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From: Van de maele, Peter
Sent: Tuesday, 9 February 2010 11:34 AM
To: McDonald, Hamish; Jacobs, Martin
Cc: Davis, Graeme; McCullough, Paul
Subject: Resource tax material [~~SEC=PROTECTED~~]
Importance: High

Hamish,

Please find attached the material we have for you for the meeting.

As there is a fair bit there I thought it worth reiterating briefly the key policy parameters that would benefit of being settled prior to announcement or up for consultation:

- proposed coverage be for all resources (noting AFTS recommended excluding low rent resources) but leave room for consultation on style of carve out from the regime eg exclude some minerals or exclude small players
- losses from resource projects would be both transferable against profits from another project by the owners and ultimately losses are refundable
- apply the regime in parallel to existing state royalties but provide entities with a refundable credit against RPT liability for any government royalties paid by them
- all existing projects to be brought into the system with consultation on the recognition of costs incurred prior to announcement by the private producers - these costs would be transferable once the new regime is running. Important the costs recognised at their value at the time of announcement to address integrity issues.
- costs incurred from announcement but prior to commencement of the new regime to have the same treatment as costs incurred post commencement to avoid distorting investment decisions (ie transferable and refundable)
- regime will only apply at the actual private producer level and not at the investor level eg at the company/trust level and not at the shareholder/beneficiary level
- the reduction in company tax rate linked to introduction of resource tax regime with initial reduction
- likely commencing 1 July 2012 at the earliest.

Also, confusion can arise as to what is the taxing point (if they get to this level of detail). We can send a couple of simple examples explaining the taxing point if that is of assistance.

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# OVERVIEW OF THE PROPOSED RESOURCE SUPER PROFITS TAX

### Background

The AFTS report made two main recommendations in the area of taxation of companies, namely that:

- the rate of tax on company income be reduced from 30 per cent to 25 per cent; and
- the Australian Government introduce a tax on rents (or super profits) earned by private firms from the extraction and sale of Australia's natural non-renewable resources.

While this paper outlines and analyses the proposed new Resource Super Profits Tax (RSPT), it is crucial that the two recommendations be treated as an inseparable package. In broad terms, the loss of revenue from the reduction in company tax rate would be replaced by revenue from the RSPT. Adverse effects of the RSPT on shareholders, on the other hand, would be counteracted to some extent by the beneficial effects of the lower tax rate. Introducing the two measures would raise the return to the Australian community for granting access to resource deposits (through the RSPT); and would stimulate greater investment and growth (through a lower company tax rate).

Getting the structure of taxes on resources right is crucial for Australia and more so than for other countries. Natural non-renewable resources are especially significant to the Australian economy. An abundance of resources means that Australia has relatively large proportions of known world reserves of some minerals; and that the mining and related industries are more important to the Australian economy than they are for most other economies.

Getting the structure of taxes on resources right will have substantial benefits for Australians in terms of the generation and distribution of income.

### Rationale for the tax on resource super profits

The introduction and design of the Resource Super Profits Tax is based on two main principles:

- The community, which has the rights to natural resource deposits, is entitled to charge for access to the deposits that brings private commercial gain.
- The charge should be structured in a way that has minimal adverse effect on investment and production decisions and therefore assists the creation of output and income from extracting resources.

#### *Basis for a charge*

The Australian community, through its governments, is the owner of non-renewable resources. A resource tax is a charge for access to the resources that brings private commercial gain. It is a way to return at least some of the value of resource deposits to the community from giving up the rights to them.

The value of a resource deposit is the value of the resources *in situ*. That is the revenue that could be gained from extracting and selling embedded resources, less the costs of extracting them. To illustrate the crucial point, two deposits could yield the same amount and quality of ore, and therefore the same revenue. But, if it is more costly to extract the resources from one of the deposits, the value of that deposit in its undisturbed state will be less. Obviously, if one deposit would yield more revenue for the same extraction effort, it would have a higher value than the other.

A charge for access to a resource deposit is akin to a price for the sale of a public asset. From a miner's point of view, a charge is akin to paying a price for an input to its production process.

