Australian Government

Policy Transition Group

POLICY TRANSITION GROUP
REPORT TO THE AUSTRALIAN GOVERNMENT

NEW RESOURCE TAXATION ARRANGEMENTS

December 2010

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Dear Treasurer,

We are pleased to present the *Policy Transition Group Report to the Australian Government – New Resource Taxation Arrangements*.

As requested under our terms of reference, this report provides recommendations for the design and implementation of the Minerals Resource Rent Tax (MRRT) and the transitional arrangements for the Petroleum Resource Rent Tax (PRRT). We have also provided a separate report, *Policy Transition Group Report to the Australian Government – Minerals and Petroleum Exploration,* on our findings and recommendations regarding policies to promote mineral and petroleum exploration in Australia.

The importance and potential of Australia's major mineral and petroleum industries are well documented and understood. We believe that our recommendations strike an effective balance between the Government's policy objective of ensuring that all Australians receive a fair return from the use of our valuable mineral and petroleum resources and providing an efficient, internationally competitive, and sustainable taxation framework that supports continued investment in these important industries. Throughout our deliberations we have sought to base our recommendations on a consistent set of principles, while being mindful of industry submissions, to achieve a balanced outcome.

We have also been mindful of the need not to impose an undue or unnecessary compliance burden on companies, particularly those small and medium sized companies that are emerging as increasingly important players in the development of new resources, such as magnetite and unconventional gas.

We believe the proposed MRRT framework will achieve these goals in a manner that is consistent with our terms of reference and the framework established by the Heads of Agreement entered into on 1 July 2010. Similarly, we believe the proposed PRRT changes will provide for a smooth transition for Australia's onshore oil and gas industries. In several instances, we have provided advice on some changes to the PRRT to improve its administration.

Throughout our deliberations we conducted extensive consultations across Australia. We acknowledge that not all those consulted support the new taxation arrangements. However, the consultations were overwhelmingly constructive, as were the written materials received through the public submission process. Our deliberations have been unambiguously enhanced by this input and we thank all those who participated for their time, effort and positive approach. We encourage industry and the Government to continue to work together in the detailed administrative design and implementation of the new taxation arrangements.

We also wish to thank the Secretariat and officers from the Treasury, the Australian Taxation Office, the Department of Resources, Energy and Tourism and Geoscience Australia who supported our work.

Yours sincerely,

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Acronyms

ATO	Australian Taxation Office
GDP	Gross domestic product
ITAA	Income Tax Assessment Act. Australia has two such Acts that together provide our income tax law: the *Income Tax Assessment Act 1936* (the ITAA 1936) and the *Income Tax Assessment Act 1997* (the ITAA 1997)
LTBR	Long term bond rate
MRRT	Minerals resource rent tax
PRRT	Petroleum resource rent tax
PTG	Policy Transition Group
RET	The Department of Resources, Energy and Tourism
RPM	Residual price methodology
MPC	Marketable petroleum commodity

Defined terms

LTBR+7 — The long term bond rate increased by seven percentage points. A similar explanation applies to LTBR+5 and LTBR+15.

Mining tenement — A prospecting licence, exploration licence, retention licence, mining lease, general purpose lease, miscellaneous licence, or any interest in the preceding.

Petroleum tenement — A petroleum exploration permit, exploration permit, petroleum exploration licence, authority to prospect, petroleum retention lease, retention lease, petroleum lease, petroleum retention licence, assessment lease, petroleum production licence, production licence, petroleum production licence, petroleum lease, or production lease, or an interest in any of the preceding.

Production right — An authority, licence, permit, lease or right under an Australian law to mine or produce a taxable resource; or a lease of an area that allows the lessee to mine or produce a taxable resource; or an interest in any of the preceding.

1 Introduction

1.1 Background

On 2 July 2010, the Government announced new taxation arrangements for the resources sector. From 1 July 2012, a new Minerals Resource Rent Tax (MRRT) will apply to coal and iron ore, and the Petroleum Resource Rent Tax (PRRT) will be extended to include all onshore and offshore oil and gas projects. A key policy objective for the Government is to ensure that Australians receive a fair return for the extraction and use of these valuable non-renewable resources.

The broad design features of the MRRT and the extension of the PRRT were outlined in the Government's press release and associated MRRT Fact Sheet of 2 July 2010. The broad design features of the MRRT were derived from the Heads of Agreement signed by the Government and representatives of BHP Billiton, Rio Tinto and Xstrata on 1 July 2010.

On 3 August 2010, the Government established the Policy Transition Group (PTG) to advise on the technical design of the new arrangements. The terms of reference and membership of the PTG are provided at Attachments A and B.

As the Heads of Agreement and terms of reference provide only a broad outline of the intended design of the MRRT and PRRT transition, the PTG was asked to consult widely with particular attention to those elements that require interpretation or development of new policy. The PTG was asked to report back to the Government by the end of 2010. While this was a challenging timeframe, it was considered necessary to provide business with the maximum practical certainty about the proposed arrangements. The Government has indicated its intention to continue the consultation process as draft legislation and other supporting material is prepared, prior to presenting the legislation to Parliament.

The PTG has been supported by a Secretariat comprising representatives from the Treasury, the Australian Taxation Office, the Department of Resources, Energy and Tourism and the private sector.

1.2 PTG process

The PTG commenced a consultation process, outlined in Attachment C, the first step of which was the release of an issues paper on 1 October 2010. This sought to identify key issues and stimulate stakeholder feedback.

A comprehensive program of face-to-face consultations was then undertaken in Perth, Brisbane, Sydney, Adelaide and Melbourne. Participants included affected companies, relevant industry associations, major accounting firms and other tax professionals. While the PTG regrets it was unable to visit individual mining towns due to time constraints, it feels confident that the full range of issues has been captured through the representations made during its process.

The PTG received 88 written submissions and undertook follow up discussions with individual stakeholders as required. Non-confidential submissions can be found on the Future Tax Website (www.futuretax.gov.au). A full list of stakeholders who contributed to the PTG's deliberations is provided in Attachment D.

The consultation process was constructive and deepened the PTG's understanding of the context and issues associated with the proposed taxes. The PTG sincerely appreciates the efforts of the stakeholders to engage and provide information that has been beneficial in formulating advice on the technical design of the MRRT and PRRT extension. Summaries of stakeholder views are provided on an issue by issue basis throughout the relevant sections of the report, with further detail in Attachment E. Where an approach or position is recommended that differs from the views submitted, the PTG has explained the rationale and principles underpinning its stance.

The PTG is conscious it has not been able in the time available to respond to every issue or suggestion raised during the consultation process. In particular, a range of administrative and implementation suggestions raised through the consultation and submission process have not been explicitly addressed in this report. These were generally technical in nature and will be more relevant to subsequent stages of the implementation process. It is to be expected that as the PTG's recommendations are translated into legislation, further issues will arise that will require resolution. The PTG has recommended that an Implementation Group be established to progress these issues. The Implementation Group should comprise industry representatives, relevant advisors and officers from RET, the Treasury and the ATO.

To ensure this valuable input is not lost, the PTG recommends the relevant policy and implementation agencies continue to work with industry to ensure these issues are taken into account. The proposed industry-government Implementation Group will represent an important mechanism in this regard.

1.3 Nature of the industries covered

It is instructive to briefly consider the context for the new tax arrangements, and in particular the nature of the Australian iron ore, coal and petroleum industries.

The enormous contribution these industries have and will continue to make to the Australian economy, particularly in regional areas, is generally well known. What is perhaps less well understood is the rapidly changing nature of the resources sector, which is today very different from that of 20 or even 10 years ago. Key aspects of relevance to the implementation of new taxation arrangements include:

A growing diversity in structure and operations: In recent years there has been a significant expansion in the number of emerging small and medium sized miners operating in Australia. While the major miners are an enduring strength of the Australian resources sector, it is clear that the small and medium miners are playing an increasingly important role in the exploration and development of newer resources and technologies. Similarly, the range of project configurations is expanding, ranging from large scale, long-lived, multi-mine operations in the Pilbara, or the multi-field operations that will feed the Gladstone liquefied natural gas hub, through to relatively short-lived projects based on smaller ore bodies or tight gas fields.

The emergence of new industries: The maturation of Australia's high quality haematite and onshore oil and gas resources has seen the development of new extractive industries such as magnetite and unconventional petroleum (for example, coal seam methane and tight gas). These industries are expected to continue to grow substantially in the future. It has been necessary to ensure the tax arrangements are robust with respect to new industries and technologies.

The increasing integration and centralisation of operational management: This has been driven by the need for Australian operations to continually improve cost efficiencies and minimise operational constraints imposed by shortages in skilled and unskilled staff as well as access to infrastructure. Improvements in communication, information technology and mining technologies are providing a greater capacity for firms to undertake remote operational management from central locations.

A changing regulatory environment: Mining operations increasingly face growing native title, environmental and operational requirements to comply with changing societal expectations. This has resulted in the development of new mining techniques and technologies and has generally increased the cost and length of time required to bring projects to development.

A changing international environment: The re-emergence of China and India has markedly changed the supply-demand balance for iron ore and energy commodities and contributed to substantial and prolonged shifts in prices. The resulting expansion in the mining sector has been very large and, if it continues as expected, will drive profound structural change in the Australian economy.

1.4 Tax design considerations

Throughout its deliberations, the PTG has followed a number of guiding principles or objectives in addition to those set out in the terms of reference. In summary, these are that the respective arrangements should:

- broadly be neutral across included resources and different project configurations;
- minimise taxpayer uncertainty and compliance costs;
- apply general tax principles in a consistent fashion; and
- minimise incentives for tax avoidance and maintain the integrity of the tax base.

In reaching its recommendations the PTG has also been mindful of a number of additional considerations:

- the new tax arrangements should generally be prospective in nature and thus should not unduly penalise investments made before 1 May 2010;
- the MRRT and PRRT are different taxes. While both are profit based, differences in key parameters and the industries to which they apply mean that a strict comparison of the two frameworks should be avoided;
- specific exclusions should be avoided to ensure a robust tax framework and minimise unintended distortionary impacts;
- vertically integrated transformational operations that use taxable resources, such as electricity generation or steel production, may face particular challenges in estimating their resource value, and tax liability. The PTG has sought to develop an approach that addresses this issue; and
- the compliance impact on smaller enterprises, as with many tax laws, has the potential to be disproportionate. The PTG has been concerned to ensure the taxation arrangements do not become a discriminatory barrier to entry for this segment of the industry.

The Minerals Resource Rent Tax

As a new tax, the MRRT presents an opportunity for the Government to put in place a robust tax framework based on sound tax design principles, that ensures the long term investment attractiveness of the iron ore and coal industries is not impaired. In implementing its terms of reference the PTG has sought to strike an appropriate balance between revenue, equity, economic efficiency and compliance objectives.

Finalising advice to Government consistent with the PTG's terms of reference on the technical design of the MRRT in particular was challenging. In order to develop recommendations in areas where there was some ambiguity in the Heads of Agreement, all members of the PTG agreed a series of proposals which reflected a balance between positions expressed by industry and the need to maintain the integrity of the revenue base. When combined with other recommendations made by the PTG, they form a package which Treasury has assessed does not materially compromise the requirement for the PTG's recommendations to be revenue neutral.

Particular elements proposed were:

- crediting royalties earlier in the loss ordering rules, to minimise the risk of stranding those royalties;

- uplifting unused market value starting base losses to maintain their real value;

- agreement that starting base losses would not be transferable between projects; and

- non-transferability of project losses between iron ore and coal.

The PTG acknowledged that minimising the risk that royalty credits could become stranded was important to industry and would assist in ensuring that the overall rate of taxation faced by iron ore and coal producers remained internationally competitive. The PTG also recognised that this could result in some de-facto transfer of royalty credits due to the increase in the pool of transferable project losses.

It was further agreed that the real value of market value starting base losses should be maintained by providing an uplift rate at the consumer price index and that they should be non-transferable. This recognised the industry view that miners who were unable to utilise their market value starting base shield in a given year should not be disadvantaged. To balance the above benefits against the potential risks they might pose to the revenue base, it was agreed that MRRT project losses in coal projects could not be transferred to iron ore projects and vice versa.

The Petroleum Resource Rent Tax

Consideration of the extension of the PRRT has been a markedly different exercise to designing the MRRT, with the key challenge being to identify a minimal set of changes to accommodate the transitioning projects within the existing PRRT. Minimising change to the existing provisions is important to avoid creating uncertainty or confusion over an established tax framework that is generally well understood and considered to function well.

