Submission to Policy Transition Group on Technical Design of the Minerals Resource Rent Tax

1. Introduction

This submission has been prepared by the Taxation Committee of the Business Law Section of the Law Council of Australia and represents the views of the Taxation Committee.

The Law Council – the peak body for Australian lawyers – speaks on issues of national and international importance, federal law and the operation of federal courts and tribunals, as well as advising governments, courts and federal agencies on ways in which the law and the justice system can be improved for the benefit of the community.

The Taxation Committee welcomes the opportunity to comment in relation to the Issues Paper issued by the Policy Transition Group (***PTG***) on the technical design of the minerals resource rent tax (***MRRT***) on 1 October 2010 (the ***Issues Paper***).

The answers to many of the questions raised in the Issues Paper are dependent upon practical matters arising within the iron ore, coal and petroleum industries, and specifically upon the way in which those industries operate. Other questions depend upon matters of policy associated with the scope of the tax.

The Taxation Committee does not intend to comment upon these matters in any detail. Rather our comments are focused upon:

(a) issues associated with the design of the law and the capacity of that design to:

  (i) provide taxpayers with clarity and certainty in the application of the law to their specific circumstances; and

  (ii) avoid imposing unnecessary and significant compliance burdens; and

(b) selected policy issues that transcend any particular taxpayer, but which are important to consider in undertaking significant tax reform of this nature.

2. Executive Summary

2.1 **Consultation process:** At this stage, it appears that the PTG's role may be limited to the conduct of consultations during the 2010 calendar year. Having regard to the wide range of commercial arrangements which are already in existence in relation to current projects, and the need for taxpayers to carefully consider whether or not the legislation introduced is sufficiently flexible to deal with those existing arrangements, we would recommend that the consultation process should continue during the 2011 year. Further, there should be detailed consultation on the terms of any draft legislation, which should initially be released by way of exposure draft.

2.2 **Complexity and compliance costs:** A tax imposed on the profits arising from a part of a company's operations is inherently more complex than a tax on the profit of the company's entire operations, its revenue or other transactions. That complexity is compounded by the range of different commercial arrangements which are already in place in relation to existing projects, and the flexibility which exists for the provision of tenure in the iron ore and coal industries. This complexity has the potential to impose a significant administrative and compliance burden on taxpayers. The issue of compliance cost is a significant issue in the context of smaller producers. In formulating its recommendations, we recommend that the PTG focus on methods of providing taxpayers with certainty, while attempting to minimise the additional compliance costs arising from the new tax. This may be achieved, in many cases, by setting out general principles, but providing for specific and clear safe harbours similar to the structure of the thin capitalisation regime for income tax.

2.3 **Taxing Point:** There will be difficulties in establishing a clear taxing point which is appropriate for all projects. As such, while we support the mine gate concept, we recommend that the PTG consider whether it is appropriate to allow some taxpayers the option of electing a taxing point which is further downstream than the 'mine gate', where that reduces the administrative and compliance costs for them.

2.4 **Taxable Value:** We consider it inappropriate to adopt international transfer pricing principles to determine the taxable value of commodities at the mine gate. Rather, we recommend that “market value” be used where there is no consideration or no arm’s length dealing. Further, to provide certainty and minimise compliance costs, taxpayers ought to be given the option of one or more safe harbours.

2.5 **Time of recognition of project:** We recommend that a project be recognised once a taxpayer has been granted a right to explore in an area to avoid the difficulties which have been encountered with the Petroleum Resource Rent Tax (***PRRT***) and provide appropriate recognition of a starting base.

2.6 **Deductible expenses:** While the Issues Paper states that the categories of expenditure which will be deductible for MRRT purposes are to be modelled on the existing PRRT rules, we believe that there are compelling grounds to suggest that the rules should be modified to deal with the particular circumstances in the industries to which the MRRT will apply, and provide taxpayers with a greater level of certainty than currently exists in relation to PRRT. We have provided comments on the deductibility (and timing thereof) in relation to some specific costs - native title expenditure, private royalties, rehabilitation and closing down expenditure and hedge expenses.

