One Firm Worldwide®

WHITE PAPER

July 2023

Chile's New Mining Royalty Law: What It Means for Foreign Investors

Since the 1990s, Latin American states have sought to attract large-scale foreign investment by implementing specific policies and regulatory regimes aimed at attracting investors from abroad. This trend has, however, recently seen a reversal, and many Latin American countries, such as Mexico, Colombia, and Peru, have watered down their investor-friendly policies, specifically as concerns their natural resources. Chile, by and large, has not been at the forefront of this Latin American trend, but recent changes to its Mining Law imposing new taxes on large mining companies involved in copper production raise concerns.

This *White Paper* provides an overview of the history of Chile's Mining Tax Reform and recently adopted Mining Royalty Law, examines how these legislative changes may potentially affect large mining operators, and discusses how foreign investors might mitigate their legal and political risk in Chile through strategic investment planning and the assessment of potential international law remedies. We conclude with some observations and practical considerations for foreign investors addressing how to protect their existing or future investments in Chile.

INTRODUCTION

In recent years, many resource-rich Latin American countries, in an attempt to increase their control over their natural resources, have taken steps to reverse their historic pro-privatization policies of the 1990s. While states are imbued with the sovereign power to regulate within their territory in the interests of their population, this power is not absolute. When amending or promulgating laws and regulations aimed at increasing a state's control over its natural resources, Latin American states have a history of resorting to measures that can violate the international law protections granted to foreign investors in international investment treaties. We have previously discussed the ongoing wave of resource nationalism in Latin America, particularly with respect to recent regulatory changes in Mexico and Peru.

Most recently, Chile, generally considered an investor-friendly jurisdiction with a strong rule of law, has begun to show signs that it too is being swept up in this trend. Given its prominent position as a leading global producer of copper and lithium, the country's latest legislative changes in the mining sector raise legitimate concerns.

In December 2021, then-presidential candidate Gabriel Boric tapped into public anger at Chile's market-oriented economic model and became Chile's youngest president. As part of his campaign, President Boric promised to raise taxes to expand social services, fight inequality, and boost protection of the environment. In July 2022, President Boric introduced amendments to the Mining Tax Bill, which was undergoing discussion at the Senate at the time (the "Mining Tax Reform"). The Mining Tax Reform seeks to introduce a new tax—namely a mining royalty—applicable to large-scale mining companies and, in particular, those involved in copper and lithium mining.

Mining is the most important economic activity in Chile and the main economic sector receiving foreign direct investment. Mining is responsible for the direct generation of 14.6% of Chile's GDP, and if the multiplier effect it has on other industries is taken into account, its contribution to Chile's GDP is approximately 20%. Mining products account for 55% of Chile's total exports, and copper accounts for 90% of Chile's total mining exports. With an average production of five million to six million tons of copper per year, Chile is the largest global producer of copper, representing 27% of the world's copper production. It is the second largest lithium producer in the world.

The copper and lithium mining sectors therefore generate significant tax revenue for Chile. In general, a mining project in Chile has a tax burden of 38.4%, a level similar to that of benchmark countries such as Australia, Canada, Peru, and the United States. The proposed Mining Tax Reform seeks additional revenue through the imposition of extra taxes on those mining companies considered "large." The proposed changes create uncertainty for copper and lithium mining companies based in Chile that would be caught by the Mining Tax Reform. Foreign investors should be aware of these changes and consider available international treaty protections to safeguard their investments in Chile.

THE HISTORY OF THE MINING TAX REFORM

The predecessor of President Boric's Mining Tax Reform was the Mining Tax Bill, which dates back to September 12, 2018. The Mining Tax Bill was approved by the House of Representatives on May 6, 2021, in a first constitutional procedure, after which it was sent to the Senate. The Bill, however, was not approved by the Senate, but rather stalled there during the presidential elections.

In July 2022, as part of President Boric's promised tax reform, he introduced a series of amendments to the Mining Tax Bill. In particular, President Boric sought to establish a new tax aimed at increasing the mining sector's contribution to Chile's tax revenues and allocating part of the proceeds to the development of the country's regions and municipalities. The government estimates that the project will generate an annual revenue of 0.45% of GDP, in the order of US$1.5 billion. This is addressed later.

