CLAYTON UTZ

MRRT: The Policy Transition Group's new issue paper

Overview

On 6 July 2010, we published an article summarising the proposed Minerals Resource Rent Tax (MRRT) which was announced by the Australian Government on 2 July 2010, and referred to consultations to be carried out by the Policy Transition Group (PTG).

The PTG was formed to advise the Australian Government on the:

- development and design of the MRRT; and
- transition of existing petroleum projects to the Petroleum Resource Rent Tax (PRRT) regime.

The PTG published an issues paper (Issues Paper) on 1 October 2010 which (at 133 pages) covers a wide range of issues, grouped around three broad topics:

- the design of the MRRT;
- transition of existing petroleum projects to the PRRT regime; and
- policies to promote exploration expenditure.

The Issues Paper is designed as a platform for:

- informing stakeholders of the PTG's view on certain issues; and
- consultation with stakeholders, with submissions being sought by 28 October 2010.

The PTG has also released some spreadsheets to assist in modelling the impact of the MRRT and PRRT and these are available at http://www.futuretax.gov.au/pages/resourcetax_PTG_conslt.aspx.

The PTG announced that a number of consultation meetings have been scheduled around Australia during October and November. These consultation meetings are focused on impacted resource companies and the relevant associations. As at time of this publication, the venues for those meetings have not been announced but the proposed dates for those meetings are:

- 7 October 2010, Perth, focused on iron ore;
- 8 October 2010, Perth, focused on oil and gas;
- 14 October 2010, Brisbane, focused on coal;
- 15 October 2010, Brisbane, focused on oil and gas;
- 29 October 2010, Melbourne, focused on coal and vertically integrated electricity generators;
- 3 November 2010, Sydney, focused on coal seam gas;
- 4 November 2010, Sydney, focused on iron ore and coal;
- 5 November 2010, Adelaide, focused on iron ore and coal; and
- 19 November 2010, Melbourne, focused on exploration incentives.

The email address to contact the PTG for more information is ptg@ret.gov.au.

Summary

The Issues Paper is comprehensive and identifies a number of issues that the PTG needs to address and for which comments can be submitted. The Issues Paper does clarify certain issues such as identifying the proposed taxing point and the treatment of royalty payments.

The following table is based on table 1.1 of the Issues Paper, which compares some of the key features of the MRRT and PRRT.

Feature	MRRT	PRRT (for new entities/projects to be covered under this regime)
Commencement Date	1 July 2012	1 July 2012
Application	Iron and coal projects with "MRRT profits" that exceed $50m	All onshore and offshore oil, gas, coal seam methane projects including projects within the "North West Shelf"
Basis of tax	Project-based tax	Project-based tax
Tax rate	30% (effective rate 22.5%)	40%
Extraction allowance	25% reduction in MRRT liability. This will reduce the effective tax rate to 22.5%	None
Taxing point	Mine Gate which is likely to be defined as the point after the crushing and screening of the ore	Production of a marketable petroleum commodity
Profit or loss calculation	Assessable receipts less deductible expenditure less uplifted carry forward losses	Assessable receipts less deductible expenditure less uplifted undeducted expenditure
Deductible expenditure	Non-deductible expenditure will be broadly consistent with PRRT Note certain expenditure such as financing costs, costs to acquire an interest in a project, and administration costs are likely not to be deductible	Expenditure directly related to the project that falls within the definition of exploration, general or closing down expenditure. Some expenditures are specifically excluded from deductibility and these include borrowing costs, costs to acquire an interest in a project, administration costs
Treatment of expenditure	Immediately expensed against revenue	Immediately expensed against revenue
Transferability of losses	Transferable to other MRRT projects	Transferability is restricted to exploration expenditure
Treatment of losses	Uplifted and carried forward to offset future revenue. Market value starting base not uplifted	Undeducted expenditure uplifted and carried forward to offset future revenue
Uplift rates	A single uplift rate - LTBR plus 7%	Multiple uplift rates differentiated by the class and timing of expenditure
Treatment on sale of project interest	Losses and cost bases are transferred to new owner	Losses and cost bases are transferred to new owner
Treatment for income tax	Deductible	Deductible
Treatment of state royalties	Creditable against MRRT liability, excess will be uplifted to apply against future liabilities – Non-refundable	Creditable against PRRT liability, excess will be uplifted to apply against future liabilities – Non-refundable

