The Institute of Chartered Accountants in Australia

19 November 2010

Committee Secretary
Senate Select Committee on the Scrutiny of New Taxes
PO Box 6100
Parliament House
Canberra ACT 2600

The Institute of Chartered Accountants in Australia (the Institute) is pleased to provide this submission to the Senate Select Committee on Scrutiny of New Taxes (the Committee) in relation to the proposed new mining tax arrangements.

As the Committee will be aware, the Institute is one of Australia's most respected professional bodies. Our membership reach extends to more than 55,000 chartered accountants who work in a wide variety of professional roles across numerous Australian industries. This breadth and depth of membership equips the Institute to credibly advocate the case for meaningful reforms to our financial and taxation systems that deliver long-term benefits to the broader Australian community.

It is important to note of course that the work of this Committee in examining the merits and unintended consequences of various new policy initiatives put forward by the Federal Government is being conducted against the backdrop of a newly invigorated national debate about tax reform during 2011. In that context there will be a key opportunity for this Committee to work with stakeholders, such as the Institute, in identifying and making recommendations to the Parliament about improvements to tax policy-making and consultation processes.

Included as an attachment to this submission is a full copy of the Institute's recent submission lodged with the Policy Transition Group in respect of the proposed new mining tax arrangements. For the purposes of this Committee's inquiry, we make particular reference to Part One of the submission which identifies a range of issues in relation to the overarching design parameters of the new tax arrangements, as well as the policy-making and consultation processes currently employed by the Federal Government.

The Institute would be pleased to provide further information to the Committee as it conducts this inquiry over the coming weeks and months. Please contact me if you need to discuss any aspect of this submission further.

Yours sincerely,

Yasser El-Ansary
Tax Counsel
The Institute of Chartered Accountants in Australia

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Attachment

The Institute of Chartered Accountants in Australia

28 October 2010

Mr Don Argus AC & Hon. Martin Ferguson AM MP
Co-chairs
Policy Transition Group
GPO Box 1564
CANBERRA ACT 2601

Submission in response to October 2010 Policy Transition Group Issues Paper

Dear Mr Argus and Mr Ferguson

It is with pleasure that the Institute of Chartered Accountants in Australia (the Institute) provides you with the attached submission in response to the Issues Paper released by the PTG on 1 October 2010.

As I am sure you will both be aware, the Institute is one of Australia's most well respected professional bodies, with a long track record in providing the highest quality advice to government on a wide range of policies that impact Australia's tax system.

The Institute has a membership of around 55,000 chartered accountants who work in a diverse range of professional roles across countless industries in Australia, including the natural resources sectors. It is this breadth and depth of membership, as well as expertise, which ensures that the Institute in a strong position to advocate the case for sound policy reforms that are in the public interest.

The submission attached to this letter, *'Digging in and drilling down'*, addresses a number of the questions contained in the PTG's October 2010 Issues Paper. Whilst not intending to be exhaustive, or in some places highly detailed, the submission does attempt to provide practical guidance and advice to the PTG on the direction in which certain matters should be progressed as part of the formulation of detailed design principles in relation to the MRRT, PRRT and the need for new policies in relation to exploration incentives. The submission also refers to other considerations outside of the scope of the Issues Paper that we believe should be taken into account as part of the PTG's consultative process.

If you would like to discuss of any of the matters contained in the attached submission, please do not hesitate to contact me

Yours sincerely,

Yasser El-Ansary
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Digging in and drilling down

Submission to the PTG in response to the proposed MRRT and extended PRRT

In the first part of this submission, the Institute raises a number of important overarching issues that we believe should be taken into consideration by the PTG as part of its process of developing the detailed design attributes of the new MRRT and extended PRRT. Whilst some of the matters raised in this first section go to government policy decisions in respect of which the PTG is not ultimately accountable, we believe the issues may in some way have a significant bearing on the detailed design principles that are put forward to the government at the conclusion of this consultation process.

The second part of this submission deals with a number of the more specific and detailed technical design features of the new MRRT, extended PRRT and consideration of policies to promote exploration expenditure. Whilst not intending to be exhaustive or necessarily overly prescriptive, the views put forward are intended to guide the PTG's thinking during the course of the remaining phases of the consultation process and the preparation of the Group's report to government at the end of 2010.

