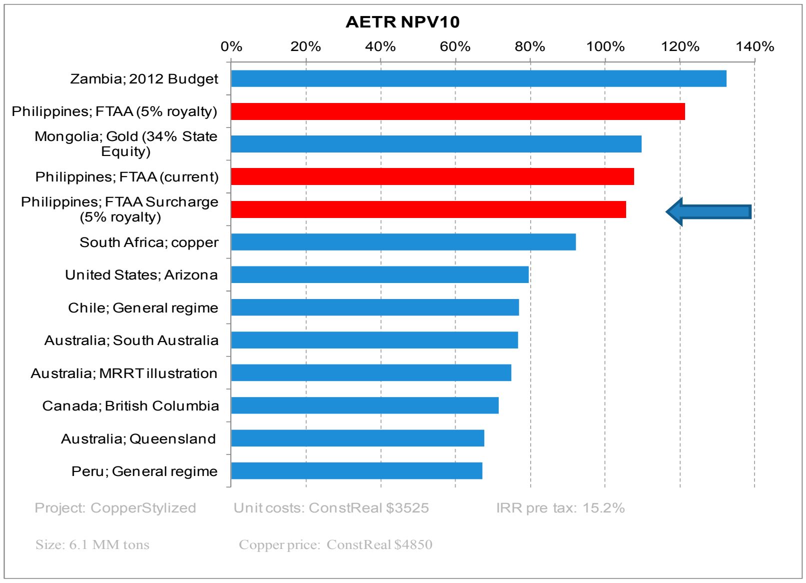
88. **The fiscal regimes discussed above are assessed against several major international copper producers.**[56] The Philippines ensures a large government take comparable with countries like Zambia and Mongolia (Figure 4.A). The Zambian regime is tougher on account of a high royalty rate (recently increased for both copper and gold to 6 percent from 3 percent and 5 percent respectively) and an income tax which at the minimum is 30 percent. In Mongolia, the royalty is composed of a fixed rate of 5 percent plus an additional royalty that varies with prices. The government can also take equity participation in the project (assumed at 34 percent). Such regimes perform well on profitable projects, but are also highly onerous on marginal investors. An untapped location like the Philippines would want to rank somewhat lower on this scale.

---

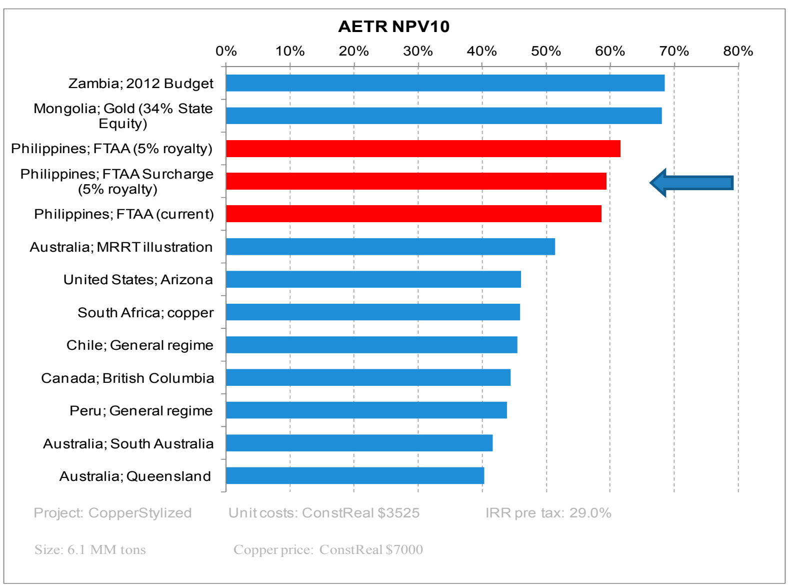
[56] Individual fiscal terms are summarized in Appendix I.