The consultation process identified several issues associated with the current operation of the PRRT that could be addressed as part of the legislative amendment to the PRRT and would improve administration and reduce disputation. While not strictly within the PTG's terms of reference, these issues have been identified for further consideration by the Government.

Administration and compliance

Within its recommendations the PTG has proposed a package of implementation and compliance measures to minimise the impact on taxpayers, particularly those with smaller operations. This includes providing early guidance, safe harbour provisions and reference parameters for valuation and assessment, simplified compliance tests, a phased approach to the $50 million profit threshold for the MRRT and specific transition and ongoing administration arrangements. The PTG is strongly of the view that the ATO should be properly resourced to ensure the smooth and effective implementation of the new arrangements.

In considering stakeholder feedback the PTG also identified a number of administrative irritations being experienced in the existing PRRT. The PTG recognised that issues with the current administration of the PRRT are outside its terms of reference. However, in considering how to design the MRRT and looking at the wider PRRT administration, the PTG has recommended a number of solutions to Government.

Delivering the package

The PTG has sought to create an overall package that delivers a sound tax outcome through a combination of industry and government views. This has necessarily meant that no group has secured its full ambition. That is the nature of compromise and co-design. The PTG is also fully cognisant that it is not the decision making body in relation to the structure and content of the final taxation laws – this power appropriately rests with the Government and, subsequently, the Parliament of Australia.

Many of these proposals will require further elaboration in the course of developing legislation and administrative procedures. The PTG encourages government and industry to continue working closely and, to assist in this process, has proposed the establishment of an Implementation Group comprising representatives from industry, tax professionals and officials from the Treasury, the ATO and RET. This Group would have an active role in providing expert advice and oversight and should provide continuity with the knowledge and experience developed through the PTG.

The PTG believes strongly that the MRRT should be aligned, wherever practicable, with the familiar concepts and style of the income tax law to make the transition for taxpayers as easy as possible. This should include consistency in drafting approaches and administrative arrangements, and the use of income tax terms and definitions for relevant concepts.

1.5 Fiscal impact

The terms of reference require the PTG's recommendations to be consistent with the Government's fiscal strategy as stated in the 2010-11 Budget, with any policy deviation from the Government's announcement of 2 July 2010 to be fully offset within its recommendations in terms of its fiscal impact.

In undertaking an assessment of the fiscal impact of its recommendations, the PTG has had to form judgments about the starting point implied by its terms of reference. The key recommendations that have potential fiscal impacts are:

- moving the taxing point upstream to the run of mine stockpile;
- deferred recognition of a starting base for non-producing tenements;
- uplifting market value starting base losses by the consumer price index;

- transferability of exploration expenditure;
- the order of deducting project amounts;
- applying a necessarily incurred test for deductible expenditure;
- limiting the transferability of project losses between coal and iron ore;
- phased extension of the $50 million dollar threshold offset; and
- assessing the full year sales in 2012-13.

Accepting the informational limitations generally associated with any new tax arrangements, the Treasury has advised the PTG that the package of measures identified above are broadly fiscal neutral over the forward estimates, consistent with its terms of reference. Some of the recommendations involve fiscal cost, while others involve a fiscal gain. The package of measures also balances the downside risk to MRRT revenues over the longer-term.

Those recommendations Treasury have been unable to cost due to informational constraints are not considered by Treasury to have significant fiscal impacts over the forward estimates based on current economic parameters.

1.6 Structure of the report

This report is structured in two parts. The first part deals with the design of the MRRT. The second part deals with the transitional arrangements for bringing all onshore and offshore oil and gas projects within the existing PRRT.

A consistent terminology has been adopted throughout this report, which is outlined in the Acronyms and Defined Terms. The reader should be aware that this can sometime refer to legal or physical concepts that have different names in various jurisdictions or across the resources sector.

Part 1
Minerals Resource Rent Tax

2 Overview of MRRT

On 2 July 2010, the Government announced its proposal for a Minerals Resource Rent Tax (MRRT) to ensure Australians receive a fair return for the use of their valuable natural resources.

In conjunction with existing State and Territory royalties, the MRRT will provide the Australian community with a share of mineral rents. The MRRT will provide the community with an additional return when substantial profits are made from the extraction of iron ore and coal. Integration of the State and Territory and Australian Government resource tax regimes is to be achieved through State and Territory royalties being creditable against MRRT liabilities.

The MRRT will be levied on profits derived from the extraction of iron ore and coal. Profits derived from the beneficiation or any other downstream processing of coal or iron ore are not intended to fall within the scope of the MRRT. This is achieved through specifying a taxing point early in the production chain, and applying arm's length principles in valuing the resource at the taxing point.

The PTG's terms of reference state that existing investment in a project is to be recognised through a starting base. The starting base acts as a partial offset against an MRRT liability arising in respect of interests in a project or tenement held prior to 2 May 2010. For each project, entities can choose between:

- a starting base composed of the book value of the project's assets (excluding the value of the resource), to be fully deducted over five years; or
- a starting base composed of the market value of the project's assets (including the resource), to be deducted over the life of the assets (to a maximum of 25 years).

The PTG considers that the 1 May 2010 cut off for being eligible for a starting base should include the value of potential projects that are yet to commence production. It therefore recommends that all tenements held at 1 May 2010 be eligible for a starting base. However, in recognition that production on some tenements may not commence until many years into the future, and possibly not at all, the PTG recommends that the starting base for non-producing tenements as at 1 July 2012 not be deductible until the commencement of production from the tenement.

The PTG notes that market valuation of the starting base could have a significant bearing on taxpayer liabilities for MRRT, and that different valuation methodologies and assumptions can produce quite different results. Taxpayers should be free to use a starting base valuation methodology that is appropriate for the specific circumstances of their project. The approach should be consistent with accepted methodologies, consistent with market expectations at 1 May 2010, transparent and defensible.

Resources subject to the MRRT

The MRRT is to apply to profits derived from the extraction of all forms of iron ore and coal.

In its recommendations, the PTG has sought to clarify that mining activities that result in the depletion of coal or iron ore would be taxable under the MRRT irrespective of the form in which the resource is extracted. For example, the conversion of coal to gas through a process of underground combustion would be assessable under the MRRT. As a matter of practicality, the PTG recommends that coal mine methane sold by a miner that is produced as a necessary and integral part of a coal mining operation also be taxed under the MRRT.

A project-based tax design

To bring a consistent approach to the design features outlined in its terms of reference, the PTG's recommendations are framed around a project-based design, with transferability of losses between projects being a key feature of the MRRT.

The foundation for the project-based design is an entity's interest in a mining tenement for which a production right has been granted. This 'bottom-up' approach uses legally enforceable rights as the basis upon which to define the iron ore and coal projects subject to the MRRT.

To address the potential compliance costs associated with levying the MRRT at such a level, the PTG recommends entities be able to aggregate a combination of interests in production rights that constitute a mine, or a combination of interests in production rights (which may constitute several mines) operated as an integrated project. To maximise the potential benefit of the integrated project, a consolidated group of entities could elect to have their integrated projects treated as if held by the head entity of the group.

Mining tenements for which a production right does not exist would not be considered projects. However, the market value as at 1 May 2010 of those tenements would be recognised in a starting base when the production right is issued and would become deductible from commencement of production. To ensure expenditure on these tenements is recognised under the MRRT, the PTG recommends that exploration and other pre-project expenditure incurred after 1 July 2012 be transferable to any other project held by the entity. In recognition that exploration companies may not be able to offset such expenditure against other projects, the PTG recommends that losses on those tenements be transferred upon sale of the tenement.

Taxable profits

The profit a project makes is the value of the resources at the taxing point, less the costs incurred in getting them to that point. The recommended taxing point is the point at which the resource leaves the 'run-of-mine' stockpile (or ROM stockpile). Where there is no ROM stockpile, or the ROM stockpile is bypassed, the taxing point would be delivery to the first unit of operation after the resource is extracted.

The value of the resource is to be determined using the most appropriate and reliable arm's length pricing methodology. In many cases, this would involve starting with the sale price of the resource and 'netting back' to its value at the taxing point by subtracting an appropriate amount for activities undertaken between the taxing point and the point of sale. The time of derivation of MRRT assessable receipts is when the resource, or product derived from it, is supplied to a third party, but not later than when the resource, or product derived from it, is loaded for export. In practice this will mean the assessable value would be calculated on an annual basis without having to relate sale prices and costs to particular parcels of the resource.

Eligible deductions used to determine MRRT profit would be those amounts *necessarily incurred* in extracting the resource and bringing it to the taxing point. They would include relevant indirect expenses (such as head office management costs) that have the necessary relationship to the project, but not expenses related to the entity's non-project activities. Certain expenses would be excluded for consistency with the design of the MRRT. For example, financing costs would not be eligible deductions, as the value of the resource should be independent of how it is financed and a return to capital invested in the project is recognised through the MRRT uplift rate.

Applying the accepted pricing methodologies will involve compliance costs and the potential for uncertainty and disputes. To assist smaller producers who wish to avoid those possibilities, the PTG recommends a legislated safe harbour methodology be made available to small producers and existing vertically integrated transformative operations. The existence of the safe harbour would also assist smaller producers by providing fiscal certainty for their investment decisions.

Extending the safe harbour methodology to existing vertically integrated transformative operations, such as electricity generation and steel making, would provide an efficient means to establish the value of the resource at the taxing point. The PTG does not consider it necessary to extend this treatment to future investment in such operations.

The treatment of deductible amounts and loss transfers within an entity

Where project expenditure, losses, royalty credits and book value starting base amounts are not able to be used immediately, they are to be carried forward and uplifted at LTBR+7. Part of the reason for the uplift rate is to compensate taxpayers for the risk that some expenditure might not be able to be offset against MRRT profits under the project-based design of the MRRT.

The PTG considers the uplift rate should be limited in some circumstances to limit the compounding effect over time. First, given the potentially long lead times from initial exploration to an operating mine, exploration expenditure should only be uplifted at LTBR+7 for a period of 10 years with the uplift rate then reducing to LTBR. Second, mines can be held on a care and maintenance basis for long periods. To limit the application of the uplift rate, a project should be deemed to cease to exist no later than 10 years after its last commercial production.

A key design feature of the proposed MRRT is that an entity can transfer losses from its loss making projects to its profitable projects producing the same commodity, to reduce the entity's overall MRRT profits and liabilities. Consistent with the rationale for the uplift rate, transfer is required where an entity has profits (after crediting of royalties and applying starting base deductions) against which it could deduct an MRRT loss or transferable exploration expenditure. The relevant group for loss transfer is the wholly-owned entities that comprise a consolidatable group.

The terms of reference clearly state that State and Territory royalty credits are to be non-transferable. This applies to both current year and carried forward royalties. Where market value is used to establish a starting base, it is not to be uplifted. Consistent with the role of the starting base as a tax shield for existing investment, losses derived from unused starting base deductions are to be non-transferable. Where such losses derive from a market value starting base they should only be uplifted by the consumer price index, to maintain their real value.

Commensurate with the design of the MRRT as a project-based tax with transferability of losses, project profits should be reduced by project related amounts before transferable amounts. This provides a degree of consistency in the treatment of projects held in separate entities and projects held within a single entity. It also reduces the potential for royalty credits and starting base deductions to be wasted.

Project deductions should be the first amounts to reduce MRRT revenue. Royalty credits should be applied next, followed by carried forward project losses. Starting base deductions should then be applied to at least partially shield existing investment from a residual tax liability. Where an MRRT liability exists, transferable amounts (exploration expenditure and project losses) are to be applied in that order, to further reduce the MRRT liability.

Transfer of losses between entities

An intended design feature of the MRRT is that undeducted expenditure be transferable to a new owner of a mining tenement. However, it is also intended that losses not be refundable. Allowing the free transfer of project losses to acquiring entities would, in effect, provide refundability through the market place. A common ownership test is recommended to limit the free transfer of losses in this way, and protect the integrity of the tax base. Losses transferred through the sale of a project are to be quarantined to future profits from that project and not transferable to other projects of the acquiring entity. Similarly, past losses from projects already owned by the acquirer are not to be applied against the future profits of a newly acquired project.

A less stringent test is to apply to the transfer of exploration and other pre-commencement losses on a mining tenement that is not a production right, in recognition that the ownership of such tenements may be transferred several times before any production commences. Where acquired through the transfer of ownership of the tenement, such losses would be transferable to projects producing the same MRRT commodity within the acquiring entity without restriction. To discourage loss selling, the value of such losses would be limited by reference to the amount paid for the tenement.