PART ONE – Overarching issues warranting consideration by the PTG

Context

Tax reform is more often than not a difficult and challenging exercise for any government. Whilst it is true to say that the Australian community has been prepared for much needed structural reforms of our tax system for some time, this appetite has always been predicated on a principled approach to reform. Fundamentally, this principled approach has brought with it an obligation for the Australian community to be convinced of the policy merits of major changes to our tax system, which are built around the making of a strong and compelling case for change.

The introduction of new taxation arrangements for our nation's abundance of natural resource wealth is acknowledged by many stakeholders as being an important ingredient in Australia's tax reform landscape over the next few years. Australia's resource sectors are widely regarded as having delivered a stable platform for the nation's economic prosperity over recent years, which is expected to continue over many years into the future.

In that context, whilst the modernisation of resource sector taxation arrangements is both necessary and appropriate, the government must approach these changes with a level of carefully measured judgment. The government must guarantee that reforms to the taxation of non-renewable resources strike the right balance between delivering a greater share of the national wealth to the Australian community, whilst at the same time not disrupting the overall investment landscape within the mining, oil and gas sectors.

Theoretical economic arguments can of course be progressed by some about the inherent efficiency of taxing non-renewable natural resources, but the realities of the economic and business landscape are that investment decisions in the resources sectors are not immobile, and overly punitive or uncompetitive tax arrangements can clearly have the effect of either deferring or discouraging resource sector investment decisions. If this were to occur, it would clearly have a major adverse impact on the strength and prosperity of the entire Australian economy.

The influence of tax policy on business decision-making

The experience of the members of the PTG will undoubtedly attest to the fact that tax arrangements will often be one of – and not certainly not the only – factors taken into account in the making of their business investment decisions. Whilst it is true to say that the boundaries of tax regimes can almost never be regarded as absolute certainties in the context of business decision making, assumptions around the tax impact of certain decisions are always factored into cost/benefit analysis studies which feed into business processes and governance arrangements in relation to the making of decisions.

For this reason, it is critically important that the PTG ensures that the policy positions promoted in its advice to government later this year are informed by practical considerations and realities of how tax impacts business behaviours and decision making. Theoretical concepts which support the view that rent taxes are the most neutral of tax imposts certainly have their place in conceptual frameworks, but it is equally important that sufficient consideration be given to the fact that tax liabilities which flow through to government revenues ultimately are borne by businesses somewhere in the value chain. In precisely the same way that economic analysis and thinking points to a conclusion that a reduction in company income taxes delivers spillover benefits to the national economy by promoting greater global competitiveness, economic growth and demand for labour, it stands to reason that the reverse holds true for any tax impost levied on firms with activities in Australia.

Ensuring that we benefit from past experiences

The government will of course be acutely aware of the potentially devastating implications of making significant policy decisions, such as the proposal for the original resource super profits tax, in the absence of a properly constructed policy development and external stakeholder consultation process.

Put simply, the nation cannot afford to endure again the consequences of a rushed policy-making process in the context of the design of the new MRRT and extended PRRT.

It is the Institute's view that the PTG's consultation timetable and the reporting timeframe back to government will prove to be quite challenging and therefore will presents some risks to the thoroughness of the policy development process. The new MRRT and extended PRRT represent a major tax reform package that would be equivalent to a number of comparable tax reforms implemented in recent decades, such as the introduction of the goods and services tax and the income tax consolidation regime. The Institute therefore urges the PTG to consider carefully whether an extended reporting timeframe back to government is necessary in light of the circumstances, and if so, to alert the government and external stakeholders to this as soon as possible. Clearly, it is in the national interest to ensure we all get this new regime right, first time around.

The Institute continues to advocate the case for a summary of the outcomes from the PTG's consultation process, as well as the Group's report to the Federal Government later this year, to be released publicly to enable a transparent understanding of the detailed policy development process. The PTG should consider recommending to the Federal Government that it release a full White Paper of the high level and detailed policy proposals for consultation prior to the development of draft legislation in the early stages of 2011.

Consistency of MRRT with negotiated Heads of Agreement

The terms of the Heads of Agreement (the agreement) reached between the Federal Government, BHP Limited, Rio Tinto Limited and Xstrata Plc in early July 2010 is an integral component of the design principles that should ultimately guide the PTG's policy development work in respect of the proposed new MRRT.

The climate of instability in which the agreement was put together between the Federal Government and the above companies representing the Australian mining sector was unique and highly pressured.

For many years now, the Institute has consistently advocated the case for tax policy development to adhere to robust principles that ultimately are geared towards delivering sensible policy outcomes for taxpayers that are in the broader public interest.

