

2

1/9

S22 exemption

2

From: Davis, Graeme
Sent: Tuesday, 19 January 2010 12:42 PM
To: Jacobs, Martin
Cc: Henry, Ken; Parker, David; McCullough, Paul; Hazlehurst, David
Subject: Resource tax explained [SEC=PROTECTED]

Martin

Attached is the background material you requested on how the resource tax would work.

This includes:

- a simple explanation of the essentials of how the proposed tax would work
- a "fact sheet" style explanation of the proposed tax
- a "fact sheet" type explanation of the PRRT

We have focussed on the new system rather than the transition of existing projects.

Let me know if there is any other material that would assist.

cheers

GCD

THE ESSENTIALS OF HOW A RESOURCE SUPER PROFITS TAX WOULD WORK

A key objective in introducing a Resource Super Profits Tax (RSPT) would be to raise the community's return for allowing access to its natural resource deposits and to do so in a way that would not distort production decisions and therefore would not inhibit the realisation of economic growth and prosperity for Australians.

Basic operation

The basic concept is to apply a tax to above-normal or super profits. Normal profits are sufficient to attract and retain miners in operation on viable deposits. Super profits arise because of the scarcity value of the resources embedded in the deposits (and not because of monopoly power among miners). Super profits are equal to the value of the deposits (resources in situ).

The AFTS report has proposed that the tax be set at 40 per cent of the revealed value of a deposit. The revealed value of a deposit is the revenue gained from selling the resources less the costs of extracting them.

To build up a picture of how the RSPT would work, let us take as a first step the case in which the tax operates on a cash-flow basis. The amount of tax payable in year t , with a 40 per cent rate of tax, would be:

$$\text{Tax}_t = 0.4 \times (\text{Revenue}_t \text{ less Costs}_t)$$

where Costs are determined by outlays or expenditures, including the full amounts spent on capital items. Tax liabilities would vary from year to year, depending on production patterns, prices and costs incurred. In some years, such as in the development phase of a mine, costs exceed revenue and so miners would be entitled to a refund.

Under the RSPT, an alternative to immediate refunds in loss years is proposed. Rather, miners would carry forward losses and be allowed to offset them against future liabilities. They would be compensated for having to wait to receive the benefit from any refund through the application of an annual interest rate 'uplift'. The interest uplift is an essential feature of the Allowance for Corporate Capital (ACC) method.

Further, the ACC method would not operate entirely on a cash expenditure basis. Operating expenses would be allowed in the year in which they are incurred. But depreciable assets would be treated in the same way they are treated for income tax purposes. Any undeducted component of capital expenditure would also attract the ACC uplift.

Although the ACC method would bring a different pattern of liabilities and payments, it is meant to have the same end results as a cash-flow method. The interest 'uplift' is the mechanism that brings equivalence.

Financing costs (such as interest payments) are not included in the calculation of RSPT liabilities. The ACC can be thought of as an allowance in lieu of financing costs. Furthermore, since it does not include financing costs, it does not favour one form of financing (such as debt) over another (equity).

The AFTS report recommended that the long term government bond rate be used as the ACC rate. Many are likely to argue that the required rate of return for the company should be used. However, with a government guarantee, the amounts carried forward under the RSPT are not at risk.

While RSPT liabilities would be determined on an entity basis, the entity's liability would be the outcome of project-by-project assessments. The entity would automatically be able to transfer project losses between projects it owns. Further, if an entity is a member of a consolidated group, the RSPT would apply to each member in its own right (unlike the income tax system). However, project losses would be transferrable between members of a consolidated group that hold resource projects. In the event that a business closes, leaving no prospect of future RSPT liabilities, any remaining credits plus interest would be refunded.

Defining the tax base

To focus on the essence of how the RSPT would work, let us take a case in which all prices and costs are determined in arm's-length transactions. If they are not, they will have to be dealt with in the same way that they are dealt with for income tax purposes.

Notionally, a 'taxing point' is needed to make the RSPT operational. The taxing point is the physical point in the production and distribution of resources at which Revenue and Costs are determined for calculation of RSPT liabilities. Where the taxing point is set has been the subject of some disagreement under the PRRT. Under the proposed RSPT, there can be considerable flexibility in determining the taxing point, and so controversy should be less likely to arise.

For illustration, let us take the mine 'gate' as being the taxing point. Revenue would obviously be the receipts from sale of resources. But the sale would mostly occur at some other place than the mine gate — delivered to port for example. It is necessary therefore to deduct transport costs from the sale proceeds in order to derive a Revenue figure at the mine gate. The measure of Costs would be defined by all the expenditures incurred in getting the resources to the mine gate. (Similarly, if the sale price included a premium for refining, refining costs would be subtracted from the Revenue figure.)

