



National Division

3-4 March 2011
Brisbane Convention &
Exhibition Centre,
Queensland

26TH NATIONAL CONVENTION

Resource and

Environmental Tax Changes

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1 INTRODUCTION

There has been a great deal of focus over the last 12 months on the taxation of resource projects.

While the Henry Review made some limited recommendations in relation to environmental tax changes, nothing has yet happened to them and we will no doubt need to wait for the tax summit in the middle of the year to see if they develop further.

More recently, the Government has started to canvass the possibility of a carbon tax, as a means of accommodating a delayed permit based carbon regime.

Given the emphasis over the last 12 months on changes to resource taxation and in particular the announced minerals resource rent tax and extended petroleum resource rent tax, this paper will focus predominately on those issues.

2 RESOURCE TAXATION

With an expected boom in resource projects already underway, the subject of resource taxation has been front and centre in the Australian political landscape over the last 12 months. Shortly after coming into office the Labor Government announced a comprehensive review of Australia's tax system¹ which ultimately resulted in the release of the Henry Review² on 2 May 2010.

The only real tax reform proposed in the Henry Review which has received any great focus is that relating to the taxation of resources. The Review recognised that the grant by State and Federal Governments of rights to extract resources have the potential to confer on producers a tremendous benefit namely: the ability to generate super profits. These super profits are what the economists refer to as rent, a return above and beyond the rate of return necessary to generate investment in a resource project.

The existing resource taxes (other than those applying to production of oil and gas in Commonwealth waters) are largely imposed by the State and Territory Government. While the method of calculation of the state taxes varies from project to project, the amount of tax payable is often calculated by reference to the value of production.

Taxes imposed on the value of production apply irrespective of the level of profitability. They have the capacity to discourage marginal projects or encourage the early close in of a project as the costs of extraction increase. At the same time the amount of tax taken, while increasing the value of production, does not increase at the same rate as that at which profit increases.

The Henry Review recommended that a Resource Super Profits Tax (**RSPT**) be introduced to replace current Federal and State resource taxation regimes with a uniform resource rent based tax. The stated intention being that such a tax would earn a greater return for the community over time from the use of its resources, while hopefully, not detracting from private investment.

The RSPT was subject to a great deal of criticism. It was announced without real consultation with industry and was too ambitious. While described as a 'super profits tax', in reality it applied to normal levels of profit, well before super profits were earned and was likely to adversely impact investment in Australia's mining sector given its place as part of a global industry in which capital generally flows to those projects that have the highest after tax risk adjusted return.

The RSPT did have one significant advantage, full crediting and refund of existing state royalties. Reducing the tax on unprofitable, or marginal projects.

The period which followed the announcement of the RSPT was one of considerable controversy, with the subject of resource taxation occupying centre stage in the media for a period of nearly two months.

¹ The Honourable Wayne Swan MP, Australia's future tax system (Press Release No. 036, 13 May 2008).

² Ken Henry et al, Australia's Future Tax System: Report to the Treasurer (December 2009).

This controversy was ultimately resolved on 2 July 2010 when the Government announced a 'break through agreement on improved resource rent tax arrangements' that was said to address the concerns of the industry while delivering a better return to the Australian community than existing state taxation arrangements.

The 2 July announcement involved:

- the abandonment of the RSPT;
- the adoption of a new Minerals Resource Rent Tax (**MRRT**) regime to apply to iron ore and coal in Australia; and
- an extended Petroleum Resource Rent Tax (**PRRT**) regime which was now to apply to all Australian onshore and offshore oil and gas projects, including the North West Shelf.

Conscious of the backlash that had arisen from the announcement of the RSPT and anxious to appear willing to take into account the concerns of industry, the Government also announced the formation of Policy Transition Group (**PTG**) lead by Resources Minister, Martin Ferguson and Mr Don Argus to consult with industry and advise the Government of the implementation of the new MRRT and extended PRRT arrangements. The PTG subsequently released an Issues Paper on 1 October 2010³ and after obtaining wide ranging submissions, delivered a report to Government in December 2010⁴.

At the time of writing, the Government is understood to be continuing discussions with industry. It is yet to announce the extent to which it intends to take up the recommendations of the PTG.

3 THE MINERALS RESOURCE RENT TAX

3.1 The announced MRRT principles

The principles which were announced by the Government on 2 July 2010 (the **MRRT Announcement**) are summarised as follows:

- the MRRT is to apply to iron ore and coal production;
- the profits will be calculated on the value of the commodity determined in its first saleable form (at the mine gate);
- deductible costs will include all of the costs involved in getting the iron ore and coal into its first saleable form, including exploration expenditure and a 'starting base' for existing projects. The categories of deductible expenditure will be broadly based on categories used in the PRRT regime;
- the tax rate which will apply is 30%;
- in recognition of the contribution of a miner's expertise to profits, projects will be entitled to a 25% extraction allowance that reduces taxable profits, effectively reducing the real rate of tax to 22.5%;
- MRRT losses will be carried forward from year to year and uplifted at the long term bond rate (**LTBR**) plus 7%;
- MRRT losses will be transferable within a group;

[Note: the PTG has subsequently recommended that losses arising from deduction of the starting base should not be transferable between projects (Recommendation 37)].

