Responses to questions on notice

from Neil Fargher, 2 May 2013.

Senator MARK BISHOP: *You were having a discussion about market valuations, Professor Fargher, and where miners using market valuation rather than book valuations to calculate the starting base have to depreciate it over the life of the mine. The value of this is indexed by CPI, not the long-term bond rate plus seven per cent. In that context, could what you said before about market valuations for the starting base eroding the MRRT revenue forever be wrong if the starting base is depreciated over the life of the mine and only indexed at CPI? If the answer to that question is yes, isn't that how the MRRT works? If you could take both of those questions on notice, Professor Fargher, and give us a written response it would be appreciated. Thank you, Chair.*

I do not believe that the market valuation for the starting base will erode the MRRT revenue *forever*, but it would appear to erode the expected tax collections substantially for at least the next five years and probably longer.

If the indexed book value is assumed to be equal to the market value then I agree with the basic premise of the question, in that depreciating the same amount using two methods can be equivalent over the life of the asset. So I have no problem with 'yes' to the first question. This is however a tautology. Isn't that how the MRRT is meant to work? Only if you do not expect substantial revenue from the tax in the early years except under extremely favourable commodity prices and exchange rates. I can only respond with the question: "Is the MRRT collecting the levels of revenue initially expected?" The start-up provisions provide a substantial tax shield. The key issue is whether the assumptions regarding the market value of the starting base, regarding the effective lives, or some other factor, have resulted in tax collections substantially below initial expectations. If substantial revenue was expected under the MRRT in the initial years of operation then a well calibrated start-up allowance would likely not have included the full market value of existing reserves.

If the question is narrowed to simply comparing the two start-up options available within the MRRT, then both the market value option and the current book value option offer substantial start-up allowances. On average, accounting rules are likely to result in book values under-stating market value. Further, there is relatively greater flexibility in the procedures used to estimate market value. The self-assessor is expected to take the higher deduction and so in my opinion is more likely to use the market value option where tax liability needs to be minimised. Both current start-up options however create substantial tax shields.

At the Perth hearing, Professor Guj was asked about restricting depreciation to the book value and replied "for instance, if an explorer finds a mineral resource, spends $30 million in proving it up, it will carry that project in the books at $30 million as a tangible asset. However, if big brother, BHP Billiton, comes along and buys that asset from the explorer for, say, $150 million, then the BHP books would show $30 million as a tangible asset, being the project money that was actually spent in drilling, digging and whatever, plus the difference between the price paid and the tangible asset of $120 million as an intangible asset called 'mining rights'. So, depending on how you get to own the project, you may or may not have in your balance sheet the value of the resources. Okay? The true tiers are somewhere in the middle and we would have to go back to the history of how the project had been set up in terms of the resource to actually determine whether the market value is, in a sense, exacerbating the deduction that you are allowing."

Do you have any response? In particular, in his example could the rules be written to restrict BHP to the $30 million valuation?

Deductions for depreciation of capital investments are large and the timing subjective. This generally results in the taxing authority specifying the basis for the deduction and the rates at which the deduction can be applied.

The example above raises an issue of the basis on which the deduction should be applied and how that basis can be maintained despite subsequent transactions. There is a proving up cost of $ 30 million, and a purchase of mining rights of $ 120 million.

One example where a similar problem occurs, and the deductions for capital expenditure must be specified, is in the legislation with respect to deductions on investment properties. Division 43 of the Income Tax Assessment Act 1997 provides for a methodology for deducting capital expenditure incurred in the construction of capital works. Under this Division no matter how many times a building has been sold the successive owners can only claim a percentage of the historical construction cost. Allowable costs are identified on a depreciation schedule that is then used as the basis for depreciation over the asset life (up to some maximum) by the initial and subsequent owners. A similar approach would need to define the allowable exploration costs, the 30 million proving up costs in the example above, and the basis for depreciation for the initial and subsequent owners of the resource.

There would need to be a definition of the allowable exploration costs incurred. The deductibility of the remaining intangible asset of $ 120 million of mining rights goes to the desired definition of "super profits" to be taxed and the level of tax collections expected.