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Afghanistan: An Assessment of Mining Tax and Royalties Policy

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Executive Summary

In response to a request made by the Minister of Finance, his Excellency Omar Zakhilwal to USAID, the Economic Governance and Growth Initiative (EGGI) project was requested to provide an advisor to undertake a strategic review of the mining fiscal regime and make recommendations in the following areas: (i) how to improve Afghanistan's mining tax and royalties legislation in line with international best practice; (ii) how to improve efficiency and effectiveness in current mining tax/royalties administration and collection procedures; (iii) assessment of the institutional relationship between the Ministry of Finance (MOF) and Ministry of Mines (MOM) and the relationship management of key stakeholders in the sector; and (iv) on required technical assistance (TA) and capacity building.

The review mission was undertaken in March/April 2010. The following recommendations have been made with respect to the terms of reference:

The Minerals Law

- The bidding of mineral rights should be restricted to deposits of national importance (e.g. Aynak and Hajigak) and the larger known deposits that have not been quantified and evaluated. Except for deposits of national importance, bidding would not be over royalty rates or bonus payments but limited to the minimum work program and the technical and financial capability of the bidder. For other deposits, exploration licenses should be given on a first-come first-served basis, with the conditions (e.g. exploration must begin within 12 months). Holders of exploration licenses should have the right to move to an exploitation license, without a round of bidding, when minerals that can be commercially developed have been discovered.

- A comprehensive reform of the royalty regime would ideally include the following elements: (i) royalty rates would be fixed and not subject to negotiation or bidding, with the possible exception of royalties for deposits of national interest; (ii) weight-based or volume-based specific royalties would be used for low-value bulk commodities and value-based royalties would be used for high-value minerals; for value-based royalties, reference prices would be used whenever possible; (iii) the royalty rate could be set at 5 percent for base and precious metals; (iv) Afghanistan could adopt a nondiscretionary scheme for deferral of royalty payments in periods when cash operating expenses rise above revenues; and (v) the liability for payment of royalty should accrue when minerals are sold or shipped. The current advanced payment of royalties for construction materials, marble, and stones should be abolished.

- As branches of foreign companies are more difficult to tax under an income tax than foreign subsidiaries, the Mining Law should amended to require that foreign investors in the mining sector establish a domestic legal entity in Afghanistan – i.e. a foreign subsidiary – that would hold the mineral rights. The government may want to consider further restricting the list of persons eligible to hold mineral rights by requiring all holders of mineral licenses be domestic legal entities.

- Article 85 of the Minerals Law (the powers of the MOF) should be repealed, as it has it has no substantive meaning.

- To eliminate overlap between the Minerals Law and the Income Tax Law, "taxes" should be deleted from Article 87 of the Minerals Law so that it would only provide for fiscal stability of mineral royalties and customs duties. Alternatively, the stability provision in the Income Tax Law (Article 85) could be repealed.

Income Tax Law

- An income tax is a complicated tax, compared to import duties or turnover taxes. Having a special regime for mining companies will lead to additional complexity. Examples of complexity that may arise under the Aynak contract include: (i) treating each mining license as a separate taxpayer (that is, ring fencing of each mining license), (ii) whether the power plant and the railway are Qualified Extractive Industry Taxpayer (QEIT) assets, (iii) whether employee housing and health clinics are QEIT assets, (iv) the tax treatment of bonus payments. Also, double taxation agreements could undermine the mining fiscal regime.

- The government, when negotiating double taxation agreements, should resist proposals to reduce the withholding tax on interest and dividends, as this will undermine income tax payments from the mining sector.

Administration of Afghanistan's Mining Fiscal Regime

- If the administration of the fiscal regime for mining is to be shared between the MOM and the Afghanistan Revenue Department (ARD) of the MOF, it is vitally important that their efforts are effectively coordinated. There should be regular meetings of MOM (including the Mining Cadastre Department, a division of the MOM) and ARD officials. To strengthen administration of the fiscal regime, effective procedures should be put in place for better and timelier exchange of information. Information to be exchanged and procedures for the exchange could be reflected in a Memorandum of Understanding (MOU) between MOM and the ARD.

Technical Assistance and Capacity Building

- In the short time this mission was in Kabul, it was not possible to take stock of all the TA and capacity building being provided to the MOF and the MOM and to identify gaps. Some clear needs were identified: (i) policy capacity building in the MOM, (ii) tax policy capacity building in the MOF, (iii) more effective tracking of mine revenues by MOF, and (iv) normalizing the marble and gemstone sectors, which will require that mineral rights be issued for reasonable periods of time and, in the case of marble, royalties no longer be pre-paid.

Chapter 1: Introduction

1.1. Strategic Overview

1. GIROA, as resource owner, has a valuable asset in the ground. This asset – a mineral deposit – can only be exploited once. In order to convert this asset into financial resources, GIROA must attract capital on terms that ensure it 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.

2. There is a fundamental conflict between mining companies and governments over 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.

3. In addition to production-based and profit-based instruments, the government may receive bonus payments (e.g., at the signing of the contract or the beginning of commercial production) and surface rents. Signing bonuses, particularly when paid with respect to unexplored areas, increase the risk of the mining companies as the bonuses are paid whether or not a commercial discovery is made. Surface rents, which must be paid annually, may provide an incentive to a holder of mineral rights to explore for minerals so as to be able to relinquish areas that are unpromising and reduce the annual payment to the government.