³ Australian Government, Policy Transition Group - Issues Paper: Technical Design of the Mineral Resource Rent Tax, Transitioning Existing Petroleum Projects to the Petroleum Resource Rent Tax and Policies to Promote Exploration Expenditure, 1 October 2010.

⁴ Policy Transition Group, Report to the Australian Government 'New Resource Taxation Arrangements', December 2010.

- State and territory royalties are creditable against the MRRT liability, but unlike RSPT they will not be transferable or refundable;
- unused royalties which are not credited in a year can be carried forward and uplifted at LTBR plus 7%;
- small miners with resource profits below \$50m per annum will not have a MRRT liability.

The MRRT Announcement contained a number of transitional measures to apply to existing projects. The transitional measures announced included:

- miners with existing projects can elect to use the book or market value as the starting base for project assets;
- book value can be written off over five years and will be uplifted at the LTBR plus 7%;
- a market value starting base will be based on the value at 1 May 2010, including the value of mining rights. It will be written off over the effective life up to 25 years. According to the announcement 'a market value starting base will not be uplifted';
- post 1 May 2010 capital expenditure will be added to the starting base with investment post 1 July 2012 being able to be written off immediately, in accordance with the normal deductibility rules.

The MRRT Announcement was very brief. It provided no real explanation of the conceptual principles underlying the design of the tax. While providing an outline of the tax, it also left much of the detail to be developed through the PTG's consultation process.

3.2 PTG - design principles

The PTG confirmed in its report that the MRRT is to be levied on profits derived from the extraction of iron ore and coal. It is not to extend to profits arising from the beneficiation of those commodities or any other downstream processing of coal or iron ore.

At the same time it also confirmed that the tax has a project based design which is founded on an entity's interest in a mining tenement for which a production right has been granted. This approach uses legally enforceable rights as the basis upon which to define the iron ore and coal project subject to MRRT and the taxpayers who are liable to tax.

3.3 PTG - implementation recommendations

The original MRRT Announcement left many aspects of the design and operation of the tax uncertain. This resulted in a considerable number of issues being identified by the PTG in its Issues Paper which were the subject of consultation. The PTG's recommendations on these issues form part of the December 2010 report to Government.

Some of the key issues which are addressed in the PTG report include:

- how do you define a project and to what extent can interests in a single project or in different projects be combined;
- at what point do the extraction activities cease and the beneficiation or other downstream processing activities begin - i.e what is the taxing point at which revenue and expenditure is to be measured;
- how is the revenue or value at the taxing point to be calculated;
- how are the deductions that are to be taken into account in calculating the profit of the activities up to the taxing point to be determined;

- what steps can be taken to try and provide certainty and reduce compliance costs;
- how is exploration expenditure to be treated;
- how are losses to be dealt with, to what extent are they transferable;
- how do the ordering rules work for calculating the MRRT payable, applying losses and royalty credits;
- which projects attract a starting base, how is it to be calculated and applied;
- how is the \$50m threshold available to small producers to be applied in practice and what can be done to minimise the compliance obligations for those producers?

3.3.1 How do you define a project

There are effectively six dimensions to the definition of a project for MRRT purposes.

1. A project will have an operational dimension. It encompasses the extraction activities up to the taxing point.
2. The activity must relate to a particular type of resource - iron ore or coal. If a project involves the production of other commodities as well as coal and iron ore, there is to be an apportionment of appropriate parts of the revenue and costs.
3. There will only be a project once someone holds an interest which entitles them to produce iron ore or coal. A project must consist of at least one production right and will commence when a production right is granted or acquired (Recommendation 7).
4. Taxpayers are entitled to elect to define a project as the aggregate interest in separate production rights that produce the same MRRT commodity and are managed as an integrated operation, demonstrated through the same downstream infrastructure being used or operated in an integrated manner in respect of production from the production rights. If a taxpayer elects to define the project in this way, the project must encompass the full extent of activities determined by these criteria (Recommendation 9).
5. In recognition of the fact that more than one company within a consolidated group may hold an interest in a project or an integrated project, entities that are consolidated for income tax purposes can elect to be consolidated for MRRT purposes, in which case the head company of a consolidated group will be responsible for paying the MRRT of the group, with each entity in the group being jointly and severally liable for any unpaid tax. (Recommendations 5, 6 and 12).
6. A project should cease to exist when the first of the following occurs:
 - a production right is rescinded or relinquished;
 - 10 years after production of a commercial quantity of coal or iron ore from the mine ceases;
 - when the taxpayer elects to close the project.

3.3.2 How is the taxing point defined

The PTG has recommended that the taxing point should be the point at which:

- the resource leaves the point at which it has been stockpiled after being extracted (the run of mine (ROM) stockpile) ready for the next unit of operation;
- where a ROM stockpile does not exist, or is by-passed, the point at which the resource is delivered to the first unit of operation after extractive mining activities have occurred (see examples below); or
- a stand alone arm's length sale to a third party, where this occurs prior to the taxing point described in the points above.

(Recommendation 16).