2.7 **$50 million (smaller miner) threshold:** In so far as the aggregation of related parties is concerned, we consider that this should be based on 100% common ownership. Further, consideration should be given to short cuts for both eligibility and ongoing compliance.

2.8 **Treatment of Losses:** We submit that MRRT losses should be able to be transferred within a consolidated income tax group or among members of any other wholly owned group of companies. Such transfers should be made at the election of the taxpayer, rather

than on a compulsory basis to avoid adverse or unanticipated impacts on project economics.

2.9 **Elections under MRRT:** It is clear that various elections will need to be made for the MRRT to operate effectively. We recommend that any MRRT elections be permitted to be made on a project by project basis, ie. a taxpayer may make different elections for different projects in which it participates.

2.10 **Policies to promote exploration expenditure:** While the Taxation Committee supports incentives being provided for exploration activities, particularly for junior explorers, the type of incentive is a matter of policy judgment. The Taxation Committee welcomes the opportunity to comment on the design of the incentive, once its basic parameters have been determined.

2.11 **Ongoing monitoring and review:** We consider the legislation will require post implementation monitoring and review to ensure that it operates as intended. Further the Australian Taxation Office (***ATO***) should be encouraged to provide clear and comprehensive guidance at an early stage.

3. Consultation process

3.1 At this stage, it appears that the PTG's role may be limited to the conduct of consultation during the 2010 calendar year.

3.2 It is likely that the law as introduced will need to be sufficiently flexible to deal with a wide range of existing commercial arrangements already in place. Accordingly, we would recommend that the consultation process continue during the 2011 year and that there should be significant consultation on the terms of any draft legislation.

3.3 Many of the issues in the Issues Paper are focused on the high level design of the MRRT. No doubt some of these 'big picture' issues are of immediate concern to participants in the affected industries. Once the Government has made decisions on these issues, it is likely that some of the administrative and compliance issues, which may be capable of being addressed in the design of the law, will come into sharper focus.

3.4 For that reason, we would suggest that the Government should release an exposure draft of the legislation and that there should be a consultation process for the development of that exposure draft. This would be consistent with the recommendations of the Tax Design Review Panel.[1] We see benefit in the PTG continuing to manage the consultation process through 2011.

[1] Tax Design Review Panel, "Better Tax Design and Implementation", 30 April 2008.

4. Complexity and compliance

4.1 A tax imposed on the profits arising from a part of a company's operations is inherently more complex than a tax on the profit of the company's entire operations (corporate income tax), its revenue (goods and services tax) or other transactions (for example stamp duty). This complexity has the potential to impose a significant administrative and compliance burden on taxpayers.

4.2 All companies maintain accounting records which measure the profits arising from their business operations as a whole. However, except for sole purpose companies, such accounts will be of little assistance in measuring profits referable to a given project.

4.3 Companies which operate mining and resource projects as joint ventures, are generally required to maintain accounting records which measure the costs and expenses associated with the operations of the joint venture. The costs charged by the operator to the joint account for the joint venture are subject to review by other joint venture participants and, usually, are externally audited. The other joint venture participants have a commercial interest in ensuring that the only costs charged to the joint account are costs which truly relate to the joint venture activities.

4.4 Joint ventures usually extend to the point that the minerals extracted have been treated and are in a state and condition in which they are able to be sold. On rare occasions, a joint venture may extend to downstream processing, without a product which is commonly sold having necessarily been brought into existence.

4.5 Where the taxing point for a project aligns at, or at a point close to the point at which the joint venture operations cease, it is to be expected that the joint venture account maintained by the operator, being subject to review by other project participants who do not want to pay costs not properly charged to them, ought to provide a reasonable reflection of the costs of the project. Where however the taxing point is upstream of the end of the operations of the joint venture, it is necessary to identify from the joint account, those costs which relate to the activities within the project and qualify for deduction. While the identification of some costs may be relatively straight forward, particularly where the description of the cost is such that it must relate to an activity within the MRRT project, identification of other costs which relate to the MRRT project will impose an additional compliance burden.