Feature	MRRT	PRRT (for new entities/projects to be covered under this regime)
Starting base/treatment of pre 1 May 2010 expenditure	1 May 2010 starting base - book value excluding value of mining rights or market value including value of mining rights If book value is elected then the starting base is depreciated over an accelerated period of 5 years with an uplift of LTBR plus 7% If market value elected starting base is depreciated over the effective life but to a period of time not exceeding 25 years with no uplift	1 May 2010 starting base for entities now caught within the PRRT- book value excluding value of oil and gas rights or market value including value of oil and gas rights Deductibility to be confirmed
Expenditure incurred between 2 May 2010 and 1 July 2012	Eligible expenditure added to starting base	To be confirmed

Key issues

The following issues are still to be resolved or further considered:

- constitutionality of the amendments;
- whether iron ore and coal should be defined, and the treatment of by products and alternative coal technologies. For example, should magnetite be included in the definition of iron ore?
- defining project boundaries and project commencement and end dates;
- the taxing point – the preferred PTG view for MRRT is after the "crushing and screening" process;
- determining taxable value at taxing point. The PTG suggest that valuation should be done on similar basis to those contained in the transfer pricing provisions, but are these provisions appropriate for determining value at the taxing point? Also, what records need to be kept to support a taxable value calculation?
- ordering rules for the transfer of losses between projects;
- whether royalty credits should be transferrable between projects;
- starting base – what assets are to be included and the valuation of those assets;
- determining "MRRT" profit for the purposes of the $50m threshold;
- determining whether the MRRT should only be paid on profits that exceed $50m;
- whether, for PRRT purposes, gas or oil obtained from coal or oil shale is "petroleum";
- how products obtained via alternative coal technologies should be taxed and under which regime (MRRT or PRRT); and
- new incentives to encourage continued exploration activities.

It appears that interest and other financing costs will not be deductible, nor will indirect expenses. As we have seen with the PRRT regime, careful consideration will need to be given to how to categorise expenditure as direct as opposed to indirect expenditure.

Client actions

A range of companies will be affected by the introduction of the MRRT and extension of the PRRT regime, as well as the proposed changes to the treatment of exploration expenditure. If the issues raised in this paper concern you, we would recommend that you:

- consider attending the PTG consultation meetings;
- consider making submissions to the PTG on issues of particular concern. Clayton Utz is able to assist in the drafting of any submissions;
- consider whether new supply contracts need a pass on clause for the MRRT or PRRT; and
- implement plans and systems to assist in the transition to the MRRT and PRRT regimes.

Design of MRRT

The Issues Paper requests submissions in relation to the fundamental design of the MRRT, including:

How should the resources within the MRRT be defined?

The PTG has raised the question of whether iron ore and coal should be defined terms in the legislation, or whether the ordinary meaning should be relied on. There are several ways in which the terms can be legislatively defined: by reference to the scientific subcategories of the materials (eg. anthracite coal versus lignite coal; detrital iron deposits versus channel iron deposits). As with relying on the ordinary meaning of iron ore and coal, a definition by reference to subcategories can give rise to ambiguities and differing views as to the scope of commodities covered.

Alternatively, the materials can be defined by reference to general characteristics (eg. "iron ore is material from which iron can be extracted"). However, this may include resources which are not intended to be covered by the MRRT.

The final alternative suggested is an approach modelled on the PRRT, in which there is a general definition of iron ore and coal along with a list of specific products which constitute iron ore and coal. However, the example used in the Issues Paper refers to a "saleable commodity", which conflates two separate concepts used in the existing PRRT, being 1) whether a commodity falls within the taxing regime, and 2) whether the mineral arrives at the taxing point. Furthermore, it raises the question of whether saleability forms an additional requirement that has to be met before an commodity is subject to the MRRT. We would strongly resist any need to establish saleability as this would add evidentiary complexity.

As the Issues Paper recognises, further difficulties arise where a project produces iron ore, coal, petroleum and/or commodities outside the PRRT and MRRT net. Where, for example, methane is produced as a by product of a coal mine, should that be taxed under the PRRT, under the MRRT, or neither? Where a bauxite mine produces relatively small proportions of iron ore, should that fall within the MRRT? These questions also go to the question of what is within the project (which is further discussed below).

Similarly, another contentious issue is how alternative coal technologies (eg coal seam methane, underground coal gasification and coal to liquids) should be taxed, especially where there is a transformation of coal to gas? As is noted below, gas produced using such processes may not constitute "petroleum" as it is currently defined for the purposes of the PRRT.

How should the project boundaries be delineated?