The PTG identified the ROM stockpile as an appropriate point in the production value chain for setting the taxing point as, in its words:

This aligns with existing practices within the iron ore and coal mining industries and would generally align with existing accounting practices, thereby minimising the cost of compliance.

The PTG identified four features of the ROM stockpile which justified its selection. They were:

- it is relevant to most iron ore and coal mining operations;
- it provides an observable point that cannot be integrated into other stages of production;
- it occurs before any significant value adding operations are undertaken, thereby reducing the likelihood that profits generated from the processing of the resource are taxed; and
- it generally aligns with existing accounting practices.

Where there is no ROM stockpile the taxing point is to be the point at which the resource is delivered to the first unit of operation after it has been extracted. An example is given of iron ore which might be delivered directly from pit to the point of first crushing and screening. In that case, the taxing point would be the point at which the ore is delivered to the crusher. Another example given is that of coal which might be loaded directly onto a conveyor belt to a power station, in which case the taxing point would be the point at which it is loaded to the conveyor.

A number of submissions supported giving industry some flexibility in the selection of the taxing point, so that a point might be identified in a given project which corresponded with the point at which a product was eventually sold and/or the operations of a joint venture conducting mining operations ceased. This would have made it relatively easy to identify costs associated with the project and its revenue.

The PTG did not support the proposal for flexibility as it was felt that it could result in taxpayers assessing each of the possible taxing points to determine which of them might produce the greatest overall benefit (i.e the lower MRRT liability). Difficulties were also envisaged where there was a change in ownership of an interest in a project, where the transferee wanted to combine with another interest with a different taxing point.

3.3.3 Measuring the revenue of the project

The PTG has recommended that the value of the resource at the taxing point has to be determined and brought to account as part of the assessable receipts by:

- looking at any arm's length sale to a third party at the taxing point; or
- where there is not an arm's length sale at the taxing point, looking at the amount determined as the market value using the most appropriate and reliable arm's length method (Recommendation 18).

While many had argued that in the absence of a sale, there should be safe harbours available to taxpayers who elected to use them, to calculate the arm's length value of the commodity, the provision of a general safe harbour was rejected. Instead a safe harbour is only recommended for:

- taxpayers with mining operations that combined, produce fewer than 10 million tonnes per annum of saleable coal and iron ore in a tax year; and
- vertically integrated transformative operations⁵ in existence at 1 May 2010 (Recommendation 21).

The PTG appears to have felt that the provision of a safe harbour methodology would be too inflexible to deal with the different circumstances of individual entities or projects and would not necessarily determine an arm's length price in a given case. It appears the PTG felt that any disadvantage arising from initial uncertainties for taxpayers and the ATO about the calculation of an appropriate value could be mitigated by material included in the explanatory memorandum and by the ATO publishing early guidance about the methods it would accept to determine market value.

Those projects able to use the safe harbour approach, would use it on a project basis. The safe harbour would effectively use a netback calculation in which costs incurred between the taxing point and the point of first arm's length sale, including an allowance for capital employed between the taxing point and the point of sale, would be deducted from the sale proceeds. A capital allowance would be provided against the capital base being the depreciated optimal replacement cost of the capital employed in the downstream operations. The PTG rejected the use of an RPM method like that prescribed in the existing PRRT regulations as a default methodology.

3.3.4 What amounts will be deductible in calculating the taxable profit

Given that the objective is to determine the profit arising from particular extraction activities, and not from beneficiation or downstream processing, it is necessary to identify the relevant costs associated with the extraction activities, i.e the costs incurred in carrying on the activities up to the taxing point.

The MRRT differs from income tax, in that all payments, whether revenue or capital, are intended to be deductible. Only after funds invested have been recouped from revenues, together with a base rate of return provided by the long term bond rate plus 7%, does a profit arise on which tax is intended to be payable.

Consequently the PTG has recommended that payments of a revenue or capital nature should be deductible for MRRT purposes:

- **to the extent** they are **necessarily incurred** by an entity **in carrying on** mining operations upstream of the taxing point.

A number of exclusions which are discussed below will apply.

⁵ Vertically integrated transformative operations are coal and iron ore producing entities that significantly transform the resources into other products through processing or transformation. The PTG refers to coal mines integrated with the production of electricity and iron ore mines integrated with the production of steel as vertically integrated transformative operations.

Although the terms of reference stated that non deductible expenditure would be broadly consistent with the PRRT, which implied that deductible expenditure should be broadly consistent, the test recommended by the PTG differs from that in the PRRT context.

The PTG recognises that for an expense to be deductible, it needs to have a sufficient connection with the tax base. Given the MRRT is a form of resource rent tax designed to levy tax on resource profits derived from activities upstream of the taxing point, the MRRT deductible expenditure should have a necessary connection with the derivation of such profits.

This necessarily means that if costs downstream of the taxing point are being taken into account in determining the value of the resource at the taxing point, identification of those costs must be determined consistently with the manner in which the MRRT deductions are determined.⁶

It appears that the PTG proposes that the test for deductibility be framed in a manner which seeks to avoid the same problems arising for MRRT as have arisen in the past in the PRRT context. In the PRRT context, the ATO has sought to argue that the requirement that liability is incurred 'in carrying on or providing' operations comprising the project is effectively a requirement that the expenditure be incurred directly on the activities occurring within the project. On some occasions the ATO has been seen to argue that this requires expenditure on the physical activities occurring within the project. The ATO argues that this construction is supported by the use of the word 'in' in the phrase 'in carrying on or providing'.