On that basis, the Institute must conclude therefore that the manner in which the agreement was reached represents a less-than-ideal approach to the making of decisions around significant public policy matters. Notwithstanding that, the Institute believes it is critically important for both the spirit, and the specific terms, of the agreement to be adhered to in the development of the final design parameters of the proposed new MRRT.

Given that the terms of the agreement ultimately informed the government's July 2010 policy announcements in respect of the new MRRT, it is important that the PTG provide those stakeholders who were not party to the agreement every opportunity to identify and raise their concerns with the design principles of the proposed new tax arrangements. We believe that the concerns of these stakeholders should be thoroughly examined by both the PTG as well as the Federal Government as part of the consultation process underway right now.

Similarly, stakeholders affected by the proposed extension of the PRRT regime should be given every opportunity to provide consultation feedback about the proposed policy design parameters of that regime to both the PTG and the Federal Government given the limited details provided in the announcements made in early July 2010.

Designing tax arrangements for the long-term

As the PTG will of course be aware, the design principles of the now defunct RSPT brought within scope of that proposed tax a broad range of non-renewable resource commodities currently exploited in Australia. This can be contrasted with the policy dimensions of the proposed new MRRT, which at this stage is limited in its application to only iron ore and coal commodities.

For understandable reasons, it is not desirable for the government to openly canvas a future expansion of the proposed MRRT regime at this early stage in this process. Notwithstanding that, it is in our view important for the PTG, as a matter of context, to take into account the basis for the analysis put forward by Dr Ken Henry in the Future Tax System Report, which recommended the introduction of broad scope resource rent tax for Australia's future. In light of that, a degree of flexibility should be built into the development of detailed design principles in relation to the new regimes on the basis that a future federal government may decide to extend the scope of the regimes to a broader range of commodities than currently foreshadowed.

Ensuring that the detailed design principles of the proposed MRRT could be adapted and applied to a broader range of commodities would seem to us to represent a sensible and prudent approach to policy development in this context. This is especially the case given the ever-changing and highly dynamic nature of the Australia mining sector whose export markets, and therefore bulk commodity demand, are likely to evolve over coming years and decades.

The design of the proposed MRRT should be capable of being replicated across to other commodities such as uranium, gold, alumina, copper and zinc in the future.

Synergy between tax and accounting concepts

Wherever possible, the PTG should seek to adopt detailed design principles that involve an alignment or synergy between existing income tax law concepts and accounting principles and standards. Part two of this submission contains some examples of where such an approach could be adopted, particularly in the context of market valuation strategies.

Ensuring that the formulation of policy and legislation giving effect to any new tax regimes are as closely aligned to pre-existing tax and accounting concepts will often deliver significant compliance cost savings to taxpayers who will be required to comply with the new regime. Anecdotal evidence from the Institute's members suggests that making use of existing synergies in this way offers one of the best opportunities to minimise the likely compliance cost burden that typically arises from the introduction of new tax regimes.

Compliance arrangements and administration

We believe that the long standing 20-year plus history of the PRRT in Australia provides the PTG with the opportunity to benefit from some of the lessons already learned in respect of past compliance and administration arrangements in this area. These lessons should play an important role in informing the PTG's development of detailed design principles around the new MRRT and extended PRRT.

For many years, the experience of taxpayers having to comply with the PRRT has been that the Australian Taxation Office (ATO) has generally failed to devote the resource commitment required to deliver to taxpayers the greatest level of certainty and confidence in the application of the PRRT laws. The Institute has been provided with examples of where there has been a consistent lack of clarity around the ATO's interpretation and application of the law in respect of key concepts such as which expenses could or could not be captured as a component of eligible indirect expenditure. Given the PRRT has been in place for well over 20 years now, it would seem sensible to expect that the ATO, as the primary administrator of the PRRT regime, would be in a position to be able to provide taxpayers with a clear articulation of its interpretation of the law in such areas within a reasonable timeframe.

Given that the new MRRT and extended PRRT will most likely find themselves being widely regarded as first order tax regimes – as opposed to view that PRRT is regarded as a second order regime – there is clearly a case for the ATO to build a more significant capability and presence in the mining sector in order to be better able to serve affected taxpayers and the broader national interest.

Whilst these considerations should certainly be taken into account by the PTG in the formulation of detailed policy principles to be recommended to the government before the end of 2010, it will be important for both the government, the ATO and external stakeholders to work openly and collaboratively during the law drafting phase to enable legislation to be put in place that minimises (to the extent possible) the likelihood of future areas of uncertainty for affected businesses emerging from the practical application of the new MRRT and extended PRRT. Such an approach would also serve the purpose of seeking to avoid any unnecessary exposure to lengthy court litigation to test the operation and underlying principles of ambiguous laws that may not deliver the clear policy intent of the government.