Figure 4. Government Take: Selected Regimes

A. Marginal project

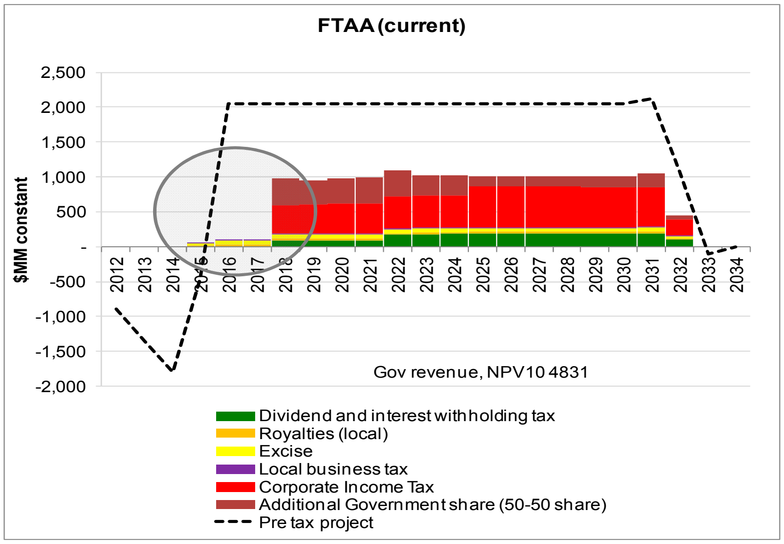


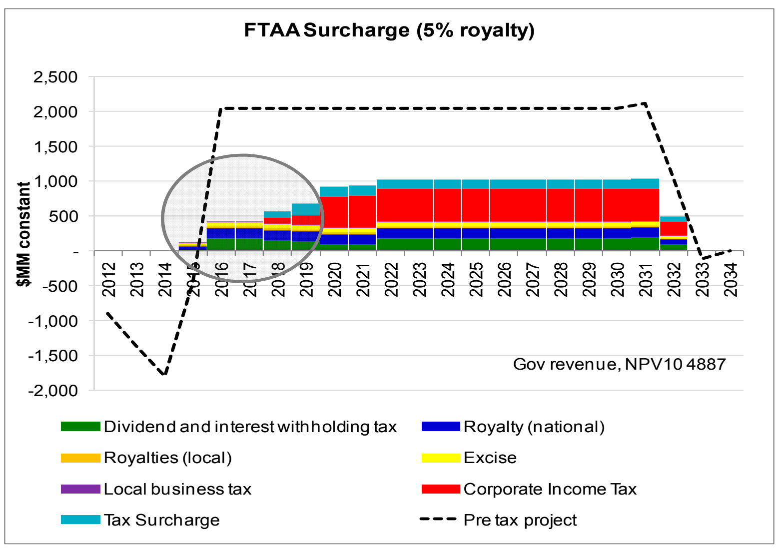
B. Profitable project



Source: IMF Staff estimates using FARI modeling platform.

Figure 5. Time Profile of Government Revenue: Current and Alternative Regimes





Source: IMF Staff estimates using FARI modeling platform.

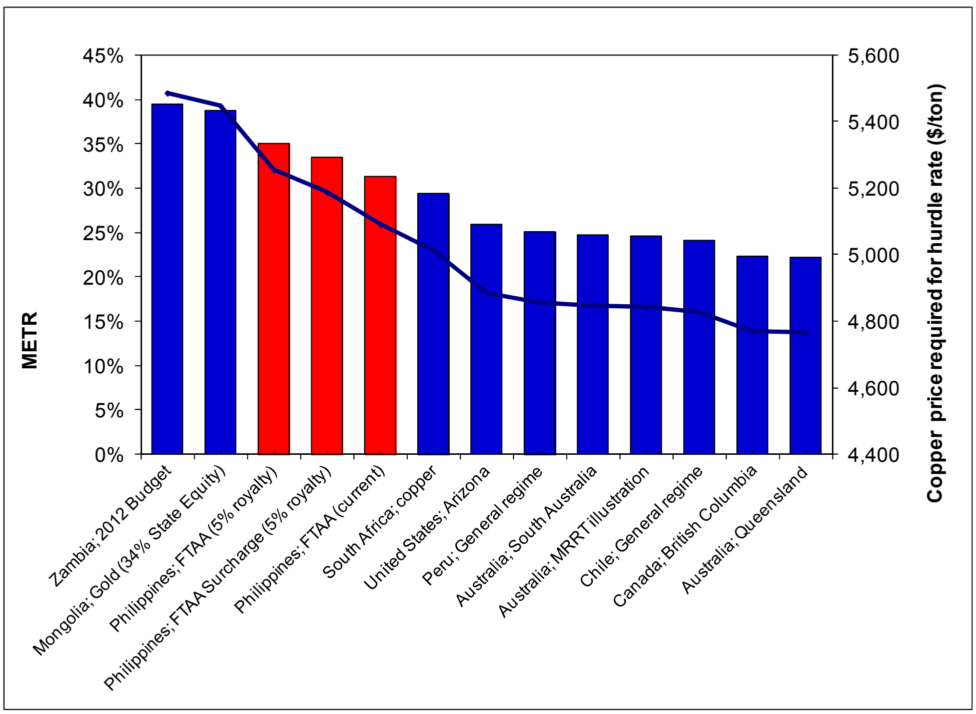
89. **The other comparators tend to have more balanced fiscal regimes.** Peru and Chile use a progressive royalty system in which rates increase gradually with changes in project operating margins. South Africa also applies a variable royalty calculated with a formula linked to operating margins and allows immediate deduction of capital expenditure in the calculation of chargeable income. In lieu of a royalty, the United States charges a state severance tax and Canada a two-tier mining tax—both on a measure of net profits. The Australian Mineral resource rent tax is included only for illustration purposes because in practice it will apply exclusively to coal and iron ore projects. It does show however that resource rent tax is highly flexible—capturing more of the profitable project but putting a

lower burden on the marginal investment. The new cash flow surcharge recommended by the mission brings the Philippines closer to these producers.

