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The Henry Tax Review

The resource super profits tax's impact on the Energy & Resources sector

The Federal Government announced on Sunday 2 May 2010 the proposed introduction of the Resource Super Profits Tax (RSPT). The RSPT is proposed to apply from 1 July 2012 and be set at 40% on the profits made from the exploitation of Australia's non-renewable resources.

This article will outline the proposed regime including the calculation of the RSPT, the Resource Exploration Rebate (RER) and the introduction of a State Infrastructure Fund. We will also discuss the impact that the proposals may have on the mining industry as well as on M&A activity.

The RSPT has been met with much criticism and it is our view that the RSPT is unlikely to be introduced in its present form. The Government has indicated that it will undertake consultation on the detailed design of the RSPT with the end result likely being that a compromise will be reached in the form of a lower rate or more concessional calculation mechanism. It is also entirely possible that the proposal will be shelved or blocked in Parliament.

Executive summary

The proposals

- The RSPT is a separate tax on profits of a company from Australian resource projects and will be levied at 40%. It is deductible in calculating the company's income tax liability. However, it does not generate franking credits as it is not an income tax.
- The corporate income tax rate will be decreased to 29% for the 2014 income year and to 28% for the 2015 income year.
- A refundable credit will be provided for State royalties at current rates.
- Due to a significantly reduced rate of return on the uplift of carried forward deductions and a less favourable deduction mechanism for capital expenditure, the RSPT will be payable in respect of eligible projects earlier than is the case for petroleum projects under the current Petroleum Resource Rent Tax (PRRT) regime. This means the RSPT will generate relatively more tax than the PRRT on similar projects. Petroleum producers will have a one-time irrevocable right to elect to switch from the PRRT to the RSPT but it is not clear at this point why a petroleum producer would make that election.
- The RER will provide a refundable tax offset for exploration expenditure undertaken from 1 July 2011.
- Potential impact on Australian mining industry
- The RER provides real cash to fund additional exploration. This is a real incentive for companies in the exploration stage.
- The implementation of the State Infrastructure Fund will potentially provide for increased infrastructure in general (including the resource industry).
- However, for resource companies that would pay the RSPT, there will prima facie be reduced financial returns for resource companies and their shareholders due to a higher effective tax rate - this will ultimately depend on whether such a tax increase can be passed onto customers by higher pricing. Members of the mining industry have stated that the RSPT would make Australian mining projects the highest taxed in the world.

Our initial research supports this (excluding certain petroleum tax regimes). For resource companies in the exploration stage, the potential high effective tax rate may be less important. However, marginal projects may no longer be feasible.

- An increase in the perceived "political risk" (a key factor for investors) with respect to the resource industry combined with the financial impact of the RSPT may significantly reduce Australia's ability to compete both internationally and domestically for investment of funds into the development of Australia's natural resources.
- Uncertainty in the market may cause current investors to divest their holdings in Australian projects. This may lead to (at least initially) a drop in the share prices of companies investing in Australian resources - prices will also be impacted by changes in commodity prices. This may however generate M&A activity due to the lower prices and also present an opportunity for investors who are primarily interested in securing supply (rather than making profits) or controlling the rate at which new supply comes to market.
- Australian miners may defer, abandon or even sell planned projects until the uncertainty is resolved. Rates of return variances may cause some entities to allocate development capital to other jurisdictions.

Outline of Federal Government proposals

The RSPT

Outline of calculation

In calculating a company's liability under the proposed RSPT, assessable receipts will be reduced by deductible expenditure, carry forward losses and undepreciated capital allowances to determine the project's profit subject to the RSPT. Qualifying expenditure and capital losses may be carried forward and deducted with an uplift at the government bond rate. Note, financing costs are excluded from the calculation.

Where a project is not profitable, carry forward losses and qualifying expenditure incurred within the year can be transferred from the loss-making project to other profitable projects within the entity or group. Where there are no other profitable projects, the loss would be carried forward (and may be refundable on a "reasonable" basis).

In calculating its taxable income, the company may then claim a deduction for the amount of the RSPT paid. For mature miners, the effective tax rate is estimated to be about 57% (up from about 42%).

Further, as the RSPT is not a "corporate income tax" as such, no franking credits will arise on payment of the RSPT.

State royalties - effectively eliminated?

The Federal Government has announced that it will provide a "refundable credit" for state royalties paid which will be available at least up to the amount of royalties imposed at the time of the announcement [ie. 2 May 2010]. Further, the State of Western Australia has already indicated that it intends to increase the rate at which royalties are paid, and that increase would not appear to be covered by the Federal Government proposal. It will be interesting to see how the Federal Government deals with this.

Comparison with existing PRRT

Australia has an existing PRRT for offshore petroleum projects.