The MRRT is a project-based tax, in which deductible expenditure and assessable receipts are determined by the boundaries of the project. Accordingly, it is fundamental to establish an understanding of what constitutes a single project.

The existing PRRT defines a project by reference to production licences and combination licences granted under the Offshore Petroleum and Greenhouse Gas Storage Act 2006 (previously under the Petroleum (Submerged Lands) Act 1967) as the existing PRRT relates to offshore waters entirely under the remit of the Commonwealth Government. As the MRRT relates to onshore projects (over which the States and Territories have jurisdiction), the relevant licences are issued on a State/Territory basis, and the question is whether the MRRT should operate by reference to these State and Territory based production licences and whether these licences should be consolidatable by the Commonwealth in particular instances. Another alternative suggested by the PTG is to define projects by reference to environmental approvals and applications.

The PTG's favoured approach is to rely on State and Territory production licences, which would also have the advantage of being consistent with the imposition of state royalties. However, this will give rise to the potential for inconsistency as between different States and Territories as to what constitutes a project.

A project has to be defined not just geographically, but chronologically. Accordingly, the PTG has also considered how to determine when a project has commenced, and when it ceases. This has especial importance because the uplift of expenditure potentially creates an incentive to commence a project early and to end a project late (so long as the closing down expenditure is transferrable).

How should the taxable value be determined?

The primary concern for industry will be the concepts surrounding taxable value, including taxing point, assessable receipts, deductible expenditure and transferable losses. This is reflected in the Issues Paper.

Taxing Point

The three taxing points proposed by the PTG are: at the point of extraction; at a stage in processing; and at the point when the resources are loaded onto long haul transport. The PTG refers to a taxing point at the point of extraction being "earlier in the production process than in implied by the terms of reference", without necessarily stating that it is an inappropriate taxing point. The expressed intent of the MRRT is to tax the value of the resource (which would imply an earlier taxing point) – however, the provision of an extraction allowance implies that the Government recognises that the taxing point may be downstream of the point of extraction, and therefore there is a need to allow for some of the value add provided by miners at early stages of processing.

The PTG's preferred taxing point appears to be at an early stage in processing, and the Issues Paper proposes a taxing point after some initial processing (eg. crushing and screening) has taken place but prior to blending and upgrading of the minerals. The advantage of an early taxing point (being that the market value of the commodity is lower) is potentially offset by the deductible expenditure which is denied as a result of the project finishing earlier in the production process. However, a netback method of determining market value where a commodity is not sold at the taxing point may adequately take account of expenditure subsequent to that point.

Another way of taxing at a stage in processing would be to identify separate taxing points for separate commodities, as per the PRRT system where (for example) sales gas, LPG, and condensate are defined by reference to properties which exist at different points in the project. This can give rise to issues in relation to expenditure which is upstream in respect of some commodities and downstream in respect of others. This approach does not appear to be favoured by the PTG.

The third alternative raised by the PTG suggests that the taxing point be when resources are loaded onto long haul transport. This is obviously the least preferable option, as it gives rise to different taxing points for different projects (and potentially for different resources in the same project) as well as the opportunity to manipulate the project to either bring more processes within the project or to take processes out of the project. Further, it fails to address integrated projects where no long-haul takes place prior to further processing of the commodities.

Taxable Value

It is obvious that where the taxing point occurs on sale (for example, where a commodity is sold to a third party prior any other taxing point occurring), the sale price will be the taxable value. However, where iron ore and coal move past the taxing point without being sold to a third party, the question arises of how the taxable value is to be determined. It is apparent that the earlier the taxing point, the more likely that the sale price will not represent taxable value, and other methodologies come into play which require speculative calculations as to what is "market value".

There are various methods that can be used to calculate arm's length value, and the Issues Paper considers whether it is preferable for the legislation to enforce one particular methodology, to allow a range of methods, or to provide for a default method which can then be replaced by another methodology on election by the taxpayer.

The Issues Paper suggests that transfer pricing case law may provide useful guidance on market value calculation methodologies. However, we note that the SNF (Australia) Pty Ltd v Commissioner of Taxation [2010] FCA 635 (SNF), a Federal Court case on appropriate market value methodologies in the transfer pricing context, has recently been appealed by the Commissioner of Taxation to the Full Federal Court and clearly there is no settled position on what valuation methodologies are appropriate for transfer pricing cases.