90. **The regimes are also compared in terms of the burden put on investor.** A measure that gauges the burden on a marginal project is the breakeven price, or the minimum price required to yield a specified post-tax return to capital. For a project with the production and costs profile assumed here, an investor would require a minimum sales price of US$5,091–US$5,255 per ton, depending on the specific regime, in order to break even in the Philippines (Figure 6). This price is below current long-term projections but close to the working assumptions of local mining companies.

91. **Another measure, the marginal effective tax rate (METR), is the wedge between pre- and post-tax rate of return**. In cross-country comparisons, when calculated for a project which just meets the required post-tax hurdle rate, it indicates the relative tendency of a fiscal system to deter a marginal project. The relative METR ranking in Figure 6 indicates that the proposed surcharge on cash flows offers a better alternative to an FTAA with 5 percent royalty.

Figure 6. Burden on Investor: Selected Regimes



Source: IMF Staff estimates using FARI modeling platform.

III. Sharing of Revenues with Local Governments

A. Current Situation

92. **Philippines is a unitary state in which the central government is supreme and subnational units exercise only powers delegated by the central government.** Under the 1987 Constitution, the local government units (LGUs) of the Philippines are provinces, cities, municipalities, and barangays. In addition, there are two autonomous regions, the Autonomous Region of Muslim Mindanao (ARMM) and Cordilleras. LGUs have the right to determine their own sources of revenues, subject to guidelines and limitations the Congress may provide, consistent with the basic policy of local autonomy. LGUs are entitled to a just share of national taxes and an equitable share the income earned from utilization of national wealth such as forests, fisheries and mineral resources. The terms of revenue sharing are prescribed by the 1991 Local Government Code (LGC) (R.A. No. 7160).

93. **LGUs receive 40 percent of the domestic tax revenues collected by the Bureau of Internal Revenue (BIR) and this is distributed to the LGUs by the Internal Revenue Allotment (IRA).** In addition to IRA, LGUs receive 40 percent of revenues collected from the development and utilization of national wealth (Section 290 of LGC). The source of the additional revenues from natural resource usage is the previous year's collections of mining taxes (i.e., the mineral excise tax), royalties, forestry and fishery charges, and such other taxes, fees, or revenues from any other co-production, joint venture or production sharing agreement within their territorial jurisdiction. Before royalty collections are split between the national governments and LGUs, 10 percent of the collections are assigned to the Mines and Geosciences Bureau (MGB).

94. **The LGUs' share from the utilization and development of national wealth is distributed among different levels of local governments according to an allocation formula provided in the LGC**. If the natural resource is located within one province, 20 percent of the LGUs' share is distributed to the province, 45 percent to the city or municipality, and 35 percent to the barangay. If the resource is located in two or more provinces, or in two or more cities or municipalities within a province, or two or more barangays, their respective shares are distributed according to the population (with a weight of 70 percent) and land area (with a weight of 30 percent).

95. **In addition to shared revenues from domestic taxes and natural resources, LGUs have their own revenue sources: property taxes, local business taxes, community taxes and various fees.**[57] The funds distributed by the IRA account for two-thirds of LGUs' revenues, and own revenue sources account for only 32.5 percent. The shared revenues from natural resources, the focus of this chapter, are only 0.35 percent of LGUs' total revenues.

---

[57] See Table 2 in Chapter 1 for a list of taxes and fees collected by LGUs.

96. **With the introduction of the LGC, LGUs are given greater autonomy to provide services such as health care, social welfare and maintain infrastructure inside their jurisdiction**. In addition, LGUs share with the national government, responsibility for environmental management and maintenance. The new responsibilities also include water and soil resource utilization and conservation projects, mangrove conservation, community-based forestry projects, solid waste collection and disposal systems, and enforcement of environment laws supervised by the Department of Environment and Natural Resources (DENR). The code also stipulates that national government should consult with LGUs in case of projects undertaken by state-owned enterprises with ecological consequences.

97. **In addition to sharing in the revenues from the mining activities LGUs, are authorized to issue permits for small scale mining under the People's Small-Scale Mining Act (PSMA) of 1991.** Accordingly, provincial governors or city mayors can issue permits for small-scale metal mining, sand and gravel extraction and, quarrying where the maximum contract area is limited to 20 hectares. The identification of the areas and issuance of permits is implemented by the DENR through the Provincial/City Mining Regulatory Board. The DENR representative is the chairperson of the Board. The other members of the Board are: representative of the governor or the mayor, representative of small-scale mines and a representative of an environmental NGO.