Policies to promote exploration expenditure

The PTG's Issues Paper makes it clear that any potential adoption of policies which are geared towards the promotion of exploration expenditure would need to be funded out of savings in other aspects of how the new MRRT and extended PRRT regimes would operate.

Whilst the basis for this limitation is understood in the context of changes within the boundaries of the MRRT and PRRT, the Institute believes that the PTG should consider putting forward a recommendation that the government should fund exploration incentives out of consolidated revenues. This would be consistent with the approach adopted for other incentives and policies that seek to promote desirable activities throughout the economy, such as the research and development tax credit. As the PTG will be aware, the costs associated with policies that promote exploration expenditure will often be repaid many times over through the direct of impact which flows from a significant investment in the economy. Imposing a constraint around how exploration policies are

funded, such as what is being proposed, will unnecessarily limit the overall effectiveness of any new incentives program.

PART 2 – Technical design of the new MRRT, extended PRRT and potential exploration incentives

Defining the scope of the MRRT and PRRT

Wherever possible, the PTG should take the view that providing taxpayers with an appropriately high degree of certainty around the intended policy scope of the new MRRT and extended PRRT is desirable.

To this end, the PTG should work with the mining and oil and gas industries to develop a generally accepted and workable boundary around which to define the intended policy scope of the new regimes. This would lend support to the proposition that terms such as “coal” and “iron ore” should be defined and encapsulated within the appropriate governing tax laws. Doing so will assist the administrators of the new regimes, the ATO, in their role of providing advice and guidance to taxpayers about how the new laws apply to their particular fact pattern scenarios.

Transfer of MRRT losses within groups and between projects

The Issues Paper canvasses whether or not the design of the new MRRT should impose any limitations on the transferability of losses across wholly owned groups and correspondingly, whether MRRT losses should be required to be offset against any eligible MRRT profits in existence elsewhere within a wholly owned group.

In our view, the sensible approach for the PTG to take would be to provide a mechanism for wholly-owned and income tax consolidated groups to make an irrevocable election to allow all MRRT losses to be transferred across to other members of the group that have derived MRRT profits during the relevant period.

On this basis, there would not appear to be a case in our view to allow losses to be transferred outside of either a wholly owned or income tax consolidated group. Such an approach has the benefit of being consistent with well-understood principles contained in existing income tax laws.

Valuation methodologies at taxing point

The Institute’s comments about the broad range of questions posed by the PTG in respect of valuation methodologies at the taxing point are intended to illustrate the complexity of the issues in this area, and at the same time provide practical recommendations of key principles which should be considered by the PTG.

One of the overarching comments that we can make in this area is that the intent of the detailed policy principles (determining a market value for the resource at the taxing point) must not be lost through the application of overly prescriptive valuation methodologies. In respect of the new MRRT, the question of which is the best method for valuing iron ore and coal at the taxing point depends heavily on the facts and circumstances in each case. It is our view therefore that the acceptable valuation methodologies should not be legislated.

While it is inappropriate to conclude that only one valuation or transfer method is appropriate in all cases from an economic or principled point of view, the drafting of legislation giving effect to approved methodologies may establish a hierarchy that would impact the legal view on which is the most appropriate method in various circumstances. Relevantly, we believe the PTG should consider

carefully whether the netback method of valuation can be argued to deliver a proper reflection of market valuation in a wide variety of circumstances given some of the inherent limitations in the practical application of the methodology.

In applying transfer pricing methodologies, as suggested in the Issues Paper, to determine an arm's length value, it may be entirely appropriate (absent a taxpayer's decision to adopt an available safe harbour method) for taxpayers to corroborate their primary valuation with a secondary method (or 'sense check') as to an appropriate market value.

Of course, practical issues including data availability, commercial / factual issues relating to the specific resource and the actual value chain from mine to market (both upstream and downstream of the taxing point), and economic principles relating to bargaining power or co-dependency, may make one valuation methodology more attractive than others.

We particularly note that the complexity of the question of co-dependency raised in the Issues Paper can be significant. For example, the use of technology that has been developed enabling previously unmarketable deposits to be developed as commercially viable projects or the value of scarce infrastructure to commercialise resources from otherwise inaccessible regions of Australia.