4.6 There is inherent tension between the desire to ensure that the provisions of the MRRT are sufficiently flexible to allow them to deal with a range of different mines, and the desire so far as possible to provide each project to which the MRRT applies, with certainty as to its application.

4.7 It is noted at paragraph 17 of the Issues Paper there is a trade off between flexibility and certainty in the design of the legislation. It seems likely that a principles-based design approach to the law may provide flexibility, which could be supplemented by appropriate safe harbours which taxpayers may choose to adopt in certain circumstances.

4.8 In formulating its recommendations, the PTG should seek out methods of providing taxpayers with certainty and of reducing compliance costs.

5. Taxing Point

5.1 Experience with the PRRT suggests that it can be difficult to formulate a definition to identify a point in the production process which is to be regarded as the 'taxing point'. The concept of a 'first saleable form' is of no real assistance. Almost anything can be sold, it is mostly a question of price. Even the raw material extracted from the ground could be sold, albeit that the purchaser may need to undertake some immediate steps to put in a condition in which it is cost effective to transport it.

5.2 Unless all iron ore and coal producers adopt similar steps as part of the process of dealing with raw materials extracted from the ground, it may be difficult to formulate a single definition of taxing point which is capable of universal application.

5.3 We support the adoption of a suitably defined point in the process at the mine gate as the taxing point.

5.4 Identification of a taxing point at or close to the mine gate may in some instances result in a taxing point which is within the middle of the scope of joint venture operations for which joint venture accounts are maintained. Identification of costs associated with these activities will impose an additional administrative burden and require additional record-keeping. In some instances it will also require the allocation of costs. It seems likely that in many instances the material at the taxing point will not be sold and may not be in a state or condition for which there is an arm’s length price. The need to value the commodity at the taxing point introduces an element of significant uncertainty for project participants.

5.5 The PTG should consider whether it might be appropriate to allow some taxpayers the option of electing a taxing point which is further downstream than the 'mine gate' where that provides greater certainty and reduces the administrative and compliance costs for them. At the time that the proposed resource super profits tax (***RSPT***) was announced, a possibility was raised of allowing taxpayers to elect that the taxing point be at the point of eventual sale. This may be of assistance to some taxpayers, particularly those who have relatively small projects and who may not wish to incur the compliance costs associated with calculating taxable profit at the 'mine gate'.

6. Taxable Value

6.1 The Taxation Committee believes 'market value' should be adopted where there is no consideration received at the taxing point or the parties are not *dealing* at arm's length.[2] Adoption of a 'market value' concept as a means of measuring revenue at the taxing point will provide maximum flexibility to deal with a range of different projects. It is also a concept that has clear meaning in Australian law.[3]

6.2 The Taxation Committee does not consider it appropriate to incorporate international transfer pricing principles, developed in the context of bilateral tax arrangements between sovereign states, into the domestic law. Amongst other concerns, the application of those principles is expensive and unlikely to provide the certainty desired, as evidenced by the increasing level of transfer pricing disputes. Further, given that those principles are determined by the Organisation for Economic Cooperation and Development, through discussion among the members thereof, they are open to change that may not suit the circumstances of the industries subject to the MRRT. The interaction of concepts developed in the international sphere with domestic law often presents difficulties, as is exemplified in a number of cases in the income tax context. [4]

6.3 We recognise that the market value concept does, however, leave taxpayers with a considerable degree of uncertainty about the precise value to be used, particularly if the legislation is structured in a manner similar to the PRRT.

6.4 Further, it is unlikely that a single method of determining market value would be appropriate for determining market value for all projects subject to the MRRT.

6.5 It may, however, be possible to reduce the uncertainty associated with the determination of the value to be brought to account by providing in the law for the adoption of one or more safe harbour methods of determining market value. [5] If this method was based on the 'resale price method' or the 'netback method', it might be possible for it to contain within it an element of flexibility, eg. recognising that the rate of return which was appropriate for downstream operations may vary from project to project.

6.6 This may be supplemented by advance pricing agreements reached between individual taxpayers and the Australian Taxation Office.