B. Issues

Revenue sharing with IRA and the national wealth

98. **The 2012 FAD mission advised on issues regarding the revenue sharing between the national government and LGUs and recommended that the IRA distribution formula should be amended to incorporate indicators of revenue capacity, in addition to population and land area.**[58] This would be an important reform. One question that was not addressed by the 2012 mission is how the sharing of national revenue from the utilization and development of national wealth should be taken into account when measuring revenue capacity.[59] If each peso of revenue received by an LGU from the sharing of national wealth increases the revenue capacity of the LGU by a peso, the IRA distribution formula would, in effect, cancel out the sharing of national wealth.

---

[58] Under the IRA, revenues are shared according to the share of population, area of the local government and an equal share component (lump sum) with assigned weights of 50 percent, 25 percent and 25 percent respectively.

[59] The 2012 FAD mission on local government discusses inclusion of revenue capacity of local governments as one of the factors to be used in determining revenue allocation between central and local governments. This issue is not discussed in this report.

Timely transfer of LGUs' revenue share

99. **LGUs' shares in national wealth are to be released and remitted to the LGUs within 5 days after the end of each quarter.** Furthermore, the shared revenues cannot be withheld by the national government for lien or any other purposes. However, contrary to the revenue sharing terms stipulated by the LGC, the transfer of funds to LGUs is delayed by as long as several years and the actual transfers are often less than the amount that should be transferred to the LGU. [60]

100. **There are several reasons for the delayed and insufficient transfers of revenues from natural resources to the LGUs.** First, the disbursement of the LGUs share of revenues is included in the General Appropriation Act (GAA) which is passed annually by the Congress, and the amount appropriated may be less than the amount that is to be shared with the LGUs. Second, the funds are released to treasury departments of LGUs after a long certification process by the Department of Budget and Management.

101. **The Department of Budget and Management distributes LGUs shares from general taxes with a lag of 60 days to a quarter.** However, LGUs' shares from the utilization and development of national wealth are distributed with a lag of at least one year or more. Because, Internal Rules and Regulations (IRR) states that the LGUs shares to be remitted to LGUs based on after certification of previous year's payments of taxes by mining companies. Since MGB provides estimates of volumes and values of sales for each mining company, estimated transfers can be made to LGUs based on these estimates. Once the sales and the taxes paid are certified, the accounts of the LGUs at the national treasury can be reconciled. Amending the IRR to allow for transfers based on estimates of sales by MGB would eliminate the delays in transferring LGU funds from natural resources.

102. **Given the legitimate concerns of the LGUs in getting their share of mining revenues provided for in the LGC, it would be beneficial for the government to join the EITI and implement this transparency initiative.** This could accelerate the process of transferring funds to LGUs and also encourage them to manage revenues efficiently thereby enhancing the delivery of basic services to the people. It will also encourage LGUs to implement developmental projects that would yield substantial benefits to the local communities. The Philippines is in the process of applying to become an EITI Candidate Country, as discussed in Chapter I.

---

[60] Soriano, M. C.G., and E. Makayan, "Component *1: Review of Collections and Distribution of Revenues from Natural Resources,*" Philippines Poverty Environment Initiative, (2012).

Potential conflict of interest and inefficiencies

103. **Allowing local mining boards to issue permits for mining undermines the efficient and impartial distribution of permits.** According to DENR officials and other sources, governors and mayors exert significant influence on the Local Board regarding the number and distribution of small-scale mining permits.[61] Many local governments issue permits for small-scale mines and have passed ordinances limiting or banning certain types of mining such as open pit mining. For example, Capiz declared a 15-year ban on large-scale mining.[62] While some of these actions are out of concerns for the environment, in many cases it is partly a response to the small-scale mining fiscal regime. Small-scale mines pay no royalty or other charges to DENR and instead pay taxes directly to LGUs that are not shared with the national government. In contrast, only a portion of taxes, royalties and fees paid by large mines to the national government go to LGUs; the amount is small; and there are long lags between the payment by the mining companies and the distribution to the LGUs. This difference in the fiscal regimes for small-scale and larger mines provides an incentive for local governments to issue many small-scale mining permits and to oppose large-scale mining.

104. **Issuance of many small-scale mines may disrupt the continuity of reserves to be mined and results in inefficient extraction.** Small-scale mining does not have the economies of scale advantage of large mining operations and extraction may leave residue minerals behind. Furthermore, the environmental damage can be much worse since small mines are not subject to the more stringent environmental standards that apply to large mining operations. Therefore, issuance of permits for metallic mines, including small-scale metallic mines could be done by DENR, which has the expertise and experience in determining the size and the number of permits. Local Boards could continue to issue permits for small-scale non-metallic mines and quarrying resources. However, such an arrangement would require amending the PSMA.

C. International Practice

105. **Revenues from natural resources are shared in terms of either revenue sharing arrangements or by assigning revenue bases to LGUs**. The factors considered in assigning revenues are: ability to provide local public services, inter-regional equity, and redistribution and environmental issues.