4. Afghanistan needs outward looking, market-oriented policies to attract investment into the mining sector. With the goal of fostering the development of the mining sector, **Afghanistan should adopt a fiscal regime for the mining sector that is simple, predictable, and transparent**. Afghanistan has made a major commitment to enhanced governance in its resource sectors by committing to implementation of the Extractive Industries Transparency Initiative (EITI), thereby promoting greater transparency of payments made and revenues received in the resource sectors.[2]

5. Afghanistan's fiscal regime needs to distinguish between deposits of national importance and other large known deposits that have not been quantified and evaluated, on the one hand, and greenfield areas and smaller known deposits, on the other hand. Large copper, iron ore, and gold projects can generate substantial royalty

[2] Article 96 of the Minerals Law commits the MOM to publish annual reports of government revenues and other direct and indirect benefits received from mineral activities, and requires holders of mineral rights and the government to submit data, including production, financial data, and other direct and indirect benefits received by them and all amounts paid by them in connection with mineral activities.

and income tax revenue for the government while smaller mining projects, quarrying and artisanal mining can generate employment but usually not much revenue for the government. The design of the mining fiscal regime will need to take these considerations into account. As discussed below in the subsection on bidding, one size does not fill all.

6. Once Afghanistan is successful in attracting investment in the mining sector, it will have room to tighten the fiscal terms for future projects, possibly by adopting an additional tax that would capture a share of the resource rents of the most profitable projects.[3]

7. Ultimately, there is a market test for each country's 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.

8. A simple, predictable, and transparent fiscal regime must be complemented by an efficient and transparent tax administration. **As the MOM collects mineral royalties and surface rents and the MOF collects the income tax and customs duties, there should be a high degree of cooperation and coordination between the two ministries. To this end, the ministries should consider entering into a memorandum of understanding on exchanges of information** (see section on administration of the mining fiscal regime). In addition, capacity building, external TA, and the use of outsourcing will be needed, given Afghanistan's limited capacity to administer the mining fiscal regime (see section on capacity building and TA).

1.2. The Fiscal Regime

9. The fiscal regime for Afghanistan's mining sector – essentially a tax/royalty regime – is regulated by the Minerals Law of 2008 and the Income Tax Law of 2009. The Minerals Law provides that holders of mineral rights and their subcontractors shall pay taxes, customs duties, mineral royalties and other taxes in accordance with the provisions of the Minerals Law and other applicable law. The Minerals Law imposes:
(i) royalties to be collected by the MOM and paid to the State Treasury and
(ii) surface rents to be collected by the Mining Cadastre Department and paid to the State Treasury.

10. The Income Tax Law contains a separate chapter (i.e. Chapter XII) which provides special taxation rules for qualifying extractive industry taxpayers (QEITs), in both the mining and petroleum sectors. However, the articles in the other chapters of the

[3] Indonesia's fiscal regime for mining, which was introduced in 1967, was gradually refined and modernized over 40 years to reflect changing conditions in Indonesia and abroad. The first generation contract negotiated with Freeport Minerals contains generous fiscal terms, which were appropriate given Indonesia's post-chaos environment in 1967. In 2009, Indonesia replaced its contract-based system with a licensed-based system equally applicable for foreign and domestic investors. Tanzania adopted a liberal fiscal regime for mining in 1997 that included an additional capital allowance for unrecovered costs. Tanzania eliminated the additional capital allowance in 2001, once it had established a track record of attracting investors in the mining sector.

Income Tax Law apply to QEITs in the same manner they apply to a taxpayer that is not a QIET unless they are changed by an article in Chapter XII.

11. In event of conflict between the mining and income tax laws, the Income Tax Law prevails, as the Income Tax Law contains a final provision providing that provisions (in other laws) inconsistent with the Income Tax Law shall be void. The Minerals Law contains a similar override provision. However, Income Tax Law was adopted last and thus it prevails.[4]

12. Under Afghanistan's customs tariff, a 1 percent import duty is levied on raw materials and a 2 percent import duty is levied on capital goods. Under the model contract included as part of the bid documents for the Hajigak project – now withdrawn – the winning bidder would be exempt for import duties during the construction period.[5] The Aynak contract contains a limited exemption from import duties. Export of marble is subject to a 3 percent duty.

[4] The Minerals Law was signed into law on November 5, 2008 and the Income Tax Law on March 17, 2009.

[5] Article 27(2)18, the Minister of Finance with approval of the Council of Ministers, may exempt goods from customs duties.

Chapter 2: Strengthening the Minerals Law

13. Adoption of the Minerals Law of 2008 and the Mining Regulations of 2010 are major milestones. There are some problems with the Minerals Law, however, which should be addressed. The primary problems relate to bidding for mineral rights, royalties, persons eligible to hold mineral rights, powers of the MOF, and fiscal stability. Some lesser problems have also been identified and are briefly mentioned.