However, other taxing points could equally be used. Let us now shift the taxing point to the port. In this case, the appropriate Revenue amount is the raw, unadjusted sales figure. But Costs would also include the cost of transport to the port. And so the tax base and the amount of tax payable would be the same at the two taxing points.

In the end, everything comes back to the actual value realised for the resource, for example, sale proceeds. All costs associated with the realisation of the resource are subtracted from this (including any uplifted carried forward losses) to determine the tax base.

Interactions

RSPT payments would be allowable deductions for income tax purposes while refunds would be assessable for the same purpose. Miners would also be given tax credits for payments of royalties to an Australian government.

Implications

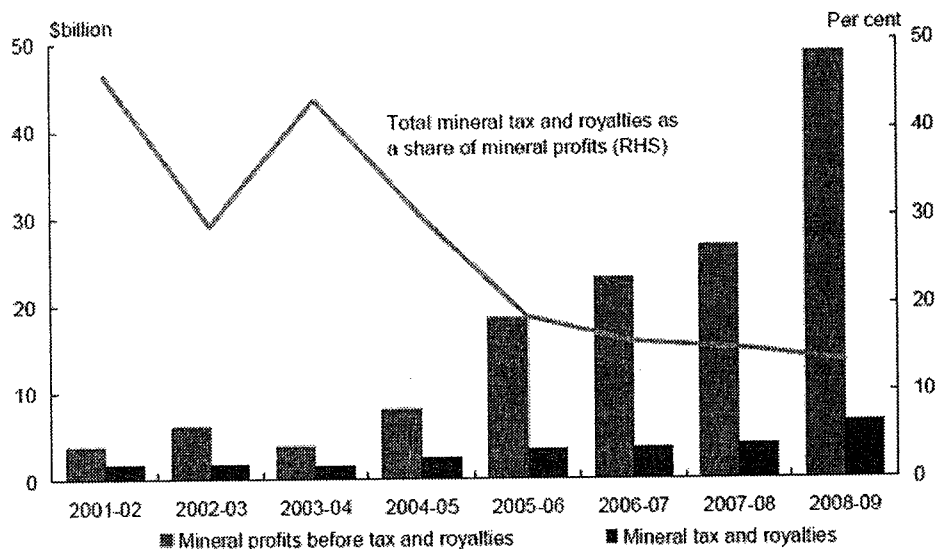
As far as resource super profits are concerned, the government would in effect be taking a 40 per cent share in mining activity, receiving 40 per cent of the profits from mineral extraction and paying 40 per cent of the costs. The government would bear some risk in return for the charge for access to the resource deposits. It bears the risk that it will incur a liability in some years, rather than receive an RSPT payment. In most cases, the government would receive positive net payments over the life

of a project. But it would also bear the risk that, in the event that a project turns out to be unprofitable, the government would grant access to a deposit but would incur a net liability.

An RSPT, unlike existing taxes (and mining royalties), would not distort investment and other production decisions. Because benefits and costs would be proportionately scaled, the tax would not change the expected rates of return for miners or the risks they face. Putting aside income tax considerations, miners would be contributing only 60 per cent of a project's cost, instead of 100 per cent, with the government contributing the other 40 per cent in one way or another. Similarly, miners would receive 60 per cent of the super profits. The relativities between benefits and costs, and therefore the rates of return would be preserved. Any differences in the timing of the flows of benefits and costs would be compensated by the ACC (so that any effect on discounted present values would be negated).

Mining Resource Profits

1. Australia has an abundant supply of mineral resources which belong to the community. Mining companies are given rights by the government to extract these resources and sell them for a profit.
2. Australian State and Northern Territory governments often levy a royalty on certain minerals, which companies pay based on the volume of resources extracted and sold. The amount of royalty collected by the government is generally only a small portion of the profits being made by the mining company.
3. When there is a mining boom, mining companies make significant profits because they are selling more minerals, at a higher price, while the costs of extraction remain stable or increase less than prices. Under the current output based royalties, mining companies pay less royalty (as a proportion of income) in boom times, and more when their profits are low.



4. The current arrangements fail to collect an appropriate return for the Australian community because they are unresponsive to changes in profit. Further, the current arrangements distort investment and production decisions because their costs are not recognised for tax purposes.
5. The current arrangements should be replaced with a uniform resource super profits tax.