106. **Depending on whether the country is a unitary state or a federal state, revenue assignment can range from highly centralized in small unitary states (e.g., Azerbaijan**

---

[61] Sorino and Makayan (2012) discuss the influence of local officials on Board decisions.

[62] See Soriano and Makayan (2012).

and Norway) to assignment of the tax base to sub-national governments in countries with a federal system (e.g., Canada and the United States). Some countries allow for a large portion of the revenues to be transferred to producing regions while other have an equalization system where the natural wealth is distributed more evenly across the whole country. For example, Indonesia transfers 15 percent of oil revenue and 30 percent of gas revenue to producing provinces even though the resources are owned by the unitary state. Other countries distribute natural resource revenues by introducing an equalization system. Different forms of equalization systems exist where the revenue from natural resources are distributed within the general equalization system such as Australia and Canada or a separate equalization system for natural resources is used as in Bolivia and Columbia.[63]

D. Options for Philippines

107. **Due to unequal geographic distribution of natural resources, the total devolution of mining taxes to LGUs is not desirable.** Taxation of natural resources should be primarily left to national governments in order to implement redistribution and stabilization policies such as establishing funds. LGUs should be given authority to meet their budgetary needs by taxing more stable sources in their jurisdiction. The Philippines has made the fiscal decentralization arrangements to allow for LGUs to utilize their own revenue capacity while, at the same time, sharing revenues of the national government. However, total own sources of revenue in Philippines at 0.8 percent of GDP is one of the lowest in the region. Furthermore, revenue of LGUs from mining industry is only 0.012 percent of GDP. In order to increase investment in mining and government revenues from mining, LGUs' revenue sharing system has to be improved. This would also improve the cooperation of LGUs in the government's efforts to stimulate growth in mining. The current allocation of revenues can be significantly improved by a combination of legislative and administrative measures.

Treatment of mining revenue

108. **The IRA sharing and the sharing of revenue from the utilization and development of national wealth are separate.** However, if the IRA formula for sharing includes indicators of revenue capacity, as recommended by the 2012 mission, how should national wealth revenue be taken into account? One way forward would be to exclude the LGUs' share of the 2 percent mineral excise from any measure of revenue capacity. The LGU's share of the 2 percent mineral excise would be considered compensation to the LGU's for the additional infrastructure, health and environmental costs associated with mining. Only 50 percent of the other revenue from the development and utilization of national wealth would be taken into account when measuring revenue capacity so as to avoid a peso-for-peso offset when determining revenue capacity. Many countries employ different

[63] Brosio, Grigorio, "*Oil Revenue and Fiscal Federalism*," in Fiscal Policy Formulation and Implementation in Oil-Producing Countries, Eds. Davis, J.M., Ossowski, R. and Fedelino, A., IMF, (2003).

revenue sharing methods and share natural resource revenues using different ratios. Philippines is planning to reform the IRA in order to mobilize LGUs own revenue sources and improve revenue productivity and efficiency of the tax system at the sub-national level. The final revenue sharing arrangement for natural resource revenues will depend ultimately on the form of new IRA.

109. **Within the new fiscal regime for mining proposed in Chapter 2, royalty revenues would be increased which would, in turn, increase revenues to be shared with LGUs**. However, a portion of the local royalty and other production-based taxes would be credited against the mining companies' additional government share. This would reduce the burden of production-based taxes on mining companies and make the Philippine mining regime more progressive, compared to current law.

Allocation and monitoring commission

110. **The current allocation of revenues by the IRA to LGUs causes significant delays in transferring funds and is unnecessarily complicated**. In the case of mining, the process requires certification by several national agencies and deprives LGUs from accessing their funds. The process of transferring LGUs' share of mining revenues takes longer than a year and in some cases even longer. To overcome this problem, transfers of LGUs share of mineral taxes should be done soon after payments are received by the national government. This can be easily accomplished by sharing revenues based on an estimate of the amount each LGU is entitled with adjustments, possibly using the IRA, once the actual shares of mining revenues are confirmed.

111. **A monitoring commission that oversees transfer of shares of mining revenue to LGUs could accelerate the transfer of funds and increase transparency**. The commission should include representatives from national agencies such as Department of Budget and Management, DOF, DENR and LGUs. It would monitor the allocation of revenues and should provide assurance that the LGUs are receiving the funds they are entitled under the distribution formula. The commission could make recommendations to stream line the process of remitting funds to the LGUs.[64]

---

[64]DOF officials indicated that Joint Circular No. 2009-1 issued by the DOF, DBM, DILG and the DENR aims to reduce the delays in releasing the tax revenues from mining industry to LGUs. However, it did not facilitate the release of funds. Implementing the Circular may be sufficient to mitigate the delays in disbursing funds to the LGUs.