The Mining Tax Reform has found strong resistance from the industry, which fears its effect on the competitiveness of the mining sector. Some legislators have expressed concern that "the total tax burden will be a couple of points above that of Chile's mining competitors, such as Peru and Canada."[1] Others fear that the Mining Tax Reform could affect the profitability of certain mining companies.

Despite this pushback, and after undergoing a few iterations in Chile's Congress, Chile's House of Representatives approved the Mining Tax Reform through the "Mining Royalty Law" Bill on May 17, 2023.

THE MINING ROYALTY LAW

The Mining Royalty Law does not distinguish, in principle, between foreign and domestic mining investors. Rather, it establishes a new tax referred to as a "mining royalty," which will be applied to mining operators according to their sales revenue and volume of mining products exploited. In particular, the mining royalty consists of two components: (i) an *ad valorem* tax applicable to annual sales of large copper mining companies; and (ii) a tax applicable to mining companies' profit margins. The Mining Royalty Law further provides for the creation of funds for regional governments.

Under the Mining Royalty Law, a "mining operator" is defined as "any natural or legal person that extracts concessionable mineral substances and sells them at any stage of production."[2] "Mining product" is "the mineral substance of a concessionable nature already extracted, whether or not it has been the object of benefit, at any stage of production."[3]

The Mining Royalty Law and Affected Mining Operators

Not all mining operators will be affected by the mining royalty imposed by the Mining Royalty Law. The mining royalty will apply to large mining operators, meaning those whose annual sales are more than 50% copper and exceed the equivalent value of 50,000 metric tons ("MT"). With respect to these large mining operators, the Mining Royalty Law provides as follows:

- Mining operators whose annual sales are more than 50% copper *and* exceed the equivalent value of 50,000 MT of fine copper will be subject to: (i) a fixed *ad valorem* component of the Mining Royalty at a rate of 1% on their annual copper sales; and (ii) a "mining margin component" of the mining royalty, which will be applied on the mining operator's Adjusted Taxable Mining Operating Income[4] ("RIOMA" or *Renta Imponible Operacional Minera Ajustada*). The rate for the mining margin component will be between 8% and 26% depending on the mining operator's Mining Operating Margin.[5] In cases where the mining operator has a negative operating result (i.e., a negative RIOMA), the mining margin component will not be assessed.
- In addition, the Mining Royalty Law establishes a maximum potential tax burden, setting out a tax liability ceiling for large mining companies, which will take into account all assessed taxes including the mining royalty. This maximum potential tax burden will vary depending on the mining company's total production figures, as follows:
  - Mining operators producing more than 80,000 MT of fine copper will be subject to a maximum potential tax burden of 46.5% on their RIOMA.
  - Mining operators producing between 50,000 and 80,000 MT will be subject to a maximum potential tax burden of 45.5%.

For those mining operators that are not deemed "large" mining operators, the Mining Royalty Law provides as follows:

- Mining operators whose annual sales are less than 12,000 MT of fine copper are exempt from the payment of a Mining Royalty.
- Mining operators producing between 12,000 and 50,000 MT of fine copper will continue with their current progressive rate regime of between 0.4% and 4.4% of their annual production.
- Mining operators with annual sales of over 50,000 MT of fine copper, but whose overall copper production figure does not exceed 50% of their total production amount, will be subject to a marginal rate of 5% to 15%, depending on their operating margin.

Creation of Funds

The Mining Royalty Law provides for the creation of three government funds: the Mining Municipalities Fund, the Territorial Equity Support Fund, and the Regional Production and Development Fund. A total of US$450 million from the Mining Royalty Law revenues will be allocated to these funds and will go to regional governments and mining municipalities, including US$55 million for local mining communes.

* * *

While the Mining Royalty Law does not appear to be as cumbersome as similar tax reforms in other Latin American countries, the Mining Royalty Law could have negative effects on foreign and domestic investors. Industry insiders have stated

that the introduction of this mining royalty will undermine Chile's competitiveness. This is so, in particular, with respect to large mining producers that, after the approval of the Mining Royalty Law, would have a higher tax burden than they originally expected when making their investment and that they would have in other copper- or lithium-producing countries. A key concern is that large mining operators will become loss-making as a result of the mining royalty.

WHAT CAN FOREIGN INVESTORS DO TO PROTECT THEIR INVESTMENTS IN CHILE?