2.1. Bidding

14. Under the Minerals Law, licenses and authorizations for exploration and exploitation are all obtained through a bidding process, which inevitably will discourage foreign mining companies from exploring for minerals in Afghanistan. That said, bidding is appropriate for known deposits of national importance – for e.g. Anyak and Hajigak. They should be bid through a transparent tender process. Exploration licenses for other known deposits that have not been quantified and evaluated could also be obtained though bidding, though bidding would be restricted to those known deposits that likely would lead to a large or very large mine. Bidding would not be over royalty rates or bonus payments but limited to the minimum work program and the technical and financial capability of the bidder. For Greenfield areas and smaller known deposits, exploration licenses would be given on a first-come first-served basis.[6]

15. Under Article 15 of the Minerals Law, holders of exploration licenses do not have the right to move to an exploitation license when their exploration leads to the discovery of minerals that can be commercially exploited. Instead there is another round of bidding, and if the holder of the exploration license loses, the winner is to compensate the loser.[7] **Serious mining companies will not want to explore for minerals in Afghanistan if they do not have the right to exploit commercial deposits that may be discovered, subject to certain conditions** – development of a feasibility study, assurances on meeting environmental standards, etc. **Afghanistan would be much better served if holders of exploration licenses could move to exploitation licenses without bidding over fiscal terms.**

2.2. Royalties

16. Royalties are either specific levies (based on weight or volume of minerals extracted) or ad valorem levies (based on the value of minerals extracted).[8] They secure revenue for the government as soon as production commences, are considerably

[6] Requirements would be imposed on the holder of the mineral license. For example, the holder would be required to begin exploration within one year or the license would be lost. Exploration licenses would be for a limited time period, such as three years.

[7] Article 37 of the Minerals Regulations provides that the loser is compensated for costs plus "fair profit," where fair profit is calculated as a percentage of costs, ranging from 20 to 60 percent, depending on the size of the mine. The winning bidder can propose a payment schedule so the actual payments would likely be spread out over a number of years.

[8] A few countries levy profit-based royalties, which can make the royalty more sensitive to the overall profitability of the mine, but it also makes the fiscal regime more complex and difficult to administer.

easier to administer than most other fiscal instruments, and ensure that companies make a minimum payment for the minerals they extract.[9]

17. Royalties 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.

18. 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 (Box 1). 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.

19. Under the Minerals Law, Afghanistan imposes royalties on gross production.[10] The royalty rates are not specified or fixed in the law or regulations. The Minerals Law provides that the royalty rate for each project will be approved by the Inter-Ministerial Committee, as per recommendation of the MOM, considering the technical characteristics of the deposits, infrastructure, economical conditions and other circumstances. In short, the royalty rates are determined separately for each holder of a mineral license based on a negotiation or bidding, an inefficient process that discourages investment.

20. A reform of Afghanistan's royalty regime should address the following questions:

    - Should royalty rates be fixed or bid?
    - Should the rates be specific or ad valorem?
    - If ad valorem, should they be based on reference prices or sales value?
    - What should the rates be?
    - Should there be any royalty relief?
    - When should the liability for royalty payment accrue?

21. **To maximize simplicity, predictability, and transparency, royalty rates would be fixed and not subject to negotiation or bidding**, with the possible exception of royalties for deposits of national interest (e.g., Aynak and Hajigak).

22. Following international best practice, **weight-based or volume-based specific royalties, expressed in Afghanis or a foreign currency, would be used for low-value bulk commodities** (including construction materials, construction stone,

[9] For an excellent discussion of royalties for hard minerals, see Craig Andrews, et. al., (2006), *Mining Royalties: A Global Study of Their Impact on Investors, Government and Civil Society*.

[10] Regulations or procedures could provide that the royalty liability is triggered when the minerals are sold (or deemed sold) instead of at the time of extraction.

ornamental stone, quarry material, industrial minerals and stones,[11] and possibly coal[12]). **Value-based royalties would be used for high-value minerals** (including base metals, precious metals, gemstones, and bituminous sand or clay).

23. Value-based royalties would be assessed on the gross sales value. To minimize disputes as to value, international market prices – reference prices – would be used whenever possible.[13] When reference prices are not available, the MOM needs authority in the Minerals Law to adjust the sales value to reflect an arm's length price[14] when the minerals are sold to a related company.[15]

24. Given the 20 percent income tax rate and the generous capital recovery, the royalty rate could be set at 5 percent for base and precious metals.[16]

25. The government may want to consider a nondiscretionary scheme for deferral of royalty payments in periods when cash operating expenses[17] rise above revenues. This would ensure that the royalty payment would never cause marginal cost to exceed marginal revenue, which could result in early mine closure.

26. Although, under the Minerals Law, royalties are levied on production, the liability for payment of royalty should accrue when minerals are sold or shipped. **The current advanced payment of royalties for construction materials and stones should be abolished**, as it raises the cost of mining these materials and reduces the attractiveness of investing in mining.

[11] These various types of construction and industrial materials are defined in the Minerals Law.
[12] The World Bank in 2004 developed a proposed schedule of royalty rates for Afghanistan. For coal the rates were expressed in US dollars per tonne but varied by the level of calories per kilogram. The schedule of rates was not adopted by the government.
[13] Appendix A provides guidance on reference prices that could be used for the major minerals.
[14] The arm's length price is the price at which a willing buyer and an unrelated willing seller would freely agree to trade.
[15] This authority would be similar to that which the Ministry of Finance has to adjust transfer prices – that is, prices charged between related parties – to accurately reflect taxable income (Article 41 of the Income Tax Law).
[16] The author of this paper does not have expertise on the appropriate rates for construction materials and stone, which would be subject to specific rates. Afghanistan might want to look at the rates in India and Pakistan.
[17] Cash operating expenses would not include depreciation, interest expense or taxes.