Given the inherent complexities associated with seeking to determine an appropriate market value, a well considered safe harbour option should be considered by the PTG which provides a choice for firms to either determine the market value themselves or adopt a safe harbor approach. To this end:

- the incorporation of a safe harbour option should be unambiguous in legislative intent and application to taxpayers;
- a variety of approaches to an appropriate safe harbour option are available and these should be considered in further detailed at a later point in this process; and
- It is recommended that a position on how to regularly update and review any safe harbour option be incorporated into the guidance to ensure that market and technological changes do not render a safe harbour option 'out of step' with the commercial realities of the industry and thereby defeat the underlying objective of providing access to such a mechanism.

The PTG should canvass opinion from the industry around whether or not it would be desirable and beneficial to seek an alignment of taxing points as between the proposed MRRT and State royalty frameworks, given the obvious compliance costs savings that would appear to exist by doing so.

Transitional revenue and exploration expenditure

Presently it appears that only transitional capital expenditure is to be included in the starting value.

In contrast, transitional revenue expenditure (presumably including exploration expenditure) is understood to be excluded from the starting value, on the basis that such costs are predominantly incurred to generate interim receipts not assessable by the new MRRT or extended PRRT.

Given the generally long time lag between exploration expenditure and first production, it is likely that much of the exploration expenditure incurred during the transitional period would be for resources extracted post-1 July 2012.

By way of example, revenue expenses such as overburden removal can in many instances amount to considerable costs (sometimes running into the many hundreds of millions of dollars) and take long periods of time to complete (in some cases six months or more) where mines face a high strip ratio. If such expenditures are incurred during the transitional period without recognition under the new MRRT, some firms may delay the development of resources if by doing so they stand to derive

significant financial benefits. Such an outcome is clearly at odds with sound tax policy which should not interfere the normal commercial decision making of firms to this potential extent.

It is therefore our view that transitional exploration expenditure should also be included in the starting base and uplifted at an appropriate rate. In the event that the exploration expenditure has led to production of resources prior to 1 July 2012, then appropriate reductions to the starting base should be made, but no more than the extent of the transitional exploration expenditure included.

We believe that this approach will go some way to addressing the concerns identified by the PTG in relation to the potential market investment distortions that could arise in respect of the investment in exploration expenditure in the lead up to 1 July 2012.

Crediting of State royalties

There has been considerable confusion caused recently by the apparent conflict in the Federal Government's stated policy position on the crediting of State royalties as announced on 2 May 2010, as compared with the terms of the MRRT agreement reached in July 2010. This conflict has been exacerbated by the Federal Government's assertion that a policy matter such as this could, and in fact would, be resolved by the PTG [rather than by the government itself]. In the Institute's view, the dimensions of this matter amount to a major policy design issue and therefore should, by rights, be dealt with by the Federal Government rather than the PTG.

In any event, it is our view (consistent with the terms of the July 2010 MRRT agreement) that all State royalties should be fully creditable for MRRT and PRRT purposes. The credit for royalties should not be capped by reference to the level of royalties currently imposed, or announced increases, at the time of May 2010 government announcement.

Denying a credit for any future royalty increases levied by State governments would clearly result in the double taxation of resource sector firms, an outcome which is inconsistent with sound policy making given the significance of the reforms surrounding the new MRRT and extended PRRT. As the PTG would be aware, it has been a long standing practice of tax policy development in Australia, and abroad, to actively put in place measures that seek to prevent the incidence of double taxation. In actual fact, paragraph 35 of section 1.2 of the PTG's Issues Paper reinforces this principle by confirming that the crediting of State royalties is necessary "to avoid double taxation".

The potential for double taxation in this context could also create a new sovereign risk concern for foreign investors into Australia, who typically are seeking certainty as to the effective tax rate of projects in which they invest. The co-existence of State royalties in conjunction with the proposed new MRRT and extended PRRT will, of itself, already present some risk issues for investors who will no doubt find it difficult to understand the reason why such an approach is being adopted in Australia; the prospect of double taxation presents a further investment risk that may have a material impact on the viability of certain projects.

The genesis of this matter can be traced through to the fact that the Federal Government did not, prior to the original government announcement in May 2010, engage in dialogue with the States and Territories in an attempt to reach an agreement for the uniform abolition of all relevant royalty regimes, in exchange for a pass-through of replacement revenues from the Commonwealth. We must not forget that this is precisely the form of approach recommended in Dr Henry's Future Tax System Report.