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[2] This is based on the test which applies to capital proceeds for capital gains tax purposes in section 116-30 of the *Income Tax Assessment Act 1997* (***ITAA 1997***).

[3] *Spencer v Commonwealth* (1907) 5 CLR 418 at 436-7 [per Barton J].

[4] *Re Roche Products Pty Ltd v Commissioner of Taxation* [2008] AATA 261, at para [191] per Downes P. *Undershaft (No 1) Ltd v Federal Commissioner of Taxation* [2009] FCA 41 at para [46] per Lindgren J. cf. *SNF (Australia) Pty Ltd v Commissioner of Taxation* [2010] FCA 635, at para [23] per Middleton J. See also *Federal Commissioner of Taxation v Lamesa Holdings BV* (1997) 157 ALR 290, 292-3 (per Burchett, Hill and Emmett JJ) and *Chong v Federal Commissioner of Taxation 2000* ATC 4315, at paras 23-6 (per Goldberg J).

[5] This follows the structure of the thin capitalization provisions in Division 820 of the ITAA 1997 which provide a safe harbor debt level, but permit taxpayers to adopt a higher level of debt if they satisfy the "arm's-length debt test".

7. Time of recognition of a project

7.1 We suggest that the existence of a project should be recognised when a taxpayer is granted a right to explore. The approach currently taken in the *Petroleum Resource Rent Tax Assessment Act* 1987 (***PRRTAA***) is flawed. The PRRTAA seeks to recognise a project only once a production licence is in force yet various provisions which have been added into the legislation since it was originally introduced need to work and be given effect to in relation to a project in the years prior to the grant of a production licence. This approach has created a tension in the interpretation of the PRRTAA which contributes to the general lack of clarity and uncertainty which exists in interpreting many aspects of that Act.

7.2 Recognition of a project at the time that a right to explore is granted would also allow appropriate recognition of a starting base for projects at the exploration stage. There can be no reason to allow a starting base for a project which was granted a production licence in April 2010, yet deny one for a project which was granted a production licence shortly thereafter.

8. Deductible expenses

8.1 We agree that only the costs associated with bringing the commodity to the taxing point ought to be deductible against MRRT receipts (paragraph 59 of the Issues Paper) and that deductible expenditure 'should have a necessary connection with the derivation of … profits' (paragraph 153).

8.2 While it is suggested that deductible expenditure should be broadly consistent with the existing arrangements for the PRRT, we believe that there is good reason for the PTG to carefully review the scope of deductible expenditure, particularly given the fact that:

(a) the MRRT is to apply to the profits arising from a part of a project, being that part which occurs up to the mine gate; and

(b) it is already contemplated within the structure of the MRRT, as a tax on iron ore and coal, that there will be a need for the apportionment of some costs, at least in circumstances in which other commodities are produced.

8.3 In this regard, we consider the provisions dealing with deductibility of PRRT provide an unstable foundation for the commencement of the MRRT. There is considerable uncertainty and debate within the PRRT context about:

(a) the degree of connection required between expenditure and the actual activities physically involved in extracting moving and treating the commodities to the taxing point; and

(b) the treatment of expenditure which, although incurred in the process of carrying on project operations, may need to be apportioned.

8.4 It is recognised, that the mere fact that a company needs to incur particular expenditure in order to carry on certain activities does not necessarily give that expenditure a relevant connection with those activities. By way of example, a company may need to incur directors' fees if it is to exist in order to carry on a sole project. The corollary is that it is not necessarily true that all expenditure – other than that incurred on digging something out of the ground, and processing and treating it to the taxing point – should not be considered expenditure in connection with the project.

8.5 In our view, the appropriate method to determine whether or not particular costs, or a part thereof, relate to activities within the project boundary, is to ask whether or not the occasion for the outgoing is to be found in the course of or in the process of carrying on or providing the particular activities in question. If it is, the expenditure ought to be deductible.

8.6 Where expenditure is incurred, which would satisfy this test, but the expenditure also serves another purpose, the expenditure ought to be apportioned. It is only by taking this approach that a true reflection of the profit of the particular operation can be obtained. In undertaking any apportionment, any reasonable basis ought to be permitted. However, again, the use of safe harbour methods may be appropriate to provide certainty and minimise the compliance costs.