Box 1. Royalties on Mining in the International Context

Some countries (notably Chile and Mexico) charge no royalty, but royalty rates in the range of 1 to 4 percent of the value of mine product – but somewhat higher for diamonds – appear to be common and acceptable to investors, depending on the level of other fiscal charges. Among other countries which have attracted significant mining investment, Papua New Guinea levies a 2 percent royalty on copper and gold, recently increased from 1.25 percent (but also levies import duties, subject to limitations, and offers slower depreciation than is offered in Afghanistan); Mongolia's royalty rate for copper and gold is 5 percent of sales value, but the rate is 2.5 percent of value for coal and other common minerals sold on the domestic market and used for power generation. The Papua New Guinea charge is based on "net smelter returns" (i.e., transport, smelting and refining charges are deducted in arriving at the revenue for royalty), whereas the charge in Indonesia appears to be based on a gross international price for refined metals. Peru levies a sliding scale ad valorem royalty based on annual sales, with rates of 1 to 3 percent.

In Africa, Botswana levies a 3 percent royalty on copper on the sale value at the mine (netback). Ghana operates a variable royalty system that depends on the operating ratio of the mine, with a minimum rate of 3 percent, and it is understood that no gold mine pays more than 3 percent. South Africa, which until recently did not impose mineral royalties, has enacted royalties with rates as percent of the sales value; the rates vary from 5 to 1.25 percent depending on the ratio earnings before interest and taxes to gross sales. Zimbabwe levies no royalty under its general regime, but is understood to have used a royalty of 2.5 percent for a project under a Special Mining Lease.

2.3. Persons Eligible to Hold Mineral Rights

27. Article 14 gives a list of persons eligible to hold mineral rights in Afghanistan. The list includes: (i) individuals who are citizens of Afghanistan, (ii) foreign nationals who are residents of Afghanistan, (iii) legal entities organized in Afghanistan, and (iv) legal entities organized under a foreign law. If a foreign legal entity obtains a mineral right, it would be operating in Afghanistan as a branch of a foreign company. **As branches of foreign companies are more difficult to tax under an income tax than a foreign subsidiaries, the Mining Law should be amended to require that foreign investors in the mining sector establish a domestic legal entity in Afghanistan – i.e. a foreign subsidiary – that would hold the mineral rights in Afghanistan.** As the new Corporation Law makes it relatively easy to establish and register a domestic corporation, foreign investors in the minerals sector would be still welcome. The administration of the income tax, however, would be easier if holders of mineral rights were domestic legal entities.[18] The government may want to consider further restricting the list of persons eligible to hold mineral rights by requiring all holders of mineral licenses be legal entities. Afghan individuals would not be allowed to hold

[18] Many foreign mining companies will want to establish a domestic legal entity in Afghanistan for non-tax reasons (e.g., to partially shield the parent company from liabilities of the Afghanistan subsidiary).

mineral rights other than a mineral authorization. This is the approach that other developing countries such as Mongolia and Ghana have taken.

2.4. Powers of the Ministry of Finance

28. Article 85 gives the MOF, taking into account the special circumstances of the holder of mineral rights, power to propose to the government various forms of fiscal relief, including deferral of tax and tax exemptions. Read literally, the article does not give the government power to negotiate fiscal terms in a mining contract that are inconsistent with enacted legislation. And if that is the proper interpretation of Article 85, it is redundant, as the MOF can always make tax proposals to the government, including tax proposals that benefit a single taxpayer. However, potential investors in the mining sector are likely to read the article more expansively as an invitation to negotiate over fiscal terms. While it is true that the MOF need not make recommendations to the government, the MOF will be under pressure to do so. **This process of negotiating tax concessions contract by contract can slow the whole process of licensing mineral rights, to the detriment of Afghanistan and the investors.[19] It is therefore recommended that Article 85 be repealed.**

2.5. Fiscal Stability

29. Article 87 of the Minerals Law provides for fiscal stability of taxes, mineral royalties and customs duties. With respect to taxes, this article is more liberal than Article 85 of the Income Tax Law, which provides that mining companies can have fiscal stability with respect to income tax provisions for 5 years (holders of a mining authorization) or 8 years (holders of a mining license) if they agree to be subject to an income tax rate of 30 percent instead of 20 percent).[20] "Taxes" should be deleted from Article 87 of the Minerals Law so that it would only provide for fiscal stability of mineral royalties and customs duties. Alternatively, Article 85 of the Income Tax Law could be repealed.

2.6. Other Issues

30. Article 3(28) defines mineral royalties as "certain percentages of gross production". As the government may want to set the royalty rates for some minerals per unit weight (e.g., AFS 1,000 per tonne), the definition could be expanded to "certain percentage of the value of gross production or certain fixed amounts in afghanis or a

[19] Many countries do not negotiate fiscal terms for exploration licenses, and this should be considered international best practice. However, in the case of the recent Mongolian mining agreement for the Oyu Togoi copper deposit, the final agreement/contract, was ratified my parliament to give it the force of law. Some of the fiscal changes that overrode current law – both the mining law and the income tax law – were needed, as the enacted laws had serious flaws, some of which penalized potential investors but others of which left major loopholes that the investors could have exploited under a stability article that froze current law. Before the agreement was ratified by Parliament, most of the changes in the law that were needed were enacted into law. The Mongolian government now plans to seek further legislative changes to reduce (and hopefully eliminate) the need for long negotiations over fiscal terms for each mining license.