MRRT $50 million threshold offset and low compliance option

The terms of reference state that the PTG is to develop a workable exclusion for taxpayers with MRRT profits of less than $50 million. The PTG has observed that the existence of the threshold is unlikely to reduce compliance costs for taxpayers subject to MRRT in that taxpayers are required to maintain full MRRT records and undertake the full MRRT calculations regardless of whether they are above or below the threshold. To avoid taxpayers facing a very large change in their MRRT tax bill as they cross the $50 million threshold, and likely changes to their production behaviour, the PTG recommends phasing in a taxpayer’s MRRT liability from an annual MRRT profit of $50 million.

To address the concern that some taxpayers could be required to account for the MRRT but never be liable to pay MRRT, the PTG recommends tests be designed to identify those taxpayers and provide them with a low cost compliance option. Entities electing to enter such a regime would forgo the right to carry-forward and uplift their unused losses and royalty credits.

Royalties

To reflect the fact that State and Territory mining royalties will apply alongside the MRRT, the royalties entities pay on iron ore and coal are to be credited against the MRRT liability of a project.

The recognition of State and Territory royalties under the MRRT raises a number of important issues. Generally speaking, the current State and Territory royalties levied on coal and iron ore are set at rates that the industries can afford to pay, at least during normal times, and provide the States and Territories with a relatively stable revenue stream. On the other hand, royalty regimes are inherently less flexible during a downturn and can unnecessarily damage the industries and prevent optimal resource extraction. Further, by their nature the royalty regimes do not capture the economic rents during a boom period.

Through the implementation of the MRRT, Australia has the opportunity to substantially improve the overall outcome for the taxation of coal and iron ore in this country. It provides a way to meet the needs of the States and Territories and captures more of the profits at the peak of the resources cycle, in a way royalties alone cannot, for the benefit of all Australians.

Recognising this objective, as well as the importance of preserving Australia's international competitiveness, the PTG recommends that there be full crediting of all current and future State and Territory royalties under the MRRT so as to provide certainty about the overall tax impost on the coal and iron ore mining industries. Equally, the MRRT should not be used as a mechanism to enable States and Territories to increase inefficient royalties on MRRT taxable commodities. Accordingly, the PTG also recommends the Australian, State and Territory Governments put in place arrangements to ensure that State and Territory governments do not have an incentive to increase royalties on coal and iron ore. This would limit their negative impacts, while allowing the Australian Government's taxation regime to maximise the return to the community during the highpoint of the resources cycle, so achieving the balanced outcome described above.

The PTG notes that some royalties are struck in agreements between State or Territory governments and mining companies and that some of those royalties can only be varied by mutual agreement. In those circumstances the mining company party to the agreement can, at the very least, significantly influence the royalty payable by it. Responsibility to maintain the integrity and competitiveness of the resource taxation regime is therefore a shared one between the Australian, State and Territory Governments and, importantly, the companies involved.

Administration

The PTG has made several recommendations to simplify the administrative and compliance burden of both the taxpayer and the ATO.

The PTG recognises the value of engaging industry on the implementation of the MRRT. The Treasury and ATO are encouraged to consult industry both through the usual consultative forums and the representative bodies that engaged with the PTG. The PTG recommends establishing an 'Implementation Group' with industry representatives and relevant advisors and officials from RET, the Treasury and the ATO. This group would consult on the development of the MRRT legislation, its administrative design and implementation, and its eventual review.

The PTG also recommends the ATO provide early guidance in the application of the MRRT, its administration and compliance and that the Australian Government ensure the ATO is appropriately funded to provide the necessary support to industry.

3 SCOPE OF THE MRRT

3.1 Resources subject to the MRRT

Recommendation 1: The MRRT should apply to all mining operations resulting in the depletion of naturally occurring coal or iron ore. For the avoidance of doubt, the following activities should be covered by the MRRT rather than the PRRT:

- coal mining operations involving the extraction of gas derived from the underground conversion of coal; and
- coal mine methane extracted as a necessary and integral part of a coal mining operation.

Recommendation 2: Where there is incidental production of coal or iron ore as part of a mining project, the proceeds from the sale of the coal or iron ore should be assessable under the MRRT, with allowance for a reasonable apportionment of mining costs.

Recommendation 3: Where there is incidental production of other minerals or products as part of an coal or iron ore project, the proceeds from the sale of the other minerals or products should not be assessable under the MRRT and the reasonable apportionment of mining costs associated with those minerals or products should not be deductible under the MRRT.

Recommendation 4: The terms 'iron ore' and 'coal' should take their ordinary meanings in the legislation, rather than being defined terms.

3.2 Who is the taxpayer

Recommendation 5: An income tax consolidated group should be permitted to elect to be treated as a single entity for MRRT purposes. Only such a group should be permitted to combine mining interests held by more than one entity into the same project.

Recommendation 6: The head company of a consolidated group that makes that election should be responsible for paying the MRRT of the group, but each entity in the group should be jointly and severally liable for the group's unpaid MRRT.

3.1 Resources subject to the MRRT

Issue

The PTG's terms of reference state that the MRRT is to apply to mined iron ore and coal. Clarity is required regarding the application of the MRRT and PRRT to coal extracted in gaseous form through underground conversion of the coal resource and coal seam methane extracted as part of a coal mining operation. A further consideration is whether the MRRT should apply to iron ore and coal mined as an incidental part of another mining operation and products other than coal or iron ore produced incidentally from coal and iron ore mining operations. The terms of reference state that coal seam methane is to be taxed under the PRRT.

Stakeholder comments

Many stakeholders suggested that 'iron ore' and 'coal' have well understood meanings in the industry and do not need to be defined in legislation. While some stakeholders are of the view that these terms need to be defined, most of these felt that iron ore should be defined to exclude magnetite.

Magnetite producers proposed that magnetite be excluded from the MRRT on the basis that magnetite projects are unlikely to be liable for MRRT but would incur significant compliance costs that could damage a nascent industry. Other stakeholders called for an exclusion of any mining operation, the output of which is consumed in a vertically integrated operation, such as a power station or steel mill.

There was broad support for exempting iron ore and coal by-products of other mining projects. While some stakeholders supported applying the MRRT to by-products of iron ore and coal mining operations, most thought they should be excluded along with an equivalent portion of mining expenses (at least if the value of the by-products amounted to no more than $100 million a year).

There was general agreement that coal seam methane extracted as an incidental part of a coal mining project should be taxed under the MRRT rather than the PRRT. Suggested definitions of 'incidental' include less than 10 or 20 per cent of the extracted resource value over the life of a mine.

Most stakeholders who commented on the treatment of coal that is converted to gas *in situ* were of the view that the MRRT should apply, rather than the PRRT, on the basis that the underlying resource should determine the tax regime. One stakeholder took an alternative view, arguing that the state of the resource at its first saleable point should determine its tax treatment.

Discussion

Commodities included within the MRRT

The PTG is of the view that the MRRT should apply to *all* mining operations resulting in the depletion of naturally occurring iron ore and coal. Excluding mining operations on the grounds there is no immediate prospect of them paying MRRT could result in the non-neutral treatment of competing segments of the iron ore and coal mining industries, additional legislative complexity, taxpayer uncertainty and ongoing pressure to extend the exemption to other mining operations. The PTG has sought to address the issue of compliance costs for taxpayers who are unlikely to be liable for MRRT through a low compliance option (see Section 11.2).

Mining operations involving the *in situ* conversion of coal to gas, often referred to as underground coal gasification (UCG), should fall within the MRRT. While there are tax neutrality arguments in favour of positioning UCG within either the MRRT or the PRRT, the PTG considers it more important to achieve tax neutrality in competition for the coal resource, rather than in competition for the products derived from the UCG process.

A necessary and integral part of underground coal mining operations is the extraction of coal mine methane for mine safety. In the future, methane extraction may become an integral part of surface coal mining as an environmental requirement.

The methane extracted from a coal mine is equivalent to coal seam methane, which is to be subject to the PRRT. Hence, there is a prima facie argument for taxing coal mine methane under the PRRT. However, stakeholders maintain that the sale value of coal mine methane is roughly the same as the cost of its extraction, if not lower. Rather than subject coal mining entities to both the MRRT and the PRRT, with the consequent compliance costs involved in apportioning the costs of extracting the two products, the PTG recommends that coal mine methane extracted as a necessary and integral part of a coal mining operation be taxed under the MRRT. Such treatment should not extend to extensive gas extraction in advance of coal mining, such as that which occurs in the production of commercial quantities of coal seam methane.

Multi-product mines

The Issues Paper raised the possibility of treating minerals incidentally extracted as part of a mining project under the regime applying to the main mineral being extracted. For example, if copper were extracted incidentally as part of an iron ore project, the copper would be liable for taxation under the MRRT and, if iron ore were incidentally extracted as part of a copper project, the iron ore would not be subject to the MRRT. This was proposed as a way to reduce the compliance costs involved in accounting for MRRT under such projects.

After careful consideration, the PTG recommends against such a proposal on the basis that it would be likely to lead to disputation as to whether the value of the resource extracted is incidental (especially when interactions with the definition of 'project' are taken into account), and could create additional complexity and compliance costs in situations where the significance of the resource changes over the life of the project. It should be noted, however, that the PTG's low compliance option would be likely to relieve entities who only produce small amounts of iron ore and coal as a by-product of their mining operations of the need to do extensive MRRT accounting.

Definitions of 'iron ore' and 'coal'

Although the views expressed in stakeholder submissions are not unanimous, the predominant view is that the expressions 'iron ore' and 'coal' are sufficiently well understood within the industry that they do not need to be defined in the MRRT legislation. That view accords with the PTG's understanding of the interpretation of these terms.

3.2 Who is the taxpayer

Issue

Integrated mining operations can be held through various wholly-owned entities within a group. Allowing aggregation of the separate interests of those entities into an integrated mining project raises the issue of who is the taxpayer for the group and who is liable for paying its MRRT. The separate issue of loss transfer within a group is addressed in Section 9.

Stakeholder comments

The few stakeholders who commented on this issue saw advantages in allowing a consolidated group to lodge a single MRRT return. Some thought that all of a group's interests in a project should be treated as a single project, even if held by separate entities, and that all of the group's MRRT revenue, expenses and royalty credits should be combined for that purpose. There was some opposition to the idea that the entities in a group should be jointly and severally liable for the group's MRRT liabilities in the way they would be for income tax purposes.

Discussion

The PTG recommends in Section 4 that interests in production rights should be permitted to be combined into a mining project where certain conditions are met. The issues considered in this section are what sort of group should be permitted to combine its interests where they are held in different entities, and which entity in the group should be liable for the MRRT attributable to such a combined project.

The PTG recommends that only income tax consolidated groups be permitted to combine interests held in more than one entity into a single project. The simplest way to achieve this would be to treat all of a consolidated group's MRRT activities as if they are being conducted by a single entity and apply the standard project rules to that group's MRRT activities. This approach would make it possible to rely on the solutions to grouping problems that have already been developed for the purposes of income tax consolidation, in many cases without having to replicate the legislative rules. It would also limit the amount of new legislation that would have to be considered by taxpayers already familiar with income tax consolidation.

The PTG is of the view that, where a group is consolidated for income tax purposes, it should be permitted to elect to be treated as a single entity for MRRT purposes rather than being so treated automatically. This should avoid any unfair consequences for groups that have chosen to consolidate for income tax purposes without knowledge of the MRRT implications.

A consequence of the consolidated group approach is that all intra-group transactions relating to a mining project of the group would be ignored for MRRT purposes in the same way as would the internal activities of any single entity. Instead, the focus would be on the transactions the group enters into with other entities and how they relate to the group's project. For example, if one group entity purchased a piece of mining plant from a manufacturer and leased it to another of the group's entities for use on a mining project, the purchase price would be treated as an expense of that project and the internal leasing transaction would be ignored. This is exactly the same treatment that would apply to those transactions in a consolidated group for income tax purposes.

Another consequence is that the group would have a single MRRT liability for a project, not one for each entity in the group. The PTG recommends that the group's MRRT liability belong to the entity that bears the group's income tax liability – the 'head company' – to avoid complicating the legislation or introducing integrity issues.

