Australian Government

Policy Transition Group

ISSUES PAPER

TECHNICAL DESIGN OF THE MINERALS RESOURCE RENT TAX

TRANSITIONING EXISTING PETROLEUM PROJECTS TO THE PETROLEUM RESOURCE RENT TAX

AND

POLICIES TO PROMOTE EXPLORATION EXPENDITURE

1 OCTOBER 2010

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FOREWORD

On 2 July 2010, the Government announced its intention to introduce a new Minerals Resource Rent Tax for the mining of iron ore and coal and to extend the existing Petroleum Resource Rent Tax to all oil and gas projects in Australia, including the North West Shelf. The key design features for the MRRT and PRRT extension were also announced.

To ensure the application of these measures is both fair and effective, the Government has formed the Policy Transition Group (PTG), with members drawn from government, the resources sector and the taxation profession to provide expert advice on design and implementation issues. A key aspect of the PTG's mandate is to consult closely with affected stakeholders and other interested groups in the development of its advice.

The PTG has prepared the attached paper to serve as a platform for consultation and to inform stakeholders of initial views on key issues. To complement the issues paper, a template financial model is provided on the PTG website, which businesses can use to assist them in quantifying aspects of the proposed tax. This is a process of genuine consultation and we would stress that the issues paper, and any views canvassed therein, are preliminary and should be not read as final statements of intent.

The PTG would like to hear from a wide range of interested stakeholders to ensure we deliver the best possible advice. To this end, we invite stakeholders to provide written submissions on issues contained in the PTG terms of reference by 28 October 2010. We have published a schedule for formal consultations across Australia on the PTG website and would also encourage stakeholders to indicate their interest in attending consultation sessions with the Group. The PTG Website can be found at the future tax website (www.futuretax.gov.au) and the PTG Secretariat can be contacted at PTG@RET.gov.au

We look forward to working closely with you in progressing this important issue.

Yours sincerely

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INTRODUCTION

TRANSITION TO A NEW RESOURCE TAX REGIME

1. On 2 July 2010, the Government announced new taxation arrangements for the resources sector. From 1 July 2012, a new Minerals Resource Rent Tax (MRRT) will apply to coal and iron ore, and the Petroleum Resource Rent Tax (PRRT) will be extended to include all oil and gas projects. The broad design features of the MRRT and extension of the PRRT were outlined in the Government's 2 July 2010 press release and MRRT Fact Sheet, available at the Futuretax website (www.futuretax.gov.au).

2. The Government also announced it would establish the Policy Transition Group (PTG) to advise on the technical design of the new arrangements. The establishment of the PTG was formalised through the Government's announcement of 3 August 2010, announcing the members of the PTG and its terms of reference (Attachment A).

3. The PTG is to provide its advice to the Government by the end of 2010 to enable the supporting legislation to be introduced to Parliament in 2011. In developing its advice, the PTG will consult directly with affected companies, relevant Australian Government agencies and State and Territory governments.

4. The release of this Issues Paper represents the first step in the consultation process. It will be complemented with a round of formal meetings with stakeholders and an invitation to provide the PTG with written submissions on the issues raised under its terms of reference. The PTG invites submissions by 28 October 2010. They will be made public through the PTG website unless indicated otherwise. Any commercially sensitive information provided will remain confidential within the PTG. More detail on the submission process is available at the Futuretax website.

5. This paper is designed to highlight the key implementation issues and potential design options for the MRRT, the extension of the PRRT and potential exploration incentives. It includes a set of guiding questions to assist stakeholders in preparing their submissions to the PTG and in their direct consultations with the PTG or the Secretariat. There may be a need to undertake further targeted consultations later in the process to test proposals or explore points raised in submissions.

6. To further assist this process, the PTG has prepared models to assist companies in understanding how the MRRT and PRRT extension would affect their projects including the size of any tax liability. In particular, the models assist in understanding the significance and implications of immediate deductibility, of new capital expenditure, the interest allowance (uplift), starting base depreciation, the royalty credit and the $50 million threshold. While it has been necessary to make some policy assumptions to simplify the models, this is not intended to pre-empt consultation with industry. These models and associated guidance material are available at the Futuretax website.

7. The PTG will develop recommendations to the Government following its consultative process. These recommendations will inform the preparation of exposure draft legislation and explanatory materials, to be released for comment in the first half of 2011 before submitting final legislation to the Parliament.

TERMS OF REFERENCE FOR THE PTG

8. The terms of reference for the PTG are contained in Attachment A.

9. There are four key elements to the terms of reference:

   - the technical design and implementation of the MRRT;
   - the transition of existing petroleum projects to the PRRT;
   - the smooth interaction between the MRRT, PRRT and State and Territory royalties; and
   - consideration of the best way to promote future exploration to ensure a pipeline of resource projects.

10. The terms of reference provide the broad design parameters for the MRRT and the transition to the PRRT. It is not the role of the PTG to revisit these design parameters. Nor is it within its role to review the existing design of the PRRT, though industry concerns with the PRRT may provide insight regarding the design of the MRRT.

11. A range of technical issues remain to be resolved for the appropriate legislation to be drafted and enacted for the proposed start date of 1 July 2012. The terms of reference set out a number of specific issues for consideration by the PTG:

   - the definition of a project and project interest;
   - the definition of exploration expenditure;
   - the taxing point and valuation methods to be used for the commodity;
   - eligible project expenditure;
   - the determination and calculation of the starting base for existing projects, including the rules for electing a particular starting base;
   - the tax treatment of the starting base and of capital expenditure incurred between 2 May 2010 and 1 July 2012;
   - a workable exclusion where resource profits are below $50 million per annum;
   - crediting State and Territory royalties;
   - integrity rules supporting the policy underpinning the new resource taxation arrangements; and
   - identifying opportunities to minimise associated compliance and administration costs.

12. The focus of the PTG will be on those design features that are required to enable the MRRT to be legislated in a way that is consistent with the announcement of 2 July 2010. In particular:

   - drawing from Australian and international tax practice and precedent where relevant to ensure the practical application of the MRRT and PRRT transition is clearly defined;

- developing administrative and compliance requirements that are, as much as possible, consistent with existing business and compliance practices and systems; and

- identifying and resolving transitional issues that cause unintended adverse impacts on either taxpayers' commercial interests or the Government's intended policy outcomes.

13. It is intended that the legislative design for the MRRT fit within the context of work being undertaken to progress the development of a single Tax Code. This means that to the greatest extent possible, the design of the MRRT should draw upon existing tax concepts and definitions.

DESIGNING AND IMPLEMENTING THE MRRT AND PRRT EXTENSION

14. It is desirable that the MRRT and extension of the PRRT not unduly distort taxpayer decisions. As a tax on economic rent or profit, the MRRT and PRRT should be relatively efficient forms of taxation. In practice, this will be influenced by the technical design and implementation of the tax. A number of guiding principles or objectives for the PTG will be to design a tax that:

    - is broadly neutral across included resources and different project configurations;

    - minimises taxpayer uncertainty and compliance costs;

    - applies general tax principles in a consistent fashion; and

    - minimises incentives for tax avoidance and maintains the integrity of the tax base.

15. Tax neutrality is an important principle for government and business. For example, in setting an appropriate taxing point, the PTG will consider the potential effect on the relative competitive position of producers of substitutable products and any incentives to alter the location of activities in the production process.

16. Some degree of complexity, compliance and administration costs will be an unavoidable feature of the new resource taxation arrangements. The PTG aims to minimise these consequences, particularly for smaller miners. In designing elements of the tax, the PTG will draw from Australian and international tax practice and precedent. Administrative and compliance requirements should be, as much as possible, consistent with existing business and compliance practices and systems.

17. There are trade-offs between flexibility and certainty in the design and administration of tax legislation. On the one hand, a less prescriptive approach provides flexibility so taxpayers and the Tax Office can apply the law to the particular circumstances of the resource project or resource entity. This approach can also accommodate future changes in the way mining operations are conducted or structured, without the need for legislative amendment. Alternatively, a more prescriptive approach provides taxpayers with greater certainty that they are compliant with the law but reduces flexibility. The PTG will seek to strike an appropriate balance in this aspect of the design of the MRRT and PRRT extension. It may be appropriate to supplement a principle-based design approach to the law with specific default or 'safe harbour' approaches in some circumstances.

18. Stability in the design of the tax law is particularly important for investment decisions involving large amounts of fixed capital, long lead times to production and lengthy production timeframes. A well designed tax law with structures that accommodate future evolution in industry practice is likely to prove more stable and sustainable through time. Stability in the law will also flow from a design that ensures the integrity of the tax base.

19. There will be tradeoffs between these objectives and constraints. In making judgements about the best way to resolve such trade-offs, the PTG will be informed by the consultation process. Its judgements may not align with the views of individual stakeholders. The PTG will strive to be open and explicit where such judgements are made.

20. In accordance with the PTG's terms of reference, the cost of any policy deviation from the Government's announcement of 2 July 2010 is to be fully offset within the recommendations in terms of its impacts on revenue or costs.

STRUCTURE OF THE ISSUES PAPER

21. The paper is structured in four Parts.

- Part A explains the concept of a resource rent tax. It then discusses which resources are liable for the MRRT and PRRT. The potential scope of the MRRT and PRRT regimes is an issue that arises in the case of less conventional uses of coal, such as the production of coal seam methane, underground coal gasification, coal to liquids, gas to liquids and the utilisation of coal mine gas.[1]

- Part B provides an overview of the MRRT, followed by a discussion of the design features of the MRRT outlined in the terms of reference. This discussion is organised under five topics: the definition of an MRRT project; determining the taxable value of a project; the treatment of losses and royalties; calculating the starting base for existing projects; and the $50 million threshold.

- Part C provides an overview of the PRRT followed by a discussion of the issues arising from the extension of the PRRT to onshore oil and gas projects and other oil and gas projects not currently subject to PRRT. This discussion is organised under four topics: the definition of a PRRT project; determining the taxable value of a project; the treatment of losses and royalties; and calculating the starting base for existing projects.

- Part D examines the need for, and merits of, policies to promote exploration to ensure a pipeline of resource projects for future generations.

[1] The terms of reference state that the PRRT is to apply to coal seam methane.

Part A

UNDERSTANDING RESOURCE RENT TAXES

1 WHAT IS A RESOURCE RENT TAX?

1.1 Taxation of resource profits through a resource rent tax

22. A resource rent tax is designed to capture a portion of the rents earned from the extraction of non-renewable resources. Rent is defined as profit in excess of the normal return to capital invested in the project. It is one mechanism for pricing the resource from which mining companies earn their profits, by transforming the resource in the ground to a saleable commodity.

23. Royalties are another mechanism for pricing these resources. In contrast to royalties, which are based on the volume or value of the resource regardless of the profitability of the project, a resource rent tax aligns the resource charge with the profitability of the project. That is, as profit levels increase the revenue raised by a resource rent tax will increase and, similarly, as profits fall the tax obligation on the entity will also fall.

24. The PRRT and the MRRT broadly reflect a project-based resource rent tax, more so in the case of the existing PRRT than with the MRRT or the PRRT extension. The key feature that distinguishes the MRRT and PRRT extension from the existing PRRT is that they only 'price' the resource in circumstances where the profitability of a project is sufficiently high that the rent-based tax exceeds existing resource charges.

25. The PRRT and MRRT aim to tax the rents or profits attributable to the value of the resource. Design features intended to achieve this outcome are to set the point at which the value of the resource is assessed, the taxing point, in proximity to the existence of a saleable commodity(ies) and to recognise the costs of producing the commodity to this point, including a return to capital.

26. As a project based tax, expenditure and receipts to which the MRRT or PRRT apply must have a direct link to the project. The broader activities of an entity, and the associated revenues and expenditures, will not be subject to the tax.

27. Losses resulting from a project subject to a project-based rent tax would normally only be used to offset the future revenue earned by that project. In a project-based tax, excess project losses would not normally be deductible against resource income derived from other projects, or be refunded.

28. Where losses are required to be carried forward and offset against future project profits, an annual interest allowance (or uplift) is provided in respect of the carried loss. The rate of interest is intended to compensate for the risk that the loss may not be recouped. In a pure project based tax, the interest allowance is set to match the project risk.

29. Under the MRRT, an entity will be able to transfer certain forms of loss from one project to another to offset an MRRT liability. The PRRT also allows loss transfer but only in respect of exploration expenditure and subject to certain restrictive conditions.

30. The design features of the MRRT were established on the basis that losses would not be refundable, as the industry placed little value on the refundability of losses. Giving effect to this condition necessarily imposes some constraints on the way losses may be used under the MRRT, notwithstanding transferability is an intended design feature.

31. The interest allowance under the MRRT is equivalent to the Long Term Bond Rate plus seven percentage points (LTBR +7). This single rate is above the uplift rate for general expenditure under the PRRT (LTBR +5) but below the uplift rate for certain exploration expenditure (LTBR +15). Under the PRRT, the uplift rate for older exploration expenditure is set at the Gross Domestic Product deflator.

Table 1.1: Comparison of the MRRT and PRRT(a)

Feature	MRRT	PRRT
Basis of tax	Project-based tax	Project-based tax
Tax rate	30 per cent	40 per cent
Extraction allowance	25 per cent reduction in MRRT liability	None
Profit or loss calculation	Assessable receipts less deductible expenditure less uplifted carry forward losses	Assessable receipts less deductible expenditure less uplifted undeducted expenditure
Deductible expenditure	Non-deductible expenditure will be broadly consistent with PRRT	Expenditure directly related to the project that falls within the definition of exploration, general or closing down expenditure. Some expenditures are excluded from deductibility
Treatment of expenditure	Immediately expensed against revenue	Immediately expensed against revenue
Transferability of losses	Transferable to other MRRT projects	Transferability is restricted to exploration expenditure
Treatment of losses	Uplifted and carried forward to offset future revenue. Market value starting base not uplifted.	Undeducted expenditure uplifted and carried forward to offset future revenue
Uplift rates	A single uplift rate	Multiple uplift rates differentiated by the class and timing of expenditure
Treatment on sale of project interest	Losses and cost bases are transferred to new owner	Losses and cost bases are transferred to new owner
Treatment for income tax	Deductible	Deductible
Treatment of state royalties	Creditable against MRRT liability, excess will be uplifted to apply against future liabilities. Non-refundable.	Creditable against PRRT liability, excess will be uplifted to apply against future liabilities. Non-refundable.

(a) Some design aspects of the MRRT and the PRRT extension are not specified in the terms of reference. Where this is the case this comparison is restricted to the terms of reference.

1.2 Comparison of MRRT/PRRT and company income tax

32. Resource rent taxes, such as the MRRT and PRRT, are a mechanism for charging for the use of non-renewable resources through the taxation of resource profits. Income tax is designed to tax an entity's annual profit.

33. Consequently, the two regimes are fundamentally similar. Under each, the tax base is derived by subtracting annual expenses from annual assessable amounts and losses are carried forward to be deducted against future years' assessable amounts.

34. However, there are key differences which arise from the application of MRRT/PRRT as project-specific taxes levied on the net value of a resource at a defined point in the production value chain. By contrast income tax is not specific to a type of profit or to any particular project. This means there is a greater need to attribute expenditure and receipts to specific activities under the MRRT/PRRT than under the income tax.

35. Some key structural differences in the features of the two types of tax include:

- Expenditure on capital is immediately deductible under the MRRT/PRRT but is usually amortised under income tax.
- Under both types of tax, losses are carried forward to be offset against future taxable income. Under income tax, losses are carried forward at their nominal value. In the case of the MRRT/PRRT an annual interest allowance, aiming to compensate for project risk, 'uplifts' the value of the loss and provides a further deduction against future taxable income. The MRRT/PRRT approach ensures that the real value of each expense is deducted and provides for a minimum return on capital, thereby only taxing rents in excess of a minimum level of profitability.
- Under an income tax, interest is deductible as the cost of debt, but the cost of equity is not deductible. Under a rent tax, debt and equity costs are effectively deductible at the specified uplift rate. Consequently, actual debt financing expenses, such as interest, are deductible under income tax but not under the MRRT/PRRT. This non-deductibility reflects the objective of pricing the underlying resource without reference to the way its development is financed. Further, because the interest allowance on carried losses ensures a uniform minimum return to capital invested in the project, allowing deductions for financing costs would provide a double deduction for the cost of capital.
- Under the MRRT/PRRT, State mining royalties are not viewed as costs that reduce profits from extracting resources, as they are for income tax purposes. Instead, they are viewed as another way of taxing the resource, and so are credited against the liability for MRRT/PRRT to avoid double taxation.

2 RESOURCES SUBJECT TO THE MRRT AND PRRT

Terms of reference

The new resource tax *[MRRT]* will apply from 1 July 2012 only to mined iron ore and coal. All other minerals are excluded.

The PRRT will be extended to all Australian onshore and offshore oil and gas projects.

Summary

The terms of reference clearly elaborate which resources will be subject to MRRT and PRRT as of 1 July 2012. An issue is whether the legislation can draw upon the ordinary meaning of the terms coal, iron ore, oil and gas, or whether it will be necessary to include a robust legal definition for each resource to enable entities to comply with the law and the Tax Office to administer it.

The definition of coal and iron ore: To efficiently administer and comply with the MRRT, it will be important for taxpayers and the Tax Office to understand what coal and iron ore are.

The scope of the extension of the PRRT: From 1 July 2012 the PRRT will apply to all Australian onshore and offshore projects with the exception of projects within the Joint Petroleum Development Area in the Timor Sea.

Taxation of alternative coal technologies: Coal seam methane will be subject to the PRRT. Other technologies that extract methane or convert coal into petroleum products as part of an integrated mining and processing operation will be liable for either the MRRT or PRRT, if the conversion takes place inside the taxing point. There is a need to define a guiding principle for their inclusion in one of the two regimes.

Taxation of multi-product mines: The application of the MRRT and PRRT to a mine extracting both included and excluded resources, particularly where one of the resources is ancillary, needs to be determined.

Questions

Question 2.1: Are the terms 'iron ore' and 'coal' sufficiently well understood that they could be used without definition, or should detailed definitions be used? If detailed definitions are required, how should they be worded?

Question 2.2: What principle(s) should determine whether the MRRT or PRRT should apply to alternative coal technologies, both existing and prospective?

Question 2.3: How should operations involving incidental production of included or excluded commodities be treated under the MRRT and PRRT? Where an apportionment approach is considered appropriate, should the approach be defined by the taxpayer or legislated?

2.1 The definition of iron ore and coal

36. To efficiently administer and comply with the MRRT, it will be important for taxpayers and the Tax Office to understand the scope of the MRRT, and this will require them to know what coal and iron ore are.

37. One approach is for the legislation to simply use the expressions 'iron ore' and 'coal' without further explanation, relying on them having sufficiently well understood meanings that there would be no, or minimal, ambiguity. If that is right, this approach is the simplest and most effective way of ensuring the legislation achieves its intended scope.

38. A second approach would be to provide detailed definitions of those terms. There are several ways in which this could be done.

39. One way to define the terms would be to refer to their scientifically described sub-categories and trust that they would have a better understood meaning than the broader terms. For example, coal can be classified into four categories: Lignite, Sub-bituminous, Bituminous and Anthracite, and iron ore can be classified into banded/bedded iron formations, channel iron deposits and detrital iron deposits.

40. A second way would be to define the terms by reference to their general characteristics, as dictionaries do. For example, 'iron ore' might be defined as naturally occurring material from which the metal iron can be economically extracted and 'coal' might be defined as an organic rock formed by the accumulation and decomposition of plant material.

41. If the general terms are uncertain, these more detailed approaches might provide more certainty about the scope of the MRRT, but would come at the costs of greater complexity and the risk that the scope of the legislation might extend to something not intended to be included, or vice versa.

42. If considered necessary, possible definitions for iron ore and coal, modelled on the PRRT marketable product approach might be:

> a '**saleable iron ore commodity**' means any ore from which Iron (Fe) is extracted or any other product declared by the regulations to be a saleable iron ore commodity; not being a product produced from a saleable iron ore commodity.
>
> a '**saleable coal commodity**' means any of the following products:
>
> (a) black coal;
> (b) thermal (steaming) coal;
> (c) metallurgical (coking) coal;
> (d) brown coal (lignite);
> (e) any other product declared by the regulations to be a saleable coal commodity; not being a product produced from another product of a kind referred to in sub-points (a) to (d) (inclusive).

2.2 The scope of the extension of the PRRT

43. The Government's press release of 2 July 2010, to which the terms of reference refer, states that the PRRT will be extended to all Australian onshore and offshore oil and gas projects. This excludes the Joint Petroleum Development Area in the Timor Sea. Projects in that region are covered by The Timor Sea Treaty (2003). All other oil and gas projects will be covered by the PRRT transition, including the North West Shelf, Barrow Island and other coastal and onshore projects.

2.3 Taxation of alternative coal technologies

44. It is clear from the terms of reference that the extraction of coal will be subject to the MRRT and that the production of coal seam methane will be subject to the PRRT extension. It will need to be specified which regime is to apply to other coal technologies that produce petroleum products from the underlying coal resource, such as underground coal gasification, the utilisation of coal mine methane, coal to liquids and gas to liquids projects.

    - Coal seam methane (CSM) production involves the extraction of gas that lies within the coal seam through a series of gas wells. The underlying coal resource is not disturbed or consumed in this process.

    - Underground coal gasification (UCG) involves the combustion of coal in situ and the extraction of the syngas (which is similar to coal seam methane) produced through the combustion process. The underlying coal resource is consumed in producing syngas.

    - Coal mine methane (CMM) or waste coal mine gas (WCMG) is a by-product of underground mining operations that needs to be removed for mine safety, but which can be used to fuel power generation facilities. Its production is incidental to the mining operation.

    - Coal to liquids (CTL) is an emerging industry in Australia involving the conversion of mined coal into a range of petroleum products. A number of pilot plants are currently exploring various coal to liquids technologies. In this case coal may be extracted prior to a conversion process.

    - Gas to liquids (GTL) involves the conversion of gas into petroleum products. The gas used as feedstock for this process can be sourced from traditional petroleum sources, coal methane or syngas.

45. The different rates of tax applicable under the MRRT and PRRT mean the choice of tax could have a material impact on the competitive position of coal technology vis-a-vis other coal mining activities or other oil and gas production. It should be noted that the conversion of extracted coal or gas into liquids would not fall within the scope of the MRRT or PRRT where the coal or gas is acquired through an arm's length purchase. Where the conversion is part of an integrated mining/processing operation, the processing may well be downstream of the taxing point and, hence, not subject to resource taxation. The setting of the taxing point is discussed in Section 5.1.

46. In deciding which tax should apply to each of the coal technologies, an objective should be to tax them in a competitively neutral fashion. The principle of competitive neutrality could be applied to either the form in which the resource occurs naturally (i.e. all production from a coal resource is subject to the MRRT) or the form in which it is first produced (i.e. all petroleum and gas production is subject to the PRRT).

47. Applying these principles yields three possible approaches:

    - The first is to tax all production processes involving the consumption of the coal resource (CTL and UCG) under the MRRT and those involving the extraction of gas without the consumption of the coal resource (GTL, CMM) under the PRRT.

- The second is to tax the production processes involving the extraction of coal (CTL) under the MRRT and those involving the extraction of methane (GTL, UCG, CMM) under the PRRT.

- The third is to determine the nature of the resource at the taxing point. If the resource is in the form of coal, the MRRT would apply irrespective of any subsequent processing. If the resource is in the form of gas then the PRRT would apply.

48. As noted above, the coal seam methane sector would be subject to the PRRT. Should the coal resource be mined following a coal seam methane operation, the mining operation would be subject to the MRRT. In the case of coal mine methane, a further consideration is whether it would be taxed as a by-product of coal production under the MRRT. This issue is discussed in the next section.

2.4 Taxation of multi-product mines

49. Mining operations involving the production of iron ore, coal, oil or gas could involve the production of excluded commodities. Three permutations are possible:

- First, coal and iron ore mining operations (and possibly some onshore projects subject to the PRRT) could involve the production of excluded minerals or other by-products. For example, some iron ore mines also produce small amounts of copper, gold, lead or zinc and significant volumes of water can be produced as a by-product of producing coal seam methane.

- Second, some mining operations concerned primarily with the extraction of minerals not subject to the MRRT or PRRT could involve the production of small amounts of included commodities. For example, iron ore may be produced as a by-product of bauxite mining in some regions.

- Third, some projects could involve mining operations assessable under the MRRT, as well as operations assessable under the PRRT. For example, underground coal mining operations could involve the sale of coal mine methane.

50. In these situations, applying the MRRT and/or PRRT in strict accordance with the stated policy intent would require apportionment of the revenue and expenditure attributable to the commodities assessable under the MRRT or PRRT, or excluded from assessment under either tax. Doing so could be compliance intensive and may be approximate at best. For example, if the taxing point were set close to the resource, it might not be possible to attribute costs up to that point to the individual commodities produced.

51. In cases where the production of the additional commodity(ies) is incidental to the principal activity, an alternative approach might be to include the incidental activity within the scope of the relevant tax in the first case above, exclude the incidental activity from the relevant tax in the second case and apply the MRRT/PRRT to the entire project in the third case, with the selection of tax being based on the primary production activity. This approach would, however, require a methodology to determine when production is incidental.

52. Under the apportionment approach, a simple and transparent method of apportionment would be desirable to ensure such operations are not faced with onerous processes that significantly increase administration and compliance costs. The

apportionment methodology could be left to the company to undertake on a 'fair and reasonable basis' as with other areas of tax law, and justify their approach to the Tax Office as required.

53. The basis for apportionment could be volume or revenue based, as appropriate. These approaches could result in significantly different outcomes. Hence, the appropriate approach could vary depending upon the individual circumstances of the mine, with potentially different approaches being used in apportioning receipts and expenditure.

54. Alternatively, a more prescriptive approach could be considered, under which the legislation would specify the approach to be taken in particular circumstances. While this would provide entities with certainty as to the outcome, the defined methods might not be the most appropriate in every situation.

55. A particular dimension of the apportionment exercise would be in respect of successful exploration expenditure, which may include discoveries of both excluded and included commodities. An appropriate means of apportioning such exploration expenditure would be required. The assignment of exploration expenditure is also discussed in Section 4.2.

Part B

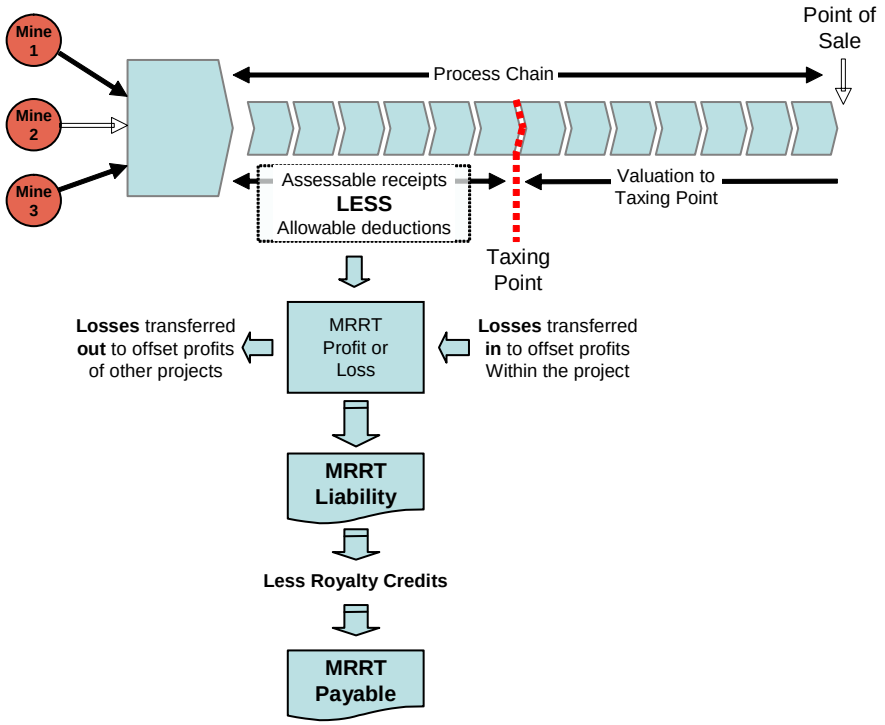
TECHNICAL DESIGN OF THE MRRT

3 OVERVIEW OF THE MRRT

3.1 How the MRRT works

56. Figure 3.1 presents a stylised view of the MRRT for a hypothetical resource project.

Figure 3.1: A stylised representation of the MRRT



Source: Policy Transition Group Secretariat

57. At the left side of the figure are three geographically separate mines assumed to be serviced by a centralised processing facility. Each mine could have associated with it a separate mining licence and be a project unit. The three mines and the centralised hub are combined into a single project to which the MRRT applies (see Section 4.1).

58. The extracted resource will pass through a number of steps that comprise the production value chain before reaching the point of sale. These will include activities such as crushing, screening, upgrading, blending, loading and transport. Some of these activities could occur within each mine site, some at the centralised hub and some further downstream.