8.7 One possible approach to the development of a safe harbour for the identification of deductible costs would be to recognise that the joint venture accounts prepared for a joint venture identify the costs which are referrable to joint venture activities. These accounts are subject to external audit and competitive pressure, in the sense that joint venture participants will not pay costs which do not truly relate to joint venture activities. Those costs which are identified in the joint venture accounts which can easily be allocated to activities upstream of the taxing point and activities downstream of the taxing point could be allocated appropriately. Any remaining costs could then be apportioned between activities upstream and downstream of the taxing point based on some shortcut (for example a comparison of the relative market value of products at the taxing point and the relative market value at the end of the joint venture). Any integrity concerns with this approach are significantly ameliorated by the fact that costs allocated to the activities downstream of the taxing point would normally be taken into account in working out the market value of the product at the taxing point on which revenue is to be determined.

8.8 Failure to recognise all costs in calculating the taxable profit for MRRT purposes would potentially create a significant distortion between those situations in which taxpayers incur costs themselves in carrying on operations, and those in which taxpayers engage contractors to provide services associated with the extraction treatment and processing activity. Any contractor will build these costs into the costs which they charge. As a cost of an extraction processing or treatment activity, the contractor's costs will be deductible.

8.9 There are some specific categories of expenditure that deserve particular consideration:

- **Native title payments:** Expenditure on native title payments is a cost of getting access to particular land, and should be deductible in the same manner as rental. These

payments are a cost of production, not a profit sharing mechanism. The fact that a payment is periodic and not one off, or calculated by reference to the value of a commodity or a project's profitability, does not necessarily determine the character of the payment in question. Rather, its appropriate to look at the character of the advantage sought by the payments.

- **Private royalties:** As for native title payments, we consider that these are costs of the project and should be taken into account, as they are for income tax purposes. Many companies will have entered long term private royalty agreements long before the MRRT (or the predecessor proposal) was announced. It is very unlikely that such agreements would allow the royalty to be adjusted to take account of the new tax. In the absence of a transitional provision providing for negotiation and arbitration between the parties, such as was included for the GST,[6] this has the potential to increase the "effective MRRT rate" considerably.

- **Rehabilitation and closing down costs:** Under AASB 137 and 116, mining companies are required to provide for rehabilitation and closing costs at their discounted value and to expense an amount each year that the mine project is under way. While ordinary principles of deductibility are generally appropriate, we think that rehabilitation and closing down costs warrant special consideration and that it would be appropriate to allow a deduction for amounts expensed in accordance with AASB 137 and 116.

  This deduction could perhaps be subject to the proviso that the accounts of the relevant entity or joint venture are audited. Of course, the legislation would need to include some form of true-up when the mine is closed and the actual costs are known.

- **Hedge expenses:** As the decision in the Woodside case[7] illustrates, under PRRT tests for deductibility hedge gains and losses on commodity hedges put in place to protect against fluctuations in the value of a commodity are unlikely to be deductible, even if the hedges are put in place in respect of the output of a specific project. This clearly presents difficulties particularly for smaller producers who may need to hedge to ensure the economic viability of their operations and may not be able to proceed with a project without hedging their output. It also results in a distortion where economically equivalent transactions (a long term sale at a fixed price and a spot sale with a hedge) are treated differently.

  We would recommend that specific allowance be made in the rules which apply to determine the assessable receipts at the taxing point, for the costs of hedges which are put in place under arrangements which meet accounting requirements for matching against the revenue of a project,[8] to be taken into account in calculating the market value of the project revenue at the mine gate.