[20] As the Income Tax Law was signed into law after the Minerals Law, the income tax stability provision prevails. It is likely that most companies will forego fiscal stability.

foreign currency – euros or US dollars – per tonne of gross production". The definition of mineral royalties, at least in the English translation, is somewhat circular, as Article 3(28) begins "Mineral royalties" means mineral royalties…"

31. The duties of the MOM (Article 6) and the duties of the Inter-Ministerial Commission (Article 7) appear to be inconsistent with current practice. The Inter-Ministerial Commission played a role in the negotiation of the Aynak contract, which is a very large scale contract. Yet under Article 7 the Inter-Ministerial Commission has no role in monitoring or approving large scale contracts (investment up to US$50 million) or very large scale contracts (investment of more than US$50 million). The Commission probably should have a role, and the Mining Law could be amended to reflect current practice.

32. Article 7 gives the Inter-Ministerial Commission power to grant exemptions from surface rent. This is an invitation for holders of mineral rights to seek exemptions and the fairness of the fiscal regime is not improved if some holders of mineral rights receive exemptions while others do not, possibly depending on political access and/or corruption. Article 7 should therefore ideally be repealed.

2.7. Recommendations

33. **Bidding of mineral rights should be restricted to deposits of national importance (e.g., Aynak and Hajigak) and the larger known deposits that have not been quantified and evaluated**. Except for deposits of national importance, bidding would not be over royalty rates or bonus payments but limited to the minimum work program and the technical and financial capability of the bidder. For other deposits, exploration licenses should be given on a first-come first-served basis, with the conditions (e.g., exploration must begin within 12 months). **Holders of exploration licenses should have the right to move to an exploitation license, without a round of bidding, when minerals that can be commercially developed have been discovered.**

34. **A comprehensive reform of the royalty regime would include the following elements**: (i) royalty rates would be fixed and not subject to negotiation or bidding, with the possible exception of royalties for deposits of national interest; (ii) weight-based or volume-based specific royalties would be used for low-value bulk commodities and value-based royalties would be used for high-value minerals; for value-based royalties, reference prices would be used whenever possible; (iii) the royalty rate could be set at 5 percent for base and precious metals; (iv) Afghanistan could adopt a nondiscretionary scheme for deferral of royalty payments in periods when cash operating expenses rise above revenues; and (v) the liability for payment of royalty should accrue when minerals are sold or shipped. The current advanced payment of royalties for construction materials, marble and stones should be abolished.

35. **The Mining Law should be amended to require that foreign investors in the mining sector establish a domestic legal entity in Afghanistan – i.e. a foreign**

subsidiary – that would hold the mineral rights. The government may want to consider further restricting the list of persons eligible to hold mineral rights by requiring all holders of mineral licenses be domestic legal entities. Afghan individuals would not be allowed to hold mineral rights other than a mineral authorization.

36. **Article 85 of the Minerals Law (the powers of the MOF) should be repealed, as it has it has no substantive meaning**.

37. To eliminate overlap between the Minerals Law and the Income Tax Law, **"taxes" should be deleted from Article 87 of the Minerals Law so that it would only provide for fiscal stability of mineral royalties and customs duties**. Alternatively, the stability provision in the Income Tax Law (Article 85) could be repealed.

Chapter 3: Income Tax Issues

3.1. Tax Treatment of Dividends and Interest

38. Mining companies are subject to income tax, but not the business receipts tax (BRT), as they pay royalties on the production of minerals. Chapter XII of the Income Tax Law provides special tax provisions for the mining and petroleum sectors, including the exemption from the business receipts tax. In general, these provisions are reasonable. Mining companies will have an unlimited loss carry forward, compared to three years for other companies. Each mining project is ring fenced so losses from a project under one mining license cannot offset income from another mining license. Capital costs are recovered on a straight-line basis over 5 years or the life of the asset, whichever is shorter. Pre-production expenses are capitalized and can be recovered over 15 years or the life of the mining license once commercial production begins whichever is shorter. Contributions to a fund for environmental and social costs will be deductible subject to a guarantee of performance. Fiscal stability for the income tax is provided for 8 years (for a holder of a mining license) and 5 years (for a holder of a mining authorization), but the mining company must elect to pay income tax at a 30 percent rate, compared to 20 percent if fiscal stability is not elected.

39. The Afghanistan income tax law has a simple, elegant solution to the potential double taxation of corporate source income once at the corporate level and a second time when the income is distributed. The 20 percent income tax rate applies to taxable profits after the deduction for interest expense and dividends. However, both interest and dividends are subject to a 20 percent withholding tax. Thus, whether profits are retained within the company or taken out through interest or dividends, the company faces the same tax charge of 20 percent. With this approach to taxing corporate income, there is no need for limits on excessive use of debt (so-call thin capitalization rules).

40. If Afghanistan enters into double taxation agreements (DTAs) with other countries, the government will likely be under pressure to reduce the withholding tax on dividends and interest. This would undermine the mining fiscal regime. Suppose Afghanistan were to agree with Country B to a 5 percent withholding tax on dividends paid to resident individuals and legal entities of Country B. A Chinese mining company could set up a wholly-owned subsidiary in Country B to hold its shares in the Afghan company that holds the mining license. Under this arrangement, profits earned by the mining company could be taken out of Afghanistan subject only to the 5 percent withholding tax rate.