Depending on the mix of exploration and production expenditure for a project, the PRRT is only paid where the project rate of return is effectively (currently) somewhere between 10.6% and 20.6%. The threshold is significantly lower under the proposed RSPT regime (which only "uplifts" expenditure by the bond rate) which means that the RSPT would be payable by projects earlier and at a lower rate of return than projects subject to the PRRT.

The RER

The proposed RER will provide a refundable tax offset to corporate entities (set at the prevailing company tax rate) for exploration expenditure carried out in Australia on or after 1 July 2011. Companies in losses will receive a cash refund.

Companies in losses which receive a refund under the RER regime will not earn franking credits immediately upon becoming taxable. Instead, the amounts previously refunded reduce the company's franking credits. In these circumstances, once the company is profitable, it will not immediately have franking credits. In this case, dividends will be unfranked, and for foreign shareholders, subject to withholding tax of 15% - 30% (depending on whether a double tax agreement applies).

State Infrastructure Fund

As part of the mining proposals, the Federal Government has announced it will use a third of the proceeds from the RSPT to support States in providing infrastructure. Note, there is no apparent undertaking that the funds will be wholly used in providing infrastructure for the resources industry but rather, in assisting States in building infrastructure that is "vital for all Australian industries" including the resource industry.

Company tax rate

As part of the announcements on Sunday 2 May 2010, the Federal Government also announced that part of the proceeds from the RSPT would go to fund a reduction in the company tax rate to 28%. The company tax rate is proposed to be reduced to 29% from the 2014 income year and to 28% from the 2015 income year.

What does this mean for the Australian mining industry?

Drivers of mining investment

Investment in the resource sector is mainly driven by:

- expected financial returns (including the effective tax rate);
- political risk; and
- access to a skilled labour force.

Introducing the RSPT puts at risk two of the three drivers for investment. This is discussed below.

Financial impact of the RSPT

The proposed RSPT imposes an effective tax rate of 57% on profits from Australian resources. Members of the mining industry have stated this is the highest effective tax rate on mining in the world. Our initial research supports this (excluding petroleum taxes). Not only does this affect the bottom line of resource companies, but it reduces Australia's ability to compete internationally for the investment of funds into Australian natural resources.

Further, the fact that no franking credits are generated by the RSPT means that shareholders are effectively taxed twice when they receive distributions of dividends. A further issue for international investors will be whether a tax credit for the underlying RSPT will be available in their home jurisdiction.

Mining companies generally reinvest profits in development/exploration and pay relatively low dividends. The RSPT is likely to result in relatively less money being invested into mining as after tax profits will be lower.

Political risk

Australia has traditionally been seen as a politically stable country in which to invest in resources. However, the proposed introduction of the RSPT is likely to increase the perceived level of potential risk for investors.

Some States are likely to take the view that for the Federal Government to seek to tax the exploitation of resources that are owned by the States rather than the Commonwealth is a significant constitutional shift. We query whether the RSPT will be subject to a constitutional challenge.

Impact on M&A activity

The RSPT will provide opportunities.

Resource companies with (predominantly) Australian projects may drop in value. Australian companies which invest mainly in offshore natural resources can be expected to become relatively more attractive as they will not be affected by the RSPT. These potential impacts on valuation will influence M&A.

However, if share prices decrease to reflect the potential impact of the proposed RSPT and certain investors are eager to dispose of their Australian investments, M&A activity may increase.

Further, we note some investors base their investment decision primarily on securing supply or other imperatives rather than the need to derive profits or accumulate capital. Such investors may take advantage of lower valuations to make acquisitions.

The scrip/cash composition of public bids may also be impacted by the proposed RSPT. Australian share investors have generally preferred cash consideration on takeovers. However, recently there has been a growing perception that many investors would prefer to take scrip, and not cash, in mining deals to retain their exposure to the growth prospects for commodity pricing. The introduction of the RSPT may in some cases reduce the attractiveness of retaining scrip in the merged entity where the entity will predominantly hold Australian projects. Alternatively, in circumstances where the acquirer has significant foreign assets, target company shareholders may prefer scrip to reduce their relative exposure to the RSPT (and also take advantage of CGT rollover relief).

A further issue for public company takeovers/schemes is whether the proposed RSPT will trigger Material Adverse Change conditions in current offers. This is a question that would only be able to be judged based on review of the relevant condition.

Concluding comments

With the unstable state of the world economy combined with the mining industry and Federal Opposition campaigning against the proposed regime, it is our view that the mining proposals are unlikely to be passed into law in their present form.

Based on our comments above, the risks to future investment and employment will likely outweigh the benefits of the proposed regime. Accordingly, in our view, it is likely that a compromise will be reached after a lengthy public consultation with the rate being reduced to a more acceptable level or a more concessional calculation mechanism being introduced. It is also entirely possible that the RSPT could be shelved entirely or blocked in Parliament.

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