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[6] *A New Tax System (Goods and Services Tax Transition) Act 1999*, section 15A

[7] *Woodside Energy Ltd v FC of T* [2009] FCAFC 12

[8] AASB 139 Financial Instruments: Recognition and Measurement

9. $50 million (smaller miner) threshold

9.1 The issues which we foresee with using a $50 million threshold for smaller miners (***smaller miner threshold***) are:

- tax compliance costs are likely to be more substantial for smaller miners than for larger producers and so compliance shortcuts are necessary;
- the potential volatility in the profits of smaller miners, suggesting the need for the threshold to be applied on an average basis over a say 3 year period;
- the tests for aggregation of related parties needs to be set at an appropriate level having regard to the structure of the industries concerned; and
- from an equity viewpoint, smaller miners must be granted recognition of their capital expenditure and royalties paid, rather than being taxable on a hypothetical profit which provides no or limited recognition for those expenditures.

9.2 We address each of these points below.

Optional compliance shortcuts

9.3 Smaller miners need mechanisms or shortcuts for simpler compliance, with less record keeping and external costs required in order to comply with their MRRT requirements as MRRT compliance will involve potentially intricate valuation of the company and resources projects on transition as part of the starting base calculations and highly complex determination of the taxable value which drives the MRRT profit calculations.

9.4 Optional shortcuts could include the use of:

- accounting records wherever possible. Compliance mechanisms based on the annual audited financial statements of smaller producers should provide appropriate safeguards and compliance integrity; and
- rules of thumb based on accounting profits, applicable to the entire sector or particular segments, and updated regularly to reflect current economic conditions. For example, the Australian Bureau of Statistics, with assistance from the Department of Resources and Environment and the Treasury, could estimate the average MRRT profit of smaller miners compared to their total published profits for a year or compared to the gross resource revenue for a year. Assume, for example, the MRRT profit of a smaller producer is estimated to be 53% of the total published profit or the gross resource sale revenue (the balance of profits arising from activities after the MRRT taxing point). This average MRRT profit ratio could be applied to published profits or gross resource revenue to identify:

  (a) which smaller miners would be subject to MRRT, in other words operating as an eligibility rule; and

  (b) for the smaller miner to comply with the MRRT requirements without producing the full array of economic analysis.

Application of smaller miner threshold

9.5 In considering the application of the threshold profits tax test, paragraph 276 of the Issues Paper suggests that the annual $50 million threshold would be calculated without reference to the smaller miner's carried forward losses and starting base. We assume, but want to highlight, that a smaller miner above the threshold would nevertheless take their starting base and carried forward losses into account when calculating their actual MRRT liability.

9.6 Another important design feature is to deal with the volatility of MRRT income of smaller miners. We suggest consideration of a rolling average of say 3 years MRRT profits before a smaller producer is 'captured' into the MRRT system.

Aggregated entity level application

9.7 The income tax legislation currently uses wholly-owned tests in the contexts of income tax consolidation, multiple entry consolidated groups and certain capital gains tax roll-overs. These tests are well understood and operate effectively in those broader contexts. A wholly owned test would appear to be most appropriate in the MRRT context.

9.8 Whilst the ability to structure ownership around 100% ownership is acknowledged, integrity measures could be introduced to deal with that particular mischief. This is managed effectively in the existing regimes that use a wholly owned test.

9.9 Extending the scope more broadly (particularly, as suggested, to the small business test threshold) would be administratively burdensome. The use of joint venture structures is common throughout the mining industry to achieve commercial objectives and ensure effective operations. Tracing through all joint venture connected entities to ascertain the threshold value would be inappropriate and, in some cases, practically impossible.

9.10 If, despite our recommendation, a broader group than "wholly-owned" is required for the aggregation test for the threshold test, from a policy perspective (and retaining the position that the same test should be applied for the loss transfer provisions), the GST grouping test, which requires 90% ownership (and is elective) may be considered.

9.11 This is consistent with our recommendation in relation to the transfer of losses (see section 9 below).

The interaction between the threshold and royalties

9.12 Paragraphs 285 to 287 of the Issues Paper consider whether to provide credits in respect of state royalties paid in years in which a smaller miner is not subject to the MRRT.

9.13 We submit that the outright denial of a credit for any state royalties in the pre-MRRT period would be inequitable. Royalties accrue by reference to production; and MRRT profits will be determined by an array of complex calculations of profit.

