Investment in Mexico’s mining industry has grown exponentially. For 2012, Mexico’s mining chamber, Camimex, estimated that investment by mining companies was USD 7.6 billion, up from USD 5.6 billion in 2011, and USD 3.3 billion in 2010. For 2013, investment in mining activity is anticipated to increase up to 40% from 2012.

This rise in investment is attributed to a combination of high precious and base metal prices, a friendly regulatory environment and the country’s geology. In addition, Mexico has a history of mining dating back to the pre-Hispanic and colonial periods and modern technologies have made it more efficient to further explore and exploit existing mineral deposits that were mined decades ago.

Mexico is the world’s largest producer of silver, which accounted for 27% of Mexico’s mining output in 2011 according to Mexico’s National Institute of Statistics and Geography (INEGI). Gold represented 25% of total mining production and copper 20%. Other base metals represented 11% of total output. The Mexican Geological Survey has identified 23 giant world class mineral deposits and six super giant deposits. Because of this, in 2011 Mexico invested more money in exploration than all but three other countries: Canada, Australia and the US. According to Camimex, more than USD 1 billion was spent on exploration in 2011 on 763 projects by 320 companies.

According to Camimex, foreign capital represents approximately 40% of all Mexican mining production with approximately 70% of this being from Canada.

Because a substantial number of foreign-owned Mexican mining companies are currently involved in exploration activities or looking at commercial production in the short-term, these companies should be interested in the corresponding tax treatment of exploration and other expenses incurred in getting their projects into production.

Under Mexico’s Income Tax Act (MITA), mining exploration expenditures in what is referred to as the pre-operating period are amortized at the maximum rate of 10% on a straight-line basis when the project for which the expenditures were made moves to the operating phase. The expenditures must be made to locate and quantify new deposits susceptible to exploitation.

Therefore, once the project is in the operating phase, all qualifying expenditures made during all years of the pre-operating period are capitalized and put into one pool and deducted for income tax purposes at the maximum rate of 10% annually. In addition, the income tax deduction for the pre-operating expenses should be indexed for inflation, thus granting an additional benefit.

Alternatively, taxpayers involved in mining activities may elect under the MITA to fully deduct expenditures during the pre-operating period in the year in which the outlays are made. This election must be taken for pre-operating expenses corresponding to the same mineral deposit or project. As a result, this election should be made in the first year...
pre-operating expenses are outlaid for a specific exploration project and expenses in all subsequent years relating to the same mineral deposit or project must be fully deducted in those years the outlays are made.

Exploration expenses relating to several mineral deposits or projects must be separated and either amortized for income tax purposes once the pre-operating period ends or an election taken to fully deduct those expenses in the year of expenditure.

What is the pre-operating period?
The MITA does not define the pre-operating period. Although International Financial Reporting Standard (IFRS) 6 discusses the accounting treatment of exploration for and evaluation of mineral resources, IFRS 6 does not give any guidance on defining the pre-operating period.

However, it is industry practice for mining companies to consider that commercial production is reached and therefore the pre-operating period concluded, when a mine is in the condition necessary for it to be capable of operating in the manner intended by management.

A range of factors are taken into account when determining whether commercial production has been reached, which may include demonstration of continuous production near the level required by the design capacity of the processing facilities, demonstration of continuous throughput levels at or above a target percentage of the design capacity and demonstration of the ability to produce output at a net margin that is consistent with expectations.

Usually a mining company will assess a mine’s ability to sustain production and throughput over a period of approximately one to three months, depending on the complexity of the operation, prior to declaring that commercial production has been reached.

Types of pre-operating expenses
The amortization or immediate deduction of exploration expenses during the pre-operating period is limited to expenses that are not otherwise depreciable (i.e. non-depreciable property or capital expenditures).

Tax depreciable property or assets such as buildings, machinery, equipment and tools must be separated from the pre-operating period exploration expenses and depreciated at the maximum authorized rates provided by the MITA on a straight-line basis or immediately deducted at the maximum rates established by the MITA or by presidential decree in the year the asset is first put into use or the following year.

Once production commences, the accumulated pre-operating period exploration expenses may be amortized at the maximum rate of 10% on a straight-line basis or if an election is made, fully deducted in the year of expenditure.

Examples of expenditures that will be treated as pre-operating exploration expenses for income tax purposes include:
- Land access fees
- Stripping costs prior to production (including labour, drill supplies, explosives, fuel, maintenance, etc.)
- Environmental studies (contractors and consultants, supplies, labour, analytical services, etc.)
Exploration expenses at properties with projects in production

Where a property already has a project in production, exploration expenses relating to another project on the same property should be fully deductible for tax purposes in the year the outlays are made unless it can be determined that the new project is exploring mineral that is in a completely separate mineral deposit than the one being exploited.

Since the new exploration is to be on the same property, it would be unlikely that the new exploration expenses would relate to another deposit and so the new exploration expenses should be fully tax deductible whether an election is made or not.

Furthermore, even if another unrelated mineral deposit is discovered on the property, it is most likely that the same smelter or processing plant on the property would also be eventually used for the newly found mineral and so the new exploration expenses should be fully tax deductible in the year they are incurred during the operating period of the original project.

Whether to amortize exploration expenses or deduct them in the year of expenditure

The MITA establishes that tax losses may be carried forward for ten years. As mining companies in the exploration and pre-production stage usually have little to no taxable income, the loss carry forward limit must be taken into consideration when deciding to elect to fully deduct pre-operating expenditures in the year that they are made since these losses may expire by the time a project goes into the production period.

In addition, shares in mining companies with expiring losses will be less valuable to potential acquirers. Nevertheless, projects still in the pre-operating period will almost always carry out pre-stripping and mining activities from which minerals will be produced and processed and thus taxable income will be generated against which the pre-stripping costs may be deducted in the that same year if the company has elected to fully deduct the expenditures in the same year. Otherwise, if an election is not made, those costs will not be tax deductible against such income until management decides that the project is in commercial production.

Companies that have elected to fully deduct pre-operating expenses for exploration and related mining activities in the year of expenditure may consider filing amended tax returns to change the original deduction and instead pool those same expenses and then amortize them at the maximum rate of 10% once the related project is in production.

Although Mexico has a five year statute of limitations, amended tax returns may be filed at any time and up to three times; however, this will re-open the year for which an amended return was filed to review by the tax authority for another five years. Nevertheless, there exists the risk that the tax authority may not permit a mining company to change the election through the filing of an amended tax return.
Flat tax

Since Mexico’s business flat tax (“IETU” by its Spanish acronym) is a tax based on cash flows instead of on an accrual basis, items such as depreciation are not deductible for IETU. All exploration or pre-operating expenditures will be deductible in the year the outlays are made.

Tax deductions taken for such expenses will usually result in a “loss” for IETU purposes since the companies should have no to little taxable IETU income. Where allowable deductions exceed taxable IETU income, this “loss” is multiplied by the IETU rate of 17.5% and may be carried forward for ten years as a credit to offset any future IETU liability.

Conclusion

Although exploration companies are focused on discovering mineral deposits, management of Mexican companies currently carrying out or planning to carry out exploration activities should consider the tax consequences as early as possible of the corresponding exploration outlays since taking income tax deductions in the year the expenditures are made could lead to the expiry of losses down the road and the loss of the accompanying deferred tax assets and benefits if a mineral deposit is located and a mine goes into production.

About the author

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