Foreign investors may protect their investment through one or more international investment treaties, of which there are more than 2,500 in force today. Chile is a party to more than 52 international investment treaties, including bilateral investment treaties, free trade agreements, and international treaties with investment provisions. One of the key features of international investment treaties is that they give foreign investors the right to initiate international arbitration directly against the state in which the investment is located, should a treaty breach occur, and the right to seek monetary damages for that breach in a neutral forum.

Not all investment treaties are created equal, however. Some treaties may contain less favorable jurisdictional and/or substantive protections than others. For example, each treaty might contain unique procedural requirements, such as temporal limitations for bringing an investor-state arbitration claim. Some treaties also contain so-called "fork-in-the-road" provisions requiring an investor to choose between bringing a domestic proceeding or an international arbitration. In some cases, fork-in-the-road provisions are so stringent that investors could potentially be foreclosed from all international fora under the applicable treaty if they initiate an action in local Chilean courts.

In terms of substantive treaty protections, while each treaty is slightly different and will be interpreted according to its own terms, in general, most investment treaties provide a set of specific substantive protections. These protections generally include: the right to fair and equitable treatment ("FET"), protection against unlawful expropriation without compensation, the right to full protection and security ("FPS"), as well as guarantees of national treatment and most-favored-nation treatment. A brief summary of each is included below:

- The **FET guarantee** is often broad and provides a guarantee of due process and access to the courts of justice and other tribunals, and requires states to refrain from committing a denial of justice. Violations of the FET provision may occur when, for example, a state's actions or omissions: (i) are not transparent and create an unstable or unpredictable legal framework or business environment for the investment; (ii) violate the investor's legitimate expectations, which were relied upon by the investor to make the investment; or (iii) are discriminatory or arbitrary.
- **Expropriation clauses** will generally provide that states may not nationalize investments except when it is for a public purpose, is done in a nondiscriminatory manner, is in accordance with due process of law, and only if full and adequate compensation is promptly paid to the investor. Expropriation may include outright takings of property (i.e., direct expropriation) as well as a substantial deprivation of value or control of the investment through a series of governmental measures that effectively expropriates the investment (i.e., indirect expropriation).
- The **FPS standard** creates an obligation for the host state to refrain from directly harming investors/investments through physical acts attributable to the state and to protect investors and investments against similar actions of private parties, e.g., in the course of civil unrest. FPS clauses generally require signatories to ensure, at minimum, the necessary level of police protection as required under customary international law, although some FPS clauses also include legal protection in addition to physical protection.
- The **national treatment** and **most-favored-treatment** obligations require each contracting party to accord to investors of the other contracting party and to their investments treatment no less favorable than the treatment it accords in like circumstances to its own investors and their investments or to investors of a noncontracting party and to their investments, respectively.

The Mining Royalty Law could potentially violate some of these provisions. For example, the tax increase imposed by the Mining Royalty Law could be substantial for large mining operators, potentially making it expropriatory. It could also contravene the investor's legitimate expectations to a stable legal

environment, thereby potentially violating the FET and/or FPS protections. Further, if the measures contained in the reform were to be applied disproportionately to foreign and domestic investors, this could be deemed a breach of national treatment and most-favored-treatment obligations. We note, however, that there is, to date, no indication the Mining Royalty Law would be applied differently to domestic and foreign investors.

While we cannot know, given the Law will not come into effect until January 2024, the manner in which Chile will apply the Mining Royalty Law to foreign investors or the way in which it will affect them, similar laws passed by other Latin American states have resulted in violations of international law and applicable investment treaties. For example, in *ConocoPhillips v. Venezuela*, an arbitral tribunal held that an increase in Venezuela's income tax and extraction tax rates ultimately led to the nationalization and unlawful expropriation of the investor's heavy crude oil and offshore projects.[6] With respect to the FET standard, the tribunal in *Mobil v. Argentina* held that Argentina's imposition of an export tax that contradicted the government's "specific commitment" to the foreign investor frustrated the investor's legitimate expectations and thus "amount[ed] to an objective breach of the fair and equitable treatment standard due under the Treaty."[7] Finally, the tribunal in *Corn Products v. Mexico* held that Mexico had violated its national treatment obligations when it imposed a high fructose corn syrup tax on foreign producers of soft drinks, while not imposing any tax measures on local Mexican producers.[8]