As is the case with income tax, each entity in the group would be jointly and severally liable for meeting the group's MRRT debt if the head company were to fail to pay the group's MRRT.[1]

The PTG has considered whether this grouping treatment should be available only to a consolidated group (that is, a group that has consolidated for income tax purposes) or should also be available to a group that could consolidate but has not yet done so. While the position can be debated, the PTG considers the balance favours limiting the treatment to groups that have actually consolidated.

If groups that were not consolidated for income tax purposes could treat themselves as a single taxpayer for MRRT purposes, there would be compliance costs, and possibly integrity issues, involved in apportioning the group's MRRT liabilities between the entities of the group for the purpose of deducting MRRT payments for income tax. There would also be complications with disputes about MRRT liabilities if the income tax consequences were to flow to different tax entities. For these reasons (and also noting that most affected mining groups have consolidated for income tax), the PTG recommends limiting the single entity treatment to consolidated groups.

[1] As with income tax, the members of the group could instead enter into a tax sharing agreement, under which each group member agrees to be liable for its reasonable share of the group's debt (see section 721-30 of the ITAA 1997).

Consolidated and consolidatable groups for income tax purposes that have chosen not to consolidate for MRRT purposes would still be permitted to transfer MRRT losses between their entities. This issue is further discussed in Section 9.

4 DEFINITION OF A PROJECT

Defining a project

Recommendation 7: A project must consist of at least one production right. A project should commence when a production right is granted or acquired.

Recommendation 8: Where separate production rights that produce the same commodity exhibit a degree of integration in the extraction and processing operations, and other activities that occur prior to the taxing point, they should be considered a single project (a single mine).

Recommendation 9: The taxpayer should be allowed to elect to define a project as the aggregated interests 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. Where a taxpayer elects to aggregate production rights, the project must encompass the full extent provided by the criteria.

Recommendation 10: A project would need to be re-defined to reflect changes in circumstances relating to the production rights in which the taxpayer holds an interest, such as where:

- an interest in a new production right is acquired, or an existing mining tenement in which the taxpayer has an interest becomes a production right, and is part of a project defined under Recommendations 8 or 9;
- an interest in a production right that is part of a project defined under Recommendations 8 or 9 is sold or relinquished; or
- the configuration of the taxpayer's mining operations change, such that one or more production rights satisfy, or no longer satisfy, the tests under Recommendations 8 or 9.

Applying the definition of a project

Recommendation 11: The taxpayer should be allowed to self-assess a project in accordance with the defining criteria. Decisions would be reviewable by the ATO and rulings available for those seeking certainty.

Recommendation 12: Entities that are consolidated for income tax purposes and elect to also be consolidated for MRRT purposes (see Recommendation 5) should apply Recommendations 8 and 9 to production rights held by members of the consolidated group under the single entity rule. In that case, the head company of the consolidated group will be the taxpayer for each aggregated project within the group.

Recommendation 13: Exploration for an MRRT commodity and pre-project expenditure relating to upstream activities, incurred on or after 1 July 2012, would be immediately deductible against assessable revenue generated by any project producing the same commodity held by a taxpayer who incurred the expenditure, in accordance with Recommendation 26.

Defining when a project ends

Recommendation 14: A project should be deemed to cease to exist when a production right is rescinded by or relinquished to the issuing authority, or 10 years after production of a commercial quantity of coal or iron ore from the mine ceases, or when the taxpayer elects to close the project, whichever occurs first.

Recommendation 15: Expenditure incurred in undertaking rehabilitation of a mine site after a project has ceased production should be deductible. To the extent that the rehabilitation costs cannot be offset against assessable revenue, or transferred to another project in the wholly-owned group, the taxpayer will be eligible for an immediate tax credit up to the amount of MRRT paid over the life of the project.

Issue

Several design features in the terms of reference are consistent with the MRRT being a project-based tax, with transferability of losses being a key design feature. For example, royalties are to be non-transferable, and the starting base is to be calculated on the basis of project assets. These amounts and any losses are to be transferred to a new owner when a project is sold.

The project definition will determine the extent to which starting base deductions and royalty credits, which are not transferable, can be shared across mines and influence the extent of potential compliance costs. A narrow definition would result in more projects, each with their own starting base and royalty credits, and the need to apportion costs both upstream of the taxing point and in valuing the resource at the taxing point where the first arm's length sale occurs downstream. A broader definition would result in fewer projects, with starting base and royalty credits aggregated and potentially lower compliance costs.

Stakeholder comments

Industry has called for flexibility to align the definition of a project with commercial considerations. The main drivers in seeking a broad definition are:

- the effective transferability of starting base and royalty credits within a project;
- lower compliance costs through removing the need to apportion shared costs; and
- greater certainty as to the deductibility of indirect expenditure – expenditure that might be relevant to a number of mines but not directly attributable to a particular mine.

A number of concepts have been put forward by industry as being relevant in defining a project. Views on the relative weighting to be applied to these concepts vary between taxpayers, with some placing a greater emphasis on the role of management than others. The concepts identified include:

- the mining licence, exploration licence or retention lease;
- the mine plan;
- the operations, facilities and other things on the mining licences, including the extent of their operational integration and physical location;
- the geological and geophysical features of the commodities on the mining licences;

- the extent to which the planning process (both short and long term) is managed as an integrated project; and
- the extent to which the ongoing management of the various components of the operation is integrated.

Industry has requested a self-assessment process to enable taxpayers to determine the extent of a project in accordance with the concepts outlined above, as opposed to being required to apply to have the proposed project definition accepted.

Discussion

Defining a project

The primary purpose of the project definition is to provide an anchor for the application of the MRRT, by identifying the set of cash flows that are relevant to the MRRT assessment. The project definition captures the source of project profits but need not determine the boundary for establishing deductible costs, nor the point at which revenue should be measured. This is determined by the application of the taxing point.

In considering the appropriate definition of a project, the PTG has considered the following principles:

- it should comprise interests in one or more legally enforceable rights to extract a resource and provide a clear basis for the allocation of resource cash flows in a mutually exclusive and collectively exhaustive manner;
- it should be sufficiently flexible to align with an economic or operational concept of a project, without unduly compromising the intended design features of the MRRT;
- it should allow sufficient flexibility to accommodate changes in ownership and project configurations; and
- it should not impose undue compliance and administration costs through the allocation of cash flows to individual projects.

The commercial development and operation of mines may involve activities across more than one production right in which the taxpayer holds an interest. Similarly, individual mines may be operated as an integrated unit through joint infrastructure, such as processing and blending hubs, to produce a final product. On this basis, it would appear that two levels of grouping are appropriate – the grouping of production rights to operate as a mine and the grouping of mines into integrated operations.

Where production rights exhibit a degree of integration upstream of the taxing point, at the level of a mine, a project should be defined by the grouping of those production rights. A set of criteria have been developed to allow the taxpayer to elect to group production rights more broadly to an operational or integrated commercial project.

These groupings would need to accommodate change over time in line with changes in the production rights held by a taxpayer and the way they are integrated. If the nature of the operation in this example were to change over time, for example one of the production rights starts to produce ore that is shipped direct to customers instead of being blended with ore from the other production rights, the taxpayer would need to reassess whether all of the production rights exhibit a sufficient level of integration to be considered one project. Changes may also be required as a result of the sale or acquisition of production rights.

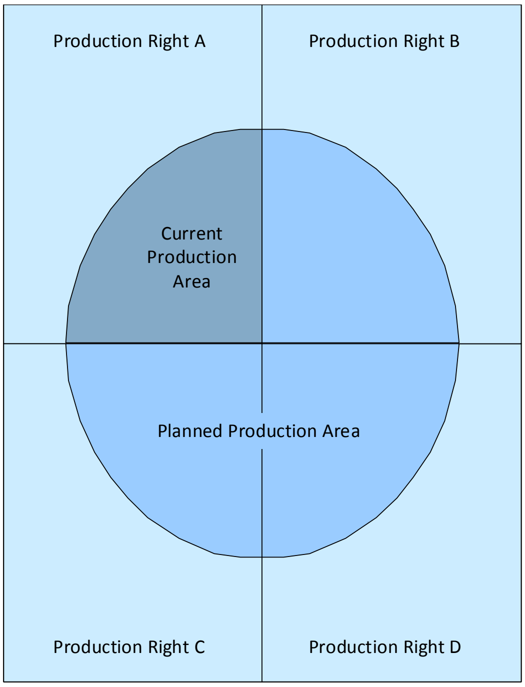
The potential for change over time will require rules to be developed in relation to the treatment of losses, royalty credits and starting base amounts where such reconfigurations occur. A key consideration is to give effect to the restrictions on transferability that apply to starting base deductions and royalty credits. It is therefore necessary that the definition of a project, and any criteria that allow a larger grouping, take into account the possibility that the project group will change over time. There must be the flexibility to deal with portions of a project being sold and the possibility of the starting base and any royalty credits associated with that portion of the project being transferred with it. Similarly, losses or royalty credits attached to an acquired project or tenement are only to be offset against the revenue generated by that project or tenement, as opposed to using them to offset the revenue of the broader project.

Applying the definition of a project

In order to apply the proposed criteria, it is necessary to consider to what extent the aggregation is to apply. The PTG recommends that where a taxpayer elects to aggregate production rights beyond separate entities within an income tax consolidated group, it should do so to the extent of the consolidated group. This election should apply across all projects held within the consolidated group, that is all projects should be aggregated to the entity level, or all projects should be aggregated to the extent of the income tax consolidated group. The implication of being treated as an income tax consolidated group for MRRT as discussed in Section 3.2.

Where a taxpayer holds a number of production rights that are, or are planned to be, operated as a single mine over time, those production rights should be treated as a single project for the purposes of MRRT.

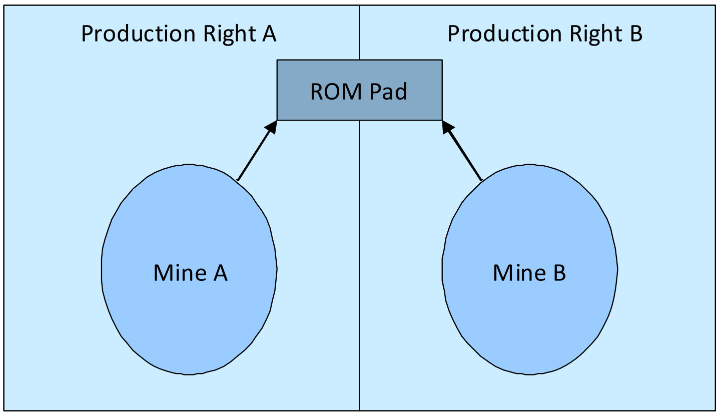
Figure 4.1 – Single mine with multiple production rights



For example, consider the case where a taxpayer holds four production rights A, B, C and D as shown in Figure 4.1. Production right A is currently producing an MRRT commodity from an ore body that extends across production rights B, C, and D. Production is planned to recover the resource from each of the production rights over a period of time, using existing upstream capital equipment and infrastructure. In this case, the taxpayer should treat the four production rights as if they are one project.[2]

Similarly, where a taxpayer holds more than one production right containing separate ore bodies of the same commodity and those ore bodies are operated using shared infrastructure or upstream capital, the taxpayer should treat the production rights as if aggregated into one project. An example is depicted in Figure 4.2, where ore from two production rights is combined at a single ROM stockpile. In this case it is clear that there is shared infrastructure upstream of the taxing point, so the taxpayer would treat these two production rights as a single project.

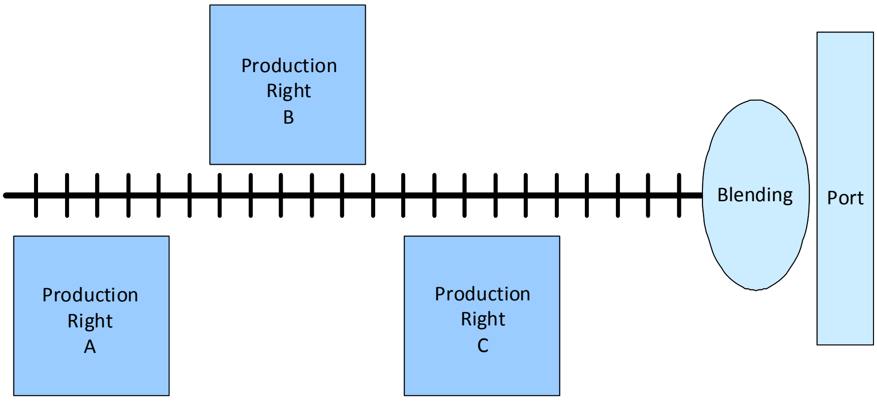
Figure 4.2 – Production rights with shared upstream infrastructure



Where a taxpayer elects to aggregate production rights of the same commodity on the basis of their integration downstream of the taxing point, consideration must be given to the extent to which the downstream infrastructure is used or operated in an integrated manner in respect of production from the production rights.