It appears that the deliberate inclusion of the words 'to the extent' are intended to ensure that expenditure can be apportioned prior to being tested for deductibility. Hopefully this should ensure that expenditure which serves more than one purpose indifferently for which cannot simply be apportioned based on the time, can still be apportioned on some other reasonable basis and that part apportioned to the activity of carrying on the mining operations tested for deductibility.

The phrase 'necessarily incurred' appears to have been adopted as a means of counteracting the narrow interpretation which might otherwise be placed on the word 'in'. A number of cases in the income tax context have considered the phrase 'necessarily incurred' in the context of second limb of section 51(1) of the *Income Tax Assessment Act* 1936 which referred to 'losses and outgoings necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income'. In that context it has been said that:

The requirement that the claimed outgoing be 'necessarily' incurred in carrying on the relevant business does not, in the context, mean that the outgoing must be either 'unavoidable' or 'essentially necessary'. Nor does the word 'necessarily' import a requisite of logical necessity. What is required is that the relevant expenditure be appropriate and adapted for the ends of the business carried on for the purpose of earning assessable income. (See *Magna Alloys and Research Pty Ltd v Federal Commissioner of Taxation* [1980] 49 FLR 183 at 205).

or put another way that:

viewed objectively, the outgoing must in the circumstances be reasonably capable of being seen as desirable or appropriate from the point of view of the pursuit of the business ends of the business being carried on for the purpose of earning assessable income. (*Magna Alloys* at page 208).

In the context of the MRRT it appears that what is recommended by the PTG, is that expenditure ought to be deductible to the extent that expenditure is reasonably capable of being seen as desirable or appropriate from the point of view of the carrying on of the mining operations. Or in other words, to the extent that the relevant expenditure is appropriate and adapted to the ends of the activities conducted for the mining operation up to the taxing point. Hopefully adoption of terminology of this nature will negate the ATO's ability to place a restrictive construction on the word 'in' and enable a deduction to be claimed

⁶ See the first paragraph of page 48 of the PTG's report to Government.

for all marginal costs which are incurred as a consequence of the conduct of activities up to the taxing point.

There are many specific types of expenditure which the PTG has recommended should be excluded from deductibility. Those categories of expenditure are very similar to the categories of excluded expenditure in section 44 of the *Petroleum Resource Rent Tax Assessment Act 1987 (PRRTA Act)*. The rationale for excluding the expenditures from deductibility appears to be based on the fact that the MRRT is in the words of the PTG a project based tax and 'a form of resource rent tax'. The specific categories of excluded expenditure are as follows:

- payments of interest or principal on a loan, and other borrowing costs, with hire purchase and finance lease arrangements treated as a debt financed asset purchase;
- payments of dividends, the cost of issuing shares, and repayments of equity capital;
- payments of resource royalties levied under State or Territory legislation;
- payments to acquire, or to acquire an interest in, an exploration permit, retention lease, production licence, pipeline licence or access authority, otherwise than in respect of the grant of the right, or project profits, receipts or expenditures;
- payments of private override royalties, other than those subject to Recommendation 33, noting that the market value starting base should be determined as if unencumbered by such royalties;
- payments to the extent they represent hedging or foreign exchange losses relating to the resource, other than those arising under an agreement to sell the resource or acquire any service or input to an upstream activity;
- payments of rehabilitation bonds or to a rehabilitation fund;
- payments that represent a provision, reserve, sinking fund, insurance fund, or similar;
- payments of a capital nature in respect of land or buildings for use in connection with administrative or accounting activities (for example, a head office), not being land or buildings located at, or adjacent to, mining operations upstream of the taxing point; and
- payments of income tax or GST.

The rationale for denying a deduction for each of these types of expenditure, is based upon the design of the tax as a rent tax. Notably, the list of exclusions does not include an exclusion equivalent to section 44(j) of the PRRTA Act, something which is colloquially referred to as the 'indirect expenditure' exclusion.

Private overriding royalties are excluded from deductibility due to the fact that they seem to represent a sharing or allocation of profit from a project which is usually granted in return for the acquisition of rights to mine or other rights used in the project. The theory is that allowing a deduction for these payments, would cause integrity issues, as it would allow a part of the profit to be paid to people who are not paying MRRT.

A distinction is made between payments for private overriding royalty and native title payments made under an agreement under the *Native Title Act 1993* or a similar Act in settlement of an indigenous land use agreement. These payments are intended to be deductible.

3.3.5 How is exploration expenditure to be treated?

The PTG has recommended that exploration expenditure be defined in terms similar to that in income tax law.

Exploration expenditure incurred within the area of a production right after it has been granted, is to be treated as project expenditure. (Recommendation 35). Exploration expenditure incurred in respect of mining tenements, other than production rights, is to be recognised as a cost of production and be transferable to other projects held by the taxpayer that had produced the same MRRT commodity.