Given the circumstances, the Institute believes that this matter should be resolved between the Commonwealth and the States and Territories through the Council of Australian Governments financial relations process. It is clearly in the interests of Australia for the Commonwealth to work collaboratively with the States and Territories to put in place a long-term solution to this undesirable and unexpected exposure to double taxation. Ultimately the spirit of the July 2010 MRRT agreement

which confirms that "[A]ll State and Territory royalties will be creditable…" must be adhered to by the PTG and the Federal Government.

The $50 million profit exclusion threshold

It is worth pointing out that there appears to be an inconsistency between the proposed policy of applying the exclusion threshold on a firm-by-firm basis and the models recently released by the PTG which seek to apply the exclusion on a project-by-project basis.

Compliance costs for small miners

The adoption of a $50 million annual profit threshold below which taxpayers will not have to comply with the MRRT will present some important challenges for small mining companies. In particular, some of the challenges will emerge from the boundaries that may be set around the definition of a project, the dissection of the capital expenditure between the MRRT-taxable and other components of the project, as well as the potential documentation standards.

As the PTG will be well aware, smaller mining companies are typified by having limited access to resources, especially tax expertise, given that their major focus is on resource production and the start-up growth of their business. Because of that, we believe that any proxies that can be drawn from the use of financial statements should be adopted in order to try to streamline MRRT compliance to the extent possible in this area.

It is recognised that there may exist some incentives for small miners to comply with the MRRT simply in order to increase the attractiveness of their business to potential suitors.

The PTG should consider the use of standard percentages of revenue, using mechanisms administered by the Department of Resources, Energy and Tourism (RET), as a proxy for more complex compliance tasks. For example, if RET or the Australian Bureau of Statistics (ABS) was able to carry out a statistical analysis to determine the average MRRT percentage of each dollar of sales proceeds of a small miner, that percentage could be used and applied by small miners to their revenues to generate a MRRT profit. The potential savings in compliance costs, and efficiency for both the ATO and small mining companies could be significant.

Another attractive shortcut would be to ensure there is maximum possible alignment with existing accounting mechanisms. Smaller miners will be required to record their revenues and expenditures in their accounting records, and as a result there should exist an opportunity for those companies to make use of those records as a basis for determining their compliance with the MRRT laws. This type of approach would be preferable to the creation of new concepts within the MRRT laws which are not presently used in the context of compliance with either income tax laws or accounting standards.

The PTG should consider all opportunities available as part of this detailed policy design phase to closely align the project definition concepts contained in section 4 of the Issues Paper with well established accounting and income tax practice.

Consideration should also be given to the tax effect accounting impacts of the new MRRT and extended PRRT for companies that are below the $50 million annual profit exclusion threshold when formulating the detailed policy principles in this area. The reason why this is important is that if companies are required to complete a tax effect accounting process for the MRRT or PRRT, even when they do not exceed the threshold, they will be subjected to a significant compliance and administrative burden in determining the correct accounting treatment and may therefore be unreasonably impacted by the associated earnings and balance sheet entries that could be required as a consequence.

Aggregation rules and tapering of threshold

The Institute believes that the aggregation rules should apply only to wholly owned entities; the lowest possible level of aggregation which should be allowed should mirror the GST-type aggregation of entities with 90 percent common ownership. The use of the controlled foreign company or other control tests is likely to lead to major compliance and efficiency challenges for small miners.

Any aggregation of projects below 100 percent ownership will be subject to major compliance challenges. These include:

a) access to information in joint venture financial and other records, even more challenging if a participant has a minority stake; and
b) availability of past records, especially for small miners in relation to the new MRRT which was not contemplated up until now.

One characteristic of the resources sector is that small miners are often ultimately acquired by larger miners as part of an ongoing process of industry consolidation and delivering economic efficiencies. Consequently, it may well be the case that small miners who are in production phase (and are potentially subject to MRRT) will not have a long life before being acquired or consolidated. On that basis, the revenue cost of a tapering mechanism which would see the gradual withdrawal of the benefit as profits increase would seem the most appropriate approach to take in our view.

Treatment of royalties

The Issues Paper canvasses various options about denying small miners credits for royalties incurred prior to the MRRT, in whole or in part, in relation to State royalties payable in the period prior to a small miner becoming subject to MRRT.

However, State royalties are typically levied on the basis of production, from the time of commencement, whereas the $50 million annual threshold will be based on the MRRT profit after amortisation of capital expenditure, and presumably after allowances for losses. On that basis, any deferral of MRRT liability will be influenced by MRRT depreciation and amortisation practices and the interest uplift. This applies to royalties paid prior to the commencement of the MRRT also.