Taxing Super Profits

6. Companies make profits to cover their costs and to make a normal profit on their investment. Normal profits are sufficient to attract and retain miners in operation on viable deposits. Super profits arise because of the scarcity value of the resources embedded in the deposits (and not because of monopoly power among miners). Super profits are equal to the value of the deposits (resources in situ).
7. The Australian government should tax these super profits so that the community gets a proper share.
8. The Resource Super Profits Tax (RSPT) uses an allowance for corporate capital (ACC). The allowance and operating costs are subtracted from company income to calculate the residual super profits.

$$(\text{Income} - \text{Expenses}) - \text{ACC} = \text{Amount of Super Profit}$$

9. Expenses include both standard operating costs (other than interest deductions) and depreciation. The allowance is calculated from the combination of unutilised losses and the value of undeducted capital expenditure multiplied by the uplift factor. The allowance compensates investors for the delay in the government's contribution to the cost of investment due to a slower recognition of expenses through depreciation and the lack of an immediate refund for losses.

10. The government intends to apply a 40 per cent tax to the super profits resulting from this calculation. Ideally, state royalties would no longer apply. However, until this can be negotiated with the States and Northern Territory, mining companies would still pay royalties at the State and Territory level and receive a credit for this payment against their RSPT liability. This approach effectively removes the impact of royalties from investment or production decisions.
11. Any losses from one project will be able to be utilised to offset RSPT tax liabilities for another project undertaken by the same company.
12. The RSPT has the same economic effect as if the government had taken a 40 per cent stake in each project, meeting 40 per cent of the costs and keeping 40 per cent of the profits.
13. Mining companies will still pay company tax. When a mining company calculates its company tax, it receives a deduction for the RSPT paid while any RSPT refunds will be assessable. That is, the profits for company tax purposes will be calculated after deducting RSPT and crediting royalties. The company tax is imposed on all company profits, including the super profit.
14. The Australian government's aim of taxing the super profits at the rate of 55 per cent will be achieved when the super profits tax at a 40 per cent rate is taken into account with a 25 per cent company income tax rate.

Effects on Future Investment Decisions and New Projects

15. The RSPT would not distort future investment decisions to start new projects. This is because the government effectively contributes to the project costs by allowing the costs of the project to reduce tax payable. The government shares in the project at the tax rate. Even if the project makes a loss, the government will pay its contribution to the costs either through allowing the loss to be uplifted or by refunding the loss if the project shuts down.
16. In contrast, the current existing output based royalties distort investment decisions because they apply irrespective of the costs of production. Companies have to pay the royalty even if they are not making a profit, because their costs are not recognised for tax purposes as they are under the RSPT.
17. In some cases, the government 'contribution' will be delayed: i) capital expenditures will be depreciated over the effective life of an asset; ii) costs can only be accessed in the year they are incurred to the extent they have profits to offset those costs otherwise they are carried forward, and ii) if they do not own other projects where the super profits tax will need to be paid.
18. However, the real value of the contribution is maintained over time because of the uplift rate of the allowance. The AFTS report recommends the long term government bond rate. Many will suggest that this is too low, arguing that the uplift rate should reflect the required rate of return for the company. However, given the government will make the contribution, these funds are not at risk and the appropriate rate should be the rate for government guaranteed debt.

Effects on Current Projects - Winners and Losers

19. Companies currently subject to output based royalties could face a lower or higher tax rate depending on the size of their mining profits. Existing projects that are making super profits will pay more tax when the government takes some of the super profits away from them. Existing projects that are making low profits will not have to pay the super profits tax. Existing projects that are making losses will be able to share those losses with the government once the RSPT commences.

20. The RSPT tax will not make any project that would have been viable under the old system unviable in the new system. Rather, some projects that would have become unviable over time may now remain viable for longer because as a project reaches the end of its mine life it pays less tax.
21. Under a RSPT, mining companies pay more tax when their profits are high and less tax when their profits are low. The super profits tax effectively takes 'some of the cream on top' of the profits being made.
22. The government will make the transition into the new system easy by recognising companies' prior expenditure through the allowance.

Applying the Tax

23. The tax will apply to all the major types of minerals including iron ore, coal, gold, bauxite, copper and diamonds (provided the producers are making super profits). The tax will also apply to petroleum products and natural gas, replacing the existing Petroleum Resource Rent Tax (PRRT) and excise arrangements.
24. While State and Northern Territory royalty charges remain in place, production companies will get a tax credit under the super profits tax for the royalty paid.
25. Private and Indigenous royalties will not be affected.
26. The tax will be collected by the Australian Government through the ATO.

P 8, P 9 - S 22 exemption