Difficulties could arise if expenditure was incurred which was not exploration expenditure prior to the grant of a production right. If a production right was never granted, this pre project expenditure, might never be deductible. To avoid it falling into a black hole, the PTG has recommended that the pre project expenditure which does not qualify as exploration expenditure should also be transferable to other projects held by a taxpayer producing the same commodity.

Where there is a transfer of a mining tenement on which exploration has been incurred, the exploration and other pre-project expenditure are to be transferred with that tenement. Unlike project losses inherited through the acquisition of an interest in a project, the PTG has specifically recommended that this exploration expenditure, inherited upon transfer of a project, should be able to be transferred by the transferee within their own projects. (See page 42 of the report to Government). To avoid trafficking in exploration losses a number of integrity measures are suggested.

Conscious of the risk that exploration expenditure may be incurred a long time before a mining project commences and that this could result in very substantial increases in the real value deductions, the PTG has recommended that the uplift for expenditure of LTBR plus 7% be reduced in the case of exploration expenditure to LTBR 10 years after the expenditure is incurred.

3.3.6 How are losses to be dealt with? To what extent are they transferable?

Project losses will be transferable within projects held by the same taxpayer, where the projects produce the same commodity. Indeed, transfers will be mandatory where the requirements for transfer are met.

A number of rules are proposed to deal with the transfer of losses which are set out in Recommendations 43 to 48.

Importantly, losses arising from depreciation of the starting base are not to be transferable to other projects.

3.3.7 How do the Ordering rules work for calculating the MRRT payable? Applying losses and royalty credits

The order in which royalty credits, carry forward project losses and expenditure transferred from other projects is used can have a significant impact on the potential outcome for project participants.

One of the significant changes recommended by the PTG, is that royalties should be credited earlier in the loss ordering rules so that the risk of them being stranded is minimised.

The table below illustrates the order of calculation.

Assessable revenue	=	Value of the resource (eg sales proceeds or value at taxing point) + other revenue
less		Deductible costs incurred in relation to the project, including exploration expenditure
less		Royalty credits (deduction equivalent)*
less		Carried forward project losses
less		Starting base depreciation, deductions and starting base losses
less		Transferable exploration expenditure
less		Transferred-in project losses
Sub-total	=	MRRT taxable profit / (MRRT loss)
MRRT taxable profit x 30%	=	MRRT liability before extraction allowance
less		25% extraction allowance
Total	=	MRRT liability
*Royalty credits, as a deduction equivalent, would be the amount of royalty payable multiplied by 1/0.225.		

3.3.8 Which projects attract a starting base?

Where a production right was in existence on 1 May 2010, that production right is to be granted a starting base using either the market value or book value methods discussed below. The starting base will be deductible:

- in the case of projects which are producing on 1 July 2012; and
- in the case of projects which are not producing - when they commence production.

Where a right is held at 1 May 2010 which does not grant a right to produce, but grants exploration rights, those tenements would not be considered to be projects. Nonetheless the market value at 1 May 2010 would be recognised in a starting base when a production right is eventually issued, and is to become deductible if the PTG's recommendations are accepted, from commencement of production.

Taxpayers have to choose when they first file their return to either:

- adopt a market value starting base (see Recommendation 51-52); or
- to adopt a book value starting base based on the most recent audited accounts prepared in accordance with Australian Accounting Standards which were in existence at 1 May 2010 (see Recommendations 52-54).

There is a significant difference in the way in which the two starting bases are treated.

The market value starting base is to be written off on a straight line basis and in the case of:

- mining rights and mining information - treated as one asset and depreciated over the lesser of life of mine or the period to 30 June 2037;
- other assets should be written off over the lesser of their effective life or the life of mine or the period to 30 June 2037.

Market value is to be calculated as if the project were not encumbered by any private overriding royalty.

In the case of the market value starting base it is not to be uplifted except by the CPI to retain its real value.

The book value starting base by contrast is written off over a period of five years at the rates of 36%, 24%, 15%, 15% and 10%. It is uplifted at LTBR plus 7%.

3.3.9 The \$50m threshold

To avoid compliance costs, taxpayers who have little prospect of ever paying MRRT are to be given the option to elect into a simplified MRRT regime.

The precise test to be used to elect the simplified regime is yet to be finalised. The PTG has suggested a couple of options. One would involve looking at earnings before interest in tax on iron ore and coal extraction plus creditable royalties. If they added up to less than \$50m then a full MRRT calculation would not be required.

To avoid taxpayers splitting their operations into different entities, the activities of related entities would be aggregated using the small business test rules in the *Income Tax Assessment Act 1997*.

It is not proposed that the \$50m threshold be indexed. It is however proposed that it phases out between \$50m and \$100m, so that entities who fail the \$50m test, while having to undertake detailed MRRT calculations, will not pay full MRRT on the first \$50m until their MRRT profit exceeds \$100m.

There are some disadvantages in electing into the simplified regime. Given that full records will not be maintained under that regime, someone moving from that regime into the full regime will be treated as a new taxpayer and will not get the benefit of prior expenditure.