Recommendations

- If indicators of revenue capacity are incorporated in the IRA distribution formula, exclude the LGU share of the 2 percent mineral excise from any measure of revenue capacity. Only 50 percent of other LGU revenue from the sharing of national wealth would be taken into account.
- Enact a continuous appropriation for the distribution of the LGUs' share of mining revenues.
- Distribute LGUs' share of mining revenues based on estimated amounts with adjustments when final amounts are known.
- Introduce a joint monitoring commission to oversee the distribution of revenues to LGUs.

IV. Reform of the Petroleum Fiscal Regime

112. **The Philippine petroleum fiscal regime is similar to a productions sharing regime.** The major difference is that instead of sharing production, the government and the contractor share the gross proceeds of petroleum sold. In determining the sharing of gross proceeds, there is an annual limit on operating expenses, similar to a production sharing limit on cost oil. Net proceed are shared 60/40 in favor of the government. There is no royalty and the income tax is paid out of the government share.

113. **The fiscal regime does not need a major overhaul.** Given the time available, the mission addressed selected issues relating to the petroleum fiscal regime; namely: (1) whether a royalty or the mineral excise should be imposed; (2) the need for the FPIA; (3) the treatment of financing costs as an operating expense; (4) progressive sharing of net proceeds; (5) the corporate income tax paid out of the government share; and (6) fiscal stability.

A. Sharing of Gross Proceeds

Royalty and mineral excise

114. **There is no explicit royalty in a petroleum service contract, and the contractor is not subject to the 3 percent excise on indigenous petroleum.**[65] However, under the NIRC, locally extracted natural gas and liquefied natural gas are exempt from the 3 percent excise on indigenous petroleum (section 151(A)(2)), but crude oil is not exempt.[66] Galoc pays the 3 percent excise on crude oil that is exported.

115. **Many countries with production sharing fiscal regimes do not have an explicit royalty**. The limit on cost oil (or the limit on operating expenses in the case of the Philippine service contracts) ensures that there is revenue for the government as soon as oil is produced (or sold in the case of Philippines). Unless the government decides to share a portion of any royalty collected with local governments, the mission sees no reason for Philippines to impose an implicit royalty or the mineral excise on natural gas, which is economically equivalent to a production-based royalty. With operating expenses limited to 70 percent of gross proceeds and 60/40 sharing of net proceeds, the government receives 18 percent of gross income (0.6*(100-70)), as soon as production commences, assuming no foreign participation and 13.5 percent of gross income (0.6*(100-7.5-70)), if the project qualifies for

---

[65] Section 7.2 of the Model Service Contract exempts the contractor from all national taxes, except the Philippine income tax, and this is consistent with Presidential Decree 87 (1972).

[66] R.A. No. 9337 (2005) made locally extracted natural gas and liquefied natural gas not subject to the mineral excise tax.

a 15 percent Filipino Participation Incentive Allowance (FPIA). This implicit royalty is higher than royalties commonly imposed in countries that have tax/royalty fiscal regime.

Filipino Participation Incentive Allowance

116. **The contractor is allowed a Filipino Participation Incentive Allowance (FPIA); that is, a share of prosecution, up to 7.5 percent of gross proceeds, depending on the aggregate participation in the contract by Filipino citizens and corporations.**[67] Over the life of the contract, this allowance reduces the project's net proceeds,[68] and as 40 percent of net proceeds go to the contractors, the FPIA increases the contractors' share of net proceeds (before FPIA) from 40 percent to up to 44.5 percent (7.5 + 40 percent of 92.5). This allowance can be viewed as a direct subsidy for Filipino participation that is paid to Filipino and foreign participants as both benefit from the increased contractor share. Most of the subsidy goes to the foreign participants, who have the larger interest in the project. If markets work, it is possible that the foreign participants will share a portion of the subsidy with the Filipino participants, possibly by allowing the Filipino participants to have a carried interest in the project.[69] This subsidy for Filipino participation lacks transparency and it very likely does not provide much benefit for the Filipino participants. It is not clear that it is needed.

Operating expenses

117. **The contractor is allowed to recover operating expenses subject to the 70 percent limit.** The model contract, however, has an expansive definition of operating expenses in that two-thirds of interest and financing charges for development and production operations are treated as an allowable operating expense (section 2.45 of the model). The normal international practice under production sharing arrangements is to allow the contractor to recover capital and operating costs but not interest or other financing costs. How the contractor decides to finance the costs incurred to develop and operate the project should not affect the sharing of the project's production (or net proceeds). This subsidy for debt finance should be dropped from future petroleum service contracts.

---

[67] Under the general rule, the FPIA slides between 1.5 percent and 7.5 percent as the Filipino participation slides between 15 percent and 30 percent. For contracts in deepwater areas or contracts covering wells drilled in water depths beyond 200 meters, whether within or outside a deepwater area, the allowance is 7.5 percent if the minimum Filipino participation is 15 percent.