9.14 It follows that a particular royalty in a pre-MRRT year may well be linked to the MRRT eventually payable.

9.15 Our recommendation, therefore, is to provide smaller miners with credits for their state royalties paid in earlier years.

9.16 If it were considered necessary to have some limits on royalty credits, we consider that the method proposed in the first sentence of paragraph 287 - to reduce the credit by any notional MRRT liability that would have existed and the threshold not applied – is preferable rather than denying credits for royalties in pre-MRRT years.

10. Treatment of losses

10.1 The key issues with the losses under the MRRT regime are the rules in relation to their transfer and the ordering of loss utilisation.

10.2 The Government announcements relating to the MRRT indicate that, other than certain quarantined losses and costs (for example, relating to starting base calculations), MRRT losses should be transferable beyond the entity owning the project.

10.3 The income tax system currently contains the concepts of income tax consolidated groups and multiple entry consolidated groups. These groups, once irrevocably elected, are treated for many income tax purposes as being a single entity. As these groups currently report their income tax liabilities on a single entity basis, it would be administratively sensible, and appropriate from a policy basis, to also enable members of both these types of groups to transfer MRRT losses between themselves.

10.4 The income tax system also currently allows certain capital gains tax roll-overs between certain wholly owned entities (including companies, where one company is a non-resident, and for certain ownership structure conversions). The scope of the "wholly owned" concept in those provisions is well understood and should be used as a basis for defining the scope of the "wholly owned group" that is used to determine loss transfer entitlements.

10.5 Importantly, any grouping parameters that are applied to the smaller miner threshold (see section 9 above), should be applied consistently in the loss transfer provisions. There is a suggestion in Chapter 8 that a broader grouping test (like the test applied in the context of the small business concessions) might be applied for the threshold application. This would create an inequitable result, with entities entering the regime, without access to all of the implicit features of the regime. Further, the tests in the small business concession are complex and difficult to apply in practice.

10.6 If a broader group than "wholly-owned" is contemplated for the aggregation test for the threshold, then the same test should be applied for the loss transfer provisions. One example of a grouping regime that does not require 100% ownership, but is not as broad as the small business concession test, is the GST grouping test, which requires 90% ownership (and is elective). This may offer a solution if there are integrity concerns relating to ownership structuring around the threshold test, but might also then be applied for the loss transfer test.

10.7 In our view, loss transfer arrangements should not be mandatory, but elective in each period, and as between projects. Mandatory transfer would adversely affect the project profile, particularly in a sale context. Commercially, there may be circumstances in which it is more appropriate for entities to be able to ring fence projects to enable appropriate valuation and sale at a future point in time. This would recognise the inherent value in the costs incurred to the sale time, and give a more correct reflex of value and return than would be the case if some losses had been required to be transferred (particularly if that transfer were required to occur prior to the use of quarantined project losses).

10.8 The only persuasive argument for mandatory transfer of losses would be if MRRT returns were submitted on a basis that aligned with income tax consolidated group or multiple entry consolidated group reporting. In that case, the single entity rule would appear to operate appropriately. However, given the quarantining elements of MRRT, any administrative concession enabling a single lodgement for a consolidated group would appear to be lost, as there will always need to be a project by project return calculated for some purposes.

10.9 There should be no quarantining of losses from acquired projects (or use of losses against other projects). Quarantining losses that are otherwise transferable on projects that are bought and sold will effect a commercial distortion of general practices and result in valuation issues. It would also be difficult and administratively burdensome for future losses relating to a project (following acquisition) to be distinguished from former losses for future transferability.

10.10 Similarly, quarantining losses from an acquired project would be burdensome and inappropriate. It is assumed that the proposal to quarantine these losses would not extend to expenses incurred in relation to the project from the point of acquisition, as that would create severe commercial distortion and inappropriately determine the allocation of future expenditure, prejudicing certain projects against others. Internal administration systems required to ring fence a particular project, but only to a particular point in time, would be complex and onerous. If such quarantining were required in the final model, those quarantined losses should be able to be used first, or at the taxpayer's discretion, regardless of any other loss ordering rules that are developed.