3.4 Where to from here?

By the time this Paper is presented, it is likely that the Government will have released its response to the PTG's recommendations and established a policy implementation group to consult on the development of the MRRT legislation, its administrative design and implementation.

4 AN EXTENDED PETROLEUM RESOURCE RENT TAX

The petroleum resource rent tax was introduced effective from 1985 to tax what economists might broadly describe as the rent arising from new offshore petroleum projects in Commonwealth waters. Given that it was to apply to Greenfield projects, both the existing Bass Strait and North West Shelf projects were excluded from its operations.

Changes were however made in 1990, to extend the reach of the PRRT and apply it to the Bass Strait project. These changes occurred as part of a number of reforms, including reforms introduced to allow the transfer of exploration expenditure from one project to another.

As the tax currently stands, it applies to all projects in Commonwealth waters other than the North West Shelf project.⁷ It does not apply to the North West Shelf project, nor to projects within the States and Territories.

4.1.1 The PRRT announcement

The original proposal announced in May 2010, would have seen the replacement of the PRRT with the RSPT, which would have applied to all resource projects, including petroleum projects.

The 2 May 2010 announcement dealt not only with MRRT, but also with changes to the PRRT regime.

Given that the PRRT regime was already in existence, the content of the announcement was fairly limited. It was simply stated that:

- the PRRT regime ... will be extended to cover all oil, gas and coal seam methane projects, onshore and offshore. The PRRT will apply at a rate of 40%;
- companies may elect to use market value as the starting base for project assets, including oil and gas rights;
- all State and Federal resource taxes will be creditable against the current and future PRRT liabilities from the project;
- the standard features of the current PRRT will otherwise apply, including the range of uplift allowances for unutilised losses and capital write offs; immediate deductibility of expenditure and limited transfer of the tax value of losses.

4.1.2 PTG consultation

While the PRRT is already in existence and well understood by those in the petroleum industry, there are a number of novel issues which arise when extending the PRRT into onshore projects, particularly where those projects involve coal seam methane. Some of the key issues identified for consideration as part of the PTG's consultation process were:

- the definition of a project;
- confirming that the current definition of a taxing point (based on the definition of marketable petroleum commodity in the PRRTA Act) was suitable for the new range of projects coming on stream;
- the valuation of resource at the taxing point;
- identification of any particular types of income or expenditure which might be incurred by projects transitioning into the extended PRRT which are not adequately contemplated by existing provisions;

⁷ There are no other projects which had commenced prior to 1985.

- recognition of existing investments by providing a starting base;
- the treatment of State licensing and royalty payments.

4.1.3 Is the current definition of project adequate?

Given that the PRRTA Act currently operates on the basis of the issue of a production licence under the Offshore Petroleum Act, changes were clearly going to be required to the PRRTA Act to deal with tenure onshore, where production rights will be granted by the States and not by Commonwealth legislation. As might be expected the PTG recommended that amendments be made to cover production licences granted under the relevant State and Territory law.

Section 20 of the PRRTA Act makes provision for the combination of a number of separate projects, identified by separate production licences, into a single PRRT project. The existing criteria may be inadequate, when dealing with onshore projects, particularly those involving coal seam gas which draw the hydrocarbons from a large number of tenements and wells over a broad geographic area.

The existing criteria in section 20 of the PRRTA Act may limit the ability to combine onshore projects because the section may:

- take into account whether there is geological connection between resources in the different production licence areas;
- place insufficient emphasis on the fact that particular production rights are managed as an integrated operation due to the use of the same downstream infrastructure; or
- not place sufficient weight on any integration which occurs in extraction and processing operations and other activities that occur prior to the taxing point.

For this reason Recommendation 69 of the PTG report suggests that the criteria that the Minister can have regard to should be expanded to include:

- the aggregated interests in separate production rights that exhibit a degree of integration in extraction and processing operations, and other activities that occur prior to the taxing point;
- the aggregated interest in separate production rights that are managed as an integrated operation because the same downstream infrastructure is used or operated in an integrated manner in respect of the production from the production rights.

A specific recommendation has also been made that legislation should specifically state that all of the licence areas associated with the North West Shelf project should be considered as one project.

4.1.4 Excluded operations

The PTG has recommended that the PRRT should apply from 1 July 2012 to all Australian onshore and offshore oil and gas extraction projects, including coal seam methane and oil shell projects (Recommendation 72). It should not apply to:

- projects within the joint petroleum development area in the Timor Sea;
- coal mining operations involving the extraction of coal or gas derived from the underground combustion of coal;
- the extraction of coal mine methane where it is a necessary and integral part of a coal mining operation.

4.1.5 The taxing point

The PTG has concluded that the existing PRRT provisions which determine the point at which petroleum or products produced from petroleum become taxable (the taxing point) are sufficient to accommodate all types of petroleum projects and should be retained.