3.2. Income Tax Complexity

41. An income tax is a complicated tax, compared to import duties or turnover taxes. Having a special regime for mining companies will lead to additional complexity. Examples of complexity that may arise under the Aynak contract are as follows:

- Chapter XII of the Income Tax Law only applies only to QEITs. Under Article 77(1)4, MCC is a qualifying taxpayer as it holds a mining license. Subcontractors are not QEITs, and they do not benefit from the tax provisions in Chapter XII. They are subject to a withholding tax on payments.[21]

- MCC will likely hold several mining licenses – one for the copper deposit, one for the coal deposit that will be mined to supply the power plant, and one or more licenses for limestone, quartz, and phosphate that will be mined to operate the smelter. Under Article 79, a QEIT is treated as a separate taxpayer in respect to each mining license (ring fencing of each license). Therefore, the costs of developing the coal mine cannot be deducted against the income derived from exploiting the copper mine. For tax purposes, MCC will have to sell coal from the coal QEIT to the power plant. Each QEIT will file a separate tax return.

- Are the power plant, which will supply power to the mine and to Kabul, and the railway QEIT assets? These assets are needed to operate the mine but are they "used directly in the business subject to the mining License" (Article 77(1)5 of the Income Tax Law)? Alternatively, construction of the power plant and railway could be considered "pre-production costs" under Article 83.

- The Aynak contract likely requires MCC to provide employee housing and health facilities. How are these costs treated for income tax purposes? The ARD could hold that these assets are not directly used in the business subject to the mining lease. Therefore these assets are not QEIT assets and their tax treatment is determined by the regular provisions of the Income Tax Law. Article 18 allows a deduction for all ordinary and necessary expenses. The ARD, however, could hold that the cost of goods purchased but used by owners or employees for personal or household purposes are not ordinary and necessary expenses and therefore not recoverable for tax purposes through depreciation deductions. Alternatively, the ARD could may hold that social infrastructure assets at a remote mine site, including employee housing, are needed to operate the mine and therefore should be considered QEIT assets.

- MCC will pay a bonus (premium) of $808 million in three tranches. How are these payments treated for income tax purposes? It is most likely a payment for the license and would be deducted over the period of the license (Article 81(3) of the Income Tax Law). The contractor could take the position that the premium payments give rise to a QEIT asset, which would allow more rapid depreciation.

42. Given the complex legal questions that will inevitably emerge relating to large scale mining projects, the ARD (MOF) will need legal skills in addition to auditing skills. This is addressed in the final section on technical training and capacity building.

[21] Under Article 72 of the Income Tax Law, contractors without a business license are subject to 7 percent final withholding; contractors with a business license are subject to 2 percent withholding, which is creditable against subsequent tax liabilities.

3.3. Recommendation

43. **The government, when negotiating double taxation agreements, should resist proposals to reduce the withholding tax on interest and dividends**, as this will undermine income tax payments from the mining sector.

Chapter 4: Administration of the Mining Fiscal Regime

4.1. Overview

44. Most countries allocate primary responsibility for fiscal policy to a finance ministry, and responsibility for fiscal administration to an agency reporting to that ministry. An exception to this is found in mining and petroleum countries, where administration of royalties and surface rents is often allocated to the industry ministry or an agency reporting to it.[22]

45. In Afghanistan, the MOM has responsibility for collecting the royalty;[23] the Mining Cadastre Department (a division of the MOM) has responsibility for collecting the surface rent; the ARD has responsibility for collecting the income tax; and the Customs Department has responsibility for collecting any import and export duties. There are strong practical administrative arguments against disturbing the current arrangement in Afghanistan. The MOM clearly has expertise to assess royalties. This will be fairly straight-forward if the royalty is based on a reference price – see discussion of royalties – but requires expertise in mineral markets if the royalty is based on sales value, particularly when there are sales to related parties.

46. If fiscal responsibility is to be shared between two departments, it becomes vital that their efforts are effectively coordinated. There should be regular meetings of senior officials of the MOM (including the Mining Cadastre) and the ARD. They need to agree what information should systematically be provided by MOM to ARD – for example:

    - Details of mineral licenses and mineral authorizations awarded and transfers of interests;
    - Feasibility studies submitted and agreed;
    - Major proposed mine developments;
    - Start of commercial production;
    - Production volumes and forecasts;
    - Approved environmental and mining reclamation costs;
    - List of subcontractors to ensure compliance with withholding; and
    - For those minerals, where the royalty is based on the value of the minerals sold, the value of the minerals for royalty purposes after any audit adjustments.

[22] When production sharing (in substance a profits tax) is used as part of the petroleum fiscal regime, its administration is often allocated to the petroleum ministry.

[23] Some royalties are collected by the Mining Extraction Enterprise, a SOE, and some by the Mining Cadastre Department.

47. There will be less need for the ARD to provide information to the MOM, but they should inform them, for example, of any serious non-payment problems or other major compliance failings by holders of mineral rights or subcontractors.