10.11 Integrity measures could be inserted to ensure that there was no practice of "trading in MRRT losses" that evolved, without precluding ordinary operational loss transfer

10.12 In terms of the ordering of losses, and assuming there is no requirement to transfer losses, quarantined project losses should be used first, so that transferable losses can be used against the project, as available, and then transferred between projects or entities, as appropriate.

10.13 If loss transfer is mandatory, then there should be no mandatory requirement to transfer any losses until all other available project specific losses have been used against applicable projects in any period.

10.14 Any calculation for mandatory use of losses must also take into account the inability to transfer royalty credits. This means that loss transfers may need to be reverse engineered to take into account available royalty credits in a notional way before finalising loss transfers.

11. Elections under MRRT

11.1 It is apparent that there will be a range of elections to be made by taxpayers in relation to the MRRT. We think is appropriate to have independent project elections, that are not tied to joint venture elections.

11.2 To have a one-in-all-in election for starting base methodology is inconsistent with a project based regime. It also means that all projects of an entity (or group of entities) would need to comply with either methodology (which is especially relevant for valuation processes). It would be impractical to require joint venture parties to make the same election. In the mining industry, the widespread use of joint venture arrangements, would end up having an effect that an election almost becomes meaningless, as each joint venture party followed the first to act in any one case, which would reach through the industry very quickly

12. Policies to promote exploration expenditure

12.1 The Taxation Committee supports incentives being provided for exploration activities, particularly for junior explorers who find it more difficult to raise capital for inherently risky activities. We do not accept the proposition that any incentive must be revenue neutral, as if the case for support of a particular sector is made out, then it is a proper matter for government expenditure and ought not be cross-subsidised by other sectors.

12.2 However, the type of incentive is a matter of policy judgment.

12.3 Of the options noted in the Issues Paper, the Exploration Refundable Tax Offset is probably the simplest. While the Flow Through Share Scheme may give rise to some drafting complexity to address any integrity concerns from Treasury's perspective, we expect these matters could be appropriately dealt with.

12.4 The Taxation Committee welcomes the opportunity to comment on the design of the incentive, once its basic parameters have been determined.

13. Legislation should be subject to ongoing monitoring and review

13.1 The Taxation Committee submits that any MRRT legislation which may be enacted will need to be monitored over a transitional period to ensure it is operating as intended, and so that any legislative refinements necessary may be identified and enacted as early as possible.

13.2 Past experience with the PRRT demonstrates the need for such a process of monitoring and refinement. In relation to the PRRT, a number of disputes over the operation of the PRRT have arisen in recent times,[9] illustrating the potential for different interpretations between taxpayers and the ATO as to key elements of those measures.

13.3 In its report to Government, the Tax Design Review Panel identified that it is unrealistic to expect that legislation implementing large policy changes will have covered all possible scenarios and identified and resolved all the potential issues. The Tax Design Review Panel recommended that the implementation of substantive new laws be monitored to ensure that the legislation is operating as intended and to identify any legislative refinements which may be needed.[10]

13.4 The Taxation Committee notes that there is precedent for such an approach - the basic framework of the consolidations regime has been augmented and modified on quite a number of occasions, most recently in 2010,[11] since the regime was first introduced in 2002.

13.5 The potential for uncertainty should also be managed by the early provision of clear and comprehensive administrative guidance. By contrast, the ATO has only issued limited rulings and other binding guidance on the PRRT in its 23 years of operation, and mostly in recent times.[12] In the context of the MRRT, which will apply to a much broader taxpayer base, this would clearly be inadequate.

28 October 2010

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[9] See for example, *Woodside Energy Ltd v FC of T* [2009] FCAFC 12.

[10] Tax Design Review Panel, 'Better Tax Design and Implementation". 30 April 2008 at [3.67-3.70] and Recommendation 22.

[11] For examples, amendments to Part 3-90 of the Income Tax Assessment Act 1997 were recently made by schedule 5 of the *Tax Laws Amendment (2010 Measures No. 1) Act 2010*.

[12] See, for example, TR 2008/6, TR 2008/10 and TR 2009/1.