In any case, valuation methods which work for transfer pricing may be inappropriate for taxing point, and vice versa. For example, the comparable uncontrolled price method of valuation is regarded as a traditional calculation method for transfer pricing purposes (see Middleton J's comments in SNF), whereas it is regarded in the Issues Paper as "generally inappropriate for determining the value of upstream activities within a rent tax" (paragraph 125). This distinction is due to transfer pricing being, at its heart, an integrity measure, whereas the determination of a taxing point for the MRRT needs to have regard to the costs and profit margins of the particular project which is being taxed.

Assessable receipts and deductible expenditure

The Issues Paper also deals with other types of revenue which may be derived in the course of a project, and whether these should be assessable receipts. In respect of deductible expenditure, the intention appears to be to align the MRRT with the PRRT, under which indirect expenses and administrative costs are not deductible. For example, head office costs and interest costs are not deductible, and hedging costs are not deductible unless hedging occurs in respect of a specific sale of a commodity.

We foresee that there will be difficulties surrounding the concept of "indirect" expenses and administrative costs, especially where certain activities may be carried out for a taxpayer by construction contractors or service companies.

Transfer of losses

The Issues Paper also considers the question of what expenditure can be transferrable to other taxpayers, whether this occurs mandatorily or at the election of the taxpayer, and whether transfers can only be made in a wholly owned group.

How should losses be dealt with?

As loss transfer between taxpayers will be allowed, there is a need to consider ordering rules in respect of the use of losses (including royalty credits), as well as how losses will be transferred in respect of acquired projects and existing projects brought into the MRRT.

Starting base for existing projects

As the MRRT is proposed to bring existing projects into the tax regime (compared with the PRRT, which when originally introduced in 1987 only applied to greenfields projects), there is a need to recognise expenditure incurred by taxpayers pre 1 July 2012. It is proposed that assets will be brought in as part of the project, and where the assets are brought in at book value, they will receive accelerated depreciation. Alternatively, taxpayers can bring in assets at market value, but will not receive an uplift in depreciation.

The Issues Paper also suggests that where projects start after 2 May 2010 but prior to 1 July 2012, the starting base may be determined by looking at eligible project expenditure incurred during that transitional period, rather than through the application of starting base rules for existing projects. That is, there may be three regimes: one for existing projects which start on or before 2 May 2010 (which will have a starting base value calculated up to 2 May 2010); one for transitional projects which start after 2 May 2010 but before 1 July 2012; and one for new projects which start on or after 1 July 2010.

We note that it is not clear yet what is the intended tax treatment in relation to project expenditure between 2 May 2010 and 1 July 2012.

The main issues which arise in this context are as follows.

Which assets are included in the starting base?

There is a potential that intangible assets other than mining rights will not be included in the starting base. Although the Issues Paper refers to this position being consistent with the existence of the 25 percent extraction allowance, this viewpoint is flawed as the extraction allowance is available not only to existing projects which enter the MRRT, but also to new projects which start in the MRRT (and which would presumably develop intangible assets within the project).

Our view is that the extraction allowance recognises the value added by miners during the course of the project during the time that it is in the MRRT, and is not confined to expertise and value added prior to entry into the MRRT. Accordingly, intangible assets which are used in the project should be included in the starting base of the existing project, consistently with the treatment of intangible assets in new projects under the MRRT.

Valuation of starting base assets

As discussed, the valuation method used for the starting based assets will be at the election of the taxpayer. However, the Issues Paper queries whether the Government should mandate a particular market value and book value method (either in the form of legislation or through an ATO valuation process), or whether the taxpayer should be able to choose their own market value or book value method.

The taxpayer election is also to be considered in more detail, namely:

- will all joint venturers be required to make the same election in a given project;
- will a taxpayer be required to make the same election in respect of all projects that they hold; and
- will there be a default valuation method in the absence of a choice by the taxpayer?

Treatment of starting base expenditure and losses

It is likely that the starting base will not be transferrable to any other project, so as to avoid giving owners of existing projects an advantage in relation to new projects that they undertake. However, there may be limited transfer of the starting base available where assets are transferred from one project to another. Further issues which are yet to be resolved include provisions for when an existing project is transferred; when assets within a starting base are transferred out of a project; and avenues to prevent distortions in investment behaviour up to 1 July 2012.

$50 million threshold

The terms of reference contemplate that taxpayers who derive less than $50m of profits per annum from resources should not be subject to MRRT. The threshold is proposed to be tested on an annual basis, and is based on a simplified concept of profits (ie. excluding starting base depreciation and carried forward losses).

