9 February 2011

MEMORANDUM

From: Bob Conrad

Subject: Ring Fencing

Performing an examining of alternative ring fencing strategies is one topic in my current work program. I cite some issues here and then ask questions about current policy so that I might be prepared for discussions in Lusaka and to be able to supply analysis of options in a timely manner.

1. Ring Fencing

Ring fencing is a generic tax term which is not restricted to natural resource extraction. Ring fencing is a term applied to any set of activities which are taxed either under special rules or by segregating a particular activity, or set of activities, for separate taxation. Segregation of income from electricity generation between production of electricity and transmission is one example of ring fencing outside the natural resource sector.

Within natural resources in general and mining in particular ring fencing is used to segregate the certain activities and tax those segregated activities independently from other activities in which an investor might engage. Ring fencing might be achieved in two ways. Horizontal ring fencing is a situation where the same, or similar, activities are taxed as separate activities. Mineral extraction from two different physical locations (or tracts or license areas) is one example of such ring fencing. That is the taxpayer will compute a separate tax for each property instead of computing a single tax of the aggregation of interests. Vertical ring fencing is a situation where downstream activities, or a particular set of downstream activities, are segregated from upstream activities. Regardless of the type, some type of separate accounting is required to compute the tax base attributable to the different bases constructed via ring fencing.

An example will illustrate the point. Suppose an investor has three mines in different parts of the country two concentrators and one smelter. All smelter output is exported. All production from Mine 1 goes to concentrator 1 for process while production from Mines 2 and 3 goes to Concenter 2 for processing. All output from concentrator 1 and Concentrator 2 goes the smelter for processing and the smelter does no use throughput from any source other than Concentrators 1 and 2.

There are a number of ways this organization can be ring fenced.

1. Vertical Ring Fencing between Mining and Processing. Mines 1, 2 and 3 would be treated as a separate group while the two concentrators and the smelter would be taxed as one unit.

2. Horizontal Ring Fencing for Mining and Vertical Ring Fencing for Mining and Processing. In this case Mines 1, 2 and 3 would be treated as separate units under horizontal ring fencing while the two concentrators and the smelter would be taxes as in Part 1.

3. Complete Horizontal and Vertical Ring Fencing: Each mine each concentrator and the smelter would be taxed as a separate unit in this case.

The three examples are not exhaustive but illustrate the different combinations of activities that might or might not be aggregated into one unit.[1]

2. Taxes and Charges to which Ring Fencing might apply

Ring fencing can be applied to a number of taxes and charges:

a. Profits and Income Tax: Ring fencing is most commonly applied to income taxes where separate accounting by ring-fenced activities is required. In effect, the intent is to treat each separate activity as a distinction independent taxpayer even though all the activities owned by one investor.

b. Value Added Tax (VAT): Ring fencing might apply to VAT and in this case each separate activity is effectively a separate VAT taxpayer. In general, ring fencing for VAT purposes might be inefficient or ineffective because trade between the separate segments will cancel out (no revenue effect) and the total VAT on trade with third parties should be independent of whether the investor's activities are ring fenced or combined. There might be cases where ring-fencing might be used for VAT purposes:

[1] Ring fencing may be the result of corporate structures either required or allowed. For instance, one investor might be allowed, or required, to establish separate special purpose entities by tract or activity. The creation of subsidiaries and reporting on a separate company basis can be equivalent to ring fencing.

a. Situations where VAT revenues are allocated from the central government to local or regional governments;

b. Ring fencing by taxed and exempt activities (a firm could produce both taxed and exempt supplies in different locations or in different operations); and,

c. Ring fencing by activity (one investor could engage in leasing and other financial transactions and production of goods like autos).

c. Royalty: Ring fencing may be a de facto outcome of the payment's function which is to compensate the resource owner (the government) for the sale of reserves when they are extracted. If the royalty is based on production of ore and the rate is either per unit or ad valorem then there is ring fencing by definition. Ring fencing may not be the result, however if the royalty is be imposed on production of concentrate or even smelter output.

d. Excess Profits Tax: An excess profits tax might be ring fenced by property if the policy intent is to capture some proportion of excess profits, however defined, attributable to a particular property. The property might be a lease, an aggregation of adjacent leases or a single mine (or well) depending on the legislation and regulations.

3. Gains and Losses from Ring Fencing

Two advantages are noted for ring fencing (either horizontal or vertical). First, tax losses from exploration, development and other start-up expenses cannot be used to offset income from either other production operations or downstream activities. Second, and related to the first, is that the ability to offset income with losses from another set of activities might create a competitive advantage for preexisting profitable firms relative to new entrants. The revenue loss and competitive advantage implications from aggregation of interests results in mining in part because exploration and development expenses are either immediately expensed or benefit from accelerated amortization. The need for ring fencing in this case can be reduced by replacing expensing with capitalization and amortization more in accord with economic principles. Exploration and development are capital expenditures and income accounting should reflect the capital nature of the expenditure by treating the expenditures like expenditures on other capital goods (either tangible or intangible).

There are costs ring fencing the most obvious being the administrative need to separate account for net income (or cash flow) attributable to the separate activities.[2] Attributions of revenue (in cases where there are transfers from upstream to downstream activities both of which operate domestically) and expenses must be made when an investor has two activities that are segregated, either horizontally or vertically. Transfer pricing rules may have to be applied or formulary methods used to attribute expenses. Absent reasonable administration an investor can use transfer pricing to offset, at least in part, the expected revenue gain created by the inability to use losses more rapidly. For instance, the investor might reduce losses attributable to a mine by shifting interest expense otherwise attributable to the mine to upstream processing or by reducing head office charges to the loss making activity by shifting more such expenses to the profitable segment.

4. How is ring fencing defined in current Zambian Law?

I understand that horizontal ring fencing is employed in Zambia. I understand this mean that separate properties, however defined, are segregated for profits tax (and perhaps excess profits tax) purposes. Before making any evaluation of this policy it would be helpful to have a better understanding of current practice. Thus, answers to the following questions will be beneficial and can lay the foundation for further discussions during my visit.

a. How many investors are affected by the current ring fencing rules?

b. What is the definition of the property or activity that is ring fenced?

c. In general, what the rules for computing income attributable to the ring fenced activities as well as to remaining set of activities (those outside the ring fence)?

d. How are transactions between ring fenced activities and other activities monitored?

    i. What are some current issues with respect to valuation?
    ii. How do interest, service cost and overheads get allocated to ring fenced activities?

[2] I am assuming that ring fencing is used to measure income for discussion purposes.

e. Is there an attempt to reconcile the consolidated income of the ring fenced activities for either information or auditing purposes?

f. What taxes and payments are computed by a ring fenced activity?

g. What are the corporate organizational rules for ring fenced activities?

h. If the government holds an equity interest in a mineral activity then is that interest limited to a ring fenced activity or to the integrated activities of the investor (and corporate structure reflecting the investors total activities)?

Thank you