59. The taxing point represents the point within this set of activities at which the assessable value of the resource will be determined. In practice, the taxing point will be the earlier

of an arm's length sale of the resource or a defined point in the value chain.[2] The taxing point will also determine the expenditures that are deductible for MRRT purposes. Only expenditures incurred in bringing the resource to the taxing point would be deductible against MRRT receipts (see Section 5).

60. Where an arm's length sale of the resource occurs downstream of the taxing point, determining the assessable value of the resource will require the value added to the product through processes undertaken downstream of the taxing point to be netted off the sale price (see Section 5.2).

61. An MRRT profit or loss for the year will be determined after deducting all deductible expenditure from the assessable revenue of the project (see Sections 5.2, 5.3 and 5.4).

62. If the project has an MRRT profit after applying any carried forward losses from previous years, and the taxpayer has another project in a loss position, the losses in the other project can be transferred to the profitable project up to the point where the loss in the other project is fully utilised or the taxable profit in the profitable project is reduced to zero.

63. Alternatively, if the project generates a loss and the taxpayer has another project with an MRRT profit, the loss can be transferred to offset the profit in the other project. The amount transferred cannot exceed the profit in the other project. If the loss cannot be transferred to another project, an interest allowance at the rate of the LTBR +7 percentage points is deductible in the following year. The interest allowance also applies in respect of any carried forward losses from earlier years that are not able to be utilised in the current year.

64. The MRRT liability is calculated by applying the 30 per cent tax rate against the MRRT profit. This amount is then reduced by 25 per cent through the extraction allowance. The extraction allowance is intended to recognise the contribution of the miner's expertise to profits at the mine gate.[3]

65. If the project has paid a royalty during the year, or has a royalty balance carried forward from previous years, this is offset against the project's MRRT liability to arrive at the net MRRT payable for the project (see Section 6.6).

66. Investment in projects in existence at the time of the announcement of the MRRT is recognised through a starting base. Entities have the choice of deriving their starting base through a market value calculation (that includes the value of the resource) or a book value calculation (that excludes the value of the resource). The starting base is deductible over a defined period, which differs depending on the chosen method. Special rules apply to the starting base (see Section 7).

67. This discussion is primarily concerned with the application of the MRRT to activities occurring upstream of the taxing point. However, where the first arm's length sale of a

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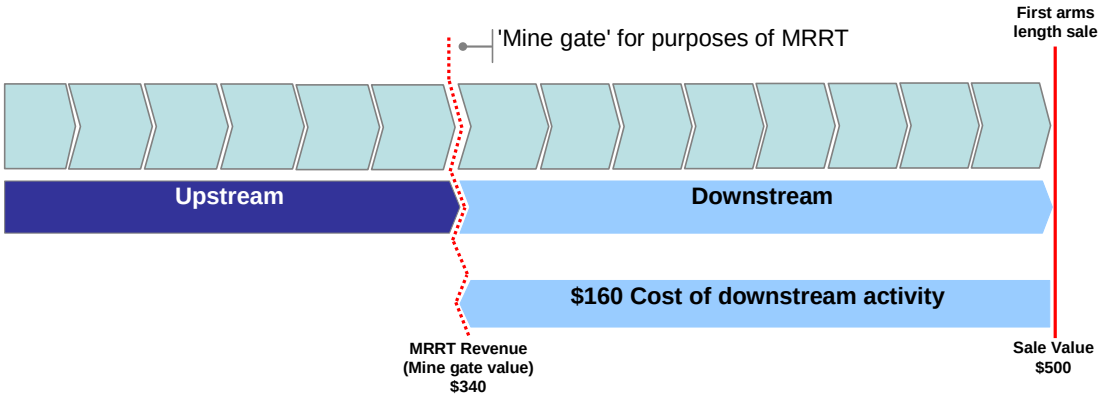
[2] Were the resource to be exported prior to one of these events occurring, the point of export would be the taxing point. Taxing value created in other jurisdictions is administratively difficult, so it would be desirable that the legislated taxing point occur within the Australian tax jurisdiction. This would reduce incentives to shift value downstream of the taxing point.

[3] Where an arm's length sale does not arise within the Australian tax jurisdiction, international transfer pricing principles would need to be applied in establishing the resource value at the taxing point.

product occurs downstream of the taxing point, similar procedures to those involved in determining MRRT profit are required to establish the value of the downstream activities and thus calculate the value of the resource and MRRT profit at the taxing point. That is, MRRT profit will be a product of both the value ascribed to downstream activities and the method of determining MRRT profit derived from upstream activities. Figure 3.2 compares the elements of the value calculation applied upstream and downstream of the taxing point for a project in existence at 2 May 2010.

Figure 3.2: Attributing value in the production value chain



Source: Policy Transition Group (PTG) Secretariat

68. The full value of the project will be taken into account where the first arm's length sale occurs at the end of the production value chain. The value of downstream activities will be a function of the downstream operating expenses, the downstream asset base and an appropriate return to capital (profit margin). This calculated value would be netted from sales revenue to determine MRRT assessable revenue. MRRT profit will be determined as assessable revenue less deductible expenditure (including capital expenditure), the interest allowance on carried losses and any available starting base deductions.

69. Where an arm's length sale does not arise within the Australian tax jurisdiction, international transfer pricing principles would need to be applied in establishing the resource value at the taxing point.

70. A simple numerical example of how the MRRT works is included in Box 3.1.

Box 3.1: How the MRRT works - a numerical example

The following example is intended to illustrate how the MRRT will apply to iron ore and coal projects, commencing after 1 July 2012.

The example presents outcomes for a single project company with an equity financed mine that operates for 5 years. The company is assumed to invest $1 billion in the first year of the project. Over the life of the project the pre-tax rate of return (revenue less operating and investment costs) is 50 per cent.

The MRRT is levied at a rate of 30 per cent of the operating margin (revenue less operating and investment costs) less the MRRT allowance and the extraction allowance. The MRRT allowance is calculated as the value of unused losses uplifted by an allowance rate equal to the Long Term Government Bond rate plus 7 percentage points. In this example, LTBR is assumed to be 6 per cent. The extraction allowance provides a 25 per cent discount to the MRRT liability to focus the tax on the value of the resource rather than the value added through mining expertise.

State royalties are assumed to be equal to 7.5 per cent of sales revenue and are credited against the MRRT liability to produce the net MRRT liability. Where royalty payments exceed the MRRT liability in any one year, the balance is uplifted at the allowance rate to be offset against future MRRT liabilities. The total resource charge is the sum of royalties paid in the year and the net MRRT liability.

	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**
Resource Charge	$m	$m	$m	$m	$m	$m
Revenue	0	520	830	910	1090	1100
Operating expenses	0	130	210	230	270	280
Expensing of capital	1000	0	0	0	0	0
MRRT allowance @ 13 per cent	0	130	96	28	0	0
MRRT unutilised losses	0	1000	740	216	0	0
MRRT profit/loss	-1000	-740	-216	436	820	820
MRRT @ 30 per cent	0	0	0	131	246	246
Extraction allowance @ 25%	0	0	0	33	62	62
MRRT after extraction allowance	0	0	0	98	185	185
Royalty @ 7.5 per cent	0	39	62	68	82	83
Uplifted Royalty offset	0	0	44	120	102	0
Net MRRT	0	0	0	0	1	102
Total resource charge	**0**	**39**	**62**	**68**	**82**	**185**
Company tax						
Revenue	0	520	830	910	1090	1100
Operating expenses	0	130	210	230	270	280
Depreciation	0	200	200	200	200	200
Total resource charge	0	39	62	68	82	185
Company taxable income	0	151	358	412	538	436
Company tax @ 29 per cent	**0**	**44**	**104**	**119**	**156**	**126**
Profit before tax	0	190	420	480	620	620
Total tax	0	83	166	188	238	311

* Figures may not add due to rounding.

4 DEFINITION OF A PROJECT SUBJECT TO THE MRRT

Terms of reference

The new resource tax will apply, from 1 July 2012, only to mined iron ore and coal. All other minerals are excluded.

The MRRT is to be calculated on an individual taxpayer's direct ownership interest in the project.

Summary

The terms of reference make it clear that the MRRT is a project-based tax but do not specify how a project is to be defined. Several elements of the MRRT rely on the definition of a project. The starting base for pre-existing projects is calculated on project assets and is transferred on the sale of a project interest. Royalty credits can not be transferred outside a project. This section addresses two topics concerned with the definition of a project subject to the MRRT.

Defining the boundaries of a project: A project needs to be defined in such a way that MRRT revenues, expenses and royalty credits can be uniquely allocated, gaps are not created and ambiguity is minimised. It needs to be defined so that the tax is applied consistently across different projects and taxpayers, who may have very different operations. Finally, it needs to be defined pragmatically to operate consistently with state royalty regimes and other state requirements. A geographic definition (potentially based on state production licences) could be used, although this may not be consistent between each State and Territory, and even between different operations.

Defining the beginning and end of a project: The time at which a project comes into existence and ceases to exist needs to be clearly defined and accommodate all assessable revenues and deductible expenses (from exploration through to rehabilitation and closure). A particular issue that arises in the onshore context is how to attribute pre-production exploration to individual projects.

Questions

Question 4.1: Which principles should determine how a project is defined?

Question 4.2: When should a project commence, and how should this interact with the deductibility of exploration expenditure?

Question 4.3: When should a project cease, and how should this interact with the existence of prior year losses and the deductibility of closing down and rehabilitation expenditure?

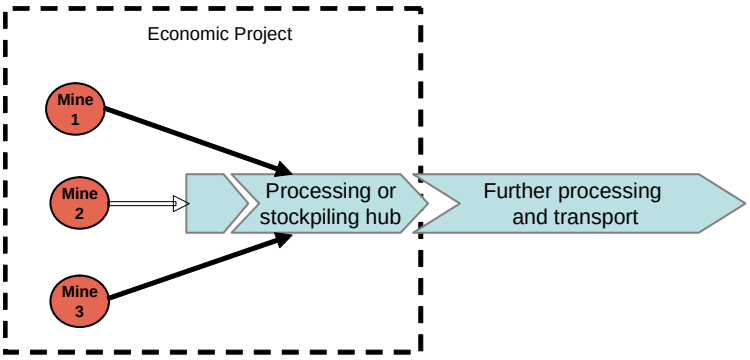
4.1 Defining the boundaries of a project

71. Key requirements in defining the concept of a resource project are that project boundaries are unambiguous and that projects provide a mutually exclusive and collectively exhaustive basis (across resource activities) for allocating assessable revenues and allowable expenditures.

72. It is not necessary that the project aligns with the economic or operational features of a mining activity if those features can be replicated through the aggregation of individual

project units. For example, an operation involving the processing of ore from three separate mines at a centralised 'hub' could be replicated through the combination of the three project units into a single economic project (Figure 4.1). A nexus test would provide the basis for allocating assessable revenue, deductible expenditure, losses and royalties to the project and for assigning the project starting base.

Figure 4.1: Combining project units into an economic project



Source: Policy Transition Group (PTG) Secretariat

73. Some States address this issue by allowing an entity to replace existing production licences with a new consolidated production licence. The Commonwealth (either through the Minister for Resources and Energy or the Commissioner of Taxation) could also have the power to issue a certificate consolidating state production licenses for the purpose of the MRRT. A question would be whether such certificates would be issued at the election of the owner(s) of the production licences or at the discretion of the Australian Government.

74. If individual project units are able to be combined, provisions may be required to clarify how assessable revenue and deductible expenditure, the starting base, carried losses and royalty offsets should be combined from several projects into one, or allocated from one project into several should the need arise. Existing sections of the income tax law that address the combining and splitting of assets for capital allowance purposes may offer a possible approach for dealing with these issues.

75. Two possible approaches to defining a project are to use:

- State production licences; or
- environmental approvals.

4.1.1 State and Territory production licences

76. State and Territory resource departments, through state legislation, determine the size of a production licence and how it is defined, providing an objective means to verify the scope of a project. This approach has the advantage of being consistent with current industry practice, potentially reducing compliance costs for entities. State and Territory production licences should be mutually exclusive and collectively exhaustive, to the extent such licences exist, given they provide legally enforceable property rights. These properties would extend to secondary interests in production licences, such as sub-leases. However, under this approach there is potential for inconsistency between the States and Territories.

77. Using State and Territory production licences also means that the States and Territories, through their legislation, could alter the nature of a production licence and thereby potentially affect revenue collection and the administration of the MRRT. In such circumstances, the Australian Government could provide stability for existing projects by issuing a certificate setting existing state production licences for the purpose of the MRRT. However, the mutually exclusive and collectively exhaustive attribute of State and Territory licences might be compromised.

4.1.2 Environmental approvals

78. Mining (and petroleum) activities must receive environmental approval before production titles can be granted in most States and Territories. Environmental approval must also be sought before exploration permits are granted in a number of jurisdictions. Activities in offshore waters are also subject to the *Commonwealth Environmental Protection and Biodiversity Conservation Act 1999* (EPBC Act). Onshore activities that trigger certain defined matters of national significance also trigger the EPBC Act.

79. Under the various regimes, approval requires the proposed activities to be defined and described. Projects appear to be defined through a combination of geographic and activity-based definitions. There are no common templates or criteria across jurisdictions for how projects are described, although there appears to be a high degree of commonality across the regimes.

80. Environmental approvals can be sought for part or all of a project, and are generally required if the project or activity is materially changed relative to the original approval.

81. While there would clearly be much useful information in the environmental project applications and approvals, further work is required to assess whether differences across jurisdictions are material and whether the project definitions are sufficiently robust for the purposes discussed in this paper. It should also be noted that, in all cases, the environmental approval does not itself provide the legal basis for activity to proceed. This is granted under the relevant exploration or production titles in each jurisdiction.

4.1.3 Other options considered

82. The PTG also considered the feasibility of defining a project by reference to an independent assessment of a proven ore reserve, or by reference to a collection of related production activities, such as extraction, crushing and screening, which result in a distinct revenue or product stream. Neither of these approaches was considered sufficiently robust to meet the requirements that project boundaries are unambiguous and that projects are mutually exclusive and collectively exhaustive.

4.1.4 Linking the project definition to royalties

83. Of the two options outlined above for defining a project, the use of state production licences seems more practical. Such an approach would align most closely with the obligation to pay royalties and could therefore simplify the task of assigning royalty payments to projects.

84. The concept of a 'project' is not used by any Australian State to determine the basis for paying mining royalties. Instead, jurisdictions use the concept of a 'mining authority' a mining licence, a mining or mineral claim, or a mining tenement. The holder or owner of a mining authority is liable to pay royalties on minerals extracted from that mining

authority or licence area. In some States, multiple adjacent leases or contiguous parcels of land with the same owner can be combined into a consolidated lease, and the subsequent royalty paid on the consolidated area.

85. The Northern Territory uses the concept of a 'production unit' to define a project under its profit-based royalty. The 'production unit' concept is defined as a mining tenement or two or more mining tenements that are operated as an 'integrated operation'. The holders of mining tenements that form part of a production unit are jointly and severally liable for the payment of the royalty in respect of the production unit.

86. The State royalty systems are generally based on self-assessment. Entities are required to keep records of the quantity of minerals recovered from a lease area. In most States, returns are lodged on an annual basis for firms with an annual royalty liability of less than $50,000, and on a quarterly basis for those firms with a liability greater than $50,000. The entity that holds a mining authority is required to keep accurate accounting records to determine the amount of royalty payable.

4.2 Defining the beginning and end of a project

4.2.1 Defining when a project starts

87. The commencement of a project is the time from which revenue and expenses fall within the MRRT. It could also determine the time from which the interest allowance would accrue on undeducted expenditure.

88. A key consideration is whether a project should commence from the time of a publicly announced Final Investment Decision, at the commencement of a production licence, or at some earlier time (such as when exploration expenditure is first incurred).

89. Related to the time of project commencement is the capacity to attribute exploration expenditure to a project. Exploration is a necessary precursor to the discovery of resource deposits, determining their characteristics, and identifying workable and efficient means of extraction. As such, it is appropriate that exploration expenditure related to the development of a particular MRRT assessable deposit would be deductible.

90. However, the Tax Office would be limited in its capacity to verify the purpose of an entity's exploration activity, as exploration permits issued by State and Territory governments do not require the permit holder to specify a target resource. It could thus be difficult to separate past successful and unsuccessful exploration expenditure for iron ore and coal from that for other minerals, particularly in attributing exploration expenditure that occurred outside the boundaries of a specific production licence to that licence. Consequently, rules would be required to allocate pre-commencement exploration expenditure to projects.

91. Possible ways of handling the assignment of exploration expenditure include:

- Allowing an entity to deduct any onshore exploration expenditure it undertakes or acquires against MRRT or PRRT profits. This option would be least consistent with the narrow commodity focus of the MRRT and PRRT.

- Allowing all exploration expenditure in an exploration licence area incurred prior to a discovery of an MRRT or PRRT assessable deposit to be attributable to a subsequent project in the exploration licence area, for which the production licence

is issued after the exploration activity.[4] From the time the production licence is issued, only exploration within the production licence area might be attributed to that project.

- Allowing an entity to deduct exploration expenditure incurred within a production licence area after a Final Investment Decision. This option would be somewhat restrictive in terms of recognising the costs of resource development but would have the obvious advantage of minimising administration and compliance costs associated with the attribution of exploration expenditure.

92. Under the second option, it would be possible to formally commence a project from the issuance of a production licence or a Final Investment Decision, by providing a legislative mechanism to attribute any earlier exploration expenditure to that project.

93. A related issue is the time from which undeducted expenditure would begin to attract the interest allowance. The lead time between exploration and the development of a resource can be many decades. Such lead times may be attributable to the sub-economic nature of a discovered deposit. Providing an interest allowance at the Long Term Bond Rate + 7 per cent over such periods would result in a significant escalation of the value of the expenditure in real terms. This issue could be addressed through the timing of when a project commences or a special interest allowance rule for such expenditure. This issue is discussed further in Section 5.4.2.

4.2.2 Defining when a project ends

94. In determining when a mine is closed, several factors need to be taken into consideration.

- Mines can be placed on a care and maintenance basis for extended periods, after which they may close or re-enter production. Where such a mine has a significant carried loss the mine would continue to generate an annual interest allowance. Providing an interest allowance at the Long Term Bond Rate + 7 per cent over long periods could result in a significant escalation of the value of the carried losses in real terms. This could provide an incentive not to decommission a mine. This issue could be addressed through deeming the closure of a mine or a special interest allowance rule for such losses.

- Decommissioning and rehabilitation costs may arise at a time when the entity owning the mine has no other MRRT profits against which to offset the expenses. As is the case in the PRRT, a tax credit, limited to MRRT paid, could be provided for these expenses, given their timing is unavoidably at the end of the project. It may also be appropriate to deem a project to be closed even if the production license remains active, to allow the tax credit to be claimed.

- Rehabilitation costs may be incurred many years after the closure of a mine. The entity may no longer hold a production licence over the mined area. Recognition of these expenses could be provided through a tax credit, limited to net MRRT paid on the originating project.

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[4] Under the PRRT, deductible exploration expenditure for a project is restricted to the activity within the exploration permit area or retention lease area from which the production licence is derived. Such expenditure may be transferable to other projects.

95. Transitional arrangements may also be required for any mine in the process of closing when the MRRT comes into force. An entity may not expect to extract further minerals from the mine, but may still hold the production licence or otherwise qualify for project status under the MRRT.

5 TAXABLE VALUE

Terms of reference

Taxable profit is to be calculated by reference to:

- The value of the commodity, determined at its first saleable form (at mine gate) less all costs at that point.
- An extraction allowance equal to 25 per cent of the otherwise taxable profit will be deductible to recognise the profit attributable to the extraction process (i.e. to only tax the resource profit).
- Arms length principles on all transactions pre and post first saleable form.

From 1 July 2012, all expenditure is to be immediately deductible under the MRRT on an incurred basis. Non-deductible expenditure will be broadly consistent with PRRT.

Summary

Taxable value means assessable revenues less deductible expenditure, which forms the profit that is taxable under the MRRT. Establishing the taxing point and determining an appropriate return downstream of the taxing point are two significant determinants of MRRT liability. This section addresses four topics concerned with taxable value.

Taxing point: Under the MRRT, assessable receipts and deductible expenses must be 'upstream' of the taxing point. The terms of reference define this point as first saleable form (at mine gate). Giving precise meaning to this concept is not straightforward, as no standard definitions of the terms 'first saleable form' and 'mine gate' exist and the taxing points they suggest may not always be the same. Factors to consider in giving precise meaning to the taxing point are being able to establish a point that can be legislated in a practical way and minimising incentives to distort investment or production decisions. Establishing the taxing point as a stage early in the production value chain (prior to beneficiation) would provide a consistent, competitively neutral point for mining. The PTG is inclined to set the taxing point after initial crushing and screening. Alternatives include a definition based on resource quality, such as the PRRT excluded commodity definition, or a geographic definition.

Valuing resource revenue: A resource's assessable value will need to be derived if the first arm's length sale occurs after the taxing point. The Tax Office uses arm's length principles and transfer pricing methods recommended by the OECD in applying the transfer pricing provisions of the income tax law. Assuming this approach is extended to the MRRT, one option is to allow companies to self determine an appropriate methodology for deriving taxable value that is based on an analysis of the activities that comprise the production value chain and is consistent with the Tax Office's application of the arm's length principles. A more prescriptive approach would be to specify a methodology in legislation, possibly as a default approach. The resale price method ('netback') would be appropriate in many circumstances, but other methods may suit particular operations (especially vertically integrated operations). These methods require a rate of return to be applied to capital invested downstream of the taxing point. Legislating a method would create early certainty and could reduce compliance costs, but would also limit flexibility and may be inappropriate for some projects.

Other revenue: Some receipts other than the value of the resource are likely to be assessable. For example, such amounts may arise to reverse a previously deducted expense.

Deductible expenses: The terms of reference state that non-deductible expenditure under the MRRT should be broadly consistent with the PRRT. This implies that deductible expenditure under the MRRT should also be broadly consistent with the deductible expenditure arrangements for PRRT. In most cases the features of the PRRT should readily translate to the MRRT. However, the application may differ in some respects, such as the treatment of pre-commencement exploration expenditure, the treatment of private override royalties and payments to indigenous communities.

Questions

Question 5.1: Is the production value chain the most appropriate way to set the taxing point in all circumstances? If so, at what point in the production process should it be set?

Question 5.2: What methods should be used for valuing a resource at the taxing point? Should those methods be legislated? What is the appropriate rate of return downstream of the taxing point?

Question 5.3: Should any receipts other than those identified in Section 5.3 be included as assessable receipts? Are there specific resource project receipts that should not be assessable?

Question 5.4: Are there particular expenses which should or should not be deductible under the MRRT? What practical definitions of these expenses would give certainty in the final design of the MRRT?

5.1 Taxing point

96. The taxing point is the point at which the value of the resource is calculated. Tax is levied on that value less the costs of bringing the resource to that point. Where the taxing point is positioned determines MRRT revenue. The terms of reference state that the taxing point is 'the first saleable form (at mine gate)'.

97. The taxing point described in the terms of reference would seem to imply that at least some initial transportation from the point of extraction and some early stage processing, such as primary crushing, would fall within the taxing point. This is consistent with the existence of the extraction allowance. By way of example, the following activities might be considered to fall within the taxing point:

    - early stage processing of coal, such as crushing, screening and grading; and
    - early stage processing of iron ore, such as crushing and grading.

98. However, the terms of reference are less clear on the intended application of the taxing point where the processing required to bring the commodity to market is more substantial. The PTG is inclined to the view that beneficiation processes would be beyond the taxing point.

99. It is clear from the terms of reference that the taxing point is not intended to capture operations in which the resource is consumed on site as part of an integrated project.

An example would be onsite power generation from coal or gas for sale in the wholesale or retail market. In such cases, the taxing point would occur before the conversion to electricity.

100. In practice, the taxing point will be the earlier of an arm's length sale of the resource or the taxing point defined by legislation. Were the resource to be exported prior to one of these events occurring, the point of export would be the taxing point. Taxing value created in other jurisdictions is administratively difficult, so it would be desirable that the legislated taxing point occur within the Australian jurisdiction. This would reduce incentives to shift MRRT assessable value offshore through structuring of the physical or legal characteristics of the mining operation.

5.1.1 Legislating the taxing point

101. The definition of the taxing point needs to be both relevant to its intended purpose and sufficiently clear in meaning to provide certainty to both administrators and industry. It also needs to be relevant over the life of a project to minimise complexity in accounting for costs and revenue. Ideally, the taxing point will be neutral across projects with different configurations.

102. The terms 'mine gate' and 'first saleable form' may not be sufficiently precise to use in legislation, even though they may be commonly used in the industry.

- Mine gate' is presumed to be a reference to some conceptual point at which the resource stops being within the scope of a mining activity. This might be a reference to the resource leaving the geographic area of the mine or to some physical step in the production process.

- First saleable form' has no definitive meaning. If taken to mean only that the entity is legally able to sell it, this would occur at the point of extraction.

103. Three possible legislative approaches that could be consistent with the taxing point concept used in the terms of reference are considered below:

- a physical step in the production value chain;
- some quality achieved in the resource; and
- a point based on some geographic boundary.

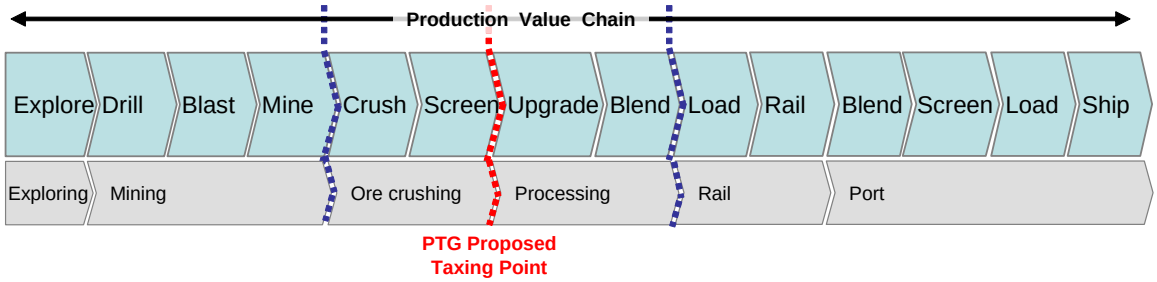
104. Of these alternatives, the PTG is inclined to setting the taxing point by reference to a stage in the value chain.

A value chain approach to defining the taxing point

105. Under this approach, the taxing point would be defined as a stage in the production value chain. Figure 5.1 illustrates some alternative points at which the taxing point might be set in the value chain. These include:

- the point of extraction;
- a stage in processing the resource; and
- loading onto long haul transport.

Figure 5.1: Examples of possible value chain taxing points



Source: Policy Transition Group (PTG) Secretariat

106. The point of extraction – that is, before any processing – provides the advantage of being consistent across all mining projects. However, such a point would appear to be earlier in the production process than is implied by the terms of reference.

107. Using a stage in the production value chain to determine the taxing point would present the challenge of defining an equivalent point across different mining projects. Future changes in processing could also render a particular point less relevant at least in some mining operations, leading to uncertainty and the need for legislative amendment. Setting the taxing point at an early stage (such as after primary crushing) would be a logical point in the value chain as it is more likely to be common to all mining operations and stable over time.

108. The point at which resources are loaded onto long haul transport (whether ships, trains, or trucks) would be of practical relevance to most iron ore and coal operations. A separate taxing point would be required where the resource is not loaded onto long haul transport before it is consumed (such as in the case of vertically integrated electricity generation located at the mine site or integrated iron ore extraction and steel making operations). However, using loading to define the taxing point could create an incentive to shift processing operations beyond the point of first haulage where commercially feasible. The meaning of long haul transport would also be critical – for example, it would need to include not only road, rail and shipping, but also conveyor belts and slurry lines of a minimum distance.

A 'resource quality' approach to defining the taxing point

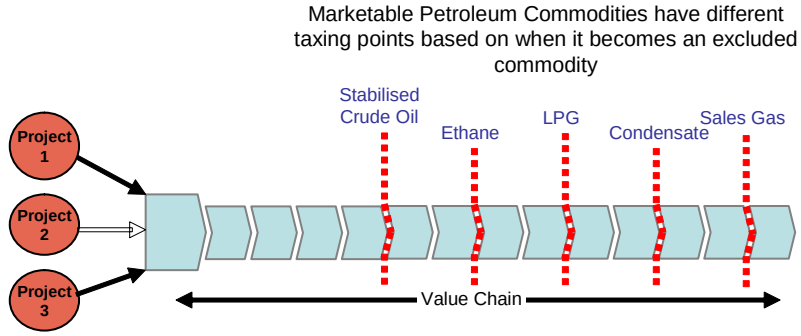
109. Setting the taxing point by reference to a quality being achieved is relevant to the existence of a saleable or marketable commodity. The taxing point would have to be defined in terms of the point at which the resource is transformed into a form in which it is usually sold or marketed, or in terms of specific products.

110. This type of approach is used in the PRRT. Under the PRRT, the taxing point is determined where a marketable petroleum commodity becomes an 'excluded commodity' (Figure 5.2), which is a marketable petroleum commodity that:

- has been sold;
- after being produced, has been further processed or treated;
- has been moved away from the place of its production other than to a storage site adjacent to that place; or
- has been moved away from a storage site adjacent to the place of its production.