4.1.6 Valuation of the resource

The existing provisions of the PRRTA Act operate on the basis that:

- where petroleum is sold at the taxing point under an arm's length transaction, the amount brought to account is the sales consideration;
- where petroleum is not sold at the taxing point, the amount brought to account is either:
 - where the petroleum meets the definition of 'sales gas' in the PRRTA Act and certain other conditions are satisfied – an amount determined in accordance with the Petroleum Resource Rent Tax Assessment Regulations 2005; or
 - otherwise - the market value of the resource;
- where there is a sale of the petroleum at the taxing point and the Commissioner is satisfied that the transaction is not an arm's length transaction, the amount to be brought to account is the amount which could reasonably have been expected to have been the amount of the receipts for the sale if the transaction had been an arm's length transaction.

The Petroleum Resource Rent Tax Assessment Regulations 2005 apply where petroleum is not sold at the taxing point or is sold under a non arm's length transaction, provided the following conditions are satisfied:

- the petroleum at the taxing point meets the 'sales gas' definition;
- the sales gas is project sales gas of an integrated gas to liquid operation (including LNG operations); and
- the taxpayer is a participant in that gas to liquids operation.

Where the regulations apply, it allows a taxpayer to select to use either an advance pricing arrangement, a comparable uncontrolled price, or the Residual Pricing Method (*RPM*) set out in the regulations.

The regulations are designed to provide certainty to taxpayers who are dealing with an integrated gas to liquids operation, about the value of the hydrocarbons on which they are going to pay PRRT.

One of the concerns in extending the PRRT, particularly to coal seam gas projects, was whether or not the regulations would operate effectively to allow the use of the RPM method for LNG plants which process coal seam gas. It appears from the PTG's recommendations that they have concluded that they will.

The PTG has recommended that existing integrated gas to liquid projects such as LNG in existence at 1 May 2010 which are to transition into PRRT (for example the North West Shelf) should have access to a simplified RPM as a default methodology. It seems that this will be simpler than the current regulations as it will have a single agreed phase point and capital base.

At the same time, the existing RPM provisions are to be amended to provide for integrated gas to electricity projects, and onshore integrated gas to liquids projects (such as LNG) are to have the option of using the existing RPM as a default methodology.

Provision is also to be made for valuations which are currently undertaken under State or Commonwealth royalty rules to be used in certain circumstances (Recommendation 74).

4.1.7 Deductible expenditure

Onshore projects and coal seam gas projects bring with them some types of expenditure which are not common in offshore projects. Specifically:

- payments under the Native Title Act or similar Acts in settlement of indigenous land use agreements;
- costs of water treatment processes and associated facilities integrated to the production of coal seam methane.

The PTG has recommended that each of these types of expenditure should be deductible. Private override royalties are to remain non deductible.

Although not within the PTG's terms of reference, a number of recommendations have been made by the PTG about the existing rules governing deductible expenditure. Specifically:

- the PTG has recommended that the existing test for deductibility be amended to one of expenditure 'necessarily incurred in carrying on activities in relation to petroleum project'; and
- that the definition of exploration under the PRRT Act should be aligned with that in the Income Tax Act.

4.1.8 The starting base

Given that significant investments have already been made in projects without PRRT applying to them, each of those existing projects is to be provided with a starting base for the interest held in a project or other petroleum tenement in existence at 1 May 2010. A starting base is to be given to all tenements held at 1 May 2010 which entitle participants to produce petroleum.

Where the tenements are not producing at 1 July 2012, it is recommended that the starting base first be deductible at the commencement of the production from the tenement.

The approach taken in relation to the starting base from the PRRT context differs from that in the MRRT context.

There are three different methods of calculating the starting base. They are:

- a starting base based on the market value of petroleum assets upstream of the taxing point at 1 May 2010 (the **Market Value Starting Base**);
- a book value starting base based on the accounting book value of existing project assets (excluding the value of the resource) as at the most recent audited accounts available on 1 May 2010 (the **Book Value Starting Base**); or
- a look back starting base - essentially a starting base calculated as if the PRRT Act had applied to the project from its inception, testing all expenditure under the normal rules for deductible expenditure and uplifting undeducted expenditure in accordance with the various rates of augmentation in the PRRTA Act.

The starting base will be immediately deductible on 30 June 2012 (assuming the project is producing), or in the case of non producing tenements will be deductible at the commencement of production from the tenement. This entitlement to immediate deductibility of the entire starting base applies to all methods. The amount claimed then forms part of the pool of expenditure carried forward and augmented in accordance with the normal principles in the PRRTA Act.

4.1.9 The Market Value Starting Base

The PTG makes a number of observations about the principles which should be taken into account in determining the amount of the Market Value Starting Base. It also recommends that:

- the starting base should include all tangible assets including improvements to land and mining rights (as defined by income tax - that is mining, quarrying and prospecting) as well as relevant intangible assets such as petroleum information;
- the starting base should be calculated as if it were unencumbered by any private override royalty which existed in relation to the project or tenement at 2 May 2010;
- the starting base should not be reduced to reflect any depletion in the resource between 2 May 2010 and 30 June 2012;
- the starting base is to be reduced if any of the starting base assets are disposed of between 2 May 2010 and 30 June 2012.
- capital expenditure incurred between 2 May 2010 and 30 June 2012 should be added to the starting base.

4.1.10 Transfer of losses

The existing PRRT regime does not provide for the general transfer of losses from one project to another. Rather it provides for limited entitlements to transfer exploration expenditure between one project or potential project and another subject to the satisfaction of certain common interest rules.