4.2. Recommendation

48. **Effective procedures should be put in place for better and timelier exchange of information**. Information to be exchanged and procedures for the exchange could be reflected in a Memorandum of Understanding (MOU) between MOM and the ARD

Chapter 5: Technical Assistance and Capacity Building

49. The international community provides wide-ranging support in the form of Technical Assistance (TA) and capacity building (CB) to both the MOF and the MOM. Since 2003, when Afghanistan commenced its reform program, substantial progress has been made. Income tax reforms have been developed and implemented, including a special chapter in the Income Tax Law for mining companies, largely reflecting advice of the International Monetary Fund (IMF). The ARD has established large taxpayer offices (LTOs) to control the large taxpayers, beginning with the Kabul LTO in 2004. The Kabul LTO controls the taxation affairs of 197 registered taxpayers and 30 SOEs, which account for more than half of total tax collections. UK-DFID through its contractor, Adam Smith International, has supported implementation of tax administration reforms with more than 10 resident advisors, including a legal advisor. The IMF has periodically reviewed progress and sent short-term experts to complement the work of resident advisors. The Asian Development Bank (ADB) has funded a mining advisor to the Minister. USAID and UK-DFID have also funded advisors to the Minister.

50. The Minerals Law and Mining Regulations have been adopted largely reflecting the advice of the World Bank (WB) and its contractors. Technical assistance and institutional support are provided to the MOM by the WB, the ADB, USAID, the Japan International Cooperation Agency, the US Geological Survey, the British Geological Survey, and Norway. A transaction advisor was engaged by the Ministry to prepare and implement the Aynak tender and Hajigak tender. UK DFID is launching an expanded program of TA for the ministry, beginning with the development of a business plan.

51. In the short time in Kabul, it was not possible to take stock of all the technical assistance and capacity building being provided and to identify gaps. Some clear needs were identified:

Policy Capacity in the Ministry of Mines

52. Within the MOM, the Policy Planning and Coordination Division has a lead role in policy formulation. The Division does not have capability to model mining or petroleum agreements and thus support contract negotiations or reviews of contract terms that may be required under existing contracts. Possible TA would be:

    Objective: Support contract negotiation

    Output: Contract based financial modeling of proposed and signed contracts

    Outcome: Negotiation of contracts that maximize government revenue and minimize distortions

    Timing: One-year to implement

Tax Policy Capacity in the Ministry of Finance

53. Tax policy formulation has been largely supported by outside advisors. This critical function of a ministry of finance needs to be taken in house and supported by one or two contractual foreign advisors, if they can be identified. The first step would be to develop a plan outlining the functions the office would provide and who within the ministry is performing tax policy functions now, including: revenue estimating, modeling of reform proposals, legal drafting, policy analysis, and tax treaty negotiation.

    Objective: Establish tax policy capacity in the MOF

    Output: A dedicated staff of tax policy advisors

    Outcome: Improved tax policy formulation that takes into account the Afghan situation

    Timing: Six months to place a policy expert; 2 months to survey current situation, identify potential staff, and establish the office.[24]

Effective Tracking of Mining Revenues

54. Royalties and surface rents are collected by the MOM and transferred to the budget; taxes are collected by the ARD of the MOF. For budget planning purposes, the MOF needs to be able to track revenue from the larger mines. For example, it will be years before Aynak is paying income tax or royalties. It should be paying withholding tax on subcontractors. During this mission, we learned that a large payment from the Northern Coal Enterprise was wrongly classified as income tax. A contract-based model is needed for tracking payments. This model is much simpler than the financial model needed to support contract negotiation (e.g., it does not need to calculate rates of return).

    Objective: Efficient collection of revenue

    Output: A contract-based model for tracking payments

    Outcome: Continuous tracking of payments received from the largest mining companies

    Timing: Work could begin once the Tax Policy Office is established.

Normalizing the Marble and Gemstone Sectors

55. Marble and gemstones sectors have the potential to generate substantial employment, but too much of the money now flowing in these sectors is ending up in the hands of anti-government elements. These sectors should be normalized and

[24] This office could be part of the macro-fiscal unit within the Ministry of Finance.

made transparent. Normalization will require the issuance of mineral authorizations for reasonable periods of time to make it worthwhile for holders of mineral rights to investment in marble quarrying and gemstone mining. Royalties should not be pre-paid.

Objective: Normalize the marble and gemstone sectors of the mining industry

Output: Ministerial decrees to normalize

Outcome: Increased income and employment in the mining sector; reduction in money flowing to anti-government elements

Timing: A short-term legal/regulatory advisor should be engaged in the near term.

Appendix A: Reference Prices for Specific Minerals

1. *Gold*. The London afternoon gold price fixing (London PM fix) is used as a reference (spot) gold price around the world. There is also a morning fixing, but as the afternoon fixing takes place when both the US market and the European (e.g., Zurich), Middle Eastern and African markets are still trading; it tends to be the most liquid period during the day. Many long-term contracts will be priced on the basis of either the morning or afternoon London fix, and the market will usually refer to one or other of these prices when looking for a basis for valuations.

   Despite its name, the fixing process closely resembles an open auction process, with offers and bids netted off throughout the market before the final bidding process is conducted during the fix itself. The fix is executed on a single price. This price is quoted in US dollars. Where the gold price is presented in currencies other than the US dollar, it is converted into the local currency unit using the foreign exchange rate closing price on the same day. (World Gold Council, www.gold.org, London Bullion Market Association, www.lbma.org.uk).