#### ***Minimising distortions through a super-profits tax***

A charge can take a number of forms. State and territory governments currently charge royalties for access to resources. These are typically charged on a volume basis, such as a certain dollar amount per ton of resource extracted or recovered.
Royalties can distort production decisions. Being charged at a fixed rate per ton, they do not vary with the value of a resource deposit. They represent a relatively small proportion of high-value deposits (or the increased value of a given deposit in boom times) and a relatively large proportion of low-value deposits (or the reduced value of a deposit in lean times). They therefore discourage investment in viable, but lower value, deposits and discourage the continued working of viable, but lower value, deposits when price expectations fall or when deposits have reached a mature, more-costly stage.
The RSPT would not distort production decisions. A key principle is that RSPT liabilities would represent a fixed proportion of the value of all deposits at all times. It therefore would not interfere with decisions about investment in and operation of mines. As explained below, imposition of the RSPT would not change the expected returns for miners or the amount of risk they face.

#### **How the RSPT would work**

The value of a deposit (resources in situ) is equal to the amount of above-normal or super profits that can be earned from extracting embedded resources. Super profits arise because of the scarcity value of the resources (and not because of monopoly power among miners).
In keeping with the AFTS recommendation, it is proposed that the RSPT be charged at 40 per cent of the realised value of a deposit.
If liabilities were determined as and when revenues and costs fall, they would vary greatly 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, in principle, miners would be entitled to a refund.
However, two important departures are proposed.

- Depreciable assets would not be immediately deductible. Their costs would be treated in the same way they are treated for income tax purposes—that is, as an annual depreciation expense.
- Miners would not be given immediate refunds in loss years.

Miners would be able to use losses to offset against other RSPT liabilities. The one company would be able to use a loss on one project to offset against a liability on another of its projects. Or losses on one project could be carried forward and offset against future liabilities on the same project.
Miners would be compensated for having to wait to receive an RSPT benefit from unclaimed costs of depreciable assets, as well as an RSPT benefit from any unclaimed losses. Under the Allowance for Corporate Capital (ACC) method, the residual value of depreciating assets and any losses incurred would go into an ACC 'account'. A rate of interest would be applied each year to the ACC base and that interest would be deducted from a miner's annual RSPT liability (or added back to the ACC base in the event that the project makes a loss in the year of assessment).
That is:

RSPT liability = 0.40 x (Revenue – Costs) – ACC interest allowance.

In the event that an entity or group closes, leaving no prospect of any future offsetting super profits, any remaining amounts in the ACC base would be refunded.
It is crucial to the operation of the scheme that the government guarantees to give miners the benefit of 40 per cent of their costs. The benefit can take the form of offset against revenue in a year, deferred offset with interest, or ultimately as a cash refund. This principle of guaranteeing the benefit of 40 per cent of the costs ensures that investment and production decisions are not distorted by the introduction of the RSPT (see below).

***Implications of the ACC method***

The ACC method puts the assessment of liabilities onto the equivalent of a 'cash flow' basis. Although the ACC method would bring a different pattern of liabilities and payments, the ACC interest uplift brings equivalence to a cash-flow method. For example, because the ACC interest allowance compensates miners for having to wait for tax benefits to apply, miners should be indifferent as to whether a full immediate deduction for an asset is allowed or whether the ACC interest allowance is applied to any undeducted value of an asset. The effects of any differences in the timing of the flows of benefits and costs on discounted present values would be negated by the ACC interest allowance.

***Implications of imposing the RSPT***

The RSPT arises in the context of granting access to resource deposits and realising the value of deposits. The realised value is the net proceeds from the sale of embedded resources. Putting aside income tax considerations, the government takes a 40 per cent stake in realising the value of deposits. It receives 40 per cent of the net proceeds. The government guarantees to contribute 40 per cent of the costs in one form or another (as an offset against revenue for RSPT assessment or, ultimately, as a refund) and gets the benefit of 40 per cent of the revenue.
Miners contribute 60 per cent of the costs and get the benefit of 60 per cent of the revenue (putting aside income tax and royalty considerations). This is consistent with miners receiving 60 per cent of super profits or the value of a deposit.

***Specific issues***

## RSPT rate

The AFTS report recommended an RSPT rate of 40 per cent of super profits. This was predicated on the company tax rate being lowered to 25 per cent. With RSPT payments being tax deductible for the purposes of income tax assessment, RSPT would be 30 per cent of super profits after tax. Combined with the 25 per cent income tax, the total amount of tax on super profits would be 55 per cent of super profits (earned by companies).
The AFTS report recommended preserving this overall RSPT plus income tax proportion of super profits. It included a formula for deriving the RSPT rate at different income tax rates.