111. This approach would provide the flexibility to set the taxing point in accordance with the form in which commodities are usually sold, avoids taxation of significant value-adding activities and recognises the movement of the commodity away from its place of production. The PRRT excluded commodity approach is not without its difficulties, which arise in defining the terms 'processed', 'treated' or 'storage site'. It is possible that coal and iron ore mines have multiple storage sites or treatment facilities.

Figure 5.2: The PRRT excluded commodity approach to setting the taxing point



Source: Policy Transition Group (PTG) Secretariat

A geographical 'mine gate' definition of the taxing point

112. A geographic taxing point would require a readily identifiable boundary such as the border of the mining tenement. A major deficiency with this approach is that it could apply to different stages in the mining process across different mining operations and distort production decisions. For example, on-site processing might be within the mine gate where it is congruent with the mine, but be beyond the mine gate where the processing is centralised for a number of separate mines. Firms may also be able to shift activities beyond the mine site to reduce taxable value.

5.2 Valuing resource revenue

113. A project's MRRT profit is the assessable revenue at the taxing point less the costs of getting the resource to the taxing point. In most cases the value of the resource will represent the main source of assessable revenue of a project.

114. If an arm's length sale of the resource occurs at the taxing point, this could be used to value the resource. If there is no arm's length sale at that point, it would be necessary to derive the value at the taxing point.

5.2.1 Methods to work out a resource's value

115. The Tax Office uses the arm's-length principles and transfer pricing methods recommended by the OECD for cross-border transactions in applying the transfer pricing provisions of the income tax law. Some or all of those methods could be useful in valuing coal or iron ore at the taxing point.

116. The arm's length principle uses the behaviour of independent parties operating under the same or similar circumstances as the basis for determining an appropriate price for a good or service, or an appropriate value for an activity or asset.

117. For the majority of mining projects it will be necessary to break an integrated operation into the various components that comprise the value chain and determine an appropriate return for each of the activities.

118. Particular assets or activities within the value chain may lend themselves more readily to a market-based comparison or valuation, based on an analysis of 'comparable' assets or activities. It may not be possible to price other parts of the value chain with direct reference to market based outcomes.

119. Where a direct open market price does not exist for particular activities within the production value chain, an appropriate methodology to determine an arm's length price or apply a rate of return will need to be determined. See Box 5.1 for a discussion of factors to be considered in determining an arm's length return.

Box 5.1: Applying the arm's length principle

In applying the arm's length principle, analysis and evaluation of the economically significant functions, assets and risks in the value chain is the key threshold consideration. Consistent with the guidance set out in the OECD's Transfer Pricing Guidelines (TPG), this so-called 'functional analysis' is the initial step that informs the selection and application of the most appropriate pricing method.

The key underlying concept regarding the selection and application of the most appropriate method is 'comparability' – that is, the extent to which the price of an activity or asset can be compared, taking into account the comparability of the circumstances of the transaction.

In undertaking a functional analysis of a value chain involving a number of assets and activities, including steps in the value chain which may be co-dependent, it may be necessary to determine which activities or assets are the most economically significant, and therefore of most value.

Determining an appropriate rate of return

In the open market, rates of return to investment vary according to the activity being performed and the level of risk assumed.

In determining an arm's length price or rate of return for an activity or asset for which there is no direct open market price, factors such as the degree of competition, the uniqueness of the asset or activity and the extent to which the owner of the asset or the provider of an activity is able to exert power in the market will be important considerations. Consideration of the nature and type of risks involved at different points in the value chain is also important. This analysis will reveal any instances where functions, assets and risks have been transferred to related parties in an uncommercial manner.

5.2.2 Valuation methodologies

120. A number of methodologies exist to establish an arm's length price for a particular activity undertaken within the production value chain in the absence of a direct open market price. The selection of an appropriate method will be influenced by the nature of the activity against which it is to be applied and its position both within the value chain and relative to the taxing point.

121. The traditional transaction methods utilised by the Tax Office are:

- the comparable uncontrolled price method;
- the cost plus method;
- the resale price (or 'netback') method; and
- the residual price method (transactional profit methods).

122. Comparable uncontrolled price methods value something by looking at the value of the same or a similar thing in the same or similar circumstances. Where the thing or circumstances being compared differ in a material way, the methods can allow for adjustments. For example, geographic differences in the markets for the resource, or differences in the contractual arrangements, could require adjustments to the comparable value.

123. This method may be appropriate for determining the value of specific activities undertaken within the production value chain. However, it is likely to be of limited relevance for application against an integrated mining operation as a whole, as the significance of project specific factors associated with most mining projects leads to a lack of comparable transactions.

124. The cost plus method values something by starting with the firm's arm's length costs of producing it and adding an appropriate amount for an arm's length gross profit on those costs. In the case of a resource, the costs would be the firm's costs of extracting, transforming or relocating the resource up to the taxing point.

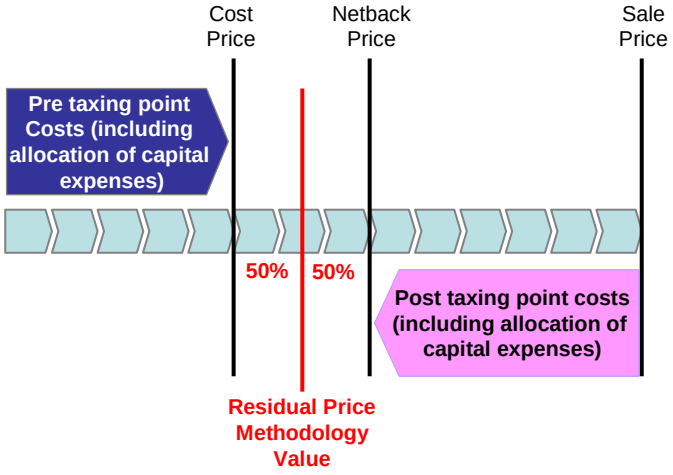
125. This method may be appropriate for determining the value of specific activities undertaken within the production value chain but it is generally inappropriate for determining the value of upstream activities within a rent tax. This is because it applies a standard gross profit margin rather than estimating the rents associated with a particular project. In doing so, it could shift any resource rent beyond the taxing point or shift downstream value within the taxing point.

126. The resale price method values something by starting with the price for which it is eventually sold in an arm's length transaction (or an attributed value where there is no arm's length sale in Australia) and working backward to the taxing point by subtracting the arm's length costs involved in transforming the product from the taxing point to the sale point. This method is sometimes called the 'netback' method. Because the costs subtracted are worked out at arm's length, they include a reasonable allowance for gross profit. They might need to be adjusted from market norms to take into account the firm's particular costs and other circumstances.

127. The residual price method determines a value by using a combination of the resale price and cost plus methods. This method may be considered appropriate where economic rents exist both upstream and downstream of the taxing point, such as where the value of a mineral and a new processing technology are co-dependent.

128. The residual price method is used in the PRRT for integrated enterprises that extract gas and liquefy it before transportation.[5] Under the PRRT residual price method, the entity would work out the minimum price at which it would have to sell the resource to recover its extraction and other pre-taxing point costs (including a portion of its relevant capital costs). It would also take the sale price of the resource (or its arm's length equivalent) and reduce it by its post-taxing-point costs. The point half way between those two figures is assumed to be the value of the resource at the taxing point (on the basis that profit is allocated equally between the pre and post taxing point stages) (Figure 5.3). Where the netback method yields a value less than the cost plus value, the netback value is used as the resource value at the taxing point.

Figure 5.3: The PRRT residual price method



Source: Policy Transition Group (PTG) Secretariat

129. The allocation of the difference between the netback and cost plus price could be determined using a range of criteria rather than a straight 50 per cent allocation. For example, the allocation could reflect the proportion of the costs that fall on each side of the taxing point.

130. OECD guidelines favour the 'best method' in pricing activities. Increasingly, profit based methods rather than traditional pricing mechanisms are used. Two profit based methods are:

- the profit split method; and
- the transactional net margin method

131. The profit split method is used when there are unique contributions from several associated entities within a vertically integrated business. The profit from the series of transactions is determined and then split between the enterprises involved. It can be split in several different ways (for example, in proportion to the value of the functions each enterprise performs). The residual price method from the PRRT regulations, which is discussed above, is an unsophisticated type of a profit split method.

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[5] See regulations 16 to 23 of the *Petroleum Resource Rent Tax Assessment Regulations 2005* and the discussion in Taxation Ruling TR 2008/10 – *Petroleum resource rent tax: application of the Petroleum Resource Rent Tax Assessment Regulations 2005 to an integrated gas-to-liquid operation*.

132. The transactional net margin method compares the net profit (which takes into account overheads but generally not financing costs) the enterprise makes on the controlled transactions with the net profit it makes on a comparable uncontrolled transaction, or with that made by an independent enterprise on a comparable transaction. This method is a variation of the resale price and cost plus methods, but using net profit rather than gross profit. The outcome depends heavily on the basis on which the comparison is made (for example, whether it is based on costs, sales or returns on assets) and the particular transactions considered.[6]

Asset base for applying the rate of return

133. In circumstances where it is appropriate to apply a derived rate of return, it may be necessary to determine an appropriate capital base for upstream and downstream operations.

134. In the case of new projects, the capital expenditure relating to particular underlying assets will be obvious. For existing projects, an approach needs to be identified for determining the starting capital base to be used within the pricing methodologies.

135. For the purpose of consistency within the MRRT regime, it might be appropriate to make available the same options used for determining the starting base for the project, either book or market value.

5.2.3 Should the valuation methodologies be legislated?

136. Three distinct legislative options exist for the valuation of resource receipts at the taxing point:

- the law could simply say that the assessable receipts include the market value of the resource at the taxing point, without specifying a methodology for calculating this value;
- the law could be more prescriptive about the methodology to be used to determine market value; or
- the law could specify a default methodology but allow companies to choose other approaches if they are considered more appropriate.

137. There are examples of the first two options in the legislation used to set State and Territory royalties for the Australian resource sector.

A non-prescriptive approach

138. If the law did not specify a methodology, the calculation would be left to the entity and the Tax Office to determine. In cases where disputes arise regarding methodologies, recourse could be sought to the courts or the Administrative Appeals Tribunal.

139. The main advantage of this approach is that it would provide flexibility in the valuation methodology used and so would be more sensitive to differences between the

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[6] The practical issues that can be involved can be observed in the decisions of Downes J in the AAT case *Roche Products Pty Ltd v FCT* [2008] AATA 639 and Middleton J in the Federal Court case *SNF (Australia) Pty Ltd v FCT* [2010] FCA 635

circumstances of individual entities or projects. It would allow an entity to propose a methodology that is easier for it to use or more appropriate to its circumstances.[7] The entity would be able to seek a ruling from the Commissioner of Taxation to provide certainty as to the acceptance of the methodology. A particular mechanism by which the ATO provides such certainty to entities is through an Advance Pricing Arrangement.[8]

140. An additional advantage is that it would be clear on the face of the law that the intention was to arrive at the resource's market value; a legislated formula might not provide such clarity about what the law aims to achieve.

141. A disadvantage of this approach is that there could be initial uncertainty about the methodologies that would be acceptable to the Tax Office to determine a resource's market value. This lack of certainty could be mitigated to some extent by material included in the explanatory memorandum and by the Tax Office publishing early guidance. There would also be guidance from existing methodologies used for similar purposes, such as:

- the methodologies recommended by the OECD for these purposes;[9]
- the methodologies accepted by the Tax Office for working out market value for the purposes of the income tax law's trading stock, consolidation and transfer pricing regimes,[10] which are based on the OECD's accepted methodologies; and
- the methodologies used by the States and Territories to work out market value for the purposes of their mining royalty regimes.[11]

A more prescriptive approach

142. The main advantage of directly legislating a methodology (whether in the principal Act or in regulations) is that entities would have certainty from the commencement of the

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[7] As the ATO says in its ruling TR 97/20 (at paragraph 1.8): 'The statutory objective should be interpreted as allowing the greatest possible scope to use methodologies appropriate in the circumstances, given the myriad of different and possibly unique cases that may arise. It goes on to say (in paragraph 1.9): Accordingly, the use of a novel methodology does not mean that the method is invalid, so long as it is applied consistently, so far as practicable, with the statutory objective.

[8] An Advance Pricing Arrangement could be used to give entities an opportunity to reach an agreement with the Tax Office on the future application of the arm's length principle in their dealings with related parties.

[9] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2010.

[10] There are many ATO rulings and other information products that discuss market valuation methodologies. For example, Taxation Rulings TR 94/14 – *Income tax: application of Division 13 of Part III (international profit shifting)*, TR 97/20 – *Income tax: arm's length transfer pricing methodologies for international dealings* and Taxation Determination TD 93/127 – *Income tax: trading stock of gold miners*. It should be noted that the income tax methodologies simply look at value and are not concerned with whether that value is attributable to resource rents or firm specific rents. That might mean that the ATO would need to adapt its income tax methodologies for use in an MRRT context.

[11] See regulations 86 and 87 of the *Western Australian Mining Regulations 1981*; regulations 7 and 8 of the Victorian *Mineral Resources Development Regulations 2002*; section 17 of the South Australian *Mining Act 1971*; regulation 42 of the Queensland *Mineral Resources Regulations 2003*; regulation 44 of the NSW *Mining Regulations 2003* and section 283 of the NSW *Mining Act 1992*.

MRRT on 1 July 2012 as to how assessable receipts should be calculated. The benefit of this approach would be greatest in the early years of the MRRT and would decline over time as entities become familiar with the available methodologies. However, there would be an ongoing benefit to entities starting a resource project for the first time in the future.

143. The disadvantage of directly legislating the valuation methodologies is the resulting lack of flexibility. The prescribed valuation methodologies would have to be used even where both the entity and the Tax Office agreed that they produced inappropriate results. Situations such as this could only be addressed by amending the law, and therefore the circumstances of individual entities could only be taken into account in a broad brush manner.

144. A possible alternative would be to combine the two approaches. For example, the law could state the general principle but provide a default valuation method or allow regulations to provide for acceptable methodologies. While this approach would provide certainty and describe the policy objective, it would still be possible that the methodologies prescribed may result in outcomes that would not be consistent with the stated policy objective.

5.3 Other revenue

145. In addition to resource revenue, there may be other categories of assessable revenue. For tax symmetry, if an expense is deductible then any related receipts should be assessable. Four categories of other assessable revenue are:

- the disposal of an asset used within a project;
- refunds;
- final payments lower than deductions; and
- bad debts.

146. The first type is an amount received for disposing of an asset used within a project (for example, the sale price received for a piece of machinery). Where the cost of the asset was deductible against assessable receipts of a mining project, any amount recovered for disposing of that asset would need to be assessable so that only the actual loss of the asset's value is ultimately recognised. This amount is similar to the depreciation balancing charge recognised for accounting and income tax purposes.

147. Where the asset has been depreciated as part of the starting base rather than fully deducted, any excess of its sale price (or other compensation for disposal) over its depreciated value would need to be assessable revenue. It would also be appropriate to reduce the starting base by the undepreciated amount. The disposal of the mining right would not be treated this way because it would be equivalent to the disposal of the project interest, the treatment of which is discussed in Section 7.7.

148. Where an asset is moved from one project to another, either in part or whole,[12] it should be treated as a disposal by the first project and an acquisition by the second project, at the asset's market value. This deemed sale and acquisition approach would ensure that any loss or gain in value while the asset is in the original project stays within that project and is not transferred to the new project. The treatment of the proceeds would be as outlined in paragraphs 146 and 147.

149. A second type of assessable revenue is a refund of a previously deducted expense. Such refunds need to be assessable because they mean that the entity did not effectively incur the deducted expense (or some part of it). Examples of such refunds include contractual reimbursements, price adjustments and government grants and rebates. If the adjustment were to results in a payment by the resource entity, that payment should be a deductible expense. It might be necessary to apportion such amounts between projects.

150. A third type of assessable revenue arises where the amount eventually paid turns out to be lower than the claimed deduction. This could happen, for example, where the amount actually paid is less than the deducted amount because of favourable exchange rate movements.

151. A fourth type of assessable revenue can arise in bad debt cases. If the value of the resource has been an assessable amount but the purchaser looks unlikely to pay for it, the entity would be entitled to a deduction for the bad debt in the same way as it would be for income tax purposes. If that debt (or some part of it) is later recovered (for example through a liquidator's distribution), the amount recovered should be included as an assessable receipt to offset the previously allowed deduction. This is as it would be for income tax purposes.

152. To the extent that expenditure is not fully deducted against assessable revenue in the year incurred, it would be uplifted by the MRRT allowance. Where a deduction is later reversed by an assessable amount, the issue arises whether an adjustment needs to be made to reverse the uplift.

5.4 Deductible expenses

153. For an expense to be deductible under a taxation law, it needs to have sufficient connection with the tax base. Deductible expenditure under the PRRT and MRRT need not align with that allowable under the income tax law. The PRRT and MRRT are forms of a resource rent tax and are intended to levy tax on the resource profits of individual projects derived through activities upstream of the designated taxing point. Deductible expenditure against PRRT/MRRT assessable revenue should have a necessary connection with the derivation of such profits.

154. The terms of reference state that non-deductible expenditure under the MRRT would be broadly consistent with the current arrangements under the PRRT. This implies that deductible expenditure under the MRRT should also be broadly consistent with the existing arrangements for the PRRT. However, the onshore application of the MRRT

[12] Note that a project could comprise several mines, as discussed in Section 4.1, and in such cases the movement of equipment or other assets between the individual mines within the project would not trigger a disposal and acquisition event.

and PRRT extension may mean there are some differences in the type of expenses to be considered.

155. Deductibility under the PRRT is based on whether eligible expenditure is directly related to a resource project and incurred upstream of the taxing point.

156. Deductions under the MRRT will be allowed for eligible capital and operating expenditures. Eligible expenditures incurred from 1 July 2012 will be deductible against assessable receipts in the year they are incurred.

5.4.1 General project expenditures

157. Under the PRRT, expenditure of a capital or a revenue nature that is directly related to a project and incurred upstream of the taxing point is deductible in the year incurred. Broadly, the eligible expenditures include those incurred:

- on operations, facilities and other things preparatory to undertaking the activities of the project;
- on operations, facilities and other things comprising the project;
- in purchasing external resources as part of the project; and
- in procuring another person to undertake processes in relation to the resource recovered from the project.

5.4.2 Exploration Expenditure

158. Exploration expenditure is a necessary precursor to the discovery of resource deposits, determining their characteristics, and identifying workable and efficient means of extraction. As a general principle, it is appropriate that exploration expenditures related to the development of an MRRT assessable deposit be deductible. However, the application of this principle onshore raises a range of issues. These issues and the scope of deductible exploration expenditure are discussed in Section 4.2.

159. Legislative precedents for what constitutes exploration expenditure are found in the *Income Tax Assessment Act 1997* (ITAA) and the *Petroleum Resource Rent Tax Assessment Act 1987* (PRRTAA) (see Box 5.2). There does not appear to be a strong argument for defining exploration expenditure differently in the MRRT to the PRRT or income tax and using the same definition will reduce compliance costs.

Uplifting exploration expenditure

160. The distinction between exploration and general expenditure in the MRRT is less critical than is the case under PRRT, as only one uplift rate is to apply under the MRRT.

161. However, the potential implications of the long and variable time-lag between exploration expenditure and first production, combined with the uplifting of losses at Long Term Bond Rate + 7 percentage points need to be considered. Ideally, the design of the MRRT would mitigate any incentive for entities to defer developing the resource to gain an advantage from the uplift.

Box 5.2: The definition of exploration expenditure in the *Income Tax Assessment Act 1997*

Subsection 40-730(4) of the ITAA defines 'exploration' to include:

(a) for mining in general, and quarrying:

(i) geological mapping, geophysical surveys, systematic search for areas containing minerals (except petroleum) or quarry materials, and search by drilling or other means for such minerals or materials within those areas; and

(ii) search for ore within, or near, an ore-body or search for quarry materials by drives, shafts, cross-cuts, winzes, rises and drilling; and

(b) feasibility studies to evaluate the economic feasibility of mining minerals or quarry materials once they have been discovered; and

(c) obtaining mining, quarrying or prospecting information associated with the search for, and evaluation of, areas containing minerals or quarry materials.

The explanatory memorandum to the New Business Tax System (Capital Allowances) Bill 2001 notes that exploration is not defined exhaustively in the ITAA and is based on its ordinary meaning. The explanatory memorandum also indicates that the point at which a decision is made to proceed to actual mining operations marks the dividing line between exploration and development.

162. Under the PRRT, exploration expenditure incurred less than five years prior to the issuing of a production licence receives an uplift rate of Long Term Bond Rate + 15 per cent. This encourages firms to progress discoveries to the production stage to ensure these expenditures receive the higher uplift rate. Significant expenditure is incurred proving up reserves and drilling appraisal wells prior to a company's Final Investment Decision. All these expenditures would receive the LTBR + 15 per cent uplift rate. Exploration expenditure incurred more than five years prior to the issuing of a production licence is uplifted at the GDP deflator rate, which preserves the original value of the exploration expenditure.

163. As in the mining industry, many petroleum discoveries take considerably longer than five years to transition from an initial discovery to the issuance of a production licence.

5.4.3 Hedging gains and losses

164. There are a range of ways in which entities can hedge against adverse resource price movements, including forward contracts for sale at an agreed price, or through utilising financial instruments such as exchange traded derivatives (futures) or over-the-counter derivatives (swaps) to hedge price or currency risk.

165. Hedging gains and losses are not specifically excluded under the existing PRRT arrangements. The deductibility of these payments will be determined according to the test for deductibility outlined above − that is, whether the expense is directly related to the project.

166. The two possible options for treating hedging gains and losses arising from particular arrangements within the MRRT framework are:

- both gains and losses could be excluded from the MRRT; or
- both gains and losses could be included within the MRRT.

167. In determining the appropriate treatment of gains and losses from hedging arrangements, it is necessary to consider the nature of the arrangement and the association of the gain/loss from hedging with the production and sale of the resource.

168. For expenditure to be directly related to the production of the resource, the expense must be incurred by an entity to receive consideration for a particular sale. In the case of hedging costs it needs to be possible to relate the expense or loss incurred to a particular sale. Where a sale would occur regardless of whether the expenditure relating to the hedging arrangement had been incurred, the expenditure or loss could not be said to relate to a particular sale.

169. Similarly, to be considered an assessable receipt, gains relating to hedging need to be shown to be directly related to the production of a commodity. Where the receipt from a hedging contract would occur regardless of whether the underlying sale was to take place, the receipt would not be considered assessable revenue.

170. The policy intent to value the extracted resources, not other aspects of an entity's activities, is relevant in deciding whether a broader range of hedging costs should be included within the MRRT, or whether greater guidance is required in relation to the circumstances in which hedging costs will or will not be deductible.

5.4.4 Closing-down and rehabilitation expenditures

171. The principle closing-down expenditure is expenditure incurred in ceasing project operations, including rehabilitation of the project site. The costs of closing a project are legitimate project costs and, consistent with PRRT, should be deductible under the MRRT.

172. Under the PRRT, closing-down expenditure, like general expenditure, is not transferable. However, a tax credit is provided to the entity to the extent that costs cannot be offset against assessable revenue in the year of closure to ensure that the entity is able to 'deduct' the full cost of closing down. The tax credit cannot exceed the total PRRT paid over the life of the project.

173. The ability to transfer losses under the MRRT will mean in many cases, closing down expenditures will be deductible against other operating projects. However, some method of recognising these expenses will be necessary to cater for single project entities. Any tax credit should not be available until a project is deemed to have closed (see Section 4.2.2).

Treatment of environmental and rehabilitation bonds

174. Under State legislation,[13] mining entities are required to lodge rehabilitation or environmental bonds before undertaking operations, to provide assurance that the

[13] See, for example, *Mining Act 1975 (WA)*, *Mineral Resources Act 1989 (QLD)*.

land disturbed by the mining operations will be rehabilitated once mining is completed.

175. While providing a bond is a pre-condition for a project to be developed, it is important to note that costs are not incurred at the time the bond is provided. Rather, the cash bonds are refunded when the mine site is successfully rehabilitated, the cost of which is deductible under the MRRT. Therefore, it is appropriate that environmental bonds should not be eligible expenses under the MRRT. This is consistent with the existing arrangements under the PRRT.

176. If an environmental bond were to be deductible when deposited, the refund of the bond, and any interest payments on it, would need to be included as assessable revenue. However, even this treatment could fall short of a neutral outcome if the deduction for the bond were to be augmented at the uplift rate while earning a return well below this.

5.4.5 Excluded Expenditures

177. Under the terms of reference, non-deductible expenditure under the MRRT is to be broadly consistent with the PRRT. While this provides a good basis for developing rules in this area for the MRRT, it also suggests a more considered treatment than an automatic translation and, therefore, which of the specific exclusions within the PRRT should be applied under the MRRT.

178. Under the PRRT regime, exploration, general and closing down expenditure in relation to a petroleum project is deductible, except where it is excluded expenditure. The *Woodside* decision[14] dealt with the interpretation of the phrase 'in relation to'. In essence, the Federal Court ruled that there needed to be a close connection between the expense and the project for the expense to be deductible.

179. Once a close connection has been established between the expense and the petroleum project, the expense needs to pass a further test under the excluded expenditure provisions. If the expenditure is 'excluded expenditure' it will not be allowed as a deduction.

180. It is not clear from the terms of reference whether this interpretation is also to apply to expenditure incurred under the MRRT. It may be useful however, to refer to the PRRT regime as a base from which to work.

181. The types of expenditure that are specifically excluded from deductibility under the PRRT regime[15] include:

- financing costs (including payments of principal and interest, hire purchase arrangement, other borrowing costs, and dividends), and the cost of issuing shares and repaying equity;
- payments to acquire an interest in a mining or access licence, or an interest in project profits, receipts or expenditures;

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[14] *Woodside Energy Ltd v Commonwealth of Taxation* [2009] FCAFC 12.

[15] See section 44 *Petroleum Resource Rent Tax Act 1987.*

- payments of administrative or accounting costs, or of wages incurred indirectly in carrying on the project (including payments in respect of land or a building for indirect activities that are not located at or adjacent to the project; and
- payments of private override royalties.

Interest and financing costs

182. The purpose of the MRRT is to set a value on the resource extracted by a mining company. That value should be independent of an entity's choices about the way it finances its mining operations. The required return to capital invested in a mining operation is recognised through the interest allowance for activities upstream of the taxing point and through arm's length pricing of downstream activities where the first arm's length sale is beyond the taxing point. Allowing a specific deduction for interest and other financing costs would amount to a double deduction for the cost of capital. Further, it would tend to bias financing decisions toward debt. Therefore, consistent with the PRRT, interest and other financing costs should not be deductible under the MRRT.

183. In the absence of being able to deduct finance costs, it is sometimes argued that a bias is created toward outsourcing mining activities. It is argued that where a service is outsourced, financing costs will be embedded in the price of the service and will thereby be deductible under the general expenditure provisions. By contrast, where the resource firm undertakes the operations directly, the firm would not be able to deduct any financing costs associated with that activity.

184. Where outsourced operations are contracted at arms-length, a decision to outsource may hinge on whether the third party provider is able to provide the required service at a cost below that of the project owner undertaking the operations directly. The fact that the cost of financing is implicitly included by the third party in the amount it charges should not itself be relevant to that decision.

185. The argument that there is an outsourcing bias incorrectly presumes there is no allowance for capital costs under the MRRT or PRRT. In a competitive market for the services being contracted, the price charged by the contracted party should reflect a market rate of return to the capital required to perform the services. The profit margin of the contracted party would cover both a return to their equity and any interest costs. Whether the MRRT induces a bias toward outsourcing or in-sourcing would turn on the relativity between the return to capital provided under the MRRT and that available to market providers of the service. If, for example, the interest allowance under the MRRT were below that required by market providers of the service, there could be a small bias toward outsourcing. Of course the converse would also be true. One source of bias toward in-sourcing is the immediate expensing of the resource entity's capital under the MRRT.

186. This argument also applies to related party transactions, provided the services are charged at fair market value. However, the project owner might have an incentive to pay a related party service provider more than the cost of the operations in order to maximise MRRT deductions and improve the overall after-tax return to the related entities. The general anti-avoidance and transfer pricing rules under the PRRT are designed to deal with such situations.

Transfer of project ownership or interest

187. Payments to acquire an interest in an existing permit, lease or licence, access authority, or project are excluded as deductible expenses under the PRRT. Similarly, the proceeds from the disposal of a project interest are not assessable under the PRRT.

188. It is proposed that, consistent with these arrangements, the disposal of a project interest would not give rise to assessable receipts or deductions under the MRRT. Rather, the purchaser could inherit the vendor's net assessable receipts and deductible expenditure for the year in which the transfer takes place. The purchaser would also inherit any carried losses, undeducted starting base and unutilised royalty credits associated with the project interest.

189. Under this approach, all amounts payable directly to government as consideration for a mining right and any in-kind payments negotiated with government as a condition for proceeding with a project should be non-deductible. In both cases, the payments (cash or in-kind) should be considered part of the consideration for the right to mine.