It would not be sufficient that one or more production rights utilise the same downstream infrastructure. They would need to be somehow integrated in the way that infrastructure is used. For example, this integration may be demonstrated through the scheduling of the use of the infrastructure owned by the taxpayer who also owns the production rights or, where that is not the case, through the combining of the resource from different production rights into a blended product.

Figure 4.3 – Project that uses integrated downstream infrastructure



[2] Note that under Section 10 the starting base for production right B, C and D would only be deductible once production commenced on those rights.

In Figure 4.3 a number of production rights use railway infrastructure in an integrated fashion to supply ore for blending at the port into a final product for sale. These production rights could be aggregated into a single project based on the integration of the operation.

Where a taxpayer elects to aggregate production rights based on an integrated operation, the project must encompass the full extent of the integrated unit. Under the example described above, the taxpayer could not elect to aggregate two of the production rights and operate the third as a separate project. All three would have to form part of the integrated project. The aggregation would extend to the individual production rights comprising a mine that is part of an integrated project.

Consistent with the position put forward by industry, the PTG recommends that taxpayers, instead of requesting a combination certificate, be allowed to self-assess the scope of a project. This would provide the flexibility to industry, within the guidelines, to structure their project for tax purposes in line with operational activity.

Under the proposed definition, a project would commence once a production right has been issued by a relevant State body. However, this would not determine the point at which deductible costs could be first incurred. Pre-project and exploration expenditure incurred on activities within a mining tenement for an MRRT commodity would be immediately deductible against assessable revenue generated by any interest in a production right for the same MRRT commodity held by the taxpayer who incurred the expenditure (see Section 6.3).

Defining when a project ends

Expenditure incurred in undertaking rehabilitation of a mine site after a project has ceased production should be deductible. To the extent that the rehabilitation costs cannot be offset against assessable revenue, or transferred to another project in the wholly-owned group, the taxpayer will be eligible for an immediate tax credit up to the amount of MRRT paid over the life of the project. The tax credit would equal the tax value of that expenditure as if it were deductible in an ongoing project. Determining the amount of MRRT paid in respect of a project would require a reconstruction of the accounts to reverse losses transferred out of the project and losses transferred into the project.

A project should cease when a production right is relinquished to, or rescinded by the issuing authority. However, there may be a considerable period between a mine ceasing commercial production and the underlying production right being rescinded. The PTG recommends that a project be deemed to cease at the earlier of the production right being rescinded, 10 years after commercial production has ceased, or when the taxpayer elects to close the project for MRRT purposes by notifying the ATO. In electing to close a project, the taxpayer would lose the right to access any remaining losses or royalty credits associated with the project but would become eligible for the credit for rehabilitation expenditure.

5 TAXING POINT

Recommendation 16: The taxing point is 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 (for example loading onto a conveyor belt to a processing unit or loading into an in-pit crusher); 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 17: The ATO should work with industry to develop acceptable administratively efficient approaches to allocating costs at the taxing point where existing accounting and administration systems are not aligned to that point.

Issue

The taxing point is the earlier of the point of sale and a defined point at which the value of the resource is determined. Tax is levied on that value less the costs of bringing the resource to that point. The position of the taxing point determines MRRT revenue.

The terms of reference state that the taxing point is the 'first saleable form (at mine gate)', implying that at least some initial transportation from the point of extraction and some early stage processing was intended to fall within the taxing point. Implementing this concept literally in legislation would, however, be problematic due to a lack of clarity as to its meaning.

Stakeholder comments

Industry supports the need for the taxing point to be relatively neutral in the way it influences the MRRT liability for different iron ore and coal mining operations. It has broadly supported a value chain definition of the taxing point but has called for taxpayer flexibility in selecting the taxing point to apply to a particular project from within a given range of possible taxing points. Industry considers that this would allow the taxing point to be aligned with existing mining operations and accounting practices, thereby avoiding issues with consistency of application across projects and reducing compliance costs.

Representatives of the coal industry have indicated that the point after crushing and screening, suggested in the Issues Paper, may be difficult to identify due to the integrated nature of some processing operations. The run of mine (ROM) coal stockpile was suggested as an alternative taxing point that would be applicable to all coal operations (but which is before crushing and screening).

During individual consultation sessions a range of other taxing points were proposed (including the point of extraction, various points in the production chain, the point of loading onto long haul transport or free-on-board ship). Primary considerations in proposing these alternative points were to align the taxing point with mining technology or operations, or to draw on existing accounting procedures.

Discussion

A taxing point at the ROM stockpile

The taxing point needs to be both relevant to its intended purpose (to tax the value of the resource and not downstream processing) and sufficiently clear in meaning to provide certainty to both administrators and industry. It needs to be broadly applicable and relatively neutral in its impact across the broad range of mining operations, given that moving the taxing point closer to the resource has an MRRT revenue impact. It also needs to be relevant over the life of a project and able to accommodate changes in industry practice over time. It is also desirable that the choice of taxing point not cause taxpayers to alter their production practices solely for tax considerations.

The point at which the resource leaves the ROM stockpile has been identified as an appropriate point in the production value chain for setting the taxing point. 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 key features of the ROM stockpile are that:

- 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.

There are, however, some mining operations for which a ROM stockpile does not exist. In these circumstances the taxing point will be the point at which the resource is delivered to the first unit of operation after it has been extracted. For example, iron ore could be delivered directly from the pit to the point of first crushing and screening, in which case the taxing point would be the point at which the ore is delivered to the crusher. Similarly, coal could 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. In the case of coal mine methane or underground coal gasification, the taxing point could be where the resulting gas is delivered to the initial gas processing plant. Such an approach provides the flexibility to apply the taxing point across all mining configurations and accommodate the development of future mining technology or processes that do not require a ROM stockpile.

Being after the point of separation of the resource from its natural state, it would be feasible for there to be an arm’s length sale of the resource to a third party prior to the resource reaching the taxing point. Were such a sale to occur, the point of sale would be the taxing point. For example, two parties enter into an agreement whereby Party A operates a coal mine and delivers coal to a ROM stockpile, at which point it becomes the property of Party B. The taxing point would be when the coal is delivered to the ROM stockpile by Party A, not when the coal is removed from the ROM stockpile by Party B. This approach would ensure that the application of the taxing point does not result in commercial arrangements being distorted by the MRRT or the need to apply the tax to more than one party where there is a sale of the resource.

To provide certainty to taxpayers, the PTG suggests that the explanatory memorandum to the MRRT legislation and ATO guidelines provide examples illustrating the application of the recommended taxing point to a range of typical mining operations.

The PTG does not support the industry proposal for flexibility in setting the taxing point between the ROM stockpile and the point of loading the resource onto long haul transport. Providing such flexibility could result in taxpayers assessing each of the possible taxing points to determine which of them might produce the greatest overall benefit (that is, the lowest total of MRRT liability and ongoing compliance cost).

The incentive to assess multiple taxing points could be expected to add to taxpayer compliance costs. The need to manage risks to MRRT revenue could further add to compliance costs, due to the need to include rules to assure tax integrity. For example, rules would be required to deal with the potential need to change a taxing point because the original point ceased to exist due to changes in the mining operation. Rules would also be required to deal with changes in mine ownership where the taxpayer acquiring an interest wished to combine it with another project with a different taxing point.

Administratively efficient processes

Industry has highlighted a desire for administrative simplicity in setting the taxing point. This is the central reasoning for seeking a flexible taxing point – that is, to allow the taxpayer to select a taxing point that aligns with existing accounting arrangements within their resource project to minimise their compliance burden.

While the PTG is not inclined towards the introduction of a flexible taxing point, the issues surrounding compliance and administrative burden should be addressed. The PTG recommends that the ATO work with industry to develop acceptable, administratively efficient approaches to allocating costs at the taxing point, where existing accounting and administration systems are not aligned to that point.

6 Taxable revenue

6.1 Resource revenue

Recommendation 18: The value of the resource at the taxing point should be determined by:

- an 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, the amount determined using the most appropriate and reliable arm's length method.

Recommendation 19: The value of the resource should be determined at the time of supply of the resource, but no later than when the resource is loaded for export.

Recommendation 20: The explanatory memorandum should provide guidance as to the type of valuation methodologies that are suitable and be detailed enough to provide certainty to taxpayers and guidance to the ATO and the courts. In addition, draft ATO guidance on acceptable resource valuation methodologies and procedures should be developed, in parallel to the legislative process, to be available prior to the MRRT coming into effect.

Recommendation 21: A 'safe harbour' method to calculate the value of the resource at the taxing point where there is no arm's length supply to a third party at the taxing point should be available to:

- 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 operations in existence at 1 May 2010.

Recommendation 22: Taxpayers eligible to apply the 'safe harbour' method may calculate the value of the resource at the taxing point as the value derived from the first arm's length supply to a third party less:

- operating costs incurred between the taxing point and the point of sale;
- an allowance for capital employed between the taxing point and the point of supply, calculated as the depreciated optimal replacement cost of the capital employed multiplied by LTBR+7; and
- deductible and creditable amounts attributable to the use of the 'safe harbour' method should not be available to offset assessable receipts generated from other resource sales from the mining project or be transferable to other projects of the taxpayer.

6.2 Annual calculations

Recommendation 23: The MRRT should be assessed on an annual basis that includes MRRT deductions incurred throughout the year and all MRRT revenue receivable during the year.

Recommendation 24: The MRRT income should be deemed to be derived at the time of supply of the resource, but no later than when the resource is loaded for export.

Recommendation 25: The approach outlined in Recommendation 23 should apply from 1 July 2012, recognising that some resources supplied after that date will have been extracted prior to 1 July 2012.

6.3 Exploration and other pre-project expenditure

Recommendation 26: MRRT exploration and other pre-project upstream expenditure incurred in respect of mining tenements other than a production right should be:

- transferable to other projects producing the same MRRT commodity held by a taxpayer, subject to Recommendation 44; and
- transferable to projects producing the same MRRT commodity within an entity acquiring the tenement on which the expenditure is incurred, subject to Recommendation 47.

Recommendation 27: The uplift rate applying to eligible exploration and other pre-project expenditure incurred in respect of mining tenements other than a production right should reduce from the LTBR+7 to LTBR ten years after the expenditure is incurred.

6.4 Other revenue and deductions

Recommendation 28: Project revenue and deductions should include other amounts relating to changes in the use of project assets and amounts previously assessed or deducted. These include:

- balancing adjustments when a project asset (whether in the starting base or acquired from 1 July 2012) leaves the project or the extent of its use in the project changes;
- compensation for the loss of an asset or an MRRT deductible expense (for example, an insurance payout);
- explicit or implicit reimbursements, reductions or subsidies of deductible expenditure; and
- amounts arising under a risk sharing arrangement embedded in a contract entered into by the taxpayer where the counterparty is the purchaser of the resource or supplier of a service or input to an upstream activity (for example, under a take or pay arrangement).

Recommendation 29: Amounts received from contract mining services which an MRRT entity provides to a third party, such as extraction services, should not be MRRT assessable receipts to the entity and the costs of providing those services should not be MRRT deductible to the entity.

6.1 Resource revenue

Issue

Where an arm’s length sale does not occur at or before the taxing point it will be necessary to apply an appropriate methodology to determine the value of the resource at the taxing point. The terms of reference state that arm’s length principles are to be applied in determining the value of the resource at the taxing point.

Stakeholder comments

Industry supports an approach that would accurately determine the arm’s length value for the resource at the taxing point, where an arm’s length sale to a third party occurs downstream of that point. Industry has proposed a two-stage hierarchy of approaches to be used in determining the arm’s length value of the resource at the taxing point:

- the Comparable Uncontrolled Price (CUP) method; and
- if a CUP is not available, a deductive method such as a netback.

Industry emphasised the need for any netback calculation to use arm's length values, which should include appropriate returns to capital employed in downstream activities. Specifically, the rate of return provided to downstream capital should generate a capital charge consistent with the return an arm's length investor would require to invest in the asset if it was not regulated.

Industry proposed that an RPM be considered if a default methodology is to be adopted.