2. *Copper*. World copper markets are London Metal Exchange (LME) and New York Mercantile Exchange (NYMEX). The more quoted spot reference price comes from LME: the cash seller and settlement spot price for copper grade A.

3. *Copper Concentrate*. The value of copper concentrate can be obtained by subtracting the treatment and refining charges (TC and RC) from the (refined) copper price. There are spot and annual TC/RC markets in Japan and a spot market in Shanghai. The annual market includes a price participation (PP) element by which smelters share part of increases in copper prices. There can be sizable differences between the prices quoted in the annual and spot markets, which suggests that the impact of imposing a uniform reference tax price to all transactions would be significant. The equilibrium in the refined copper market is the one that drives both products. The netback from copper prices is traditionally determined in negotiations between copper concentrate producers and smelters. Transportation costs might also have to be deducted to get the price of copper concentrate. There seem to be several distortions in world markets to the advantage of Indian (high import tariffs on cathodes) and Chinese smelters. In China, there have been reports of collusive behavior by their smelters.

4. *Coal.* The majority of coal is either utilized in power generation (steam coal or lignite) or iron and steel production (coking coal). Coal is readily available from a wide variety of sources in a well-supplied worldwide market. Transportation costs account for a large share of the total delivered price of coal, therefore international trade in steam coal is effectively divided into two regional markets: (i) the Atlantic market, made up of importing countries in Western Europe, notably the UK, Germany and Spain; and (ii) the Pacific market, which consists of developing and OECD Asian importers, notably Japan, Korea and Chinese Taipei. The Pacific market currently accounts for about 60 percent of world seaborne steam coal trade. By contrast,

international coking coal trade is limited. Coking coal is more expensive than steam coal.

5. BP Statistical Review of the World Energy provides the following coal pricing information: (i) Northwest Europe marker price, (ii) US Central Appalachian coal spot price index (CAPP 12,500 BTU, 1.2 SO2 coal) from NYMEX, (iii) Japan coking coal import CIF price, (iv) Japan steam coal import CIF price. The Paris-based International Energy Agency (IEA) maintains annual and quarterly time series of steam and coking coal import prices. The mission was not able to find a source that price information on the Chinese market for coal, which is likely the most relevant market for Afghanistan coal.

6. *Zinc Concentrate*. The main world reference spot price for zinc is the LME, high grade 98 percent pure zinc price, CIF, UK ports. As in the case of copper, the spot cash seller and settlement price can be specifically used as the reference price of zinc. It is not easy to find references to markets for zinc TC/RC. A 2005 report on zinc markets in Asia-Pacific suggested that zinc smelters and zinc mines negotiate base TC/RC once a year, with actual TC/RC being determined by the base TC/RC plus/minus 15% of zinc-price changes from the base zinc price.

7. *Lead*. LME has a 99.97 percent minimum purity lead spot price, CIF for European ports. Cash seller and settlement price.

8. *Tin.* LME, standard grade tin spot price. Cash seller and settlement price.

9. Nickel. LME, primary nickel of 99.8 percent minimum purity, spot price. Cash seller and settlement price.

10. *Aluminum.* LME, standard grade aluminum, minimum 99.7 percent purity, spot price. Cash seller and settlement price.

11. *Iron ore.* Two iron ore price lists, one for prices of ore to Europe and the other for prices to Japan are widely published. These prices are usually set during lengthy negotiations between Brazilian iron ore producers and German steelmakers and between Australian producers and Japanese steelmakers. Until recently, iron ore prices have been negotiated annually, but pressure to change came after iron ore spot prices rose sharply in the second half of 2009, but mining companies were locked into price agreements negotiated earlier in the year. An agreement with Asian steel mills has changed the system to quarterly pricing. The unit pricing system is used with iron ore to accommodate variations in iron content. Prices are quoted in U.S. cents per ton unit of iron. A unit is 1/100, or 1 percent, of the weight of a ton of iron so that 1 metric ton unit corresponds to 1/100th of a metric ton. This means that a steelmaker that buys 1 ton of ore that is about 65 percent iron is paying for 1 ton of iron contained in that ore and will receive about 1½ tons of ore. The IMF World Economic Outlook (WEO) reports the Brazilian iron ore's contract price to Europe, fob, 67.55 percent iron content.

Acronyms

ADB	Asian Development Bank
AFS	Afghanis
ARD	Afghanistan Revenue Department, Ministry of Finance
BTU	British thermal unit
CIF	Cost, insurance and freight
DTA	Double Taxation Agreement
EBIT	Earnings before interest and taxes
EGGI	Economic Growth & Governance Initiative
EITI	Extractive Industries Transparency Initiative
GIROA	Government of the Islamic Republic of Afghanistan
IMF	International Monetary Fund
LME	London Metal Exchange
LTO	Large Taxpayer Office
MOF	Ministry of Finance
MOM	Ministry of Mines
MOU	Memorandum Of Understanding
NYMEX	New York Mercantile Exchange
OECD	Organization for Economic Co-operation and Development
PP	Price participation
QEIT	Qualified Extractive Industry Taxpayer
SME	Small and medium enterprise
SOE	State-owned enterprise
TA	Technical Assistance
TC/RC	Treatment and refining charges
UK	United Kingdom
UK-DFID	United Kingdom Department for International Development
US	United States
US$	United States dollar
USAID	United States Agency for International Development
WB	World Bank