190. The alternative treatment would be to allow the acquisition cost of an interest in a project as a deductible amount and include any sale proceeds in assessable revenue. An effect of this would be to bring forward MRRT liabilities through the capitalised value of future earnings from the project.

Indirect expenditures

191. In addition to expenditures directly incurred in relation to exploration, development and operation of a resource project, entities may also incur other costs that are *indirectly* related to the project. Such expenditures may include general head office administrative or accounting costs.

192. As stated earlier, the PRRT provisions require there to be a close connection between the expenditure incurred and the project. The provisions under PRRT specifically exclude administrative and accounting costs that are incurred indirectly. Administrative and accounting costs that are incurred directly in carrying on or providing the operations, facilities and other things that give rise to exploration, general project or closing down expenditure will, however, be deductible. The phrase *indirect expenditure* for PRRT purposes is not a reference to a class or type of expenditure, but rather, a reference to whether activities undertaken are directly or indirectly related to the project.

193. Using the PRRT provisions as a guide, allowing MRRT deductions for overhead expenses where they are necessary to undertake the project would be consistent with the principle that costs directly associated with a project should be deductible against project receipts.

194. This could be achieved in one of two ways. One would be to legislate a list of deductible expenses. Such an approach would be restrictive, and would require legislative amendment to enable deductions for new types of costs.

195. The second would be a principle-based approach, under which those activities with a sufficiently strong causal link to the upstream activities of a resource project (such as project design activities) would be deductible. General overhead costs, such as those incurred in the day-to-day operations of the business, which would be undertaken irrespective of the project, would not be deductible. An approach such as this may

result in ongoing uncertainty as to the link required for an expense to be deductible, and present similar issues to those experienced under PRRT.

196. Where a cost is incurred directly in relation to several resource projects or in relation to a resource project and other activities (for example, salaries associated with accounting services), the total cost of these activities would need to be apportioned to determine the share deductible for each resource project.

Private royalty payments

197. Private royalty payments can take several forms, including: royalties to a landowner where the mineral rights have not been alienated by the State or Territory; payments to a party other than the Government for access to the land; and resource profit sharing arrangements (private override royalties).

198. In some States, some mineral rights are held privately. In these cases, the quantum of private royalties payable is set by the State with reference to the State royalty rate. In practice, these private royalties are set at the same level as broader State royalty arrangements, but a portion is then on-paid to the private landowner.[16] As these entitlements would be embedded in the value of the land to which they attach, it is arguable that such payments should be treated consistently with normal state mining royalties.

199. Private override royalty arrangements differ from State imposed royalties in that they are, in substance, a profit sharing agreement in respect of the exploitation of a resource, rather than the sale of the resource by the owner. Consistent with the overarching principle that the MRRT represents a charge by the Australian community for the exploitation of the resource, it follows that the MRRT should capture a share of the resource revenues regardless of who receives them (see Box 5.3). This suggests two possible approaches to the treatment of private override royalties, both of which impose symmetry of treatment in respect of the payer and recipient of private royalties:

- if a private royalty is deductible expenditure for the payer, then it should also be treated as an assessable receipt of the recipient; and
- conversely, if the private royalty is not an assessable receipt then the royalty should not be deductible.

200. Of the two approaches, making private override royalties non-deductible would be simpler, as all MRRT profits would be taxed in the hands of the project entity and the landowner would not be subject to MRRT. This approach is consistent with that under the PRRT, which excludes private override royalties as a deduction. The *Northern Territory Mineral Royalty Act* also excludes royalty-like payments as deductions unless the amounts expended were required to be expended in accordance with a law in force in the Territory.[17]

201. In the case of existing projects, non-deductibility would be consistent with a market valuation of the starting base where the valuation of the resource takes into account the

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[16] In Western Australia, 9/10ths of the royalties received by the Crown for minerals on unalientated private land are paid to the landholder. Similar arrangements exist in Queensland, New South Wales and Tasmania.

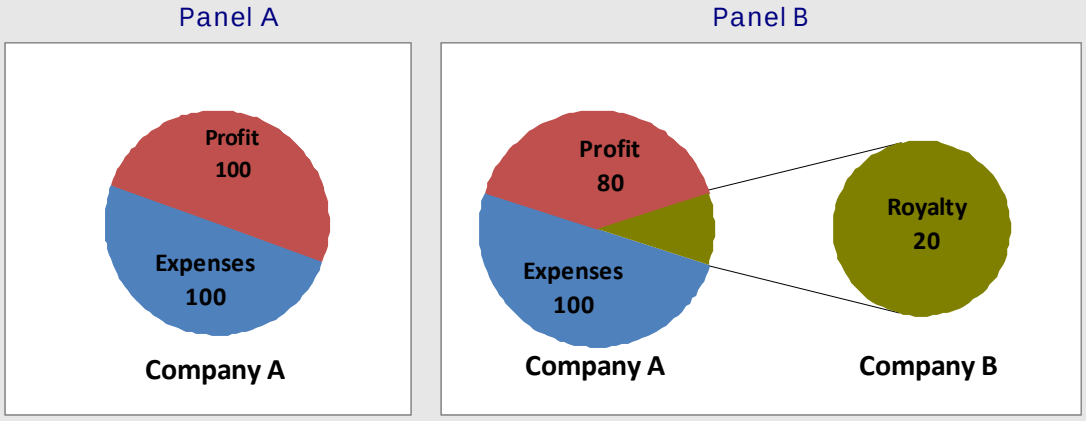
[17] See section 4B of the *Mineral Royalty Act*.

profit derived both by the company and the private royalty recipient, rather than the *net* profit stream to the company. Valuing the resource in this way would be equivalent to providing a deduction for the value of the resource represented by the private royalty payment. Providing a deduction for a private royalty in addition to the full starting base would in effect allow the project to claim the deduction twice.

Box 5.3: The treatment of private override royalties

Figure 5.4 illustrates the case of a company (Company A) that operates a resource project that generates $200 from the sale of a resource, while incurring eligible deductions of $100. The MRRT profit of the project is $100.

Figure 5.4: The relationship between resource profits and private royalties



Source: Policy Transition Group (PTG) Secretariat

In Panel A, Company A receives all of the profit from the project and incurs all of the costs. In Panel B, Company A shares the profit with Company B through a private royalty.

A neutral outcome for a new project would be where the MRRT is levied on the entire $100 profit. This would mean that equivalent projects would be taxed in the same way irrespective of their legal ownership structure. There are two options for dealing with the private override royalty to achieve the same outcome as in the Panel A case.

The first and simplest option is not to allow a deduction for private override royalties. This results in the full $100 profit being taxed in the hand of Company A.

The second option would allow the private override royalty payment to be a deductible expense for Company A. Under such an approach, Company A's taxable MRRT profit would be $80. Under this approach, Company B should also fall within the scope of the MRRT, as it receives a share of the project profits. Company B would have a taxable MRRT profit of $20. While significantly more complex, this approach would also tax all of the project's profit.

In contrast with these two options, allowing a deduction for the royalty but exempting the royalty recipient from MRRT would lead to under-taxation of project profits and provide a means through which companies could avoid MRRT.

	No private royalty	**Private royalty deductible but not taxable**		**Private royalty deductible & taxable**	
	Co. A	*Co. A*	*Co. B*	*Co. A*	*Co. B*
Revenue	200	200		200	
Private royalty			20		20
less expenses	(100)	(100)		(100)	
Deduction for private royalty		(20)		(20)	
MRRT profit	100	80	0	80	20
MRRT payable	22.5	18	0	18	4.5
Total MRRT	**22.5**	**18**		**22.5**	

Native title and other payments to indigenous persons

202. Native title payments can be paid under legislation or pursuant to privately negotiated agreements. They can involve a flat amount, a share of mining revenues, or a combination of the two. The payments can be in cash or in kind (such as shares in the mining company or the provision of community facilities).

203. As with private royalties, a key question is how these payments should be treated under the MRRT. They could be viewed as an expense of mining. That position would be defensible if the payments were properly characterised as a cost of the mining activity (for example, if the payment compensates for access and/or disturbance to land that would otherwise be denied). In that case, it could be argued that the expense should be deductible for MRRT purposes but not assessable to the recipient native title owners.

204. On the other hand, the payments could be viewed as part of the rents from exploiting the resource (that position would be more arguable if the payments are a share of the mining revenues). In that case, as for private royalties generally, the payments should be either deductible to the mining entity and assessable to the recipients, or non-deductible to the entity and non-assessable to the recipients, to ensure that all the rents from exploiting the resource are subject to the MRRT.[18]

205. If native title payments could be categorised in both these ways, it would be necessary to decide which payments fell into which category. That decision would often be difficult and, if particular arrangements produced beneficial tax outcomes, the tax result could distort the form of the payments.

206. An alternative way of approaching native title payments and benefits would be to recognise that while native title payments can take many forms, the form should not dictate the treatment of the payment for MRRT purposes. In all cases, the principal purpose of the payment or benefit will be the same – that is, to compensate native title holders for use of land over which they hold or claim native title rights. In this context, neither native title holders nor mining firms would be subject to distorting incentives if all native title benefits and payments were treated in the same way.

207. A further question is whether all payments to native title holders by mining firms should be within the MRRT. While some payments to native title holders (say, to secure agreement to developing a resource project) should be within the MRRT, it is not obvious that all payments to native title holders should be. For example, it might be difficult to link payments under a mining firm's indigenous persons scholarship scheme to any particular mining project.

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[18] In the case of native title, a payment will usually be made to the native title holders collectively, making it at best difficult to assign individual liability. Therefore, non-deductibility and non-assessability might be the easier approach.

Table 5.1 Payments might be categorised according to the following table:

	Direct project expenditure	Indirect project expenditure
Resource expense	A	B
Other expense	C	D

208. Table 5.1 provides an illustration of a possible way to categorise such payments. Payments which fall into boxes A and C would be within the MRRT because they relate directly to a specific resource project. It is unclear whether payments would be likely to fall within box B, but if there were they would not be sufficiently connected with a project to be deductible within the MRRT. Payments that fall into box D would not be within the MRRT because they are not directly related to a resource project and are not incurred in extracting the resource. An example of this sort of payment might be the scholarship scheme mentioned above.

209. Some payments that could be within the MRRT are paid to a government by law and then redistributed by the government to native title holders. Such payments should be treated in the same way as legislated private royalties that are collected by a government and substantially redistributed to the landowner − that is, deductible to the mining entity.

5.4.6 When expenditures are incurred

210. The PRRT operates on an accrual basis, with assessable receipts derived when consideration is receivable and expenditures deductible when payments are liable to be made.

211. This interpretation is consistent with that intended under the PRRT, for which the Explanatory Memorandum states:

> "*Expenditure for which provision is made but for which liability has not yet arisen (for example, accruing leave entitlements of employees and provision for contingent costs) will not be deductible*".

212. Having the MRRT operate so that eligible expenditures are only taken to be incurred when they are liable to be made, rather than at the time accrued, would ensure the MRRT operation is consistent with both the PRRT and the income tax laws.

6 TREATMENT OF LOSSES AND ROYALTIES

Terms of reference

MRRT losses will be transferable to offset MRRT profits the taxpayer has on other iron ore and coal operations.

Carried-forward MRRT losses are to be indexed at the allowance rate equal to the Long Term Bond Rate + 7 per cent.

All State and Territory royalties will be creditable against the resources tax liability but not transferable or refundable. Any royalties paid and not claimed as a credit will be carried forward at the uplift rate of Long Term Bond Rate + 7 per cent.

Summary

An MRRT loss occurs when deductible expenditure, including any interest allowance on losses carried forward, exceeds the assessable revenue for a project in a given year. Unlike company income tax, losses can be uplifted (i.e. compounded at the Long Term Bond Rate + 7 per cent). This section addresses six topics concerned with the transferability and uplift of losses and royalties.

Transfers of MRRT losses within wholly owned groups: Other areas of the tax law require two entities to be part of a wholly owned group to transfer losses. Transfers of MRRT losses could be allowed where an entity makes an irrevocable election to allow MRRT losses to be transferred between projects of a wholly owned group. A variant would be to only allow this for groups that had elected to consolidate for income tax purposes

***Transfer of MRRT losses between projects*:** The terms of reference do not specify whether an entity should be required to transfer MRRT losses to offset MRRT profits or whether it is at the election of the taxpayer. MRRT losses are uplifted at the Long term Bond Rate + 7 per cent to compensate entities for the risk they may not be able to utilise those losses against a future profit. Where a loss can be transferred against a MRRT profit, requiring such a transfer would seem consistent with the policy intent.

Transfers of MRRT losses from acquired projects: Under the MRRT, losses are transferable, but not refundable (this is the reason the uplift rate is above the Long Term Bond Rate). Allowing losses to be transferred from an acquired project could unintentionally create a 'market' for MRRT losses and effectively result in refundability.

Starting base losses: The terms of reference do not specifically address this issue. There would appear to be a case for starting base losses to be quarantined to a project consistent with the principle that the recognition of the starting base for existing projects is intended to shield those projects from MRRT. This issue is discussed further in Section 7.

Deduction (loss) ordering rules: The potential existence of quarantined and transferable losses means there will need to be a defined order in which losses are applied against profits. Generally, transferable losses would take precedence over quarantined losses. This ordering is required to give effect to the non-refundability condition.

Royalty credits: The terms of reference state that royalties can be credited against MRRT liability, and can be uplifted, but they can not be transferred or refunded.

Questions

Question 6.1: Should losses be transferrable beyond the entity owning a project? If so, is there a case for extending transferability beyond a wholly owned group?

Question 6.2: Should MRRT losses be required to be transferred or should this be at the choice of the taxpayer? If the latter, what is the supporting rationale given the arguments in favour of requiring transfer?

Question 6.3: Are there circumstances where transferability of losses from an acquired project should be allowed?

Question 6.4: How should deduction (loss) ordering rules be applied to give effect to the quarantining of some types of deduction and non-refundability of losses?

6.1 Transfers of MRRT losses within wholly owned groups

213. The terms of reference state that project losses will be transferable to offset MRRT profits on other projects that a taxpayer owns. The terms of reference do not, however, discuss whether losses might be transferred to projects owned by a related entity.

214. Allowing MRRT losses from an entity to offset MRRT profits of a related entity's project would avoid any bias that might otherwise arise concerning the choice of corporate structure. If there were a prohibition on the transfer of MRRT losses within a wholly owned group, there could be a bias toward holding projects within a single company structure. This may be at odds with commercial practice.

215. In other areas of the tax law, losses may be transferrable where the loss entity and profit entity are part of a wholly owned group. There are two possible models to allow the transfer of MRRT losses within wholly owned groups.

216. Similar to the income tax law[19] and PRRT,[20] wholly owned groups of entities could make an irrevocable election to allow MRRT losses to be transferred between projects of the wholly owned group. A 'company group' would be defined as companies in which there is 100 per cent common ownership. A variant would be to only allow this for groups that had elected to consolidate for income tax purposes. Under these types of group treatment, project losses of group members would automatically be transferred.

6.2 Transfer of MRRT losses between projects

217. The terms of reference do not state whether companies would be required to transfer MRRT losses to offset MRRT profits in other projects or whether this is to be at the discretion of the taxpayer. There are several issues that deserve consideration.

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[19] Although the head company of a consolidated group is required to be an Australian resident, foreign-owned groups can form a 'multiple entry consolidated' (MEC) group and for their Australian entities nominate an Australian head company.

[20] The two basic tests governing PRRT transfers between two companies are that: (i) over the period one of the companies was a subsidiary of the other or; (ii) both companies are subsidiaries of the same parent.

218. The uplift rate of the LTBR plus 7 per cent is intended to compensate entities for the risk they may not be able to utilise their MRRT losses. If a company were able to offset its losses against profits on other projects, but chose not to, the entity would be receiving compensation through the uplift for a risk that does not exist, namely the possibility that MRRT losses will not be able to be utilised in the future.

219. Requiring entities to transfer MRRT losses to offset any eligible MRRT profits elsewhere is, therefore, consistent with the policy rationale for the higher than Long Term Bond Rate allowance. This approach would also be consistent with the PRRT, which requires a taxpayer with unused exploration losses to transfer them to the maximum extent possible.

220. A further argument in support of requiring transfer of losses is that a consequence of setting the uplift rate at such a level is that the real value of an MRRT loss will increase over time at a rate that may be above the marginal cost of funds of many entities. If this were to be the case, it would give rise to an incentive to 'bank' losses and thereby reduce MRRT liabilities. An entity could do this by electing not to transfer MRRT losses to offset current MRRT profits, thereby deferring their use to a future time.

6.3 Transfers of MRRT losses from acquired projects

221. While the terms of reference state that MRRT losses will be able to be transferred to reduce current MRRT profits from an entity's other projects, MRRT losses are not intended to be refundable.

222. Allowing losses that are attached to a project interest to be transferrable in the hands of the acquiring entity would be inconsistent with non-refundability. This is because the value of losses that might otherwise remain unutilised within the project in question could, in substance, be refunded through the sale of the project interest. Giving effect to non-refundability in this circumstance would require that any losses acquired through the purchase of a project interest be quarantined to the acquired project interest.

223. Loss utilisation within an entity or group could also be enhanced by acquiring profitable projects to which existing non-starting bases losses could be transferred. Limiting this type of activity would require more comprehensive continuity of ownership rules, similar to those applying for income tax purposes.

224. Under continuity of ownership rules there must be continuity of ownership of the loss entity and profit entity between incurring the loss and deriving the gain. This approach is consistent with the PRRT, which restricts transferability of exploration expenditure using continuity of ownership rules.[21]

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[21] Under clauses 22 and 31 of the Schedule to the PRRTAA, exploration expenditure can only be transferred if the person held an interest in both the transferring project and the receiving project from the beginning of the year the expenditure was incurred, to the end of the transfer year.

For company group transfers, the loss transferring company must have held its interest in the transferring project, and the loss recipient company must have held its interest in the receiving project from the beginning of the year the transferable expenditure was incurred, up until the end of the transfer year.

6.4 Starting base losses

225. The terms of reference do not specifically address the treatment of starting base losses. Given that the recognition of the starting base for existing projects is intended to shield those projects from the MRRT, there appears to be a case in favour of quarantining the starting base. This also suggests that losses associated with the starting base should also be quarantined. The PTG is interested in hearing alternative views, particularly the underlying rationale for transferability. The treatment of losses arising through the depreciation of the starting base is considered in Section 7.6.

6.5 Deduction (loss) ordering rules

226. The potential existence of quarantined and transferable losses means there will need to be a defined order in which deductions and losses are applied against profits. Generally, transferable losses (and deductions that give rise to transferable losses) should be applied first. This ordering is required to give effect to the non-refundability condition.

227. A related issue is whether losses would be transferable before or after the application of royalty credits on projects with MRRT profits.

6.6 Royalty credits

228. The terms of reference provide clear guidance that State and Territory royalties paid on projects in respect of MRRT assessable receipts will be neither transferable nor refundable under the MRRT. Instead, they will be quarantined to the project, and carried-forward while being uplifted at the allowance rate of the Long Term Bond Rate + 7 per cent.

229. State and Territory royalties will be creditable at least up to the amount imposed at the time of announcement, including scheduled increases and appropriate indexation factors.

7 STARTING BASE

Terms of reference

The starting base for project assets is, at the election of the taxpayer, either:

- Book value (excluding the value of the resource); or
- Market value (as at 1 May 2010)

All capital expenditure incurred post 1 May 2010 will be added to the starting base and depreciated against mining operations from 1 July 2012.

Project assets for the purpose of the MRRT will be defined to include tangible assets, improvements to land and mining rights (using the Income Tax definition).

When book value is used to calculate the starting base, depreciation will be accelerated over the first 5 years. The undepreciated value will be uplifted at LTBR + 7 per cent.

Where market value is used to calculate starting base, there will be no uplift and depreciation will be based on an appropriate effective life of assets, not exceeding 25 years.

Any undepreciated starting base and carry forward MRRT losses are to be transferred to a new owner if the project interest is sold.

Summary

The starting base arrangements recognise that decisions to invest in existing projects were made before resource tax reforms were announced. Recognising the value of existing project assets largely preserves the tax treatment of investments made before the tax reforms were announced. This section addresses eight topics concerned with the assets within a project's starting base, the valuation of the starting base and starting base losses.

Assets included in the starting base: The terms of reference specify project assets as including tangible assets, improvements to land and mining rights (using the Income Tax definition). Whether intangible assets other than mining rights (such as mining information or intellectual property) fall within the definition of project assets needs to be determined.

New capital expenditure incurred prior to 1 July 2012: New capital expenditure incurred prior to 1 July 2012 is to be added to the starting base for a project. The PTG acknowledges the treatment of capital expenditure prior to 1 July 2012 could affect the timing of investment decisions.

The starting base election: The terms of reference are clear that the election of a market value or book value starting base is at the discretion of the taxpayer. Guidelines will be required as to whether joint venturers can make different choices, whether the election is irrevocable and whether to use a default option in the absence of an election.

Market value approach: Calculating market value can be a complex undertaking, with a variety of different approaches. Three approaches to legislating the valuation of the starting base are to: simply state that the 'market value' of the project assets is to be included in the starting base, leaving the entity to apply an appropriate methodology; require an entity to follow a Tax Office accepted valuation process; or legislate a particular methodology or methodologies for arriving at a value. The PTG will seek the need for further advice

regarding the methodology for establishing the starting base using the market value method.

Book value approach: Where the book value approach is used, the starting base will depend upon values recorded in an entity's accounts. The terms of reference are silent on the features of the book value option. However, there is merit in basing this option on the starting base rules put forward under the Government's initial resource tax proposal of 2 May 2010. During the initial round of consultations a number of observations were made as to the appropriateness of the proposed book value method. These issues would be examined before implementing this approach.

Treatment of starting base and starting base losses: The starting base provides a tax shield for existing investments from the MRRT. In recognising interest in existing projects, it is arguable that the starting base should not be transferable. To give effect to this it would also be necessary to treat starting base deductions in the same manner.

Transfer of projects with a starting base: The terms of reference state that any undepreciated starting base or carried forward losses are to be transferred to a new owner if the project interest is sold. There would be a bias against the sale of projects if this were not the case.

Changes in the assets of a project: Rules covering the removal or sale of assets which were part of the starting base will be required. Where an asset is removed from the starting base, a corresponding adjustment should be made to the starting base. Any net gain/loss should also be treated as an assessable receipt/deductible expense.

Questions

Question 7.1: Which assets should be included in the starting base?

Question 7.2: Which valuation methods will provide an appropriate assessment of market value? Should any methods be prescribed or proscribed? Are there ways to provide greater certainty as to how market valuation should be conducted?

Question 7.3: How significant are the potential distortions to investment behaviour in the lead up to 1 July 2012?

Question 7.4: What adjustments to book value (if any) are necessary to fairly recognise the value of existing project assets?

Question 7.5: What rules should govern starting base elections?

Question 7.6: Which, if any, starting base losses should be quarantined? Does transferability of starting base losses give an entity a competitive advantage for new project acquisitions? Should losses from a starting base assessed using the market value method be uplifted?

Question 7.7: What principles should determine whether a project interest has been sold, rather than a project asset? What rules are required to govern changes in project assets?

230. The starting base arrangements outlined in the terms of reference are designed to recognise that decisions to invest in existing projects preceded the announcement of resource tax reform. Recognising the value of existing project assets largely preserves the tax treatment of investments made before the tax reforms were announced. Entities

will have a choice in the way they value the starting base for their projects. They can use either the market value approach or the book value approach.

7.1 Assets included in the starting base

231. The terms of reference state that project assets for the starting base are to include tangible assets, improvements to land and mining rights (using the income tax definition).

232. One interpretation is that, other than mining rights (as defined in the income tax laws),[22] intangible assets – non-monetary assets without physical substance – would not be project assets. Such exclusion would be consistent with the 25 per cent extraction allowance, which reduces the taxable profits subject to MRRT. The extraction allowance is intended to recognise the contribution of the miner's expertise to profits at the mine gate. To the extent that this expertise is attributable to intangible assets other than mining rights, to include their value in the starting base would be double counting their contribution to taxable profit.

233. An alternative interpretation is that the identified project assets are meant to be indicative, rather than exhaustive, and that all project assets should be included in the starting base, including intangible assets.

234. The general meaning of "improvements to land" includes fixtures, such as fences, and other improvements to land, such as a dam or a road. It would be envisaged that many other tangible alterations would also be classed as improvements to land (e.g. tailings dams and haul roads).

235. The definition of a project and when a project is created, the treatment of multi-product projects, the taxing point and apportionment of assets are relevant in determining the starting base of an existing project.

- The ability to recognise a starting base could be limited to projects with a production licence in existence at 2 May 2010. Where a project meets this stage after 2 May 2010, eligible project expenditure incurred after that time and before 1 July 2012 could comprise a starting base for that project.

- In calculating the starting base, only those assets eligible under the terms of reference and upstream of the taxing point would constitute part of the starting base, and only to the extent they are used upstream of the taxing point.

- The value of the resource as at 1 May 2010 would, ideally, be reduced in accordance with any depletion of the resource in the period to 1 July 2012. This would reflect the fact that any such reduction in the value of the resource through production in the period to 1 July 2012 would be taxed under the existing taxation regime, not within the MRRT.

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[22] The term 'mining, quarrying or prospecting right' is a defined term under the income tax law – see Division 995 of the *Income Tax Assessment Act 1997*. The definition includes any licence, right or permit to mine or prospect for minerals or petroleum. The definition also includes leases that allow the lessee to mine or prospect for minerals or petroleum.

7.2 New capital expenditure incurred prior to 1 July 2012

236. The terms of reference note that any new capital expenditure incurred prior to 1 July 2012 is to be added to the starting base for a project.

    - Under the market value approach, such expenditure would not receive any uplift and would be deductible over the lesser of its effective life for income tax purposes or 25 years.

    - Under the proposed book value approach, such expenditure would be uplifted and would be deductible over five years following commencement of the MRRT.

237. The treatment of interim investment in the terms of reference may result in some deferral of investment in the period to 1 July 2012. This is because expenditure incurred from 1 July 2012 would be expensed and transferable between projects. The incentive to defer capital expenditure could be expected to increase as the commencement of the tax regime becomes more imminent.

238. The book value approach was originally designed within the context of the Resource Super Profits Tax proposal with the aim of reducing such distortions to the timing of investment by providing the same treatment as investment post commencement.

239. Treating capital expenditure incurred prior to 1 July 2012 more like post commencement expenditure would be a deviation from the terms of reference.

7.3 The starting base election

240. The terms of reference state that the choice of market or book value is "at the election of the taxpayer". An entity (or group of entities) may have interests in several projects. One possible option is that the entity or group's election applies to all projects. Alternatively, the election could be made for each project.

241. If the election could be made for each project, an issue is how unincorporated joint venturers (i.e. multiple investors with an interest in a project) would make their election. Joint ventures are very common in the resources industry. In these cases, the options are:

    - each entity or group chooses its starting base approach; or

    - the starting base is chosen at the project level with all joint venturers applying that method, thereby reducing compliance costs.

242. It is anticipated that taxpayers would self assess their MRRT liability, consistent with the existing PRRT and most other Commonwealth taxes. Under self-assessment, entities typically provide only limited information in their tax return.[23] However, they are required to keep relevant records to substantiate their income and deductions. In addition, there are also requirements for making and lodging elections. Some elections do not have to be in writing and many of those that are required to be in writing do not have to be lodged with the tax return.

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[23] Refer *Consultation Paper – Review of Elections in the Income Tax Law*, The Treasury, 16 June 2010.

243. Given the implications of the starting base treatment, it would be appropriate that an entity be required to make an election by the date it lodges its MRRT tax return, or within a further time allowed by the Tax Office. The way the entity prepares its MRRT tax return should be sufficient evidence of the making of that election. Where an entity is not required to lodge a MRRT tax return it could be required to make its election by the last day that return would have been due. An entity could lodge the election with the Tax Office if it is not lodging an MRRT tax return.

244. The election of the starting base methodology should be irrevocable once made by an entity. Generally, elections are irrevocable where there are potential unintended tax advantages and opportunities for tax arbitrage. In this case, revocable elections would open up opportunities for arbitrage or could affect other parties.

245. Where an entity fails to make a starting base election for a project interest that they had on 2 May 2010, a default position would need to be adopted. A default position of market value is almost certainly not viable, since an entity failing to make an election is most unlikely to have undertaken a market valuation exercise for the purposes of the MRRT. Accordingly, the two options would appear to be:

- there is no starting base for the project; or
- the starting base is determined using the book value approach.

246. The former approach would create a strong incentive for an entity to make an election. The latter approach would be seen as less harsh but may not work in all cases because some entities (particularly small unlisted companies) may not have audited accounts prepared to relevant standards.

7.4 Market value approach

247. Under the market value approach, the starting base for each project will be the market value of the project assets as at 1 May 2010.

248. In broad terms, the following categories of assets could form part of the market value of a project. Only those directly related to the upstream component of the project would be relevant in establishing a market value starting base.