However, the threshold does not lessen compliance costs for taxpayers unless they can guarantee that they will never breach the threshold, as it is still necessary to maintain records of expenditure and assets in the event that they are thrown into the MRRT subsequently. One option is that where small miners have not maintained MRRT accounts while within the threshold, any expenditure which they incur prior to reaching the $50m threshold will not be recognised in determining the assessable profits for MRRT purposes.

The threshold test also creates incentives for projects to be split between different entities. Accordingly, the PTG proposes that the threshold be applied on an aggregated entity basis. The Issues Paper favours the small business aggregation test, which focuses on 40 percent ownership or control.

The Issues Paper also recognises that if taxpayers move directly into the MRRT without transitional provisions once they hit $50m, there is an incentive to remain just below the $50m threshold. Accordingly, one proposal is to provide a graduated introduction to the MRRT system.

Finally, there is a query as to how royalties paid by taxpayers whilst under the threshold should be treated for MRRT purposes – one proposal is for royalty credits to only be carried forward after being notionally offset against any MRRT liability that would have existed in the event that there was no $50m threshold.

Transition of PRRT

Many of the issues that arise in relation to the extension of the PRRT are similar to those that arise in relation to the MRRT, including:

- how to identify an onshore project;
- how to classify coal seam methane and unconventional gas, other forms of unconventional gas;
- whether the concept of assessable receipts and deductible expenditure needs to be expanded;
- what the starting base should be and for existing PRRT projects brought into the extended PRRT; and
- how royalties should be accounted for.

Other issues are merely an extension of existing PRRT problems; eg. the question of whether the current taxing points work.

We would suggest that the extension of the PRRT raises some serious sovereign risk concerns, especially in relation to the North West Shelf, which has been kept out of the PRRT regime until now. There may also be a question of whether it would be more appropriate to treat onshore petroleum in the same way as coal and iron ore under the MRRT, given the types of issues which are likely to arise will be similar and may bear little relation to issues encountered in offshore petroleum exploration and production.

It's also worth noting that the case law on "petroleum" as defined in the Income Tax Assessment Act 1936 (definition now in section 40-730 of Income Tax Assessment Act 1997, which is consistent with the PRRT Assessment Act 1987) is that oil obtained from coal or oil shale is not "petroleum" as petroleum has to be "naturally occurring hydrocarbons", and therefore while hydrocarbons can be derived from coal or oil shale, these are not naturally occurring and are not petroleum. How this ties in with gas derived from coal shale, or even from alternative coal technologies such as coal seam gas, will need to be considered.

Policies to promote exploration expenditure

The Issues Paper also discusses the best way to promote future exploration in order to ensure that there are future resources projects that Australians will benefit from. Exploration activities are risky and there is no guarantee of any return on such activities. Accordingly, it is important to encourage exploration activities so that new discoveries continue to be made.

Currently, there are certain Federal and State/Territory Government incentives available to encourage exploration activities including the availability of an immediate deduction for certain exploration expenditure.

However, it has been suggested that more incentives may need to be introduced in order to continue to encourage exploration activities.

In particular, concerns have been raised that for small exploration entities who play a significant role in "green-field exploration" the current incentives may not be all that beneficial to them as the incentives are likely to generate losses to be carried forward and this doesn't assist them in obtaining financing for their exploration activities.

If there is a compelling case for more incentives to be introduced, the PTG has outlined four policy options:

Exploration Refundable Tax Offset (ERTO) or resource exploration rebate

An ERTO is "refundable at the company tax rate for eligible exploration expenses." The ERTO would in effect offset an entity's income tax liability and to the extent that there are surplus credits then these credits are refundable in cash to that entity.

Further consideration is required to be given to determine whether ERTO gives rise to any constitutional issues

Exploration Tax Credit (ETC)

An ETC is similar to the ERTO but the benefits flows through to the shareholders of a company and not the company itself. So the shareholders would, to the extent that there are surplus offsets be eligible for a cash refund of such offsets.

Flow Through Shares Scheme (FTS)

The FTS has been used in Canada for a number of years and provides for a mechanism under which a shareholder in company would be entitled to claim a deduction in respect of the company's exploration expenditure that the company has renounced against the shareholder's assessable income.

Concessions similar to those available for research and development (R&D)

Certain mining-related activities are currently eligible for R&D concessions. The proposed amendments aim to change the current concessions which allow for increased rate of deduction into the form of a refundable tax offset which is based on an entity's turnover.

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