[68] Net proceeds is equal to gross proceeds reduced by FPIA and allowed operating expenses.

[69] Under a carried interest, the Filipino participants would not put up cash for their share of the costs incurred. The Filipino participants would pay for their share of the costs by foregoing their share of gross proceeds until the carried costs have been fully paid off plus usually an interest charge on the carry. A carried interest is economically equivalent to a nonrecourse loan.

B. Sharing of Net Proceeds

118. **Net proceeds (after deducting FPIA and operating expenses from gross proceeds) are 60/40 shared between the government and the contractor.** This simple formula for sharing net proceeds has the advantage of meeting the 60 percent requirement in the Petroleum Exploration and Development Act. The sharing is not progressive with respect to increases in oil prices or profitability.

119. **To increase the progressivity of Philippines' fiscal regime for petroleum, two alternatives should be considered.** The first alternative would split net proceeds according to an economic criterion such as the ratio of cumulative revenues to cumulative costs (the R-factor) achieved just before the month of sharing. A possible R-factor schedule might be:

Achieved R-Factor	Government Share of Net Proceeds
<1.5	60 percent
≥1.5	70 percent

The merit of using the R-factor criterion is that it integrates the evolution of production, oil and gas prices, and costs. A second alternative would be to split net proceeds according to a scale of the internal rate of return (IRR) earned by the project. A possible IRR schedule might be:

Achieved Real IRR	Government Share of Net Proceed
<15%	60 percent
≥15%	70 percent

Although mechanically the calculation of the internal rate of return is straight-forward, the R-factor alternative is conceptually easier to understand. The advantage of a rate-of-return approach is that the time value of money is taken into account. Both alternatives described will give an opportunity to increase the current government share in case of projects that are more profitable projects than expected while continuing encouraging the exploration and development of less profitable projects.

C. Corporate Income Tax

120. **Under the current production service contract, the corporate income tax is paid out of the government share of net proceeds**. In effect, the government pays the income

tax on behalf of the contractor.[70] Companies comprising the contractor submit separate income tax returns to DOE, which files the returns with BIR. DOE remits the Philippine income tax for each company and obtains receipts that the tax was paid. The tax paid on behalf of the contractor will qualify for the U.S. foreign tax credit.[71] This approach is used, for example, in Bahrain, Côte d'Ivoire, Sudan, Libya, Oman, Qatar, South Sudan, and Trinidad and Tobago. Naturally, the State's share percentage of net proceeds should be higher when the CIT is paid out of the government share, all other things equal.

121. **Having the CIT paid out of the government share has many advantages.** First, companies have fiscal stability with respect to the income tax.[72] Second, the administration of the fiscal regime is simplified, as BIR has only a limited role. Third, the government would be protected from aggressive tax planning (e.g., excessive use of debt or transfer pricing), which is always possible under a CIT. Fourth, an automatic ring fencing applies to the determination of taxable income on a per contract area basis without any negative revenue impact for the government when a contractor holds more than one service contract. The one drawback of having the CIT paid out of the government share is that it is not as transparent as having each company make CIT payments to the government.

D. Fiscal Stability

122. **The model agreement has a broad stabilization provision.** The contractor's rights shall not be impaired and its obligations shall not be increased by: (1) changes in Philippine laws or regulations; (2) changes in the manner of implementing any laws or regulations; (3) the introduction of new laws or regulations; or (4) the cancellation of existing laws or regulations (section 21 of the model agreement). This assurance of stabilization applies to all laws and regulations, including environmental laws and laws providing worker protections. There is no time limit so it applies to full time period of the contract including any extensions. Although the broad assurance of stabilization overrides current law, there does not appear to be any legislated authority for the government to grant fiscal stability by a contract, which does not have the force of law.[73]

---

[70] For this purpose, income tax includes only the income tax on taxable corporate income (section 2.58 of the model) but not the withholding taxes on dividends, interest, payments to certain contractors, or wages. The Petroleum Exploration and Development Act specifically provides that the contractor is liable for income tax "on income derived from its petroleum operations" (section 19 of the Act).

[71] As there are no direct U.S. investors in the Philippine petroleum sector, this may not be important at this time.

[72] If the income tax rate were increased, for example, the government share of net proceeds does not change; just the portion of the government's share that is considered "income tax" changes.

[73] If the government subsequently overrode a contract by administrative or legislative changes, the petroleum company's recourse might therefore be limited to pursuit of a civil action in the courts. If the investor is located

(continued...)

123. **Fiscal stability clauses are widespread in petroleum and mining contracts.** These clauses are generally justified by: (1) the large size and the sunken nature of the initial investment; (2) a long period required to recover investment and earn a reasonable return; and (3) a lack of credibility on behalf of the host country to abstain from changing the fiscal rules—possibly singling out high rent petroleum or mining operations—once the investment is sunk. Fiscal stability is less compelling when the CIT is paid out of the government share of net proceeds.