249. The valuation process would entail isolating and valuing those assets that pertain to the upstream part of the value chain. Less clear, is the extent to which indirect tangible assets might also be included in the starting base.

250. As discussed in Section 5.4.5, where private override royalties and indigenous royalties were in existence at 2 May 2010, the resource component of the starting base could be assessed taking into account the profit derived both by the company and the private royalty recipient, rather than the net profit stream to the company. This would be consistent with denying deductibility for such royalties.

Table 7.1: Market valuation asset categories

Upstream direct project assets	Downstream direct project assets	Indirect project assets
Mining right Tangible assets used in the value chain upstream of the taxing point Improvements to land upstream of the taxing point Exploration	Tangible assets used in the value chain downstream of the taxing point Improvements to land downstream of the taxing point	Tangible assets that are not directly related to the value chain (e.g. head office assets, land) Intangible assets Entity expertise (the management asset)

251. There are two broad approaches the law could take in establishing market valuations of a project's starting base for the MRRT:[24]

- the law could simply require the 'market value' of the project assets to be included in the starting base; or
- the law could specify which particular market value methodology should be used to determine the market value of particular types of project assets.

252. Either of the above approaches could be supplemented by rules requiring the valuations to be determined by following a particular process.[25] In that case, market valuations could only be challenged by the Tax Office on the basis that the process was not followed.

253. The general tax law approach has been to not statutorily prescribe how market value is to be determined. Instead, the Tax Office has issued comprehensive guidelines setting out what it considers an allowable methodology.[26] These guidelines note various principles, supported both by industry standards and case law, that are to be used in determining market value. For example:

- market value is ascertained according to the 'highest and best use' of the asset (although interrelated assets should be valued on the same use);

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[24] An analogous issue arises in determining the assessable revenue for resources at the taxing points – see Section 5.2.

[25] For example, such a process might specify the qualifications required of a valuer, what market valuation parameters or guidelines must be followed (such as the *Market valuation for tax purposes* guidelines prepared by the Tax Office for the consolidation regime or the industry VALMIN code) and the timeframe within which the valuation process must occur.

[26] See the Tax Office's *Market valuation for tax purposes* guidelines.

- market value is to be determined as a price negotiated between willing but not anxious buyers and sellers;
- a hypothetical market is to be assumed if actual market conditions do not provide good evidence as to market value;
- the hypothetical buyer and seller are assumed to be fully informed of the advantages and disadvantages associated with the asset being valued; and
- both parties are assumed to be aware of current market conditions.

254. In addition, the guidelines note that certain valuation methods are more appropriate for a given class of asset. For example, a business or mining right might be valued using an income approach and plant and equipment might be valued using replacement depreciated cost.

255. Market valuation was an important part of the implementation of the income tax consolidation rules. A key step when an entity is acquired by a consolidated group is to allocate the net consideration paid for the entity[27] to individual assets in accordance with the assets' respective market values. Experience has been that the most difficult assets to ascribe a value to are intangibles, such as the management asset and the resource right, as the values of these are more likely to be unique to individual projects or entities and interdependent. In practice, the valuation will depend on the expertise and professional judgement of the valuers.

256. The considerations relevant to establishing asset values for the MRRT starting base may be different to those for consolidation. In particular, in consolidation, market values are relevant only insofar as they determine the allocation of a pre-determined cost base across assets. In MRRT, the market valuation would determine the starting base and the MRRT deductions that flow from it.

257. Whichever approach is taken, there will be a need to ensure that the incentive for entities to both inflate the recorded value of assets and allocate value towards assets with shorter effective lives is appropriately managed.

258. The PTG will examine the need for further advice regarding the methodology for establishing the starting base using the market value method. The PTG seeks feedback from industry on methodologies for valuing discrete projects.

7.5 Book value approach

259. Where the book value approach is used, the starting base will depend upon values recorded in an entity's accounts. The terms of reference are silent on the features of the book value option. However, it is reasonable to assume that the intention was to base this option on the starting base rules proposed under the Government's initial resource tax proposal of 2 May 2010.

260. Under that proposal, the starting base was to be based on the accounting book value of existing project assets as at the most recent audited accounts available on 2 May 2010. The book value was to reflect a value consistent with Australian Accounting Standards

[27] Net of the acquired entity's liabilities.

and exclude the value of the resource.[28] Capital expenditure incurred after the book date and before 1 July 2012 was to be added to the starting base. The entire starting base was to be uplifted at the Long Term Bond Rate through to 1 July 2012, and thereafter until fully depreciated. Depreciation was to occur over five years with the following profile 36 per cent: 24 percent: 15 percent: 15 percent: 10 percent.

261. During the initial round of consultations a number of observations were made as to the appropriateness of the proposed book value method. These included:

- company discretion in the respect of capitalisation practices may lead to different starting base outcomes for similar projects;
- book values may be understated due to impairment of some assets in response to the global financial crisis;
- book values may not appropriately reflect assets such as exploration and overburden removal; and
- not all companies prepare accounts in accordance with the Australian or international accounting standards.

262. These issues would be examined before implementing this approach to establishing the starting base for a project.

7.6 Treatment of starting base and starting base losses

263. The starting base provides a tax shield to recognise investment in projects at the 2 May 2010 date of announcement. To the extent the starting base of an existing project and its depreciation recognises the value of the existing investment, it means the MRRT does not apply to that project.

264. In recognising investment in existing projects, it is arguable that the starting base should not be transferable. To give effect to this property of the starting base, it would be necessary to treat any starting base losses arising from unutilised depreciation of the starting base in the same manner. If MRRT losses attributable to the depreciation of the starting base were transferable to offset MRRT profits of new projects, the starting base would go beyond the role of shielding pre-existing projects from the application of the MRRT. Instead, the starting base could provide the owner of the project a competitive advantage in relation to the acquisition of new projects. To prevent this distortion, rules that prevent the transfer of starting base losses would need to be included within the design of the MRRT.

265. An alternative would be to allow transferability of starting base losses where they relate to transferable assets. This would reduce the incentive to dispose and re-acquire the same or similar assets to be able to transfer depreciation deductions.

266. The terms of reference state that undepreciated amounts relating to the starting base would not be uplifted where the market value approach is used. However, the terms of reference are silent as to whether MRRT losses attributable to the starting base should be uplifted. One proposition is to treat the two similarly, so that MRRT losses

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[28] See *The Resource Super Profits Tax*, The Treasury, Section 6.3.

attributable to starting bases established using the market value approach would not be uplifted. Alternatively, the two could be treated differently, so that MRRT losses are uplifted even where the starting base to which they relate is not.

7.7 Transfer of projects with a starting base

267. The terms of reference state that any undepreciated starting base and carry forward MRRT losses are to be transferred to the new owner if a project interest is sold. Further, as credits for royalties paid are quarantined to the project, these credits should also be transferred to the new owner of the project.

268. However, where a project interest to which a starting base relates is not sold, but assets are sold out of that project, different consequences follow (see Section 5.3). As a result, rules to determine whether a project interest has been sold or not will be necessary. In many cases, it will be clear that a project interest has been transferred (e.g. where the entire mining right has been sold), but this may not always be the case (e.g. where the mining right has been partially alienated, such as the sub-lease or sub-licence of a mining right).

7.8 Changes in the assets of a project

269. The terms of reference are silent as to the effect on a project's starting base if an asset is removed from that project (e.g. by sale or transfer to another project held by the same entity). In principle, the disposal of such an asset should affect the starting base.

270. Table 7.2 sets out the range of circumstances relating to the disposal of starting base assets that may need to be dealt with and possible approaches to dealing with them.

271. There will be an incentive for entities using the market value approach to access the MRRT allowance through the sale and reacquisition of assets. These incentives would need to be managed to maintain the intent of the terms of reference.

Table 7.2: Disposal of starting base assets and possible treatment

Case	Possible approach
Asset included in the starting base is held in the project interest on 1 July 2012 (regardless of whether it was removed from the project interest at some time during the period from 2 May 2010 to 30 June 2012)	No change to the starting base. Consideration should be given to whether depreciation should be applied during the period of time prior to 1 July 2012.
Asset included in the starting base is removed from the project interest between 2 May 2010 and 30 June 2012 and is not held in the project interest on 1 July 2012	The starting base is reduced by the amount included in it for that asset
Asset (other than a mining right) included in the starting base is removed from the project interest on or after 1 July 2012	A balancing adjustment applies in relation to the asset

Case	Possible approach
A mining right included in the starting base, or an interest in such a right, is disposed of on or after 1 July 2012. It would be expected that this would result in the new holder of that right or interest obtaining an interest in the project[29]	The approach would be consistent with the "transfer of starting base projects" discussion above

[29] This category may need to be broader than just mining rights. It may need to include other project assets that can only be transferred with the mining right or an interest in it.

8 $50 MILLION THRESHOLD

Terms of reference

There will be no MRRT liability for taxpayers with low levels of resource profits (i.e. $50 million per annum).

The PTG has been asked to consider a workable exclusion where resource profits are below $50 million per annum.

Summary

The outcome of the $50 million threshold will be to exclude from an MRRT liability entities with a MRRT profit of less than $50 million in that year. Given the inter-temporal nature of the MRRT calculation, these entities would still be required to maintain MRRT records. As a consequence, the $50 million threshold will do little to reduce the compliance costs of small entities. The PTG is open to suggestions about ways in which the threshold might be redesigned to better address the issue of compliance costs. Any change involving a cost to revenue would need to be offset within the PTG's recommendations.

This section addresses five topics concerned with the design and application of the $50 million threshold.

Addressing the costs of compliance for small miners: Whether reducing the compliance costs of small entities is a worthwhile objective to pursue depends, in part, on whether there would be strong commercial incentives to maintain MRRT accounts− for example, to access future losses, including upon sale of the project. One possible way to exclude entities with small MRRT assessable profits would be to allow them the option of not maintaining MRRT accounts, on the basis that past expenditure would be ignored if they became assessable at a future time.

Annual application of the threshold profits test: The threshold test is to be applied as an annual profits test. Annual profit is interpreted to mean assessable receipts less deductible expenditure. That is, starting base depreciation and carried forward losses would be excluded. This method of applying the threshold involves lower compliance costs and avoids the interaction of the threshold with State and Territory royalties.

Applying the threshold at an aggregated entity level: Tax concessions using threshold tests are normally applied at an aggregated entity level. This avoids an incentive to split entities to take advantage of the concession. There are several entity aggregation rules that could potentially be used. A consolidation approach consistent with the transfer of losses may minimise compliance costs, but would not be applicable to all entities (e.g. partnerships) and would raise some integrity concerns. The small business test in the *Income Tax Assessment Act 1997* would seem to be an appropriate and more broadly applicable test.

Addressing the distortionary effect of the threshold: The terms of reference suggest an entity that exceeds the threshold is liable to pay MRRT on profits above and below the threshold. This has the potential to alter entities' investment and production decisions. A phased withdrawal of the tax concession could address this behaviour. Other options include providing some form of fixed concession over the life of a project.

The interaction between the threshold and royalties: Royalties are credited against an MRRT

liability. If an entity were to benefit from the threshold and preserve royalty credits this would constitute a 'double benefit' from the threshold. This could be addressed by requiring that any royalty credits be reduced by the MRRT liability that would have existed had the threshold not been applied. Another option would be to deny a credit for royalties incurred in a year when the threshold is not exceeded.

Questions

Question 8.1: How significant are compliance costs likely to be for smaller miners? Is there an alternative approach that would reduce compliance costs for small miners?

Question 8.2: Which aggregation test is most appropriate for the $50 million threshold?

Question 8.3: Is there a less distortive way to apply the threshold for entities with resource profits below $50 million per annum?

Question 8.4: How should royalties be treated when an entity has accessed the $50 million threshold?

272. The $50 million threshold is interpreted to apply as an annual profits test (assessable revenue less deductible expenditure) such that taxpayers with profits exceeding the threshold would pay tax on their entire profits (both above and below the $50 million threshold). It is assumed that the test is intended to apply to the collective MRRT profit of all project interests held by a taxpayer. For many entities with an MRRT profit around $50 million, it is possible that royalties will exceed the MRRT liability and no MRRT would be payable.

8.1 Addressing the costs of compliance for small miners

273. Through its design, the outcome of the $50 million threshold will be to exclude from an MRRT liability entities with an MRRT profit of less than $50 million in that year. Given the inter-temporal nature of the MRRT calculation, these entities would still be required to maintain MRRT records. As a consequence, the $50 million threshold will do little to reduce the compliance costs of small entities.

274. If the intention of the $50 million threshold is to exclude small entities, one possible treatment would be to provide entities with small MRRT assessable profits with the option of not maintaining MRRT accounts. The entity would still be subject to the threshold test but MRRT allowances and historic costs would not be calculated and thus not deducted from receipts in calculating profits or uplifted. This would mean that, if in a given year the entity's MRRT assessable profits exceeded the threshold, it would not receive recognition for its past investments or royalties. However, even this approach would need to recognise the needs of the Tax Office in undertaking compliance verification.

275. Whether reducing the compliance costs of small entities is a worthwhile objective to pursue depends, in part, on whether there would be strong commercial incentives to maintain MRRT accounts to be able to access past losses, including upon sale of the project or on crossing the threshold.

8.2 Annual application of the threshold profits test

276. The terms of reference indicate that the threshold test is to be applied as an annual profits test. Annual profit is interpreted to mean assessable revenue less deductible expenditure. That is, starting base and carried forward losses would be excluded. The implication of applying the threshold in this manner would be that entities would aggregate all their eligible MRRT and expenses for the year, and determine if they are above or below the $50 million threshold. This method of applying the threshold would involve lower compliance costs and avoid the potential interaction of the threshold with the State and Territory royalties.

8.3 Applying the threshold at an aggregated entity level

277. The normal tax law approach when applying a concession based on a threshold test is to apply it at an aggregated entity level (see for example the small business concessional threshold). Requiring entity aggregation removes the incentive to create single project entities or to split one project among several entities.

278. The terms of reference indicate that the threshold will apply to taxpayers. This is interpreted as applying the threshold to entities rather than to a project or project interest. Entities would be required to aggregate MRRT assessable profits of related projects and entities in applying the threshold.

279. Two options for an entity aggregation rule are to:

- use the aggregation rule proposed for transferring losses; or
- use another of the income tax law's grouping rules.

280. Under the first option, entities that are grouped for MRRT purposes would count their profits toward a single $50 million threshold. Although this option would be convenient and would minimise compliance costs, it may not achieve the intended aggregation because it is easy to move an entity outside a group. For example, if the consolidation rule requires 100 per cent commonality of ownership, a 99 per cent owned entity would not be grouped. A further issue with using the consolidation approach is that not all entities are able to consolidate. Partnerships, for instance, cannot be part of the same group unless each partner is itself within the group.

281. There are many different grouping tests in the income tax law designed for various purposes. One that seems relevant in this context is the small business test in Subdivision 328-C of the *Income Tax Assessment Act 1997*. This test examines whether an entity is a small business by asking whether its turnover, combined with that of entities connected with or affiliated with it, is below a threshold. Whether one entity is connected or affiliated with another is determined by whether one of them can control the other or whether it is reasonable to expect that one would act in accordance with the wishes of the other. The test uses among other criteria a 40 per cent ownership or control criterion to determine the level of relationship between entities.

282. In the absence of a specified aggregation methodology, the Tax Office would probably seek to use the general anti-avoidance rules where it concluded that the structure was created in a deliberate attempt to avoid MRRT liability.

8.4 Addressing the distortionary effect of the threshold

283. The description of the $50 million threshold in the terms of reference implies that entities exceeding the threshold would be expected to pay MRRT on their entire profits, both above and below the $50 million threshold. This has the potential to alter entities' investment and production decisions. Entities near the threshold may have an incentive to alter the timing of expenses or production, if the tax benefit from doing so would to exceed the before-tax profit they would otherwise earn. Entities earning an additional dollar of profit over the threshold would potentially suffer an increased liability of up to $11 million dollars.

284. This distortion could be addressed in a number of ways, though any such change would involve a cost to revenue and would need to be offset within the PTG's recommendations to the Government.

- Under a phased approach to the threshold, similar to that used elsewhere in the income tax system, the tax benefit of the threshold would be withdrawn gradually as profit increased, rather than in a single step (see Box 8.1).

- A life-of-project threshold would give entities a lifetime threshold that would effectively be a tax-free threshold. Once this had been used by the entity it would begin paying MRRT. In principle, this threshold could be quarantined to entities below a certain income or market cap value, though in practice that could prove difficult to implement.

- An inflated starting base for small entities meeting certain conditions, while non-distortive, would have to be separately quarantined so that a large entity acquiring the project would not benefit from it.

- A further option would be a fixed concession over a project's life to remove the tax benefit from inter-temporal shifts in production (for example, a different MRRT rate, extraction allowance or tax credit for small miners).

8.5 The interaction between the threshold and royalties

285. The interaction between the threshold and the royalty tax offset is important because royalties provide a base rate of resource taxation. Depending on the implementation of the threshold, there is an opportunity for the threshold and royalty credits to act in conjunction to shield entities from incurring a future MRRT liability.

286. Uncredited royalties are uplifted and carried forward for crediting against future MRRT liabilities. The application of the threshold could mean that royalty credits that would have been applied to an MRRT liability if there were no $50 million threshold would remain uncredited and would be carried forward and uplifted.

287. A possible option to address this issue is to ensure that any royalty credits are only carried forward after they have been reduced by the MRRT liability that would have existed had the threshold not applied. Another option would be to deny any credit for royalties incurred in a year when the threshold is not exceeded.

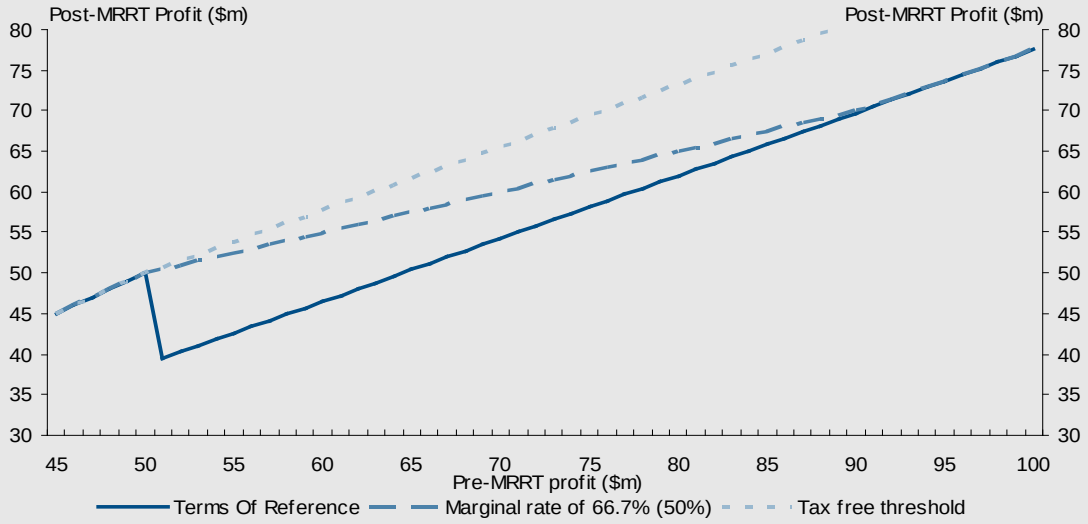
Box 8.1: The distortionary effect of the $50 million threshold

Figure 8.1 and Figure 8.2 show the impact of the $50 million threshold on post-MRRT profit and the effective tax rate for three different ways of applying the threshold. The most pronounced impact on an entity's post-MRRT profit and average effective tax rate of earnings slightly more than $50 million in profits occurs when the $50 million threshold is fully withdrawn at the threshold. The effective tax rate under this option increases from zero to 22.5 per cent at the threshold.

Gradually withdrawing the threshold at a rate that yields an effective marginal tax rate of 50 per cent of additional MRRT profit over the withdrawal range. The 50 per cent effective marginal rate applies until the benefit of the threshold is withdrawn (around $90 million of MRRT profit), at which point the effective tax rate is 22.5 per cent.

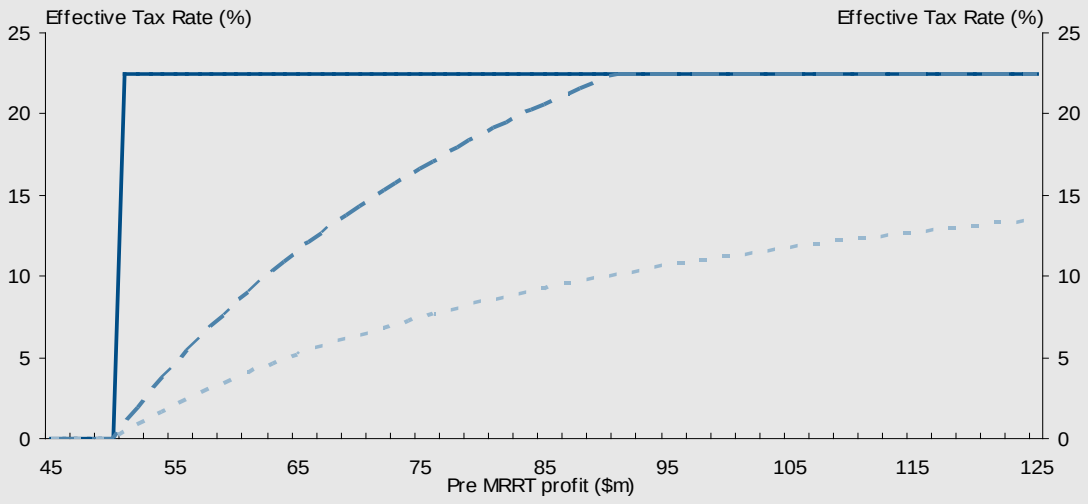
The application of the $50 million threshold operating as a tax free threshold is also demonstrated as a reference case.

Figure 8.1: Impact of the $50m exemption on post-MRRT profit



Source: Policy Transition Group (PTG) Secretariat

Figure 8.2: Impact of the $50m exemption on the average effective tax rate
(after the 25 per cent extraction allowance)



Source: Policy Transition Group (PTG) Secretariat

Part C

TRANSITIONING EXISTING OIL AND GAS PROJECTS TO THE PRRT

9 OVERVIEW OF THE PRRT

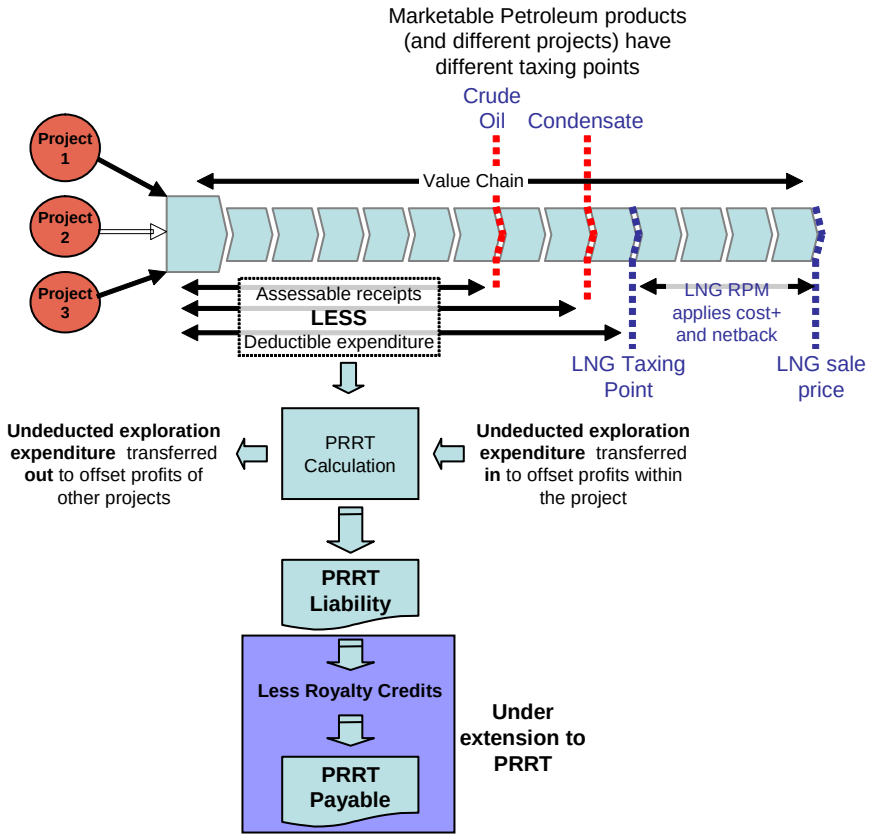
288. The PRRT has been in operation for over 20 years. This section contains an overview of how the PRRT works, and highlights the main issues that will need to be addressed to transition existing oil and gas projects, particularly those onshore, into the PRRT regime.

9.1 How the PRRT works

289. The Petroleum Resource Rent Tax (PRRT) is a profit based tax that came into effect on 1 July 1986. As defined under the *Offshore Petroleum and Greenhouse Gas Storage Act 2006*, the PRRT applies to all petroleum projects in offshore waters (or Commonwealth adjacent areas), with the exception of the North West Shelf Project and the Joint Petroleum Development Area in the Timor Sea. The offshore areas commence three nautical miles from the territorial sea baselines and extend to the outer limits of the continental shelf. The PRRT replaced the crude oil and liquefied petroleum gas excise as well as the Commonwealth royalty on the wellhead value of production.

290. Figure 9.1 presents a stylised view of the PRRT for a hypothetical petroleum project.

Figure 9.1 A stylised presentation of the PRRT



Source: Policy Transition Group (PTG) Secretariat

291. Broadly speaking, a petroleum project incorporates the production licence area, treatment and other facilities, and operations outside that area that are integral to the production of Marketable Petroleum Commodities (MPC). PRRT applies separately to each individual project. Two or more projects will be treated as a single project where the Minister for Resources and Energy, having regard to relevant factors, considers that they should be treated as one project.

292. The boundaries of a petroleum project will not extend beyond the point where an MPC is produced and becomes an "excluded" commodity. This point is commonly known as the 'taxing point'. Activities beyond this project boundary are known as 'downstream' activities and refer to things such as refineries and facilities for the transport of an MPC. Downstream activities are not subject to the PRRT provisions.

293. Oil and gas extracted from a reservoir can be produced as a range of different MPCs. An MPC is defined as one of the following products produced from petroleum:

- stabilised crude oil;
- condensate;
- sales gas;
- natural gas;
- liquefied petroleum gas (LPG); and
- ethane.

294. The various MPCs involve different degrees of processing. The taxing point under the PRRT is defined by an MPC becoming an excluded commodity. That is, the taxing point comes about when an MPC:

- has been sold; or
- has been further processed or treated; or
- has been moved away from its place of production or storage site adjacent to the place of its production.

295. Consequently, the position of the taxing point within the value chain varies according to where an MPC becomes an excluded commodity. It is even possible that a given commodity such as condensate may have different taxing points in different projects if it is produced at different stages in the processing of project hydrocarbons.

296. In the case of integrated LNG operations, special rules apply to determine the value of the project sales gas produced at the taxing point. These rules require that one of three options be used to arrive at assessable receipts in relation to the project sales gas, and in the following order:

- the terms agreed to in an Advance Pricing Arrangement between the taxpayer and the Tax Office; or
- if this does not exist, a comparable uncontrolled price for the transaction; or

- if there is no such price, the residual pricing method in which any gap between the cost plus and netback gas prices is split between the upstream and downstream process on a 50:50 basis.

9.1.1 Taxable Profit

297. PRRT is levied at a rate of 40 per cent of the taxable profit of a project and payments of PRRT are a company income tax deduction. Taxable profits are arrived at by deducting from assessable receipts the total of deductible expenditure, plus unused deductible expenditure uplifted and carried forward from prior years, plus unused exploration expenditure from other projects or entities.

298. The *Petroleum Resource Rent Tax Assessment Act 1987* (PRRTAA) has a strict interpretation of what constitutes assessable receipts, as opposed to the broad interpretation under income tax. The PRRT regime only includes specific receipts at specific times. The question of what constitutes assessable receipts is therefore likely to differ with each petroleum project.

299. Derivation of assessable receipts will occur either when petroleum is sold prior to an MPC being produced or when an MPC becomes an 'excluded' commodity. This includes external petroleum which is petroleum recovered outside the production licence area.

300. In a gas to liquids project, assessable receipts are calculated in accordance with the regulations[30] when either sales gas is sold at the taxing point under a non-arm's length transaction or is not sold at the taxing point.

301. Other assessable receipts include tolling receipts relating to payments received for the processing of external petroleum; receipts recovered or produced from within an eligible exploration or recovery area, other than a production licence area; and amounts received in respect of the disposal, loss or destruction of property for which a deduction in respect of capital expenditure has been allowed or is allowable in relation to the project.

302. Miscellaneous compensation receipts which include payments of insurance, compensation, indemnity for loss or destruction or loss of profit of any petroleum or MPC, are also considered assessable receipts. The assessability of these receipts also extends to any reimbursement of expenditure that was previously allowed as a deduction. Also included are employee amenities receipts - for example, receipts where a project participant charges employees for housing in respect of which expenditure that has been incurred by the project participant.