These limitations are to remain.

Deductions available for the starting base will form part of the pool of general project expenditure, being immediately deductible, non transferable and non refundable.

An exception will be made in the case of the exploration expenditure component of the look back starting base which will be treated in accordance with existing provisions relating to exploration expenditure. (Recommendation 88).

4.1.11 Transfers of an interest in a project

The PRRT regime operates like the proposed MRRT regime, on the basis that upon transfer of a taxpayer's entire interest, or a proportionate share of their interest in a project, the transferee steps into the shoes of the transferor and assumes the transferor's PRRT position for the interest transferred.

At this stage, it is not clear who is going to make elections where there has been a transfer between 1 May 2010 and 30 June 2012.

4.1.12 Credits for Government resource taxes

Government resource taxes will be creditable against PRRT liabilities.

5 THE FUEL TAX CREDIT REGIME

Australia's fuel taxation system has evolved as a result of the policy objectives of successive Federal Governments. Tax on fuel in Australia was first introduced in the early 1900s as customs and excise duties on transport fuels, such as petrol and diesel, to fund the development and maintenance of Australia's road network. Exemptions and later rebates were provided for fuel tax for off road users of diesel and concessional rates of excise allowed where fuel is used other than as transport fuel.

Over time the principle rationale for these taxes changed and fuel taxes became a general source of Government revenue. Concessions have remained for legitimate users of petroleum products for uses other than transport fuel.

The current arrangements for the taxation of fuel impose:

- excise on certain domestically manufactured fuels; and
- excise equivalent customs duty on relevant imported fuels.

Fuels subject to fuel tax include petrol, diesel, fuel oil, kerosene, benzene, toluene, xylene, biodiesel and fuel ethanol (Ethanol). The legal incidence of the fuel tax falls primarily on the producer or importer of the fuel.

The excise on biodiesel and Ethanol is offset by grants under the Energy Grants (Cleaner Fuel) Scheme and Ethanol Production Grants Program.

Fuel tax credits partially or fully off set the fuel tax incurred by eligible businesses.

Fuel tax credits provide a credit for the fuel tax (excise or excise equivalent customs duty) included in the price of fuel used for business activities in machinery, plant, equipment and heavy vehicles. Fuel used in light vehicles of 4.5 tonne gross vehicle mass (GVM) or less travelling on public roads are not eligible for fuel tax credits.

Methanol and gaseous fuels including liquefied petroleum gas (LPG), liquefied natural gas (LNG) and compressed natural gas (CNG) were outside the fuel tax system and thus excise free.

The key changes which are being implemented are to:

- bring LPG, LNG, CNG and methanol into the taxation regime for fuel;
- impose rates of excise and excise equivalent customs duty based on the energy content of the particular fuel;
- provide incentives to use alternative fuels - LNG, LPG, CNG, methanol, biodiesel and Ethanol through the provision of discounted rates of tax and/or grants.

These incentives are provided to reflect the potential environmental, energy, security and regional development benefits of these fuels.

The mechanisms used to provide the incentives are complex. In the case of Ethanol, the main incentive is provided by providing grants to methanol manufacturers. Those grants will apply from 1 December 2011, but will reduce over time so that they phase out on 30 July 2020. A reduced rate of tax on Ethanol will phase in over the next five years, so that by 1 July 2015 tax has reduced to 50% of the energy equivalent tax.

In the case of LNG, LPG, CNG, methane and biodiesel, the incentives are provided by phasing in over the period from 1 July 2011 to 30 June 2015 a reduced 50% rate of tax on the energy equivalent rate of tax (i.e 10% in year one, 20% in year two etc).

6 HENRY REVIEW - ENVIRONMENTAL TAX RECOMMENDATIONS

A number of recommendations were made by the Henry Review about environmental taxes, which were based on and assumed the introduction of a Carbon Pollution Reduction Scheme (CPRS).

Specifically, it was recommended that:

- once CPRS is introduced other measures which seek to reduce emissions should be phased out;

- industry assistance arrangements introduced as part of CPRS should be transitional;
- there should be an independent review of CPRS including emissions intensive trade exposed assistance every five years;
- the Government monitor tax concessions aimed at supporting environmental outcomes and consider replacing them with targeted spending programs.

Additionally, there are a number of recommendations made about road transport taxes. These recommendations are not based on environmental considerations but rather by the concept of 'user pays'. They include:

- a recommendation that the Government analyse the benefits of introducing variable congestion pricing on existing toll roads and extending it across heavily congested parts of the road network;
- the Council of Australian Governments should accelerate the development of the mass - distance - location pricing for heavy vehicles to ensure that heavy vehicles pay for their specific marginal road wear costs;
- where road freight is in direct competition with rail which is required to recover its capital costs, heavy vehicles should face an additional charge where this improves the efficient allocation of freight between transport modes.

At this stage, none of these recommendations have been taken any further. There has been an obvious move within Government towards a carbon tax at least in the short term pending the introduction of a CPRS at a later date.

No doubt there will further consideration of some of these measures at the tax summit which the Government is intending to run later this year.

Grant Cathro
23 February 2011