Importantly, an investor's ability to access the above investment protection guarantees is determined by the nationality of the investor and the location of the investment. If, for example, the investor is incorporated in Turkey, and the investment is located in Chile, there will be no international law protections afforded to the investor because there is no treaty in force between Turkey and Chile. If, however, before the dispute arises, a Turkish investor were to restructure its investment and establish a subsidiary, or other form of corporate vehicle, in a state that has a treaty in force with Chile—e.g., in the United States—the investor's investment likely would gain international law protections. Choosing a corporate structure that maximizes treaty protection before a dispute arises is therefore a worthwhile endeavor to ensure that, when a dispute arises or is foreseeable, the foreign investor and its investment can access the most advantageous international law protections possible.

CONCLUSION

If you are concerned about your existing or future investments in Chile, you should consult experienced international counsel to analyze your investment's corporate structure and determine whether it is already protected by a robust investment treaty. Where an investment does already benefit from such protection, it would be helpful to carefully examine each applicable treaty given that both international law protections and the particular strength of those protections vary widely. If no treaties (or only subpar treaties) are available under the existing corporate structure, it will be possible to restructure existing investments with respect to disputes that *are not yet foreseeable* to ensure that one of the corporate vehicles in the chain of ownership provides favorable protections. Restructuring too late could be considered, by an arbitral tribunal, as illegitimate treaty shopping, foreclosing treaty protection for the foreign investor.

LAWYER CONTACTS

Antonio Canales
Madrid
+34.91.520.3939
acanales@jonesday.com

James Egerton-Vernon
Washington
+1.202.879.3610
jegertonvernon@jonesday.com

Melissa Stear Gorsline
Washington
+1.202.879.5421
msgorsline@jonesday.com

Cristina Pérez Soto
Miami / New York
+1.305.714.9733 / +1.212.326.3939
cperezsoto@jonesday.com

Luis Riesgo
São Paulo
+55.11.3018.3939
lriesgo@jonesday.com

Maria I. Pradilla Picas
Washington
+1.202.879.4640
mpradillapicas@jonesday.com

Associates Marian Chávarri and Viktoriia Korynevych contributed to this White Paper.

ENDNOTES

1 ExAnte; *Nueva indicación al royalty dejaría a Chile con una carga a la minería superior a sus competidores Perú, Australia y Canadá*; April 19, 2023.

2 Article 1.1 of the Senate draft of the bill—"*Explotador minero: toda persona natural o jurídica que extraiga sustancias minerales de carácter concesible y las venda en cualquier estado productivo en que se encuentren.*"

3 Article 1.2 of the Senate draft of the bill—"*Producto minero: la sustancia mineral de carácter concesible ya extraída, haya o no sido objeto de beneficio, en cualquier estado productivo en que se encuentre.*"

4 Adjusted Taxable Mining Operating Income ("RIOMA") is the taxable net income of the taxpayer, determined in accordance with articles 29 to 33 of the Income Tax Law, and adjusted in accordance with article 6 of this law.

5 Mining Operating Margin ("MOM"): the quotient resulting from dividing the Adjusted Mining Operating Taxable Income by the taxpayer's mining operating income, multiplied by 100.

6 *ConocoPhillips v. Venezuela*, ICSID Case No. ARB/07/30, Interim Decision dated Jan. 17, 2017, ¶ 156(3).

7 *Mobil v. Argentina*, ICSID Case No. ARB/04/16, Decision on Jurisdiction and Liability dated Apr. 10, 2013, ¶¶ 985–87.

8 *Corn Products v. Mexico*, ICSID Case No. ARB(AF)/04/1, Decision on Responsibility dated Jan. 15, 2008, ¶¶ 141–42.

Jones Day publications should not be construed as legal advice on any specific facts or circumstances. The contents are intended for general information purposes only and may not be quoted or referred to in any other publication or proceeding without the prior written consent of the Firm, to be given or withheld at our discretion. To request reprint permission for any of our publications, please use our "Contact Us" form, which can be found on our website at www.jonesday.com. The mailing of this publication is not intended to create, and receipt of it does not constitute, an attorney-client relationship. The views set forth herein are the personal views of the authors and do not necessarily reflect those of the Firm.

© 2023 Jones Day. All rights reserved. Printed in the U.S.A.