Discussion

Taxing point valuation

Two broad approaches are available for legislating the valuation of the resource where there is no arm's length sale to a third party at the taxing point. Taxpayers could be allowed to self-assess the most appropriate and reliable arm's length methodology, based on an analysis of the production value chain and their circumstances, or one or more methodologies could be mandated for use in particular circumstances.

If the law were not to specify a methodology, the calculation would be left to the entity and the ATO to determine. Should disputes arise regarding methodologies, recourse could be sought through the courts or the Administrative Appeals Tribunal.

The main advantage of this approach is that it would provide flexibility in the valuation methodology used and therefore would be more responsive to different circumstances of individual entities or projects. It would allow an entity to select a methodology that is easier for it to use or more appropriate to its circumstances.[3] The entity would be able to seek a ruling from the Commissioner of Taxation to provide certainty as to the acceptance of the methodology. A particular mechanism by which the ATO provides such certainty to entities is through an Advance Pricing Arrangement.[4]

An additional advantage is that it would be clear from the legislation that the intention is to arrive at the resource's arm's length value; a legislated formula might not provide such clarity about what the law aims to achieve.

A disadvantage of this approach is that there could be initial uncertainty for both taxpayers and the ATO about the methodologies that would be appropriate to determine the value of the resource at the taxing point. This lack of certainty could be mitigated to some extent by material included in the explanatory memorandum and by the ATO publishing early guidance (developed in consultation with industry and the tax profession). There would also be guidance from existing methodologies used for similar purposes, such as the methodologies, including profit methodologies, recognised by the OECD for transfer pricing purposes.[5]

The main advantage of directly legislating a methodology (whether in the principal Act or in regulations) is that entities would have certainty from the commencement of the MRRT on 1 July 2012 as to how assessable receipts should be calculated.

[3] As the ATO says in its Taxation Ruling TR 97/20 (at paragraph 1.8): 'The statutory objective should be interpreted as allowing the greatest possible scope to use methodologies appropriate in the circumstances, given the myriad of different and possibly unique cases that may arise.' It goes on to say (in paragraph 1.9): 'Accordingly, the use of a novel methodology does not mean that the method is invalid, so long as it is applied consistently, so far as practicable, with the statutory objective.'

[4] An Advance Pricing Arrangement could be used to give entities an opportunity to reach an agreement with the ATO on the future application of the arm's length principle in their dealings with related parties.

[5] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2010.

The disadvantage of directly legislating the valuation methodologies is the resulting lack of flexibility. The prescribed valuation methodologies would have to be used even where both the entity and the ATO agreed they produced inappropriate or unreliable results. Situations such as this could only be addressed by amending the law, and therefore the circumstances of individual entities could only be taken into account in a broad brush manner.

On balance, the PTG recommends the legislation require the arm’s length value of the resource at the taxing point be determined using the most appropriate and reliable method. Where there is an arm’s length sale to a third party at the taxing point, this would be the most reliable value. Where a sale occurs downstream of the taxing point, the taxpayer should use the method that is the most appropriate and reliable for the circumstances of their particular case to determine the value of the resource at the taxing point. The methodology selected should value the resource on an economically valid basis that approximates the price at the taxing point that would reasonably be expected to have been achieved on a stand alone basis between parties dealing at arm’s length.

In order to use the most appropriate and reliable method, widely understood concepts and methodologies, including OECD profit methods, must be considered. The method to be applied should be selected with regard to the facts and circumstances as well as the quality and comparability of available data. Such an approach should achieve an outcome that is the most reliable value of the resource at the taxing point.

For the value of the resource to be determined at the taxing point it will usually be necessary for the resource, or a product derived from the resource, to be sold in an arm's length transaction to a third party. This may occur at the taxing point or, as is more likely, at a point downstream of the taxing point. Therefore, the PTG recommends that the value of the resource at the taxing point should not be determined until such time as the resource has been supplied by the entity to another party, but no later than when the resource is loaded for export.

Safe harbour methodology

The PTG recommends that a ‘safe harbour’ methodology be made available, at the taxpayers’ election. While this may not be the most ‘reliable’ method for determining the value of the resource at the taxing point in all circumstances, it would provide certainty for taxpayers in relation to the upper boundary of resource valuation and reduce compliance costs for those taxpayers who may not wish to undertake a detailed transfer pricing exercise. Such an approach would also provide the fiscal certainty required for investment decisions. The safe harbour method should be aimed at taxpayers with interests in mining operations that combined produced fewer than 10 million tonnes per annum of saleable coal or iron ore (and are therefore likely to have limited downstream capital equipment).

The PTG has considered the application of the MRRT to vertically integrated transformative operations. These are coal and iron ore producing entities that significantly transform the resources into other products through processing or transformation. Specifically, the PTG sees coal mines integrated with the production of electricity and iron ore mines integrated with the production of steel as vertically integrated transformative operations, although there could be other processes which meet this definition. The PTG considers that vertically integrated transformative operations in existence at 1 May 2010 should also have the option of using the safe harbour method for determining the value of the resources used in the vertically integrated operation and therefore avoid complex transfer pricing calculations. Where vertically integrated transformative operations are established after 1 May 2010, the PTG believes they would not require access to the safe harbour method as they would be able to enter into discussions with the ATO to establish an Advance Pricing Arrangement.

The proposed methodology uses a netback calculation in which the costs incurred between the taxing point and the point of the 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. The capital base against which the capital allowance would be provided should be the depreciated optimal replacement cost of capital employed.

The 'safe harbour' method would be used on a project basis, other than in association with a vertically integrated transformative operation where it could be used solely for that resource stream.

Using the safe harbour method could potentially result in the resource value at the taxing point being determined as less than the costs of producing the resource. Since the safe harbour methodology is intended to provide a default method, it is not appropriate that losses or unused royalty credits resulting from the project be applied against assessable receipts generated from other projects, or in the case of vertically integrated transformative operations, other resource streams arising from a project.

The PTG recommends that the safe harbour method have the following features;

- unused deductible and creditable amounts associated with the resource supplied to the vertically integrated transformative operation should not be available to reduce assessable receipts from other resource sales; and

- unused deductible and creditable amounts from the application of the default method to a project should not be transferable to other projects.

Consideration has been given to using an RPM similar to that prescribed within the existing PRRT as a default methodology. In the case of the PRRT, this method is provided for specific integrated projects. The varying nature of mining activities within the iron ore and coal sector makes the PRRT methodology unsuitable, because the degree of integration will vary significantly between projects. Where appropriate, the OECD guidelines provide for the use of profit-based methods that would be available when determining the most appropriate and reliable arm's length method to value the resource at the taxing point.

Several other proposals have been identified for consideration to reduce the overall compliance cost burden on taxpayers. These include:

- developing industry benchmarks for the return to downstream activities. This would provide industry with a set of benchmarks for sectors and the downstream activities undertaken within each that they may, at their option, choose to draw on in determining the value of the resource at the taxing point. Sectors that could be considered include magnetite, integrated brown coal to electricity, integrated black coal to electricity, and integrated iron ore to steel; and

- alternative default methods for vertically integrated transformative operations in existence at 1 May 2010, including alternative netback arrangements and a regulated or deemed price.

The PTG is aware that some vertically integrated transformational industries were considering possible alternative safe harbour methodologies but have been unable to respond to the PTG within its timeframe. Noting the PTG's general position against exclusions, the PTG encourages these stakeholders to reflect on the proposed approach and assess its applicability to their operations, and engage further with Government to ensure workable solutions are delivered.

Guidance

Notwithstanding the various guidelines available to taxpayers, determining an appropriate methodology for valuing the resource and undertaking the necessary valuation is likely to be a complex task. To assist in this task, the PTG recommends the explanatory memorandum to the legislation provide sufficient examples to guide taxpayers in the requirements of the law. This should be complemented with ATO guidance (developed in consultation with industry and the tax professions) detailing the circumstances in which alternative methodologies would be considered to achieve a reliable value.

6.2 Annual calculations

Issue

At any one time, taxpayers will have MRRT assessable resources at various stages in the production chain, including at the commencement of the MRRT on 1 July 2012. The determination of *when* costs and receipts are brought to account could make a significant difference to the complexity in accounting for the MRRT and tax liabilities arising in a year, including in the transitional year.

Stakeholder comments

Stakeholders generally did not comment on this issue. However, simplicity and ease of compliance have been central themes in stakeholder feedback on many other design issues. One stakeholder indicated a preference to not include receipts from resources that had progressed past the taxing point prior to 1 July 2012.

Discussion

There appear to be two broad approaches to account for the MRRT in a year:

- one is to link the MRRT revenue from any sale to the costs related to the sale. This would be complex to administer, as taxpayers would need to track the upstream costs related to the resources sold and bring them to account in the same year the sale is made; or

- the second is to account for the MRRT using an annual approach. This could be done by expensing all allowable upstream costs as a deduction in the year they are incurred and assessing the value of the resources at the taxing point in the year they are sold or ownership is transferred. Where the value of the resource at the taxing point needs to be derived, because there is no sale or comparable uncontrolled price at that point, the taxpayer would need to determine the arm's length value of the resource at that point using appropriate and reliable methods. This would be easier to administer, as there would be no requirement to determine the specific connection between the upstream costs incurred and the revenue derived in that year. The MRRT would only look at annual upstream costs and annual resource revenue at the taxing point.

The PTG recommends the MRRT be implemented using the second approach. This would mean companies would be assessed on all MRRT revenue derived during the year and would deduct all MRRT costs (pre-taxing point) incurred during the same year. Where taxpayers need to determine the arm's length value of the resource at the taxing point, they would do so applying appropriate and reliable arm's length methods.

In recommending this approach, the PTG recognises that some resources sold after 1 July 2012 would be beyond the taxing point at 1 July 2012 and that the upstream costs associated with those resources would not be recognised, as they would have been incurred in a previous period. The PTG considers that the compliance cost benefit of the annual accounting approach warrants this transitional cost and notes that each year's liability would be broadly unaffected. The alternative would be to determine all resources across the production chain at 1 July 2012 and individually track the costs related to that production and remove them and the relevant sale from the MRRT calculation.

The time of derivation of MRRT assessable receipts should be when the resource, or product derived from it, is supplied to a third party, but no later than when the resource, or product derived from it, is loaded for export. This will minimise concerns regarding the potential of having an MRRT liability when the resource has not yet been sold and no royalty paid.

6.3 Exploration and other pre-project expenditure

Issue

The PTG has recommended that a project commence when a production right has been issued (Recommendation 7). From that time, exploration expenditure within the area of the production right would be treated as project expenditure.

It is important to also recognise exploration and other pre-project expenditure on MRRT commodities that is incurred in respect of other mining tenements. However, not all exploration is successful and the lead times to the commencement of a mining operation can be considerable. This raises the questions of how to identify eligible exploration and how long exploration expenditure should be uplifted at the MRRT rate of LTBR+7.

Stakeholder comments

Several stakeholders noted a preference for project commencement to be aligned with the granting of the first exploration licence, with all exploration expenditure incurred preceding discovery and development being deductible for the purposes of MRRT. Stakeholders also suggested that exploration within the project area and in surrounding areas should be deductible and exploration losses transferable.

Some stakeholders suggested the uplift rate for MRRT exploration expenditure should be in line with the PRRT. Others suggested that deductibility of exploration expenditure within income tax creates an inequality between mature and junior companies and there is a need to clarify how this would apply in MRRT.

Discussion

Recognising MRRT exploration and other pre-project expenditure

Exploration, including failed exploration, on MRRT commodities is an integral part of the production process and should be recognised as a cost of that process.

An issue in providing recognition for such expenditure under the MRRT is whether eligible expenditure can be reliably identified, particularly where the expenditure is unsuccessful. Industry has assured the PTG that the purpose of an exploration activity will be identifiable through the investment intentions outlined in company reports, information provided to State and Territory authorities and the type of work undertaken.

To ensure eligible exploration and other pre-project expenditure incurred in respect of mining tenements other than a production right is recognised as a cost of production under the MRRT, the PTG recommends that such expenditure be transferable to other projects held by a taxpayer that produce the same MRRT commodity. For this purpose pre-project expenditure would be expenditure that would not be considered exploration because it relates to considerations about how a resource might be developed but is incurred prior to the issuance of a production right.

Such expenditure would remain transferable once the mining tenement on which the expenditure was incurred became a production right, but subsequent exploration on that right would be treated as project expenditure.