303. Expenditures of either a capital or revenue nature that are directly related to a petroleum project are deductible in the year they are incurred and liable to be made. Unlike income tax, PRRT does not distinguish between revenue and capital expenditure. As capital expenditure is deductible, there is no need for a deduction for depreciation of plant and equipment used in a petroleum project.

304. Overall, there are three categories of expenditure: exploration, general and closing down. Generally speaking, for expenditure to be deductible under the PRRT, it must:

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[30] *Petroleum Resource Rent Tax Assessment Regulations 2005*.

- be incurred by the person in relation to the petroleum project; and
- be incurred in carrying on or providing operations, facilities or other things of a kind referred to in sections 37 (exploration expenditure), 38 (general project expenditure) and 39 (closing down expenditure) of the PRRTAA; and
- not be excluded expenditure under section 44.

305. In the *Woodside* decision,[31] French J, when referring to the construction of section 38 of the PRRTAA, said:

> '*In my opinion the requirement that the expenditure contemplated by section 38 is liable to be made in carrying on or providing operations, facilities and other things comprising the project ... contemplates a close connection between the expenditure and the physical activities involved in the petroleum project*.'[32]

306. French J's view is that there needs to be a close connection between the expenditure and the physical activity involved. Being a project based tax, expenditure needs to be project specific. This approach is different from the income tax approach. Income tax is a tax imposed on entities, so the required nexus between income and expenditure is broader than that required between receipts and deductions under PRRT. It is therefore possible that items of expenditure that would be deductible under income tax would not be deductible under the PRRT (and vice versa).

307. In deciding whether expenditure is deductible under PRRT, one needs to look at the nature and the character of the expenditure and apply to it the three requirements listed above at paragraph 304.

308. Exploration expenditure comprises all expenditure (other than excluded, general and closing down expenditure) that is related to exploring and recovering petroleum in an exploration or recovery area in relation to the project (i.e. an exploration permit area), prior to a production licence coming into force. Once a production licence comes into force, expenditure on the recovery of petroleum from the production licence area would form part of general expenditure. Examples of exploration expenditure include exploration drilling, appraisal drilling and survey expenditure relating to exploration activities. Exploration expenditure also includes expenditure on storage and processing facilities and employee amenities.

309. General project expenditure comprises all expenditure (other than excluded, exploration and closing down expenditure) in a production licence area on recovering and producing an MPC. Examples of general project expenditure include production platforms, drilling plant and equipment, pipelines to transport petroleum from the well head to a reception point, payments to contractors and wage costs of project employees.

310. Closing down expenditure comprises all expenditure in closing down a petroleum project. Such expenditure will include payments for environmental restoration made necessary by the project's closure and the removal of drilling platforms (but not the cost of relocating them elsewhere).

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[31] *Woodside Energy Ltd v. Commissioner of Taxation* [2007] FCA 1961 (10 December 2007).

[32] Ibid, para 276.

311. Certain expenditure is excluded as a deduction. This includes interest payments and repayments of principal with regard to borrowings; dividend payments; share issue costs; private override royalty payments; equity capital repayments; payments made under a cash bidding system; GST payments and indirectly incurred payments of an administrative and accounting nature.

312. As the PRRT is profit based rather than production based, it applies only where there is an excess of project related receipts for a financial year over project related expenditure of the current year and undeducted expenditure from previous years brought forward and uplifted.

313. Deductible exploration and general expenditure in excess of assessable receipts at the end of any given year will be compounded and carried forward for deduction against assessable receipts in future years (Table 9.1). The compounding rate for excess expenditure carried forward will depend on:

- the type of expenditure incurred;
- the date the expenditure was incurred;
- the date a production licence came into force; and
- the provision of sufficient information to support a successful production licence application (specified in a notice issued by the designated authority).

314. Deductible expenditure is applied in a certain order. The order of deductibility is important because it determines which expenditure remains undeducted and able to be compounded forward against receipts of future years. The order of deductions is:

1. ABR General
2. Class 1 ABR Exploration
3. Class 2 ABR General
4. Class 1 GDP
5. Class 2 ABR Exploration
6. Class 2 GDP
7. Closing Down Expenditure

315. Transfers of exploration expenditure must be made to the project with the most recent production licence and the oldest eligible expenditure must be used first.

316. Unutilised exploration expenditure incurred after 1 July 1990 must be transferred and deducted against the PRRT liability of another petroleum project held by the entity.

317. Exploration expenditure incurred before 1 July 1990 that has not been utilised is able to be deducted against assessable receipts derived by other petroleum projects established within the same exploration permit area.

Table 9.1 summarises the uplift rates that apply to various expenditures

PRRT	General Expenditure	Exploration Expenditure
Class 1 ABR	Pre 1 July 1990 Incurred < 5 years before the production licence came into force LTBR + 15% Non transferrable s.33	Pre 1 July 1990 Incurred < 5 years before the production licence came into force LTBR + 15% Non-transferrable s.34
Class 2 ABR	Post 30 June 1990 Incurred < 5 years before the date specified in notice issues by Designated Authority acknowledging the provision of sufficient information to support a successful production licence application LTBR + 5% Non transferrable s. 34A	Post 30 June 1990 Incurred < 5 years before the production licence came into force LTBR + 15% Transferable Inherited expenditure not transferrable s.35A
Class 1 GDP	Any year Incurred > 5 years before the production licence came into force GDP factor Non transferrable s. 35	Pre 1 July 1990 Incurred > 5 years before the production licence came into force GDP factor Non transferrable s.35
Class 2 GDP		Post 30 June 1990 Incurred > 5 years before the production licence came into force GDP factor Transferrable Inherited expenditure not transferrable s.35B
Augmented Bond Rates (ABR) is the LTBR – augmented bond rate uplift rates apply to all other exploration and general expenditure. Augmented bond rate general expenditure is project specific, whereas augmented bond rate exploration expenditure and GDP factor expenditure is deductible against projects within project groups		

318. Exploration expenditure of an entity incurred from 1 July 1990 is deductible against the PRRT profits of any other petroleum projects held by that entity. Transfers may also occur from exploration permits and retention leases prior to the issue of a production licence related to the permit or lease.

319. The exploration expenditure transfer provisions require that an entity is to have an interest in both the transferring and receiving project, or interests in both the transferring and receiving entity are to be held by entities within the same group. This allows internal corporate restructures to occur without losing the ability to transfer exploration expenditure between petroleum projects with common ownership.

320. In response to Australia's declining oil reserves, the PRRT was amended to encourage petroleum exploration companies to explore in remote offshore frontier areas. Designated frontier areas are areas chosen by the Minister for Resources and Energy that have remained unexplored because exploration in such areas is often high cost and high risk.

321. A 150 per cent deduction is allowed in respect of eligible exploration expenditure incurred in designated frontier areas. Undeducted frontier expenditure has the same access to augmentation as all other exploration expenditure.

9.1.2 Administration

322. PRRT is imposed on an annual basis. However, entities that have a PRRT liability during a year of tax pay four quarterly PRRT instalments. The tax amount is calculated as though the instalment period was for a year of tax. After determining the liability the entity deducts any prior instalments made during the same year.

323. Liability for PRRT is on an accruals basis. Assessable receipts are included in the financial year in which they are receivable. Where an MPC is not sold at the point it becomes an excluded commodity (the taxing point), the market value of the MPC is treated as an assessable receipt of the petroleum project.

9.2 Extending the PRRT to all onshore and offshore petroleum projects

324. The PRRT currently applies to most offshore petroleum projects. The terms of reference state that the PRRT regime will be extended to apply to all offshore and onshore petroleum projects, including coal seam gas projects.

325. The existing PRRT provisions will require amendment to provide a starting base to recognise that decisions to invest in existing projects were made before resource tax reforms were announced; to accommodate state licensing and royalty regimes and types of expenditure specific to onshore operations; and to deal with a greater variety of resource operations (including coal seam methane and unconventional gas).

326. The broader principles of the PRRT, such as determining assessable receipts and deductible expenditure, are unlikely to require substantive amendment to allow them to be applied to the new projects subject to the extended PRRT.

327. This part of the paper is structured in four sections, which address these issues as follows:

- The definition of a project addresses how projects that are not under the Commonwealth's offshore petroleum production licence system should be defined, when those projects begin and end, and how coal seam methane and unconventional gas should be accommodated.

- Taxable value addresses whether the taxing point as defined in the PRRT is workable for all onshore projects, how exploration expenditure which occurs at the same time as development (particularly for coal seam methane and unconventional gas) is treated, and how types of expenditure (particularly access to land/native title) which are incurred onshore are dealt with.

- The starting base addresses the election and calculation of the starting base and the need to adapt the PRRT to recognise the starting base and starting base losses.

- The recognition of losses and royalties addresses the interaction of royalties and state taxes with the PRRT and notes the need for revised loss ordering rules.

328. The PTG is aware that extending coverage of the PRRT will create an additional compliance and administration burden for taxpayers and welcomes suggestions on how this could be minimised while still providing sufficient certainty to both taxpayers and the Tax Office that any assessed liability is accurate.

329. The PTG recognises that there is a range of concerns with the current PRRT arrangements. These issues are outside the PTG terms of reference (which focus on matters relating to the extension of the PRRT) and so will not be actively pursued in this process. However, stakeholders may wish to highlight these in their submissions for future reference.

10 DEFINITION OF A PROJECT UNDER THE PRRT

Terms of reference

The announcement by the Government on 2 July 2010 states that:

- *The Petroleum Resource Rent Tax (PRRT) regime, which currently only applies to offshore petroleum projects will be extended to cover all oil, gas and coal seam methane projects, onshore and offshore Australia. The PRRT will apply at a rate of 40 per cent.*
- *The standard features of the current PRRT will otherwise apply, including the range of uplift allowances for unutilised losses and capital write-offs; immediate expensing for expenditure and limited transfer of the tax value of losses.*

Particular issues for consideration include:

- the definition of a project and interest in a project

Summary

The PRRT is a project-based tax. PRRT liability is calculated at a project level, and most losses are quarantined to a specific project. Under the existing PRRT arrangements, offshore petroleum projects are defined by reference to the production licence area, issued by the Australian Government. A definition for other petroleum projects coming under the PRRT is required. This section addresses two topics concerned with the definition of a project under the PRRT.

Definition of a project under the PRRT: A project needs to be defined in such a way that PRRT receipts, expenses and royalty credits can be uniquely allocated, that gaps are not created and ambiguity is minimised. It needs to be defined so that the tax is applied consistently across different projects and taxpayers, who may have very different operations. Finally, it needs to be defined pragmatically to operate consistently with state royalty regimes and other state requirements. State definitions of production licences or environmental approvals may suffice. Otherwise, project boundaries could be deemed using similar principles to those which define offshore petroleum project boundaries.

Accommodating coal seam methane and unconventional gas: Coal seam methane and unconventional gas projects may involve a much larger number of wells and a broader geographic boundary than conventional oil and gas projects. The ability to combine wells which feed a common processing facility at the taxing point (e.g. the gas plant which produces the marketable petroleum commodity) is appropriate.

Questions

Question 10.1: How should the definition of a project under the PRRT be extended to consistently apply across different projects and different commodities? Are there implications for the start and end of a project?

Question 10.2: Which principles or tests (if any) should supplement the PRRT to ensure a project definition accommodates coal seam methane and unconventional gas?

10.1 Definition of a project under the PRRT

330. Under existing PRRT arrangements, a petroleum project comes into existence when an offshore production licence is issued. The issuing of an offshore petroleum production licence is governed by the Commonwealth's *Offshore Petroleum Greenhouse Gas Storage Act 2006* (OPGGSA).

331. A petroleum project incorporates the production licence area and operations and facilities for the recovery of petroleum from the production licence area.

332. The existing project definition within PRRT uses a combination of geographic location and the activities required to produce petroleum or a petroleum product. For conventional oil and gas projects, a similar approach to project definition appears appropriate. State production licences or environmental approvals could be used, rather than creating a new, potentially inconsistent, definition.

333. State production licence arrangements would mean the definition of a production area could differ between jurisdictions and potentially change over time. The Australian Government could provide stability for existing projects by issuing a certificate setting existing state production licences for the purpose of the PRRT.

334. In all States and Territories, petroleum activities must receive environmental approval before production and exploration titles can be granted. Projects appear to be defined through a combination of geographic and activity-based definitions. There are no common templates or criteria for how projects are described, although there appears to be a high degree of commonality across the jurisdictions. The concerns about differences between jurisdictions and potential changes over time apply to environmental approvals as well as state production licences. Further work is required to understand whether this option is feasible.

335. For both State production licences and environmental approvals, there is the possibility that several licences/approvals make up what would more naturally be considered a single project. The PRRT provides a basis for grouping more than one production licence through combination certificates. A combination certificate can be granted under PRRT by the Minister for Resources and Energy where the projects are sufficiently related to be treated as a single project, after considering the following:

    - the respective operations, facilities and other things that will comprise the petroleum project in relation to the eligible production licence and any other petroleum projects existing when the eligible production licence came into force;

    - the persons by whom, or on whose behalf, the operations, facilities and other things are carried on or provided; and

    - the geological, geophysical and geochemical and other features of the production licence areas in relation to the projects.

336. An alternative approach to project definition may be for the Government to deem a production licence area on the same basis as that under the OPGGSA. This could possibly provide a greater level of alignment between onshore and offshore regimes.

337. Depending on the project definition adopted, the PRRT provisions may need to be adjusted to ensure the start and end dates of a project are workable.

10.2 Accommodating coal seam methane and unconventional gas

338. Coal seam methane (CSM) is extracted from coal seams, which occur in geological structures that are quite different from those in which conventional gas occurs. The coal seams from which CSM is extracted occur over broad geographical areas and an entity may extract gas from a number of production licences over a number of years. As noted above, a combination certificate can be granted under PRRT by the Minister for Resources and Energy where the projects are sufficiently related to be treated as a single project.

339. Where multiple wells that are spread across a broad geographical region and several production licences provide gas to centralised facilities for processing into an MPC, those production licences may be eligible to apply for a combination certificate under the existing criteria. A tighter linkage to the PRRT taxing point (especially the creation of an MPC) may create greater certainty.

340. Common infrastructure downstream of the taxing point (for example, pipelines to transport feed gas to the domestic gas market or a liquid natural gas facility) would be unlikely to provide grounds for a combination certificate. The individual gas plants that used the common downstream infrastructure could belong to separate projects.

341. The application of the PRRT to other unconventional gas sources (such as tight gas) will also need to be considered for any potential anomaly. The PTG welcomes industry input, including examples of production processes or value chains which would need to be accommodated.

11 TAXABLE VALUE

Terms of reference

The announcement by the Government on 2 July 2010 states that:

- *The standard features of the current PRRT will otherwise apply, including the range of uplift allowances for unutilised losses and capital write-offs; immediate expensing for expenditure and limited transfer of the tax value of losses*

Particular issues for consideration include:

- the taxing point and valuation method to be used for the commodity
- eligible project expenditure
- the definition of exploration expenditure

Summary

Taxable value means the assessable receipts and deductible expenses which together form the profit that is taxable under the PRRT. This section addresses three topics concerned with taxable value.

Taxing point: Assessable receipts and deductible expenses must be 'upstream' of the taxing point, to be within the PRRT. The PRRT currently uses an 'excluded commodity' approach to arrive at a taxing point. This approach appears to be broad enough to accommodate the different types of projects, onshore and offshore, conventional and unconventional.

Assessable receipts: The PRRT clearly defines assessable receipts, with a focus on the sale or value of marketable petroleum commodities. The existing definitions appear to be suitable for projects which will be liable to the extended PRRT.

Deductible expenditure: The PRRT has provisions which define the types of deductible expenditure. These may need to be altered to deal with situations where exploration and production occur simultaneously within a project (e.g. for coal seam methane and unconventional gas), to allow a well-by-well delineation of expenditure. Onshore projects incur costs to access land, including native title and other payments to indigenous people, which take a variety of forms. Under existing PRRT provisions, only those expenses which are incurred in relation to the project and in carrying on or providing operations, facilities or other things comprising the project would be deductible. Payments that are made to a government by law, and then redistributed to native title holders, should be treated as legislated private royalty payments, and be non-deductible to the mining firm and non-assessable to the landowner.

Questions

Question 11.1: Does the current definition of the taxing point provide a standard, competitively neutral, point for the wider range of reserves and operating models that will be liable to the extended PRRT?

Question 11.2: Are there assessable receipts which should be included under the extended PRRT, but are not covered by existing provisions?

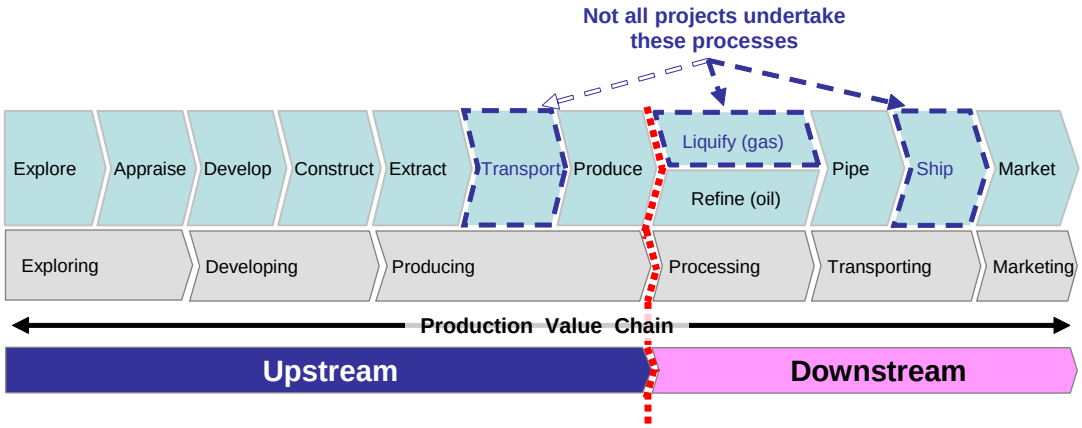
Question 11.3: Are there types of expenditure incurred by projects transitioning to the extended PRRT, which are not adequately contemplated by existing provisions? How should they be treated?

11.1 Taxing point

342. The PRRT liability is arrived at by calculating assessable receipts less deductible expenses upstream of the taxing point. Under the PRRT, the taxing point is determined where petroleum is sold prior to it becoming an MPC or where an MPC has become an excluded commodity (described in Section 9.1).

343. Figure 8.1 summarises the types of activity which are upstream and downstream of the taxing point.

Figure 11.1: Activities along the production value chain



PRRT taxing point reached when an Marketable Petroleum Commodity becomes an excluded commodity such as stabilised crude oil, condensate, natural gas, liquified petroleum gas, and ethane has been produced; and is sold, further processed or moved away from the place of production

Source: Policy Transition Group (PTG) Secretariat

344. The PRRT approach to defining the taxing point appears to be broad enough to accommodate the different types of project, onshore and offshore, conventional and unconventional, as they will all produce one form of MPC or another.

11.2 Assessable receipts

345. Assessable receipts are clearly defined within the provisions of the PRRT and focus on the sale of petroleum or sale or value of an MPC. The definition of an MPC should capture all products produced by a petroleum project and can therefore be applied directly to the projects covered by the extended PRRT.

346. Where an MPC is produced within an integrated project and no arm's length sale occurs, the assessable receipts will be calculated by one of three options in the following order:

- if an Advance Pricing Arrangement applies to the transaction—the amount calculated in accordance with the arrangement;
- if no Advance Pricing Arrangement applies to the transaction, but a comparable uncontrolled price (CUP) exists for the transaction—the CUP amount for the transaction; and

- if no Advance Pricing Arrangement, and no comparable uncontrolled price, exists for the transaction—the Residual Pricing Method (RPM) amount for the transaction.

347. The Residual Pricing Method defined within the PRRT regulations would appear suitable for projects within the extended PRRT.

348. The PTG would welcome industry input on any production processes or other arrangements in place to determine assessable receipts.

11.3 Deductible expenditure

349. Specific situations and types of expenditure are likely to arise in onshore projects that are not relevant to existing offshore projects. Two of these are delineating exploration and production expenditure for non-conventional gas projects and access to land.

11.3.1 Delineating exploration and production for non-conventional gas

350. Some onshore gas operations occur in geological structures that are quite different from those in which conventional gas occurs. Operations such as CSM and other unconventional gas require continued exploration within a production licence area to determine the gas flow and viability across a broad geographic area. Exploration wells need to operate for a period of time to establish their economic viability, after which they will either move into production or be abandoned. For many of these operations, this means exploration and development activity will occur simultaneously within one project.

351. The PRRT treats exploration expenditure differently from general project expenditure. Exploration expenditure is uplifted at different rates depending on when it is incurred and, in certain circumstances, it can be transferred between projects.

352. The PRRT may need to be amended to properly allocate amounts between exploration and general project expenditure when they occur simultaneously within one project.

353. Legislative precedents for what constitutes exploration expenditure are found in the *Income Tax Assessment Act 1997* (ITAA) (see Box 11.1).

354. The Tax Office has guidelines to assist taxpayers to determine when activities cease to be exploration and become development. The Tax Office could adapt these guidelines to enable a well-by-well allocation of expenditure between exploration and general expenditure.

Box 11.1: The definition of exploration expenditure in the *Income Tax Assessment Act 1997*

Subsection 40-730(4) of the ITAA defines 'exploration' to include:

(a) for mining in general, and quarrying:

(i) geological mapping, geophysical surveys, systematic search for areas containing minerals (except petroleum) or quarry materials, and search by drilling or other means for such minerals or materials within those areas; and

(ii) search for ore within, or near, an ore-body or search for quarry materials by drives, shafts, cross-cuts, winzes, rises and drilling; and

(b) feasibility studies to evaluate the economic feasibility of mining minerals or quarry materials once they have been discovered; and

(c) obtaining mining, quarrying or prospecting information associated with the search for, and evaluation of, areas containing minerals or quarry materials.

The explanatory memorandum to the New Business Tax System (Capital Allowances) Bill 2001 notes that exploration is not defined exhaustively in the ITAA and is based on its ordinary meaning. The explanatory memorandum also indicates that the point at which a decision is made to proceed to actual mining operations marks the dividing line between exploration and development.

11.3.2 Access to land, including native title and other payments to indigenous persons

355. The extension of the PRRT, particularly to onshore petroleum projects, means there will be costs for access to land which have not previously been contemplated by PRRT legislation or guidelines. These will include native title and other payments to indigenous persons, and payments to non-indigenous land owners.

356. Native title payments could be regarded as a an operating expense or a type of private royalty payment. As with other private royalties, they can be paid under legislation or pursuant to privately negotiated agreements. They can involve a flat amount, a share of mining revenues, or a combination of the two. The payments can be in cash or in kind (such as shares in the petroleum company or the provision of community facilities).

357. Under the PRRT, private override royalty payments are excluded expenditure and therefore not deductible. Override royalty payments are payments made to a person other than a government usually calculated by reference to a percentage of the gross or net value or the quantity of petroleum produced. It cannot be said that these payments are payments made in relation to the exploration or recovery of petroleum or petroleum commodities, or to the closing of a project.

358. On this basis, certain native title payments are likely to be treated as a private override royalty and therefore would be excluded expenditure.

359. The deductibility of all payments that are not explicitly defined as excluded expenditure, will be subject to the general rules of deductibility as defined within the PRRTAA. The deductibility of expenditure is discussed in Section 9.1.1 of this paper, and requires expenditure to be incurred by the person in relation to the petroleum project and in carrying on or providing operations, facilities or other things of a kind referred to in sections 37 (exploration expenditure), 38 (general project expenditure) and 39 (closing down expenditure) of the PRRTAA.

360. Therefore, where a native title payment is incurred in relation to the project and in carrying on or providing operation, facilities or other things comprising the project, it would be deductible. Such expenditure may be a native title payment provided to gain land access for the purpose of carrying on or providing operations, facilities or other things comprising the project. If the payment is to obtain access to land on which no project activities are to be undertaken, it would not be deductible. The same principle would apply to payments made to non-indigenous land owners to access their land.

361. Where the purpose of the payments is not obvious or is for mixed purposes, including some not directly related to the project, then the payment may not be deductible or may require apportionment.

362. Where payments are made to a government by law and then redistributed by the government to native title holders it is appropriate that they be treated in the same way as legislated private royalties that are collected by a government and substantially redistributed to the landowner. Such payments should be deductible to the petroleum entity.

363. The PTG Panel is seeking guidance from industry as to how the existing deductibility provisions within the PRRT will affect native title agreements currently in place.

12 RECOGNITION OF LOSSES AND ROYALTIES

Terms of reference

The announcement by the Government on 2 July 2010 states that:

- *All state and federal resource taxes will be creditable against current and future PRRT liabilities from a project*
- *The standard features of the current PRRT will otherwise apply, including the range of uplift allowances for unutilised losses and capital write-offs; immediate expensing for expenditure and limited transfer of the tax value of losses.*

Particular issues for consideration include:

- the crediting of state and territory royalties

Summary

Crediting of royalties: The terms of reference are clear that royalties will be creditable against current and future liabilities. The rules, including the uplift rate, need to be determined. The existing uplift rate for unutilised general project expenditure and capital write-offs may be appropriate for royalties.

Loss ordering rules: Loss ordering rules determine the sequence in which losses and offsets are applied to calculate an entity's liability. The extension of the PRRT introduces royalty credits and a starting base, which will mean loss ordering rules need to be updated. The rules should give effect to the underlying purpose of the extended PRRT.

Questions

Question 12.1: How should royalties be carried forward and uplifted?

Question 12.2: Which principles should govern the loss ordering rules? Which loss ordering rules should follow from those principles?

12.1 Crediting of royalties

364. In line with the treatment of royalties under the MRRT, State, Territory and Australian Government royalty or resource charges will be credited against PRRT liabilities. This will only be relevant for projects within the extended scope of the PRRT.

365. Any resource charge that cannot be credited in the year in which it is incurred will be carried forward. Although the terms of reference are not clear on the treatment of royalty credits carried forward, it would be reasonable to treat such credits in a similar manner to general expenditure under the current PRRT rules. This would require the carry-forward royalty credits to be uplifted by the standard PRRT rate and offset against revenue until fully utilised.

366. As with the MRRT provisions, royalty credits will not be transferable between projects. This is also in line with existing PRRT transfer rules. Unused royalty credits will be transferred to a new owner when a project interest is sold.

12.2 Loss ordering rules

367. The introduction of royalty credits and the starting base creates two new types of offsets that need to be sequenced relative to exploration and general project expenditure.

368. Loss ordering rules will need to be updated to accommodate royalty credits and the starting base. The loss ordering rules will need to give effect to the underlying intention of the extended PRRT.

13 STARTING BASE

Terms of reference

The announcement by the Government on 2 July 2010 states that:

- *The Petroleum Resource Rent Tax (PRRT) regime, which currently only applies to offshore petroleum projects will be extended to cover all oil, gas and coal seam methane projects, onshore and offshore Australia. The PRRT will apply at a rate of 40 per cent.*
- *Companies may elect to use market value as the starting base for project assets, including oil and gas rights.*
- *The standard features of the current PRRT will otherwise apply, including the range of uplift allowances for unutilised losses and capital write-offs; immediate expensing for expenditure and limited transfer of the tax value of losses.*

Particular issues for consideration include:

- tax treatment of the starting base and of capital expenditure incurred between 2 May 2010 and 1 July 2012
- the determination and calculation of the starting base for existing projects including the rules for electing a particular starting base

Summary

The starting base arrangements recognise that decisions to invest in existing projects were made before resource tax reforms were announced. Recognising the value of existing project assets shields existing investment from the PRRT.

Assets included in the starting base: The terms of reference state that entities may elect to use market value as the starting base for project assets, including oil and gas rights. While not explicitly stated, it is presumed that project assets will reflect the terms of reference in relation to the MRRT and include tangible assets, improvements to land and oil and gas rights (using the income tax definition). Whether intangible assets other than oil and gas rights (such as resource or reservoir information or intellectual property) fall within the definition of project assets needs to be determined.

Election of the starting base: The terms of reference note that a taxpayer can elect to use market value as their starting base (implying other choices exist). Guidelines will be required as to whether joint venturers can make different choices, whether the election is irrevocable, and whether to use a default option in the absence of an election.

Book value and look back approaches: The terms of reference do not state what alternatives to market value are available. Book value is one option, and this could be similar to the MRRT (where book value is the explicit alternative to market value). The PRRT does contain a 'look back' approach which would uplift past expenditure—this could be useful for newer projects.

Treatment of starting base and starting base losses: Amendments to the PRRT legislation

will be required to recognise the starting base (as it constitutes deemed, not incurred, expenditure). These amendments will need to specify the period over which the starting base is deducted, and whether uplift provisions apply to the starting base and losses resulting from starting base deductions.

New capital expenditure incurred prior to 1 July 2012: The terms of reference do not specify how capital expenditure incurred prior to 1 July 2012 will be treated. One option is to treat such expenditure in line with existing PRRT provisions, and uplift it until it can be deducted against future profits. Alternatively, arrangements contingent on the choice of starting base (similar to the MRRT) could be adopted.

Questions

Question 13.1: Which assets should be included in the starting base?