## Exclusion of interest and other financing costs

It is proposed that interest costs on debt (or the costs of servicing equity) not be included in allowable RSPT costs. The intrinsic value of a deposit does not depend on the cost of alternative forms of financing, and so neither should the charge for access.
As an important aside, exclusion of financing costs also means that the ACC method does not create incentives for miners to use one more-costly form of financing over another.

## Taxing point

The RSPT operates with respect to a 'taxing point'. 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 under the PRRT has been the subject of some disagreement. Under the proposed RSPT, however, there can be considerable flexibility in determining the taxing point, and so controversy should be less likely.

To illustrate the flexibility, first take the mine 'gate' as the taxing point. Revenue would obviously be the receipts from sale of resources. But the sale would mostly occur with respect to some other place than the mine gate — delivered to port for example—and prices received would reflect that. It would be necessary therefore to deduct transport costs from the sale proceeds in order to derive a revenue figure with respect to 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.)

Now take the taxing point to be 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 tax liability would be the same at the two taxing points.

## Identifying prices and costs

The calculation of super profits is predicated on all prices and costs being 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.

## Rate of ACC interest uplift

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

## Interaction with the income tax system

As noted above, RSPT payments would be allowable deductions for income tax purposes. The same RSPT liabilities would be incurred, irrespective of whether the entity falls within the personal or company tax system.

Any refunds of unused ACC base amounts would be assessable for income tax purposes.

## Transition of current projects

Existing projects would need to be transitioned into the RSPT system. The mechanism for doing this would be to determine an appropriate ACC base for each existing project.

## Coverage

The starting point would be to include all mining operations. A case could be made (in consultation processes) for exclusion of certain commodities or operation below a certain size.

## Interaction with state and territory royalties

The preferred position would be for the RSPT system to replace the various systems of state and territory royalties. However, this may not be possible in the short run.

While royalties remain in force it is proposed that miners be given tax credits for the payments of royalties they make to an Australian government. So long as RSPT liabilities remained greater than royalty liabilities, this would effectively give overarching status to the principles and effects of the RSPT system.

## Differences the proposal would make

### *Implications for miners*

An RSPT, unlike existing taxes (and mining royalties), should not distort investment and other production decisions. It would not affect the risks and returns that miners face, compared with the situation in which miners were not subject to the RSPT or to royalties. The RSPT would not affect the profitability — that is, the ratio of benefits to costs — of projects. First, the application of the ACC uplift compensates for the effects of the RSPT on the timing of costs and benefits. Total costs and benefits are identical in discounted present values. Second, the RSPT would scale costs and benefits proportionately. As noted above, miners would effectively contribute only 60 per cent of a project's costs, instead of 100 per cent, and would receive 60 per cent of the revenue, rather than 100 per cent. Because of these two properties, the ratio of benefits to costs would be unchanged by the RSPT.

The returns on investment would also be unchanged, provided the government contribution to costs is guaranteed. Net operating returns on a profitable investment will be lower with the RSPT than without the RSPT. The return on the full amount invested will therefore be lower. However, with a government guarantee that miners will receive back 40 per cent of their investment in one form or another, only 60 per cent of the investment is 'at risk'. With the RSPT, the return on the 'at risk' investment will be the same as the pre-RSPT return.

The risks that miners face would remain unchanged, provided the government guarantees to allow or refund all losses incurred. Again, differences in the timing of costs and of benefits, due to the RSPT, are counteracted. And so it is as if revenues and costs fall when they occur. If the government guarantees to allow or refund all losses, both the upside risks and the downside risks to miner's income remain the same.

### *Implications for governments*

As noted, the government would be taking a 40 per cent stake in the realisation of the value of deposits. It would guarantee to allow or pay 40 per cent of the costs and it would receive 40 per cent of the super profits.

The government would be at some risk because of its guarantee. It would bear the risk that it will incur a liability in some years, rather than receive an RSPT payment. This would be managed through the ACC system, in preference to a cash-flow method. 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.

There would be additional revenue to governments from higher liabilities from highly-profitable projects and from more profitable economic conditions. Additional revenue would also be derived from the taxes on marginal operations that would get underway or continue rather than be discouraged.

### *Implications for broader community*

The broader community would benefit from:

- growth in investment, output and income

  - due to lower company tax and also if marginal mines brought into operation
- increased return on its natural resources.

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