In recognition that not all exploration and other pre-project expenditure leads to the discovery of a resource, or that it can take many years to do so, with multiple taxpayers being involved in the process, the PTG recommends that exploration and other pre-project expenditure also be transferable with the acquisition of the mining tenement on which the expenditure has been incurred. Such expenditure should also be transferable between projects of the acquiring entity producing the same MRRT commodity (Section 9). This treatment differs from that recommended for project losses acquired through the acquisition of a project interest which are to be restricted to the profits in that project interest (Section 9).

A concern with such a liberal treatment of exploration losses is that it could lead to trading in exploration deductions that have a greater economic value than the underlying tenement, so the PTG has recommended a number of safeguards (see Recommendation 47):

- the unused exploration or other pre-project losses attributable to a tenement *must* go with the tenement when it is transferred;

- the part of an exploration or other pre-project loss that an entity acquiring a mining tenement can use should be limited to the grossed-up amount it paid for the tenement;[6] and

- where a tenement is acquired by purchasing the entity that owns it an equivalent amount for the purchase price of the tenement should be determined taking into account the price paid for the entity and the values of all the entity's assets and liabilities.

Uplift for exploration expenditure

The lead time between exploration expenditure and the commencement of a mining project can be considerable. To allow such expenditure to be uplifted at the rate of LTBR+7 could result in a very substantial increase in the real value of the deductions.

The PTG considers this outcome to be inconsistent with its recommendations to ensure all such expenditure is deductible under the MRRT, particularly where exploration undertaken by an entity is unsuccessful.

The PTG recommendation to allow exploration expenditure on mining tenements other than a production right to be transferred should reduce the likelihood that such expenditure is held for long periods of time. To address other situations, the PTG recommends the rate of uplift reduce to the LTBR ten years after the expenditure is incurred.

[6] The grossed-up amount is the amount paid for the tenement multiplied by 1/0.225. This ensures that the amount of MRRT saved by using the exploration losses cannot exceed the price paid for the tenement.

6.4 Other revenue and deductions

Issue

The assessable revenue of a project will include amounts other than the value of the resource. In many cases such amounts reverse earlier deductions that turn out to have been excessive (for example, to reverse a deduction for the full cost of an asset that is later sold). Similar adjustments are required on the deductions side where previously assessed amounts prove to have been excessive.

Stakeholder comments

Most stakeholders accepted that balancing adjustments for the disposal or change in use of project assets should be assessable or deductible, although some thought this should be only for changes in predominant use. Some stakeholders indicated that all asset transfers within a group should be ignored.

Some stakeholders proposed that amounts received under take or pay agreements should not be assessable if they are not for actual delivery of the resource. It was suggested that amounts an entity earns for allowing others to use its project assets could be assessable under the MRRT.

Discussion

Disposal or change in use of project and starting base assets

When project assets are sold, or otherwise stop being project assets, an amount based on the sale price (or the asset's market value where there is no sale) should be assessable revenue of the project by way of a balancing charge. This is intended to reverse, to the extent of the sale value, the deduction previously provided for the cost of the asset.

When the extent of an asset's use in a project changes (for example, when it begins to be partly used downstream of the taxing point, or partly in another project, or partly in something that is not part of any project), there could be both a deemed disposal, and a deemed purchase, of the asset at an appropriate value. The assessable amount for the disposal would reflect the original extent of the asset's use in the project. The deduction for the deemed purchase would reflect the expected extent of its future use in the project.

Some assets are deducted over time instead of being fully deducted on acquisition, such as assets that form part of the project's starting base. When these assets are sold (or the extent of their use in a project changes), the balancing charge should take into account not only the asset's disposal price (and the extent of its use in the project) but also any undeducted value.

- For market value starting base assets, the disposal proceeds could be first applied to reduce the undeducted value of the asset in the starting base, then to reduce any starting base deductions or unused starting base losses of that project, then to reduce the undeducted starting base. Any residual would be an assessable amount.

- For book value starting base assets, the disposal proceeds could first reduce any starting base or unused losses then the undeducted starting base without limit. Any residual amount would be an assessable amount.

Insurance payments

Insurance payments for lost or destroyed project assets should be treated in the same way as the proceeds of a sale of those assets.

This would apply also to insurance payments for lost, destroyed or stolen resources. While such cases are rather unlikely in the coal and iron ore industries, they could occur (for example, a coal stockpile could ignite and burn). In principle, a payment for the disposal of resources through loss, destruction or theft should be treated in the same way as the proceeds of a disposal through sale. Since the value of the resource at the taxing point, and not the proceeds of its sale, is the basis for this assessable amount, the insurance payment would be relevant only in so far as it relates to the resource's value.

Hedging, foreign exchange gains and take or pay agreements

Consistent with Section 7, gains from hedging and foreign exchange movements should be excluded from the MRRT.

By contrast, an amount received under a take or pay contract should be treated in the same manner as a hedge or risk sharing arrangement embedded in a sale contract. If a customer chose not to accept delivery of resources they had contracted to buy under a 'take or pay' agreement and to pay a (perhaps lesser) amount instead, the payment should be MRRT assessable revenue.[7] While it may be argued that, assessing the payment could amount to double taxation − once on the amount due under the 'take or pay' agreement and again when the resource is eventually sold as 'taken' − to ignore the 'pay' amount would be equivalent to a partial unwinding of the terms of a sale contract where the buyer of the resource is the counterparty.

Adjustments of assessable receipts

As a general principle, subsequent reductions of MRRT assessable receipts should be deductible amounts. The assessable receipts of a mining entity might be adjusted after the time of assessment, for example because of a failure to receive payment from the recipient of the resource. To the extent the resulting bad debt relates to the value of the resource at the taxing point, the mining entity should be allowed a deduction as it has not benefited from the full amount assessed.

Refunds of deducted amounts

Some deducted amounts will be refunded to mining entities. For example, an entity might claim a deduction for a bad debt, some or all of which is later recovered (perhaps by way of a liquidator's distribution). These recovered amounts are assessable for income tax purposes and the same treatment should apply under the MRRT.

Similarly, an entity might never have to pay the full amount it has deducted. An example might be a supplier who provides a price reduction for early payment of debts to an entity with a mining project. If the entity were to deduct the full price, any reduction for early payment should be recognised as an assessable amount.

As a general principle, explicit or implicit reimbursement, a reduction or subsidy of deductible expenditure should be an assessable amount.

[7] Of course, the price under the take or pay contract could affect the value of the resource at the taxing point (for example, it could be the price used for a netback calculation).

Services provided to a third party

Amounts received from contract mining services an entity provides to a third party, such as extraction services, should not be an MRRT assessable receipt to the contract miner. This is because the contract miner does not own the resources and it is not sharing in the resource profit. Costs incurred by the contract miner in providing those services would likewise not be deductible to the contract miner for MRRT purposes. However, the costs associated with using a contract miner would be deductible to the taxpayer who has an interest in the project (the MRRT taxpayer) on the basis that it is a legitimate cost incurred in upstream mining activities.

7 DEDUCTIBLE EXPENSES

Recommendation 30: 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, subject to the exclusions listed in Recommendation 31.

Recommendation 31: The following payments should be excluded for the purposes of Recommendation 30:

- 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.

Recommendation 32: The Implementation Group should investigate the treatment of expenses associated with plant and equipment included in head office expenditure.

Recommendation 33: Private royalties payable in respect of a period after 30 June 2012 to a State or Territory body under an agreement entered into prior to 2 May 2010 should be deductible but otherwise treated in an equivalent manner to State and Territory royalties. Recommendation 31 would not apply in respect of such royalties.

Recommendation 34: The legislation should ensure that native title payments made pursuant to an agreement under the *Native Title Act 1993* or a similar Act in settlement of an indigenous land use agreement, should be deductible to the extent they relate to upstream operations.

Recommendation 35: The definition of exploration under the MRRT should be aligned with that used for income tax.

Recommendation 36: The time of recognition of an expense should be aligned with that under income taxation.

Issue

For an expense to be deductible under a taxation law, it needs to have sufficient connection with the tax base. The MRRT is a form of resource rent tax designed to levy tax on resource profits derived from activities upstream of the taxing point. MRRT deductible expenditure should have a necessary connection with the derivation of such profits. Where the first arm's length sale of the resource occurs downstream of the taxing point, expenses taken into account in deducing the value of the resource at the taxing point (if relevant) should be determined consistently with how MRRT deductions are determined.

The terms of reference state that non-deductible expenditure will be broadly consistent with the PRRT, which implies that deductible expenditure should also be broadly consistent. In translating the PRRT provisions to the MRRT, the PTG has had regard to the practical experience of companies operating under the PRRT and the different circumstances relevant to iron ore and coal operations.

Stakeholder comments

Stakeholders expressed the view that all expenditure related to a mining operation should be either deductible as an MRRT expense or through the derivation of the value of the resource at the taxing point. There is concern that the general deductibility test used in the PRRT may exclude expenditure related to a mining activity merely because the activity is remote from the mining operation, or because there is not a sufficiently close connection between an expense and a particular project. Stakeholders were concerned that this would work against businesses that centralise business functions.

Stakeholders expressed a preference for clarity in defining which expenses are deductible when calculating an MRRT liability. Many raised concerns about the ambiguity in the PRRT legislation and the potential for similar disputes about the deductibility of particular expenses to arise under the MRRT if the PRRT provisions were to be adopted. It was proposed that deductible expenditure be defined broadly and augmented with specific exclusions for expenses that would not be deductible.

The following comments were made in respect of deductibility of specific expenses:

- There was general acceptance that *private override royalty payments* should not be deductible (and not assessable to the royalty recipient), as they are a payment for the resource rather than a cost of extracting the resource. However, there is some concern that the proposal in the Issues Paper, to set the starting base for an existing project as if it were unencumbered by an existing private override royalty, may not fully compensate the mining entity for disallowing a deduction for the royalty payments.

- There is broad support amongst stakeholders for a specific deduction for *native title payments*, to clarify that such payments are deductible regardless of the form in which they are made, being a cost of land access.

- Stakeholders were generally of the view that hedging and foreign exchange gains and losses relating to the resource should be excluded from the MRRT because they do not reflect the value of the resource. Some were concerned that distortions may arise if some hedging gains or losses were taken into account (for example, where the hedge directly related to the sale of a resource such as a forward sale) while others were not (for example, collateral hedges).

- Some stakeholders submitted that rehabilitation bonds and rehabilitation trust payments should be deductible, with the return of the bond or any trust distribution (together with any investment return) being assessable. There were differing views as to whether provisions for rehabilitation costs should be deductible.

- While there was a general acceptance that financing costs should not be deductible for MRRT, there was some concern about possible biases in relation to outsourcing and finance leasing if the MRRT were to exclude all finance costs. There was some concern that there is a bias in favour of outsourcing because the whole amount of outsourcing payments (including any embedded finance costs) would be deductible, whereas finance costs would not be deductible if the same services were provided by the miner. However, some stakeholders claimed there is a bias against outsourcing because outsourcing firms will not receive an immediate deduction for capital expenditure.

During the consultation process, stakeholders raised concerns about the ATO's characterisation and treatment of exploration expenditure under the PRRT. Specifically, they were concerned there are items of expenditure considered exploration expenditure under income tax, but which the ATO might consider are not exploration expenditure for the purposes of the PRRT. They called for the definition of exploration in the MRRT to be aligned with that used for income tax.

There is a broad preference for using methods to assess, apportion and allocate expenses that align with standard business practices or other existing legislative requirements, to reduce compliance costs.

Discussion

General deduction test

The PRRT employs a general deduction test that requires expenditure to be 'closely' or 'directly' connected with activities upstream of the taxing point. The application of this test has given rise to disputes about whether some expenses are deductible or not.

The PTG recommends that in the MRRT, the general deduction test be based on the income tax concept of an expense being *necessarily incurred*. Expenditure would qualify as an MRRT deduction to the extent it is *necessarily incurred* by an entity in carrying on mining operations upstream of the taxing point. As these words are judicially well tested, and familiar to taxpayers through their use in income tax, they should deliver a high degree of certainty regarding the deductibility of expenses. A similar test should be applied when determining the value of the resource at the taxing point, where the sale occurs downstream of the taxing point.

The words *to the extent*, which are also familiar to taxpayers through their use in income tax, support the apportionment of costs. They allow allocation of expenditure using a method that is fair and reasonable in all the circumstances.[8] Consistent with income tax, this could include apportionment using a proxy or key such as revenue, production volumes, direct costs, labour costs, or head counts.