Question 13.2: What rules should govern starting base elections?

Question 13.3: Which valuation methods will provide an appropriate assessment of market value? Should any methods be prescribed or proscribed? Are there ways to provide greater certainty as to how market valuation should be conducted?

Question 13.4: What method(s) to value the starting base should be permitted (other than market valuation)? If book value were used, what adjustments to book value (if any) are necessary to fairly recognise the value of existing project assets?

Question 13.5: How should the PRRT be amended to recognise the starting base and starting base losses?

Question 13.6: How should capital expenditure incurred between 2 May 2010 and 1 July 2012 be treated?

369. A starting base will be provided for oil and gas projects that will transition to the PRRT once it is extended to all onshore and offshore petroleum projects (other than the Joint Petroleum Development Area).

370. The starting base arrangements are designed to recognise that decisions to invest in existing projects preceded the announcement of resource tax reform. Recognising the value of existing project assets largely preserves the tax treatment of investments made before the tax reforms were announced.

371. It is not clear from the terms of reference what is considered to be an existing project. It may be reasonable to conclude however, that an existing project would be a project that had an existing State, Territory or Australian Government exploration permit, retention lease or production licence in force on 2 May 2010 and would not have been already subject to PRRT.

13.1 Assets included in the starting base

372. The terms of reference state that PRRT, entities may elect to use market value as the starting base for project assets, including oil and gas rights. While not explicitly stated, it is presumed that project assets will reflect the terms of reference in relation to the

MRRT to include "tangible assets, improvements to land and mining rights (using the income tax definition)".

373. One interpretation is that, other than "oil and gas",[33] intangible assets – non-monetary assets without physical substance – would not be project assets.

374. An alternative interpretation is that the identified project assets are meant to be indicative, rather than exhaustive, and that all project assets should be included in the starting base, including intangible assets.

375. The general meaning of "improvements to land" includes fixtures, such as fences, and other improvements to land, such as a dam or a road. It would be envisaged that many other tangible alterations would also be classed as improvements to land (e.g. tailings dams and haul roads).

376. The definition of a "project" and when a project is created, the treatment of multi-product projects, the taxing point and apportionment of assets are relevant in determining the starting base of an existing project.

    - The ability to recognise a starting base could be limited to projects with a production licence in existence at 1 May 2010. Where a project meets this stage after 1 May 2010, eligible project expenditure incurred after that time and before 1 July 2012 could comprise a starting base for that project.

    - In calculating the starting base, only those assets eligible under the terms of reference would constitute part of the starting base, and only to the extent they are used upstream of the taxing point.

377. The value of the resource as at 1 May 2010 would, ideally, be reduced in accordance with any depletion of the resource in the period to 1 July 2012. This would reflect the fact that any such reduction in the value of the resource through production in the period to 1 July 2012 would be taxed under the existing taxation regime, not within the PRRT.

13.2 Election of starting base

378. The terms of reference state that an entity will have the choice of establishing the starting base by reference to the market value of the project's assets (including oil and gas rights). This implies an alternative to the market value option. The terms of reference do not identify alternatives. An alternative could be the book value (excluding oil and gas rights) of project assets at the last set of audited accounts prior to 2 May 2010. This would be consistent with the MRRT. Another alternative could be the use of current PRRT cost recognition rules, which would allow an entity to 'look back' to past investment prior to 1 May 2010.

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[33] Oil and gas rights are not defined as such, but would fall within the definition of mining, quarrying or prospecting rights. The term 'mining, quarrying or prospecting right' is a defined term under the income tax law – see Division 995 of the *Income Tax Assessment Act 1997*. The definition includes any licence, right or permit to mine or prospect for minerals or petroleum. The definition also includes leases that allow the lessee to mine or prospect for minerals or petroleum.

379. If the election could be made for each project, an issue is how joint venturers (i.e. multiple investors with an interest in a project) would make their election. Joint ventures are very common in the petroleum industry, and in these circumstances the options are:

- each entity or group chooses its starting base approach; or
- the starting base is chosen at the project level with all joint venturers applying that method, thereby reducing compliance costs.

380. The PRRT operates on a self-assessment basis. Given the implications of the starting base treatment, it could be appropriate that an entity be required to make an election by the date it lodges its PRRT tax return, or within a further time allowed by the Tax Office. The way the entity prepares its PRRT tax return should be sufficient evidence of the making of that election. Where an entity is not required to lodge a PRRT tax return it could make its election by the last day that return would have been due. An entity could lodge the election with the Tax Office, if it is not lodging a PRRT tax return.

381. The election of the starting base methodology should be irrevocable once made. Generally, elections are irrevocable where there are potential unintended tax advantages and opportunities for tax arbitrage. In this case, revocable elections would open up opportunities for arbitrage or could affect the liability of a former owner of a project if a subsequent owner changed the starting base.

382. Where an entity fails to make a starting base election for a project interest it had on 2 May 2010, a default position would need to be adopted. A default position of market value is almost certainly not viable, since an entity failing to make an election is most unlikely to have undertaken a market valuation for the purposes of the PRRT. Accordingly, the two options appear to be:

- there is no starting base for the project interest; and
- the starting base is determined using the book value approach or possibly the look back approach.

383. The former approach would create a strong incentive for an entity to make an election. The latter approach would be seen as less harsh, but may not work in all cases, because some entities (particularly small unlisted companies) may not have audited accounts prepared to relevant standards.

13.3 Market value approach

384. Under the market value approach, the starting base for each project will be based on the market value of the project assets as at 1 May 2010.

385. The valuation process would entail isolating and valuing those assets that pertain to the upstream part of the value chain. Less clear, is the extent to which indirect tangible assets might also be included in the starting base.

386. There are two broad approaches the law could take in establishing market valuations of a project's starting base for the PRRT:

- the law could simply require the 'market value' of the project assets to be included in the starting base; or

- the law could specify which particular market value methodology should be used to determine the market value of particular types of project assets.

387. Either of the above approaches could be supplemented by rules requiring the valuations to be determined by following a particular process. In that case, market valuations could only be challenged by the Tax Office on the basis that the process was not followed.[34]

388. The general tax law approach has been to not statutorily prescribe how market value is to be determined. Instead, the Tax Office has issued comprehensive guidelines setting out what it considers an appropriate methodology.[35] These guidelines note various principles, supported both by industry standards and case law, which are to be used in determining market value. For example:

- market value is ascertained according to the 'highest and best use' of the asset (although interrelated assets should be valued on the same use);
- market value is to be determined as a price negotiated between willing but not anxious buyers and sellers;
- a hypothetical market is to be assumed if actual market conditions do not provide good evidence as to market value;
- the hypothetical buyer and seller are assumed to be fully informed of the advantages and disadvantages associated with the asset being valued; and
- both parties are assumed to be aware of current market conditions.

389. In addition, the guidelines note that certain valuation methods are more appropriate for a given class of asset (e.g. a business, plant and equipment, or an intangible asset).

390. Market valuation was an important part of the implementation of the income tax consolidation rules. A key step when an entity is acquired by a consolidated group is to allocate the net consideration paid for the entity[36] to individual assets in accordance with the assets' respective market values. Experience has been that the most difficult assets to ascribe a value to are: intangibles and the resource right, as these are more likely to be unique to individual projects or entities and interdependent. In practice, the valuation will depend on the expertise and professional judgement of the valuers.

391. The considerations relevant to establishing asset values for the PRRT starting base may be different from those for consolidation. In particular, in consolidation market values are relevant only insofar as they determine the allocation of a pre-determined cost base across assets. In PRRT, the market valuation would determine the starting base and the PRRT deductions that flow from it.

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[34] For example, such a process might specify the qualifications required of a valuer, what market valuation parameters or guidelines must be followed (such as the *Market valuation for tax purposes* guidelines prepared by the ATO for the consolidation regime or the industry VALMIN code) and the timeframe within which the valuation process must occur.

[35] See the Tax Office *Market valuation for tax purposes* guidelines.

[36] Net of the acquired entity's liabilities.

392. Whichever approach is taken, there will be a need to appropriately manage the incentive for entities to both inflate the recorded value of assets.

393. The PTG will seek further advice regarding the methodology for establishing the starting base using the market value method. The PTG seeks feedback from industry on methodologies for valuing discrete projects.

13.4 Book value and look back approaches

394. The terms of reference do not provide any guidance on what the alternative to a market valuation should be. Two possibilities are a book value approach, based on the design parameters outlined in the Government's initial resource tax proposal. Alternatively, the current PRRT cost recognition rules could be used to allow an entity to 'look back' at past expenditure.

395. It may be appropriate to base a book value approach on the design parameters outlined in the Government's initial resource tax proposal, as proposed for the MRRT. If the previous Resource Super Profits Tax (RSPT) proposal is to be used as a guide, the starting base may consist of the accounting book value of existing project assets in the most recent audited accounts available on 2 May 2010, excluding the value of the resource.

396. During consultations in relation to the RSPT proposal, a number of issues were raised, and these would need to be explored to ensure the value of existing project assets was appropriately recognised. These issues included:

- company discretion in respect of capitalisation practices may lead to different starting base outcomes for similar projects;
- book values may not appropriately reflect assets such as exploration; and
- not all companies prepare accounts in accordance with the Australian or international accounting standards.

397. An alternative could be the use of current PRRT cost recognition rules which would allow an entity to 'look back' to past investment prior to 1 May 2010. Under the look back provisions past expenditure is uplifted and can be offset against assessable receipts in future years. What is not utilised in any given year will continue to be uplifted and carried forward for offset against future assessable receipts.

398. This approach would not recognise the true value of underlying assets for most operations, but it could be a relatively simple and effective approach for new projects that have only recently incurred expenditure.

13.5 Treatment of starting base and starting base losses

399. The starting base recognises investment in projects at 1 May 2010. To the extent the starting base of an existing project and its depreciation recognises the value of the existing investment, it means the PRRT does not apply to that project. The starting base will be quarantined to a particular project, consistent with the existing operation of the PRRT.

400. The PRRT legislation will need to be amended to recognise the starting base. At present, the PRRT requires expenditure directly related to a petroleum project to be deductible in full, in the year it is incurred and liable to be made. Any undeducted expenditure is uplifted and carried forward to offset against receipts in future years. As it stands, this requirement would mean the starting base is not deductible because the cost of the assets comprising the starting base was incurred before the project entered into the PRRT regime.

401. For the starting base to be treated as deductible expenditure, provisions would need to be inserted into the existing PRRT legislation.

402. The amendments would need to address the deductibility of the starting base, the period over which it is deducted and whether uplift provisions would apply to the starting base or to any losses resulting from the deduction of the starting base. The amendments would need to state whether these arrangements vary with the choice of starting base valuation methodology.

403. These amendments should also ensure that the starting base would transfer to a new owner of the project, in line with the existing arrangements under the PRRT.

13.6 New capital expenditure incurred prior to 1 July 2012

404. The treatment of expenditure incurred on or after 2 May 2010 and before 1 July 2012 was not addressed by the terms of reference. One option would be to treat such expenditure as per the current deductible expenditure provisions under the PRRT and allow it to be immediately deductible on the extension of the PRRT at 1 July 2012.

405. Alternatively, in line with the MRRT, such expenditure could be added to the starting base. The terms of reference for the MRRT note that any new capital expenditure incurred prior to 1 July 2012 is to be added to a project's starting base.

Part D

POLICIES TO PROMOTE EXPLORATION EXPENDITURE

14 POLICIES TO PROMOTE EXPLORATION EXPENDITURE

Terms of reference

The PTG will consider the best way to promote future exploration and ensure a pipeline of resource projects for future generations. This consideration is not limited to iron ore, coal, oil and gas, but is intended to cover all resource exploration activities in Australia.

Summary

Exploration of Australia's mineral and petroleum resources is important to ensure a pipeline of resource projects is secured for the benefit of future generations. Industry has raised the need for government intervention and has previously suggested a number of possible policies to pass tax credits generated from exploration expenditure to shareholders. This section addresses the case for Australian Government intervention and canvases existing and new policy options that could be introduced or extended if intervention is warranted.

The case for Australian Government intervention: Exploration expenditure in Australia has risen significantly since 2002 (although our share of world exploration has halved since the 1990s). The recent increase in domestic exploration has been weighted toward lower risk brownfield exploration. Offshore petroleum exploration has grown, while onshore minerals and petroleum (apart from coal seam methane) have declined. It has been argued that junior exploration entities, which play an increasingly important role in greenfield exploration, have difficulty accessing capital (which could constitute a 'market failure') and that some existing policies to promote exploration (like an immediate write-off of expenses for income tax purposes) are of limited use to junior entities.

Existing policies to promote exploration: A number of incentives already exist to promote resource exploration in Australia. These include an immediate income tax deduction for exploration expenditure; the provision of pre-competitive geoscience data; designated frontier areas; incentives within the proposed MRRT and existing PRRT systems; a cooperative research centre focused on deep exploration; and specific initiatives for geothermal energy. In addition, the States and Territories have their own policies to encourage exploration.

Policy options to promote future exploration: If the case for intervention was compelling, the Australian Government could introduce new policy options. Four options are: an exploration refundable tax offset; an exploration tax credit; a flow through shares scheme; and tax concessions similar to those available for research & development. Funding for new incentive mechanisms would need to be fully offset from within the PTG's recommendations.

Questions

Question 14.1: Is exploration expenditure subject to a market failure that warrants intervention by the Australian Government? If so, is this market failure specific to any particular sectors or types of exploration?

Question 14.2: Is there a case for the Australian Government extending or adjusting existing policies to better promote exploration or adopting additional policy option(s) to promote future exploration? What costs and benefits would such policy option(s) have?

14.1 The case for government intervention

406. Exploration of Australia's mineral and petroleum resources is important to ensure a pipeline of resource projects is secured for the benefit of future generations.

407. The resource sector has suggested that policies are needed to promote exploration that will secure a sustainable stock of mineral and petroleum resources, to ensure a pipeline of future projects. In particular, it has been suggested that declines in greenfield exploration in Australia are a result of companies experiencing difficulty in raising financial capital to fund exploration activity, making the task of securing Australia's future resource stocks more difficult.

408. This section discusses the drivers of resource exploration, the state of Australia's resource stocks, the recent history of minerals and petroleum exploration in Australia, and summarises some of the arguments made for and against Australian Government intervention.

409. It is noted that the Australian Government already provides a number of incentives to encourage exploration and, in 2006-07, the Australian Government provided $58.9 million to enable Geoscience Australia to pioneer innovative, integrated geoscientific research to better understand the geological potential of onshore Australia for both minerals and petroleum.

14.1.1 Drivers of exploration

410. Exploration is an inherently risky undertaking, with a real prospect of failing to recover outlays if economic deposits are not discovered. It is typically classified as brownfield (i.e. exploration focused on geological terrain in close proximity to known ore deposits) and greenfield exploration (i.e. exploration for minerals in relatively unexplored areas).

411. The level of exploration is driven by commodity prices, changes in technology and the probability of a successful discovery (also known as prospectivity).

412. Fluctuations in commodity prices will alter the value of a resource deposit, and hence the rewards for successful exploration. The prospect of greater rewards will encourage additional exploration.

413. Advances in technology can increase access to reserves, increase recovery rates, reduce exploration, development and production costs, and reduce technological and economic risks. This can stimulate exploration for reserves previously considered uneconomic. For example, technological improvements, which have increased the accessibility of coal seam methane have had a significant influence on the level of exploration for that resource.

414. The probability of a successful discovery also drives exploration levels. A successful greenfield discovery will trigger adjacent brownfield exploration until the limits of that discovery are understood. In Australia, there has been a decline in success rates and in the average size and quality of deposits discovered (Australian Institute of Geoscientists 2010). This could reflect Australia's 'mature' environment, with very few major near-surface mineral deposits remaining, and new 'buried' deposits involving a lower chance of discovery and a higher cost of extraction (Prosser Inquiry 2003). The globalisation of mineral exploration, combined with greater perceived prospectivity elsewhere, may have led to Australian and other entities diverting funds overseas.

14.1.2 The state of Australia's resources stocks

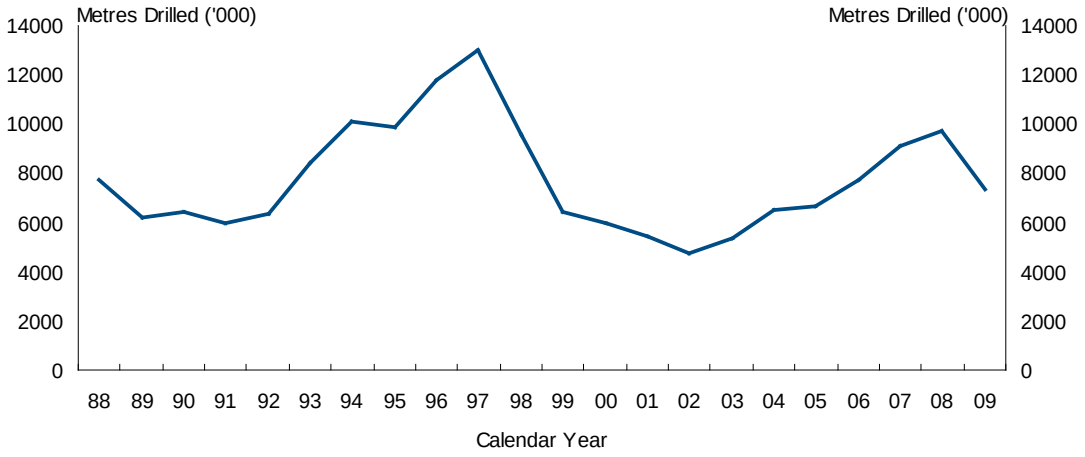
415. Most of Australia's minerals production is from deposits found 20 or more years ago. The resource sector argues that discovery of new mineral deposits and new mineral provinces is needed to underpin minerals production in the long term. Greater exploration in other countries means they will increase their share of known reserves and eventually world production at Australia's expense.

416. Australia has a solid stock of mineral and petroleum reserves. In terms of accessible, economically demonstrated mineral resources, Australia has 90 years of black coal, 490 years of brown coal, 70 years of iron ore, 29 years of gold and 70 years of bauxite at current rates of production. (Geoscience Australia, Australia's Identified Mineral Resources, 2009). For petroleum, in 2009, crude oil reserves reached 227 gigalitres (or 1,431 million barrels), condensate reserves reached 437 gigalitres (or 2,750 million barrels), and LPG reserves reached 234 gigalitres (or 1,474 million barrels) (Geoscience Australia, Petroleum Reserves, 2009).

14.1.3 Recent history of minerals exploration in Australia

417. Minerals exploration in Australia over the last four years has averaged around 8.6 million metres drilled a year—a little above the average of 7.8 million metres over the last 22 years (Figure 14.1). This is well below the peak of nearly 13 million metres drilled in 1997, but well above the low point in 2002.

Figure 14.1 – Minerals exploration expenditure (total metres drilled)



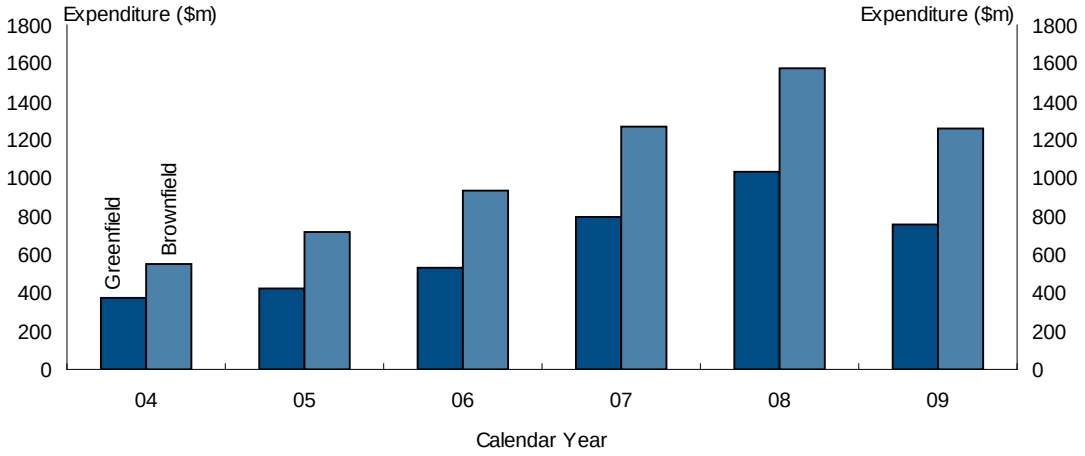
Source: ABS, 8412.0 Mineral and Petroleum Exploration (2010)

418. Recent data shows the increase in minerals exploration in Australia since 2002 has primarily been brownfield exploration. During the most recent commodity price boom, both greenfield and brownfield exploration expenditure grew at a rapid pace until late 2008 (Figure 14.2). During this time, iron ore exploration grew from less than 5 per cent of minerals exploration expenditure to around 25 per cent, and coal increased from less than 8 per cent to nearly 15 per cent. This has largely been at the expense of gold, which fell from just over 50 per cent to around 25 per cent (Mineral and Petroleum Exploration, ABS).

419. However, Australia's share of global exploration expenditure has declined from around 20 per cent in the 1990s to 11 per cent in 2006. Worldwide mineral exploration fell sharply in 2009 (Geoscience Australia 2009), more so in other countries than Australia,

and as a consequence, Australia's share of world exploration has recovered slightly to around 13 per cent (Metals Economics Group 2010).

Figure 14.2 – Minerals exploration (expenditure)



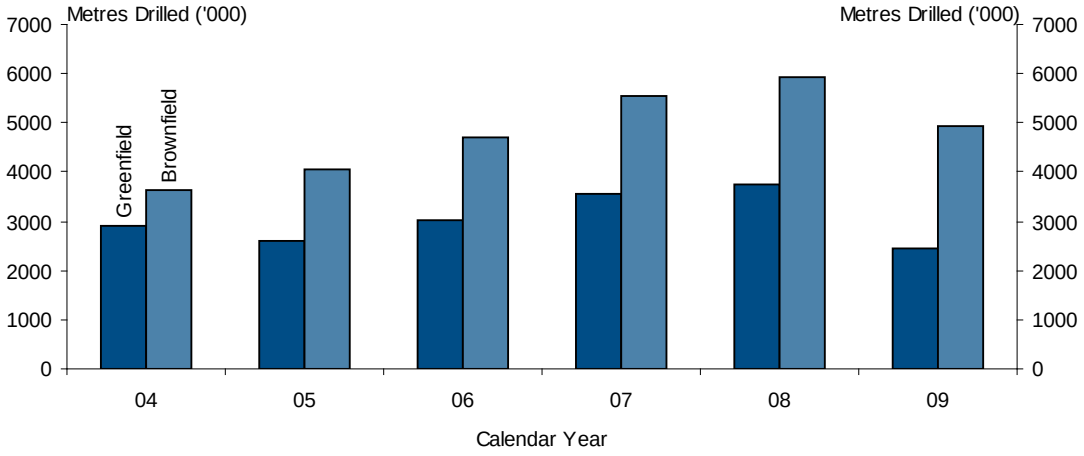
Source: Australian Bureau of Statistics, 8412.0 Mineral and Petroleum Exploration (2010)

420. It is important to note that exploration expenditure data does not distinguish between movements related to activity and the cost of inputs. Increases in exploration expenditure do not necessarily reflect an increase in the volume of exploration. Instead, it may reflect an increase in the cost of exploring, or the use of more expensive drilling techniques.

421. A better measure of activity may be metres drilled (Figure 14.3). While metres drilled also rose sharply during the boom, it grew at a much lower rate, reflecting an increase in exploration costs. However, changes in technology and industry practice are also likely to impact upon this measure. For example, within the petroleum sector there has been an increase in deepwater drilling. This will be reflected in the metres drilled but does not necessarily reflect an increase in exploration activity.

422. The metres drilled data (Figure 14.3) show an increased focus on brownfield exploration. This is consistent with developments overseas. Metals Economics Group (MEG) estimates that the proportion of global exploration budgets allocated to greenfields fell from more than 50 per cent in the 1990s to 36 per cent in 2008. MEG attributes this trend to efforts to shore up reserves and bring them into production during a time of high commodity prices. The consolidation of the resources sector and the focus of major entities on brownfield exploration may also have played a role.

Figure 14.3 – Minerals exploration (metres drilled)



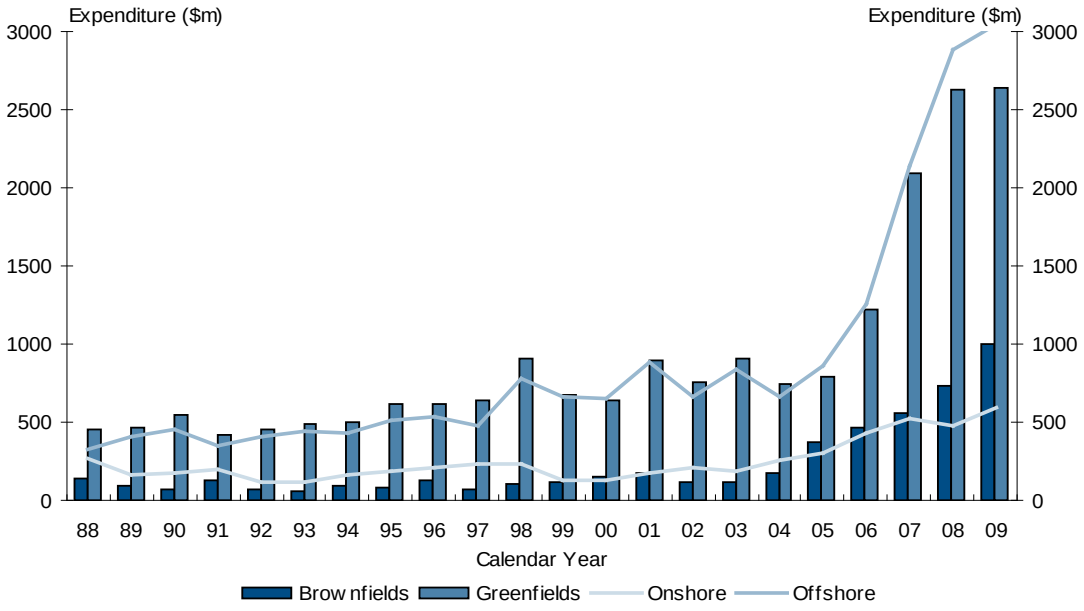
Source: Australian Bureau of Statistics, 8412.0 Mineral and Petroleum Exploration (2010)

423. This evidence of a worldwide shift towards brownfield exploration may indicate that Australian firms are exhibiting normal commercial behaviour in choosing brownfield exploration over greenfield exploration.

14.1.4 Recent history of petroleum exploration in Australia

424. Petroleum exploration expenditure has been steadily rising in Australia over the last decade. Offshore petroleum exploration expenditure is roughly four times that of onshore petroleum exploration expenditure (Figure 14.4). However, this is likely due to the high cost of offshore expenditure and not necessarily a move towards more offshore exploration.

Figure 14.4 – Petroleum exploration (expenditure)

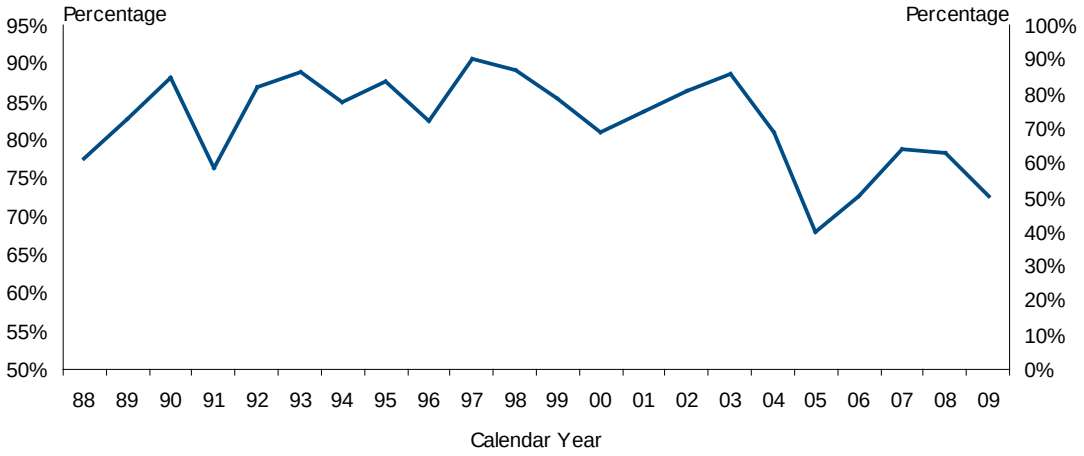


Source: Australian Bureau of Statistics, 8412.0 Mineral and Petroleum Exploration (2010)

425. The majority of petroleum exploration expenditure is directed at greenfield areas (that is, in areas that are not in a current production licence area). Over the last 24 years, the

proportion of petroleum expenditure in greenfield areas has averaged 83 per cent. Over the last four years, the average has been a little lower at 77 per cent (ABS) (Figure 14.5).