The Institute does not believe that a compelling case is made in the Issues Paper for the denial of a credit for all State royalties. However, taking into consideration the unique challenges which emerge as between the interaction of the royalty credit mechanism and the $50 million profit exclusion threshold, whilst a sensible policy approach on this issue would appear to be to reduce the aggregate credit by the amount of the notional amount of MRRT payable had the threshold not applied, this would require that the small mining company go through the process of quantifying their notional liability to MRRT even though they are not formally required to comply with the regime.

However, in the interests of seeking out an administratively simple mechanism to deal with this issue, the PTG should consider adopting a simple approach which perhaps involves a partial credit to be allowed, for example a 50 percent credit of previously paid State royalties. This type of approach whilst being an imprecise solution, would clearly deliver significant compliance cost savings to small miners.

Applying the $50 million threshold to the extended PRRT regime

The Institute believes that the PTG should consider recommending that the $50 million profit exclusion threshold be applied to the extended PRRT regime also. Onshore oil and gas projects are more accessible [from a cost perspective] to smaller firms that have a focus on low-cost projects. For precisely the same policy reasons as to why the exclusion threshold is proposed to apply to MRRT projects, small firms operating in the oil and gas industries should be exempted from the need to comply with the extended PRRT regime in similar circumstances. This approach would appear to

deliver a consistent and equitable outcome for tax policy purposes, particularly in the context of the government seeking to promote the expansion of all mining, oil and gas sectors without unduly favouring various sectors over others.

Interaction between the MRRT and setting a price on carbon

As the PTG would be broadly aware, the government has recently established a new Multi-Party Climate Change Committee, which is mandated to explore options for the introduction of a price on carbon in Australia.

From a broader policy perspective, carbon costs are not dissimilar to other business costs associated with the mining and onshore oil and gas operations and it is our view therefore that in the event that Australia does take steps to impose a price on carbon, those costs should in principle be deductible for the purposes of the MRRT and extended PRRT.

Given that the carbon pricing policy is yet to be worked through and agreed, the appropriate mechanisms should be built into the policy design principles of the MRRT and extended PRRT to provide sufficient flexibility to accommodate future carbon pricing policy developments. By way of example, a 'tracing' principle could be established that if, and when, Australian businesses are required to meet obligations under a carbon pricing mechanism that so much of those costs that can reasonably be attributable to activities prior to the taxing point are immediately deductible for MRRT and PRRT purposes.

The tracing principle could be developed to also recognise carbon mitigation costs incurred by firms to the extent that the costs are necessary to mitigate or offset carbon emissions arising out of pre-taxing point activities. Where a strict tracing mechanism is not possible, carbon pricing costs and relevant mitigation costs could be deducted, on a reasonable apportionment basis, having regard to the carbon intensity of those activities carried out within the scope of the MRRT or PRRT, as opposed to outside of it.

Exploration incentives

The Issues Paper raises a number of questions in section 14 in relation to whether there is compelling case for the government to put in place specific policies to promote exploration expenditure in Australia, and if so, precisely what form of approach would be most appropriate. One of the PTG's objectives is to consider the best way to promote future exploration in order to ensure there is a pipeline of future resource projects in this country.

The PTG Issues Paper correctly recognises that the exploration industry feels there is an unambiguous need for the Federal Government to put in place policies to promote exploration expenditure. In fact, in light of commitments given by the current government on this issue over recent years, it may well be appropriate to even say there is already a positive obligation and expectation on the government to advance suitable policies in this area. In our view, the impact of the current tax treatment of exploration expenditure for junior explorers is another component of why it is both appropriate and necessary for some form of government intervention to take place.

For junior explorers there is a reduced tax benefit (usually nil) for exploration expenditure until a project enters production phase, which often takes place at a much later point in time in the future. This policy outcome can be contrasted with an existing profitable (ie. tax-paying) firm, which can access the benefit of an exploration deduction on a current basis, via reduced income tax payments.

This disparity in outcome represents a fundamental policy failure in the manner in which our current tax rules apply in this area. The case for government intervention therefore, in our view, is quite clear.

Of the four options put forward by the PTG in the Issues Paper, we believe that any one of them, if implemented, would have a net positive impact on exploration activity in Australia in the future. The four options can be split into two main groups:

1. Those that directly benefit the firm (Exploration Refundable Tax Offset and R&D tax credit); and

2. Those that directly benefit the shareholder (Exploration Tax Credit and Flow Through Shares).

All four of the above options have certain costs and benefits. Importantly, in our view any one of the four options would go some way to addressing the tax policy and market failure issue which exists in this area at the moment.