124. **The stabilization provision if retained should be narrowed.** First, stabilization assurance should be limited to fiscal laws. Second, stabilization should be limited to the first five to ten years of the contract period.

Recommendations

- Continue to exempt crude oil and natural gas from the royalty and exempt natural gas from the 3 percent mineral excise.
- Repeal the Filipino Participation Incentive Allowance but grandfather current contractors.
- Remove interest and other financial costs as deductible operating expenses in determining net proceeds.
- Adopt profit-based sharing of net proceeds to increase the progressivity of the petroleum fiscal regime
- Continue to have the corporate income tax paid out of the government share of net proceeds
- Restrict assurances of stabilization to fiscal provisions and limit the assurance to five to ten years.

---

in a jurisdiction that has entered into an investment protection agreement with the Philippines and its national government agrees to pursue the disadvantage on behalf of the investor, the matter could be escalated to an independent Arbitral Tribunal.

Appendix. Fiscal Regimes for Copper: Selected International Producers 1/

	Royalty (or equivalent)	Corporate income tax	Capital allowances	Loss carry forward	DWT nonresident	IWT nonresident	VAT/GST tax	Import duties	Others
Australia (Queensland/ South Australia)	South Australia: 3.5% ex-mine gate value. Queensland: 2.5%-5%	Federal: 29% *[2]* No state tax.	100% SL over effective asset life (15-20 yrs for most mining)	Indefinite	0% (30% if out of previously untaxed income)	10%	5% std GST rate [none for exported minerals]	10% [concessions apply]	22.5% MRRT *[2]*
Canada (British Columbia)	Mining tax levied in two stages. Maximum tax: 13% of net revenue.	Combined federal and provincial: 25% (2012)	100% pre-prod expl and dev costs; 25% DB capital assets; 30% DB dev costs after production start	3 yrs carry back; 20 yrs carry forward	25% [5-25% under DTAs]	25% [10-15% under DTAs]	5% federal GST plus provincial sales tax [zero for exports]	None [assumed]	None
Chile	Specific mining tax based on operating margins. Rates:5-14%.	35% final tax on distributed profits*[3]*	expl: max 6 yrs SL; dev costs: 100%; capex 9 yrs SL (3 yrs SL accelerated depr)	Indefinite	None	4%	19% std VAT rate [exemptions assumed]	Exempt [assumed]	35% workers profit share
Mongolia	5% [gold] plus price-based progressive royalty on gross revenue	25%	100% expl, 10 years SL dev costs	8 years	20% [reducible under DTA's]	20% [reducible under DTA's]	Exempt	5%	Up to 34% [assumed carried interest]
Peru	Royalty based on operating margins. Progressive marginal rate: 1-12%	30%	100% expl and dev costs ; 5% SL building, 20% SL equipment	4 yrs or indefinite loss offsetting against 50% of future profits	4%	30%, 4.99% to related nonresident	19% stdVAT rate; tax credits and exemptions for mining	Exempt	8% workers profit share
South Africa	Max 7% unrefined minerals*[4]*	28% standard rate*[5]*	100% capex and all dev costs.	Indefinite	None to nonresidents.	None to nonresidents	14% [certain mining rights are zero-rated]	None	None
USA (Arizona)	2.5% state severance tax. Base: 50% of gross value - production costs	Federal: 35%; State: 6.968% [2013] declining to 4.9% [2017on]	expl and dev costs: 70% first year, then 20%SL; mining assets: 7% DB	Federal: 20 yrs forward (2 yrs back). State: 5-20 yrs carry forward.	30% (reducible by DTA)	30% (reducible by DTA)	6.6% local sales tax	Vary by country and commodity	Depletion allowance: 15% on gross income for federal tax subject to limitations.
Zambia	6% [copper, gold] on net revenue	Variable formula, min 30%	Capital costs 100% *[6]*	10 years	15%	15%	Assumed exempt	10% avg	None

Source: FAD's Fiscal Analysis of Resource Industries (FARI) database.

[1] The fiscal terms in the comparator countries may vary contract by contract. The terms above are those used in the model simulations.

[2] Rate effective 2013; current CIT rate is 30%.The mineral resource rent tax (MRRT) only applies to coal and iron project starting July 2012. Modeled for illustration only.

[3] Final tax of 42 percent for foreign companies that opt for a tax stability regime.

[4] Unrefined minerals: 0.5 + [EBIT/(gross sales x 9)] x 100. Max 7%.Refined minerals: 0.5 + [EBIT/gross sales x 12.5)] x 100. Max 5%.EBIT is earnings before income and tax.

[5] Gold mining companies pay a variable income tax calculated as 43- (215/x)%, where x is the ratio of taxable income from gold mining.

[6] The Zambian variable income tax is calculated as 30% + 15%(1-8%/profitability ratio).