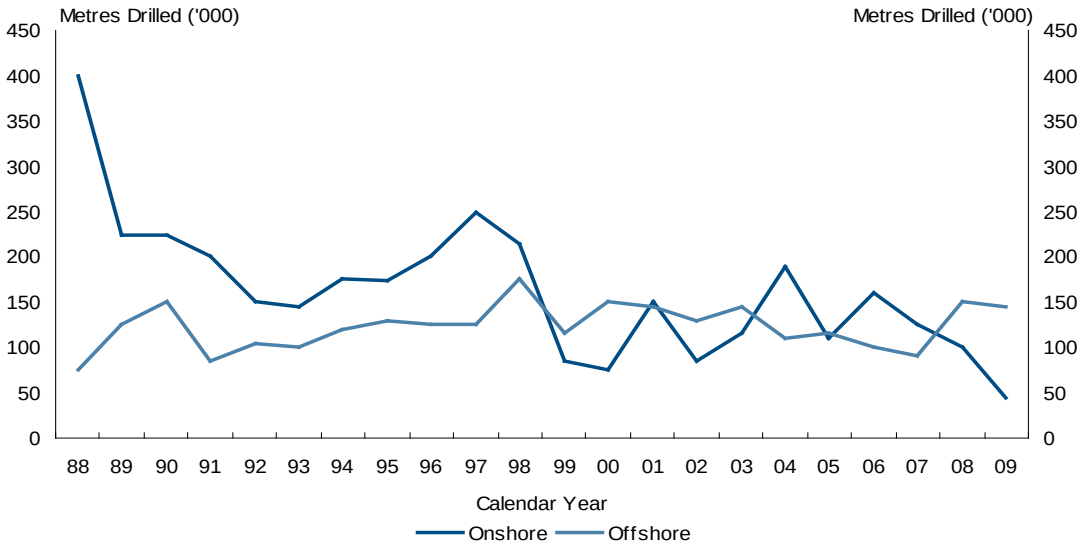
Figure 14.5 – Proportion of greenfield petroleum expenditure



Source: Australian Bureau of Statistics, 8412.0 Mineral and Petroleum Exploration (2010)

426. A more appropriate indicator of petroleum exploration may be metres drilled (Figure 14.6). The amount of onshore exploration and offshore exploration has varied over time. Over the 20 years to 2009, total petroleum exploration in Australia has declined despite rises in the level of expenditure. This data excludes coal seam methane (CSM), which has seen rapid growth.

Figure 14.6 – Petroleum exploration (metres drilled)



Source: Australian Petroleum Production and Exploration Association (APPEA), Exploration Statistics 1984-2009

Move toward coal seam methane exploration

427. Coal seam methane is the naturally occurring methane-rich gas in coal seams. In 2007-08, CSM accounted for around 6 per cent of total gas consumption in Australia

and 80 per cent in Queensland[37]. The rapid growth of the CSM industry has been underpinned by the strong demand growth in the eastern gas market and the recent recognition of the large size of the coal seam gas resources.

428. Some industry participants have suggested that the strong growth in demand for CSM has resulted in companies moving away from traditional exploration towards CSM exploration.

14.1.5 Arguments for and against Government intervention

429. For Government to intervene beyond existing policies, there needs to be evidence of market failure: that is, the amount of exploration (or some forms of exploration) is below the socially optimal level.

430. Greenfield exploration is increasingly conducted by junior explorers (Prosser Inquiry 2003). These smaller, entrepreneurial entities are willing to accept the high risk profile of such exploration. As such, they have a distinct and important role in maintaining the long-term pipeline of future resource projects. The focus of brownfield exploration tends to be on activities that deliver more immediate benefits but are incremental rather than transformative.

431. At least two arguments are often made in support of intervention to support exploration, particularly by junior explorers. The first argument for intervention is access to capital. The second goes to the effectiveness of existing measures to support exploration.

Market failure in raising capital

432. The resources sector suggests that there is a 'market failure' which gives rise to an under-allocation of financial capital for junior exploration entities. This arises from a disconnect between the short-term focus of the risk capital market, and the long-term nature of benefits that flow from exploration. The difficulties faced by junior exploration entities in raising capital are supported by the observation that (Prosser Inquiry 2003, ABARE 2003):

- the private equity market provides little financing for resource entities;
- major institutions such as superannuation funds traditionally do not invest in junior entities because they comprise an insignificant part of benchmark indices, such as the All Ordinaries Index; and
- the initial public offering (IPO) market has become more difficult to access, reflecting:
  - an increased cost of listing and remaining on the Australian Stock Exchange; and
  - a scaled-back involvement of stockbroking firms in the resource sector due to a reduction in the trading of resource stocks.

[37] ABARE *Australian Energy Projections to 2029-30*, 2010

433. Despite the concerns of the resource exploration sector about its ability to raise capital, the Australian equity market does provide a highly efficient mechanism to allocate scarce capital among competing sectors and companies. The perceived difficulty faced by the exploration sector in raising capital is not in and of itself proof of market failure.

434. The introduction of a significant incentive for shareholders to invest in exploration companies has the potential to divert funds from other sectors, particularly from other high-risk industries. There needs to be a compelling case that a market failure exists before introducing an incentive that may result in a distortion to the capital allocation process.

Shortcomings for junior exploration entities of existing incentives

435. Some of the existing exploration incentives (detailed in Section 14.2) may be of little use to junior exploration entities. For example, exploration expenditure is immediately deductible for income tax purposes. However, junior exploration entities generally have little or no taxable income. This means that they cannot obtain an immediate benefit from deducting exploration expenditure against taxable income, leaving these losses 'trapped'. While losses can be carried forward and deducted against future income, where an entity is in tax loss for a number of years the delay will erode the benefit of deductibility. In the case of entities whose sole focus is on exploration, there is no certainty that they will ever generate the income required to offset these losses.

14.2 Existing policies to promote exploration

436. Incentives already exist to promote resource exploration in Australia. These include an immediate deduction within the income tax system for exploration expenditure; the provision of pre-competitive geoscience data by State geological surveys and Geoscience Australia; designated frontier areas; incentives within the PRRT; and a cooperative research centre focused on deep exploration.

14.2.1 Immediate deduction for exploration expenditure

437. Under the ITAA 1997, exploration expenditure is immediately deductible for income tax purposes (where it could otherwise, at least in part, be treated as a capital expense and deducted over the life of the discovered resource).

438. Exploration entities also benefit from the immediate deductibility of successful exploration (in the form of income tax and R&D concessions further discussed in 14.3.4) for activities related to the development of new or improved exploration techniques. In addition, those entities with an aggregate turnover of less than $2 million will benefit from small business concessions, and those with total assets not greater than $50 million will benefit from concessions available for pooled development funds.

14.2.2 Pre-competitive geoscience data

439. Pre-competitive geoscience data acquisition in Australia refers to the collection, collation and integration of basic geoscientific data by government agencies, essentially Geoscience Australia and the States' geological surveys.

440. Geoscience Australia assists the Australian Government and the community to make informed decisions about the discovery and development of mineral and petroleum resources. Geoscience Australia conducts exploration surveys both onshore and

offshore, focusing on providing pre-competitive data (such as aerial electromagnetic and geophysical surveys and seismic data acquisition) and information to assist industry to move towards more competitive forms of exploration such as core drilling and testing.

441. These strategic regional geoscientific research programs generally aim at upgrading historic data sets and filling data gaps by acquiring, efficiently and economically, modern geoscientific data at geologic province scale.

442. The provision of pre-competitive geoscience data has similar positive externalities to those associated with R&D. For example, the provision of additional geological and pre-competitive information lowers the risk to other entities that are entering the sector. There is also a public good element of pre-competitive exploration as it is difficult for a private company to capture the full value of the activity due to the associated externality.

443. Australia is in competition with other countries for investment. Generally, there is a view by industry that exploration of frontier basins suffers from a market failure because there is insufficient information, or access to information, to adequately assess the prospectivity and risk of exploration, leading to less than optimal investment. It is therefore in governments' interests to mitigate this market failure by publicly providing non-exclusive information on the basic geology of an area (including information from past exploration). Companies can then make informed decisions as to potential within their own risk and reward framework.

444. The Australian Government currently provides funding to Geoscience Australia for the public provision of pre-competitive geoscience data (e.g. publishing the results of geological research, producing geoscience maps and databases). In 2006-07, the Government provided $58.9 million to enable Geoscience Australia to pioneer innovative, integrated geoscientific research to better understand the geological potential of onshore Australia for both minerals and petroleum.

445. Industry has previously been critical of the fact that Geoscience Australia's funding base for its pre-competitive exploration programs has generally been provided through sequential three or four year non-ongoing programs rather than on a more certain long term footing. Current funding for Geoscience Australia's on-shore pre-competitive data acquisition work will cease on 30 June 2011. Without renewed funding to maintain a significant precompetitive program Geoscience Australia's effectiveness in this arena will undoubtedly be reduced.

446. Such information allows the government and the private sector to make informed decisions about the exploitation of resources. Increasing funding to Geoscience Australia would enable it to expand its activities, and could further lower the risk of private exploration projects.

14.2.3 Designated frontier area

447. Under the PRRT, exploration expenditure in areas designated as 'frontier' from 2004 to 2009 is eligible for a 150 per cent deduction. This provided the greatest benefit to entities with existing PRRT paying projects and did not address the issue of trapped losses or provide an incentive for new companies to undertake exploration within these areas.

448. Entities that hold an exploration licence with a designated frontier area will continue to receive that benefit.

14.2.4 Incentives within the MRRT and PRRT

449. The MRRT and PRRT provide an incentive to explore because losses (including those arising from undeducted exploration expenditure) can be carried forward with an uplift, or be transferred to existing tax-paying projects to offset liabilities.

450. The PRRT provides concessions in the form of an augmented uplift (an additional 10 percentage points for exploration expenditure within five years of the granting of a production licence) and transferability (only project losses stemming from exploration are transferable). Exploration that occurs more than five years before the granting of a production licence is uplifted at the GDP deflator to maintain its real value.

451. The possible treatment of exploration expenditure under the MRRT is discussed in Part B of this paper.

452. Of course, the MRRT and PRRT only apply to a defined set of resources (coal, iron ore, oil and gas) and so do not apply to exploration for other resources.

14.2.5 Research into new technologies

453. A Cooperative Research Centre focused on deep exploration technologies (CRC-DET) was launched in 2009 to help develop new drilling technologies, better ways of getting more valuable information from drill holes, and new targeting strategies. CRC-DET will receive $28 million from the Government plus $70 million from industry partners. The technologies developed from this joint government-industry initiative should promote greenfield exploration by lowering the cost and risk of activities.

14.2.6 Geothermal energy initiatives

454. Geothermal energy is power extracted from heat stored in the earth. Following the announcement of the Australian Government's *Onshore Energy Security Initiative* in August 2006, Geoscience Australia established a geothermal energy project. The project aims to improve existing knowledge about the type and location of geothermal resources in Australia on a national scale. It also aims to encourage investment, exploration and exploitation of this energy source through provision of pre-competitive geoscience data sets relevant to geothermal energy.

455. There are also several State and Territory initiatives in place to encourage geothermal exploration, including facilitation of geothermal exploration through the establishment of licensing and permit systems, the provision of geological information, and drilling programs.

14.2.7 Existing State and Territory Government incentives

456. Australian jurisdictions each offer their own incentives to encourage greater exploration in their State or Territory. Box 14.1 provides information on some of the major incentives currently in place.

457. Additionally, all State geological survey agencies maintain core libraries which currently hold core samples (mostly from past exploration drilling and selected cores from old mine leases).

Box 14.1: Existing State Government incentives

Plan for Accelerating Exploration (PACE) (South Australia)

South Australia's *Plan for Accelerating Exploration (PACE)* was designed to promote South Australia as a destination for mineral and energy investment. The South Australian Government committed $22.5 million in funding for 2004–09 to attract further mineral and petroleum exploration investment. The PACE initiative included funding of $2 million per year available for collaborative drilling over the full five years.

Exploration Incentive Scheme (Western Australia)

The Exploration Incentive Scheme is a WA State Government initiative that aims to encourage exploration in Western Australia for the long-term sustainability of the State's resources sector. The $80 million initiative, funded by the Royalties for Regions Program over five years, is designed to stimulate increased private sector resources exploration and ultimately lead to new mineral and energy discoveries.

New Frontiers (NSW)

The New Frontiers Initiative is an exploration enhancement to further stimulate mineral and petroleum investment in underexplored terrain. It builds on the previous Exploration NSW Initiative (which consisted of $30 million over 7 years from July 2000 to promote exploration in the state). The New Frontiers Initiative consists of an additional $16 million to continue the program of pre-competitive geophysical surveys, data compilation, mapping and data interpretation and delivery.

Smart Mining (Queensland)

The $29.08 million Smart Mining - Future Prosperity program includes three funding initiatives aimed at stimulating exploration investment in Queensland. Funds totalling $7.28 million are available to assist mineral and energy explorers under the Collaborative Drilling Initiative, Cluster Formation Initiative and Industry Network Initiative.

Bringing Forward Discovery (Northern Territory)

The Territory Government has committed to a four-year, $14.4 million exploration initiative titled Bringing Forward Discovery, which commenced in July 2007. Bringing Forward Discovery comprises 3 broad elements - geoscience programs, industry collaborations and project facilitation and promotion.

Rediscover (Victoria)

The Rediscover Victoria initiative will invest $5 million over four years until June 2011 in a geoscience program to encourage earth resources exploration, especially in parts of the state where little exploration has occurred to date. The Rediscover Victoria program comprises a drilling initiative and 3D geological mapping.

Tasmania

Over the past decade, the Tasmanian and Australian governments have invested over $16 million in developing new geophysical and geological information, including 1:25,000 scale digital geological maps of Tasmania's most mineralised regions and a world-first 3-D geological model and prospectivity analysis of the entire state.

14.3 Policy options to promote future exploration

458. There are a range of policies available to the Government if it chose to further promote resource exploration in Australia. These include:

- an exploration refundable tax offset (ERTO) or resource exploration rebate;
- an Exploration Tax Credit (ETC);
- a flow through shares scheme (FTS), such as the model currently in operation in Canada; and
- concessions similar to those for R&D.

459. Table 14.1 summarises the key design features of the first three policy options, and further details are below.

14.3.1 Exploration refundable tax offset (ERTO)

460. A tax offset directly reduces the amount of tax an entity has to pay (unlike deductions, which are subtracted from income before a tax liability is calculated). Most tax offsets can only reduce a tax liability to zero. A *refundable* tax offset can reduce tax liability to zero, but results in a refund. An exploration refundable tax offset (ERTO) is refundable at the company tax rate for all eligible exploration expenses.

461. With an ERTO, expenditure incurred in exploring or prospecting for minerals, petroleum or quarry materials can be immediately deducted, subject to the taxpayer passing certain tests.

462. The introduction of an ERTO would increase the level of exploration that can be undertaken with a given amount of capital, because a company can spend the capital it has raised, claim an ERTO, and then spend the ERTO. As a result, entities would need to return to the market less frequently to raise funds.

463. Further, the ERTO could increase the expected rate of return on contributed capital, because it would increase the number of metres drilled per dollar of share capital, increasing the likelihood of a successful discovery. This should make it easier to raise capital. Alternatively, companies might be able to provide investors with similar incentives to an exploration tax credit with a refundable tax offset.

464. A refundable tax offset will not be of use if the entity is unable to raise capital for exploration. However, the value of the ERTO to an investor should be similar to the exploration tax credit described below.

465. Further, the extent to which refundable tax offsets are supported by the constitution is uncertain.

466. All entities could potentially benefit from a refundable tax offset. However, those entities that are in a tax loss position would particularly benefit because they would receive an immediate cash benefit. A refundable tax offset offered to all entities avoids the complexity of having to define an 'Australian small listed exploration company' in the tax law, which could be required if the incentive was targeted at junior explorers.

Table 14.1: Key design features of alternative policy options

	Exploration Refundable Tax Offset (AFTS Review)	Exploration Tax Credit	Flow-Through Share Scheme (Canada)
Direct Beneficiary	Entity	Resident shareholders	Resident shareholders
Rate	30 per cent	30 per cent	Investor's marginal rate
Nature	Refundable offset	Refundable offset	Deduction
Capital Gains	No implication	Cost base reduced by grossed up ETC	Cost base reduced to zero
Timing of benefit	Company could pass on benefit in the form of a taxable dividend	ETC is voluntary. Can only be distributed after exploration expenditure has occurred and if company does not pay income tax	Company is required to issue a special class of shares and incur eligible exploration no less than the consideration paid for the FTS within 24 months. The deduction to shareholders can be prior to actual spending under the 'look-back rule'
Advantages	Improves cash flow for entities not yet profitable Encourages investment from residents and non-residents alike Has fewer integrity and administrative issues than shareholder-level incentives	Helps junior companies raise equity financing from Australian investors Does not require a special class of shares Helps level the playing field between junior and large companies	Helps junior companies raise equity financing from Australian investors Investors can deduct renounced expenses from their income Helps level the playing field between junior and large companies
Disadvantages	Only useful if a company is able to raise funds for exploration	Higher administration and compliance costs. Distortionary effect of industry-specific tax concessions	Higher administration and compliance costs. Distortionary effect of industry-specific tax concessions

467. The recent *Australia's Future Tax System (AFTS) Review* assessed the case for government intervention to promote exploration. The Review recommended that '[if] earlier access to tax benefits from exploration expenses (relative to other expenses) is to be provided, it should take the form of a refundable tax offset at the company level for exploration expenses incurred by Australian junior listed exploration entities, with the offset set at the company income tax rate.'

468. The *Review* also noted that '[a] resource rent tax should not provide concessions to encourage exploration or production activity at a faster rate than the commercial rate or in particular geographical areas, and should not allow deductions above acquisition costs to stimulate investment'.

14.3.2 Exploration tax credit (ETC)

469. In 2008, industry indicated a preference for a model that allows exploration entities to flow-through to shareholders the tax benefit associated with deducting exploration expenditure at the company level. Such a model is seen as helping entities to raise capital as well as addressing the issue of trapped losses.

470. The particular model suggested by industry is an ETC at the shareholder level. The ETC, like the ERTO, is a refundable tax offset. However, it is available to the shareholders not the company. The details of the ETC model are as follows:

- an ETC would be offered to resident shareholders of Australian companies for exploration expenditure incurred by those companies on projects within Australian jurisdictions;
- the ETC would be available to all shareholders on the register on the day the ETC was 'implemented';
- the ETC would not be available to be claimed until after exploration expenditure is actually incurred;
- the ETC would be optional—companies could retain their losses from exploration expenditure for future use. Provided the exploration expenditure has been incurred, companies would have flexibility in the timing of the credit, using a mechanism like a franking-account;
- the ETC would be available at the prevailing company income tax rate. All taxpayers would be entitled to the credit based on this rate, regardless of their tax rate. Taxpayers unable to use their full credit would receive a refund;
- credits could not be distributed to shareholders where the company —considered from a corporate consolidated group perspective—pays income tax (this would help to confine the scheme's availability to junior start-up companies);
- in the case of new capital raisings, a company could direct the ETCs to the new shareholders via different share classes, as is the case with franking;
- to ensure there was no double deduction of the exploration expenditure, the ETC would reduce the shareholders' capital gains tax (CGT) cost base of their shares;
- if a company were to distribute ETCs and it was later found that its expenditure did not meet the eligible exploration definitions, this should be dealt with at the

corporate level. A legislative mechanism based on the franking deficits tax model could be adopted; and

- anti-avoidance provisions similar to those existing in the franking law would also apply to the ETC system (e.g. anti-streaming and the 45-day rule).

471. An ETC would help junior companies raise equity financing from Australian investors. The incentive to invest would be especially large for superannuation funds, given their returns are only taxed at 15 per cent. Major institutions like superannuation funds have not traditionally invested in junior entities.

472. The ETC only provides an advantage to exploration financed by Australian equity. In contrast to the ERTO, it would not assist in attracting investment from non-resident investors.

473. An ETC has the potential to create more opportunities for 'tax gaming' than an ERTO, and legislation would need to be tight to prevent misuse of the scheme. This could increase complexity in the law governing the ETC.

14.3.3 Flow-through share scheme

474. Flow-through share (FTS) schemes provide a mechanism by which a company can pass deductions generated from exploration expenditure to its shareholders. Providing a tax incentive to investors who acquire FTS could assist junior companies to raise capital to finance their exploration activity.

475. An FTS scheme has been used in Canada for a number of years. The scheme, in place since 1954, has the following key elements:

- an entity engaged in exploration in Canada may issue a separate class of shares called FTS;
- the corporation that issues the FTS can renounce any 'flow through' eligible exploration and development expenses to the investor;
- the entity agrees to incur and renounce eligible exploration, the total of which will not be less than the consideration paid for the FTS, within 24 months;
- investors in FTS benefit by deducting from their income the renounced expenses at the date of renunciation;
- a 'look-back rule' allows an entity to provide an effective date of renunciation prior to actual spending;
- investors in FTS can also benefit from a 15 per cent non-refundable investment tax credit for exploration (ITCE) in the year the investment is made; and
- an investor who sells the FTS will pay CGT on the full value received on the sale rather than the actual capital gain.

476. In this model, investors will benefit from the deduction at their marginal rate, which will often be higher than that of the company that renounces the expenditure. The CGT base is set to the full value of the share in order to offset this additional benefit to the investor. The ITCE is in addition to the flow-through deductions that the investor

benefits from (as a result the Canadian model is sometimes referred to as a 'super' FTS scheme).

477. The introduction of the federal ITCE in 2000 led to the introduction of various concessions at the provincial level. The provinces have largely adopted provincial tax credits which are applied in respect of provincial exploration expenditure. The provincial tax credits are in addition to the federal ITCE and vary in rate from 5 to 30 per cent. While both the federal and provincial tax credits were introduced as 'temporary' measures, they have been extended several times.

478. Australian industry points to the large rise in exploration expenditure in Canada between 2000 and 2008 as evidence of the success of the 'super' FTS scheme. However, there is evidence to suggest that FTS-related exploration incentives were not equally effective throughout the period (Intergovernmental Working Group on the Mineral Industry 2009).

479. *Flow-Through Shares: An Evaluation Report*, released by the Canadian Department of Finance in 1994, provided a very mixed review of the scheme's effectiveness. It found that effectiveness depended on the stage of the economic cycle. At a time of low commodity prices (as was the case in the 2000-2003 period), tax incentives become more important as funds for exploration are harder to come by. Other key findings were:

- incremental exploration activity generated by FTS was not particularly high;
- inflated exploration costs were experienced in the mining industry;
- there was little evidence that the incremental exploration spending resulted in incremental discoveries attributable to FTS; and
- FTS were often tax-motivated investments.

480. In Australia, an FTS scheme (or variants) operated for the resource sector over the periods 1958 to 1973 and 1978 to 1985. The scheme operating in the period 1958 to 1973 was based on providing tax deductions on funds invested in petroleum and mining entities for the purposes of exploration. It was abolished in 1973 because it had been used extensively for tax avoidance and was assessed as an expensive and inefficient form of Government intervention in the resources industry. The 1978 to 1985 scheme was abolished by the government of the day, reflecting a preference to remove taxation concessions and to broaden the income tax base.

481. The FTS scheme operating over the period 1978 to 1985 was based on providing a rebate of 27 cents in the dollar of share capital subscribed to a petroleum or mining entity. The concession applied initially to offshore exploration (primarily to encourage exploration on the North West Shelf) and was subsequently extended to onshore exploration.

14.3.4 Concessions similar to those for R&D

482. Minerals exploration has similar spillovers to those associated with R&D (e.g. additional geological information lowers the risk for other entities and the discovery of resources provides benefits to the community). It is partly for this reason that exploration expenditure in areas designated as 'frontier' from 2004 to 2009 is eligible for a 150 per cent deduction under the PRRT.

483. The AFTS review recommended against providing concessions based on spillovers due to the absence of a persuasive 'public good' justification. Nonetheless, it is constructive to review the concessions for R&D.

484. The R&D tax concession was introduced in 1985 and currently comprises:

- a tax deduction of up to 125 per cent for R&D expenditure;
- a 'premium' deduction of 175 per cent for increases in R&D expenditure above a rolling three year average; and
- an R&D tax offset for entities spending less than $2 million[38] for the year and with turnover less than $5 million. The tax offset is designed to address 'trapped' losses.

485. The Tax Laws Amendment (Research and Development) Bill 2010, which implements a 2009-10 Budget measure, aims to replace the concession with a new R&D tax incentive. The proposed incentive is in the form of an offset and whether it is refundable or not depends primarily on the aggregated turnover of the entity—a 45 per cent refundable tax offset if the aggregated turnover is less than $20 million, and a 40 per cent non-refundable tax offset for all other entities (unused offset amounts can be carried forward). The proposed changes also involve tightening the definition of qualifying R&D to better align the scheme with the underlying rationale.

[38] $1 million prior to 2009-10.

ATTACHMENT A: TERMS OF REFERENCE

Purpose

The purpose of the PTG is to advise the Australian Government in the development of the technical design of the Minerals Resource Rent Tax (MRRT) and transition of existing petroleum projects to the Petroleum Resource Rent Tax (PRRT) regime as announced by the Government on 2 July 2010.

In developing this advice, the PTG will consult with directly affected companies, relevant government departments and stakeholders on the implementation of the new MRRT and the extension of the PRRT to ensure the new tax arrangements are implemented as efficiently and consistent with the design principles as possible.

The design principles of the MRRT are attached.

Particular issues for consideration for iron ore, coal, oil, gas and coal seam gas include:

- the taxing point and valuation method to be used for the commodity;
- the definition of a project and interest in a project;
- eligible project expenditure;
- the definition of exploration expenditure;
- the determination and calculation of the starting base for existing projects including the rules for electing a particular starting base;
- tax treatment of the starting base and of capital expenditure incurred between 2 May 2010 and 1 July 2012;
- a workable exclusion where resource profits are below $50 million per annum;
- crediting of state and territory royalties;
- integrity rules supporting the policy underpinning the new resource taxation arrangements; and
- identifying opportunities to minimise associated compliance and administration costs.

The Government has stated that the resource exploration rebate will not be pursued with resource exploration costs continuing to be deductible in the normal way. However the PTG will consider the best way to promote future exploration and ensure a pipeline of resource projects for future generations.

The PTG will consider the best way to achieve smooth interaction between the MRRT, PRRT and State and Territory royalty regimes.

The Committee's recommendations will be consistent with the Government's fiscal strategy as stated in the 2010/11 Budget. Any policy deviation from the Government's announcement

of 2 July 2010 is to be fully offset within the recommendations in terms of impacts on revenue or costs.

Process

The PTG will be led by the Minister for Resources and Energy, Martin Ferguson AM and Mr Don Argus AC.

In order to protect the integrity of the process, the PTG will be supported by representatives of Treasury, the Department of Resources, Energy and Tourism, the Australian Taxation Office and, as required, the resources industry. The PTG will also obtain advice as appropriate from other independent experts.

The PTG is to provide its advice to the Government by the end of 2010 to allow for the legislation supporting the MRRT and extension of the PRRT to be introduced into Parliament in accordance with Government's announced timetable.

The Design of the Minerals Resource Rent Tax

The new resource tax will apply from 1 July 2012 only to mined iron ore and coal. All other minerals are excluded.

The rate of tax will be 30% applied to the taxable profit at the resource.

Taxable profit is to be calculated by reference to:

- The value of the commodity, determined at its first saleable form (at mine gate) less all costs to that point.
- An extraction allowance equal to 25% of the otherwise taxable profit will be deductible to recognise the profit attributable to the extraction process (i.e. to only tax the resource profit).
- Arms length principles on all transactions pre and post first saleable form.

MRRT is to be calculated on an individual taxpayer's direct ownership interest in the project.

There will be no MRRT liability for taxpayers with low levels of resource profits (i.e. $50m per annum).

All post 1 July 2012 expenditure is to be immediately deductible for MRRT on an incurred basis. Non-deductible expenditure will be broadly consistent with PRRT.

MRRT losses will be transferable to offset MRRT profits the taxpayer has on other iron ore and coal operations.

Carried-forward MRRT losses are to be indexed at the allowance rate equal to the LTBR plus 7 percent.

The MRRT will be an allowable deduction for income tax.

All State and Territory royalties will be creditable against the resources tax liability but not transferable or refundable. Any royalties paid and not claimed as a credit will be carried forward at the uplift rate of LTBR plus 7 percent.

Starting Base

The starting base for project assets is, at the election of the taxpayer, either:

- Book value (excluding the value of the resource) or
- Market value (as at 1 May 2010).

All capital expenditure incurred post 1 May 2010 will be added to the starting base and depreciated against mining operations from 1 July 2012.

"Project assets" for the purpose of the MRRT will be defined to include tangible assets, improvements to land and mining rights (using the Income Tax definition).

Where book value is used to calculate starting base, depreciation will be accelerated over the first 5 years. The undepreciated value will be uplifted at LTBR plus 7 percent.

Where market value is used to calculate starting base, there will be no uplift and depreciation will be based on an appropriate effective life of assets, not exceeding 25 years.

Any undepreciated starting base and carry forward MRRT losses are to be transferred to a new owner if the project interest is sold.

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