In terms of identifying whether the perceived market failure is specific to any one particular sector or type of exploration activity, there is a significant difference that can be illustrated between the following three scenarios:

1. An exploration company with a single project area of interest which spends A$10m on exploration each year for five years and begins producing in the sixth year, eventually recouping the taxation deductions generated by the exploration expenditure in the seventh year.

2. An exploration company with multiple project areas of interest which spends A$10m on exploration each year for three years before a discovery on one project leads to production in year four. This production revenue is offset each year by continued exploration deductions, but the initial tranche of exploration deductions cannot be utilised until a further discovery is made.

3. A large production and exploration company that has multiple projects in different stages of their life cycle. Deductions generated by $40m of exploration each year are fully utilised from revenue generated by mature projects on a year by year basis.

In the first scenario, the tax benefit would not be recovered until years six and seven. In the second scenario, the exploration spend over the first three years continues to not be recovered (although current year spend from year four is recovered by other production). In many cases the benefit of exploration deductions may never be realised if certain tests for the carry forward of tax losses are not satisfied. These tests are often not capable of being satisfied as a consequence of the explorer raising finance for ongoing exploration via the introduction of new cornerstone investors.

In contrast, under the third scenario above an immediate tax benefit is generated from exploration.

The fact that the same expenditure can result in such dramatic differences in net cash impact reinforces the view that there does exist a tax policy and market failure in this area, regardless of whether the exploration is regarded as greenfields or brownfields.

In our view, the disparity shown above leads to a conclusion that adopting additional policy options to promote future exploration and offset this market failure is in the best interests of sound tax policy, the Australian resource sector and the broader Australian economy.

The policy options outlined in the PTG Issues Paper are appropriate to, at the very least, begin the discussion regarding potential benefits and costs.

The key attributes of the options that directly benefit firms are their relative simplicity and associated low administration costs. They result in an enhanced cash flow, but not necessarily a greater capacity to initially raise capital. The benefit in these options is unlikely to be returned to shareholders at least in the short-term. However, they are likely to result in increased exploration expenditure, giving an

indirect benefit to shareholders, whose $1 investment in the company should equate to at least $1.30 being spent on exploration.

The key attributes of the options that directly benefit the shareholder are their attractiveness to all Australian investors (retail to superannuation funds) which is likely to result in an enhanced capacity for exploration companies to raise local capital. However, these options are inherently complex and would result in a heightened administration and compliance burden. In addition, they may be of little value to foreign shareholders or investors.

The key features of each of the four policy options are summarised below in the table below. Further discussion of the more specific attributes of each of the options can be developed once the government's policy approach in this area is more settled.

	ERTO OPTION 1	ETC OPTION 2	FTS OPTION 3	R&D OPTION 4
Nature	Rebate of exploration to company	Credit for exploration tax benefit to investor	Deduction to investor for capital invested	Rebate or deduction to company
Direct benefit	Company	Shareholder (Australian only)	Shareholder (Australian only)	Company
Timing of benefit	Rebate through tax return	ETC distributed at company's discretion – may never be distributed	Option for immediate deduction or over a specified period	Credit or deduction through tax return
Rate	Corporate rate	Corporate rate	Tax rate of shareholder (e.g. marginal rate for individual)	Corporate rate
Impact on company tax losses	Reduction	Reduction	Reduction	Potentially increase
Impact on investor CGT cost base	No impact	Reduction	Reduction	No impact
Key strengths	Improves cash flow – makes each dollar of equity invested stretch further. Fewer administrative, compliance and integrity issues as compared to benefits at shareholder-level	Helps junior companies raise equity from Australian investors Helps level the playing field between junior and large companies	Helps junior companies raise equity from Australian investors Helps level the playing field between junior and large companies	Improves cash flow Encourages investment from residents and non-residents Helps level the playing field between junior and large companies Leverages off an existing framework May save administrative and compliance cost
Key Weaknesses	Only valuable for companies in a tax loss position No benefit at the shareholder level unless distributed. May not assist in raising initial capital.	High compliance costs More complex integrity measures No direct benefit at the shareholder level unless distributed No benefit to foreign shareholders	High compliance costs More complex integrity measures Little or no benefit to many foreign shareholders	No direct benefit at the shareholder level unless distributed