Excluded expenditures

The MRRT should specifically exclude, either as a deduction or as expenditure taken into account in deducing the value of the resource at the taxing point, certain categories of expenditure. Some specific exclusions are necessary for consistency with the design of the MRRT, while others result from the way the MRRT is intended to interact with various claims to the resource right.

State and Territory royalties

The MRRT provides a credit for State and Territory royalties paid under State and Territory legislation and, accordingly, these payments should not be deductible as well.

[8] See *Ronpibon Tin NL v FCT* (1948) 78 CLR 47 at 60.

Payments to acquire a mining project or tenement

The MRRT, like the PRRT, should not allow a deduction for payments made to acquire a mining project or tenement other than on the initial grant of the tenement. If a deduction were available to a buyer for the acquisition price of a production right or other mining tenement, tax symmetry would require that the proceeds of the sale be assessed as MRRT revenue (to the extent they relate to the upstream mining operations). This would effectively capitalise future profits and bring forward tax on any change in the value of the project or mining tenement.

Payments made as consideration for the initial grant of the right should be deductible if they satisfy the general deductibility test − *necessarily incurred* in carrying on mining operations upstream of the taxing point. This would apply regardless of the form of the payment (for example, it would extend to the provision of community infrastructure where such expenditure is a condition of the grant of the right).

Private override royalty payments

Private override royalty arrangements differ from State and Territory imposed royalties being, in substance, a profit sharing agreement in respect of the exploitation of a resource, rather than the cost of acquiring the resource from the State or Territory.

The PTG recommends private override royalties be non-deductible to the mining entity and non-assessable to the recipient (consistent with the PRRT). This approach avoids the need to assess individual royalty recipients against their share of a project's proceeds, as would be the case if private override royalties were deductible.

For private override royalties agreed prior to 2 May 2010 it may not be possible for the entity paying the royalty to renegotiate the terms of the royalty agreement, in which case they would bear an MRRT liability in respect of profits they do not earn. The PTG recommends this be addressed by valuing any production right included in the starting base for the mining project as if it were unencumbered by the private override royalty liability. This would inflate the value of the starting base above its actual value and lead to additional starting base deductions provide an equivalent shield to that otherwise available to the royalty recipient.

Hedging and foreign exchange losses (and gains)

There is a range of ways in which entities can hedge against adverse price movements, including forward contracts for sale at an agreed price, or through financial instruments such as exchange traded derivatives (futures) or over-the-counter derivatives (swaps) to hedge price or currency risk.

Hedging and foreign exchange arrangements should not, in general, affect the MRRT liability, as they do not affect the value of the resource, though there is some cost associated with de-risking project cash flows. There would also be potential compliance costs in linking particular hedging or foreign exchange losses with upstream mining operations. A simpler approach is to exclude all such losses (and gains) for MRRT purposes.

Where, however, the hedge or foreign exchange arrangement is embedded within the sale arrangements for the resource, capital item or service (for example, under a take or pay contract or forward sale arrangement), there may be high compliance costs in removing the effect of any hedging integrated within the sale. In these circumstances it would be practical to include any loss (or gain) on the hedging or foreign exchange component integrated within the sale or purchase contract.

Accordingly, the PTG recommends that any loss (or gain) on a hedging or foreign exchange arrangement should not be taken into account in calculating the MRRT, unless the loss (or gain) is a part of the sale contract (that is, where the buyer of the resource or seller of a capital item is the counterparty).

Rehabilitation bond and trust payments, provisions and non-adjacent land and buildings

Rehabilitation is a legitimate cost of a mining operation and should be recognised as an MRRT expense to the extent it relates to activities upstream of the taxing point. Rehabilitation bond and trust payments are amounts set aside to provide security for rehabilitation costs rather than expenses incurred in a mining project. Given their role in securing this liability, for prudential reasons they are typically held as low risk investments. As the MRRT uplift rate is intended to reflect the higher risk associated with a resource project, it would be inappropriate for it to apply to such payments. Accordingly, the PTG recommends that rehabilitation bond and trust payments should not be deductible (and the repayment plus any investment returns should not be assessable).

Similar arguments apply in respect of the provisions entities may make in respect of future liabilities. Provisions, or other amounts that serve the purpose of meeting future liabilities, are not incurred in respect of a payment to extract a resource. Accordingly, they should not be deductible, as they represent an anticipated cost of extracting the resource rather than the cost itself.

The PTG recommends that capital expenditure to acquire an interest in land and buildings used for administrative and accounting purposes – other than land subject to the production right, or adjacent land, and buildings thereon – not be deductible. Land and buildings located at, or adjacent to, upstream mining operations are likely to take their value from the production right itself. Ownership of such land and buildings should reflect the risk associated with the resource project. However, the value of other land and buildings[9] such as head office does not reflect this risk, and is likely to appreciate over time. Accordingly, like rehabilitation bond and trust payments, the PTG recommends that payments to acquire these assets not be deductible.

Finance costs, including finance leases and hire purchase agreements

The value of the resource extracted by a mining company should be independent of an entity’s choices about the way it finances its mining operations. The required return to capital invested in a mining operation is recognised through the interest allowance for activities upstream of the taxing point and through arm’s length pricing of downstream activities where the first arm’s length sale is beyond the taxing point. Allowing a specific deduction for interest and other financing costs would amount to a double deduction for the cost of capital. It would also tend to bias financing decisions towards debt. Therefore, consistent with the PRRT, interest and other financing costs should not be deductible under the MRRT.

Whether this approach induces a bias toward outsourcing or insourcing would turn on the relativity between the return to capital provided under the MRRT through the uplift, and that required by the contracted parties providing the service. Where they are equivalent (an outcome that might be expected in a competitive market) the MRRT should not result in a bias. However, to ensure there is no bias in the use of hire purchase and finance leasing arrangements, these arrangements need to be treated under the MRRT in a manner equivalent to a debt funded purchase, allowing the up-front capital cost of the item as a deduction and ignoring actual payment arrangements.

[9] Other than unusual buildings that are effectively plant – see for example *Wangaratta Woollen Mills Ltd v. FCT* 69 ATC 4095.

Head office capital expenditure

The allowance of expenditures to the extent they are *necessarily incurred* in carrying on mining operations arguably will allow a broader range of costs to be deducted against upstream revenues. Some capital expenditure that might be deductible under this broader concept could potentially require reallocation through time as business operations change – for example, equipment costs included in head office expenditure. The tax laws in a number of different areas deal with a change in use of capital – for example, capital expenditure under the PRRT, adjustments for the change of use under the GST, and the immediate deduction of expenditure included in capital allowance pools under income tax.

There is, however, a greater likelihood that the basis of allocation could change in the MRRT because of the need to allocate expenditure to different activities of an entity (for example, between MRRT and non-MRRT activities, between individual MRRT projects, and between upstream and downstream operations). One means of addressing this issue would be for head office capital expenditure to be depreciated on a similar basis to income tax rules, rather than being expensed. This would allow the use of existing business systems to assist in calculating the MRRT. The PTG recommends this issue be considered by the Implementation Group proposed in Recommendation 61.

Negotiated royalties paid to States and Territories

The PTG recognises that there may be some circumstances where a mining entity has entered into agreements with a State or Territory where they have negotiated to pay additional royalties to those paid under State or Territory legislation.

These negotiated payments may capture a greater proportion of the rents associated with the resource. Where these arrangements were entered into prior to 2 May 2010, the mining entity would not have had the opportunity to take into account the announced resource tax reforms in striking their agreement. If these payments are large relative to profits, the mechanism proposed to handle pre-existing private override royalties may be inadequate. Specifically, disregarding these payments when assessing the market value of the starting base, so that the value of these obligations flows into increased starting base deductions, may expose the mining entity to the possibility of significant MRRT taxation of rents captured by the State or Territory.

Accordingly, the PTG recommends that taxpayers who are obliged to pay such additional royalty payments to a State or Territory body under an agreement entered into prior to 2 May 2010 should be able to deduct those royalty payments instead of inflating the starting base. The royalties should be assessable receipts of the recipient, though the PTG notes that State-owned bodies are normally taxed under the National Tax Equivalents Regime, with revenues returning to the State or Territory.

This treatment would provide a more complete shield from the MRRT than would otherwise be available, which recognises the prior arrangements implemented by the States and Territories to capture resource rents for the benefit of the Australian community.

Native title payments

Native title payments can be paid under legislation or pursuant to privately negotiated agreements. They can involve a flat amount, a share of mining revenues, or a combination of the two. The payments can be in cash or in kind (such as shares in the mining company or the provision of community facilities).

The High Court has confirmed that native title rights and interests, even if found to exist over an area of land, will not extend to most commercially produced minerals which exist in the land.[10] A payment pursuant to an agreement under the *Native Title Act 1993* or a similar Act in settlement of an indigenous land use agreement, should be deductible to the extent they relate to upstream operations and should be properly recognised as a downstream cost when deriving the value of the resource at the taxing point from a sale price.

It is the PTG's understanding that such payments should be deductible without reference to a specific provision under the recommended general deduction test – *necessarily incurred* in carrying on mining operations upstream of the taxing point. Should this prove not to be the case, provision should be made to ensure the intended outcome.

Exploration expenditure

There is clearly a degree of confusion as to the application of the exploration provisions under the PRRT. The PTG recommends that the provisions be aligned between the MRRT and income tax to provide certainty, avoid disputation and reduce compliance and administrative costs.

Timing of deductions

Aligning the recognition of an expense under the MRRT with that under income tax will provide certainty and consistency and minimise compliance costs.

[10] This is because native title holders do not have native title rights over the mineral resources (*Western Australia v Ward* (2002) 191 ALF 1), and so payments to native title holders could not be characterised as consideration for the disposal of their interest in the resource or profit sharing.

8 TREATMENT OF DEDUCTIONS

8.1 Starting base losses and royalties

Recommendation 37: Losses arising from unused depreciation of the starting base (starting base losses) should not be transferable to other projects.

Recommendation 38: Starting base losses should be uplifted in the following manner:

- market value starting base – by the consumer price index to retain their real value; and
- book value starting base – by the MRRT uplift rate consistent with the design announced on 2 May 2010.

Recommendation 39: State and Territory mineral and gas royalties (including those raised on behalf of private land owners holding mineral rights) should be:

- creditable against MRRT liabilities;
- non-transferable and non-refundable; and
- carried forward and uplifted where they are unable to be used.

Recommendation 40: It is important to ensure that the taxation of Australia's resources preserves our international competitiveness and ensures Australians receive a greater benefit from mineral resources and that this is reflected in the treatment of royalties under the MRRT. The MRRT should not be used as a mechanism to enable States and Territories to increase inefficient royalties on MRRT taxable commodities. All current and future State and Territory royalties on coal and iron ore should, therefore, be credited and it is imperative that the Australian, State and Territory Governments put in place arrangements to ensure that the States and Territories do not have an incentive to increase royalties.

Recommendation 41: Private royalties imposed by the States and Territories on behalf of private land owners should be treated in the same manner as State and Territory royalties and therefore be creditable and uplifted but not transferable.

8.2 Deduction ordering rules

Recommendation 42: MRRT revenue should be reduced by deductions, losses and royalty credits in the following order:

1. Project deductions.
2. Royalty credits (current year and carried forward).
3. Carried forward losses of the project.
4. Starting base depreciation deductions and starting base losses.
5. Transferable exploration expenditure.
6. Transferred-in project losses.

8.1 Treatment of starting base losses and royalties

Issue

The concept of a starting base was negotiated with industry as a partial shield against an MRRT liability arising in respect of interests in a project prior to 2 May 2010 (Section 10). The terms of reference state how the starting base is to be treated but do not specify how losses arising from starting base deductions should be treated. State and Territory royalties are creditable against the MRRT liability on a project.

Stakeholder comments

Stakeholders proposed that starting base losses be treated the same as a normal MRRT loss. That is, starting base losses should be transferable to reduce the MRRT liability on another project and, regardless of whether they relate to a market value or book value starting base, uplifted if they are carried forward. A common observation was that the terms of reference do not contemplate a separate class of losses arising from starting base deductions. Some stakeholders stated that, if starting base losses were quarantined to prevent them from shielding new projects from MRRT, they should be transferable between other starting base projects.

Stakeholders were unanimously of the view that all State and Territory royalties on assessable commodities should be creditable against the MRRT to avoid a situation whereby companies could potentially face double taxation on a component of their revenue.

Discussion

Transferability and uplift of starting base losses

The PTG recommends starting base losses be non-transferable and market value starting base losses be uplifted by the consumer price index.

The starting base is intended to provide a partial shield against an MRRT liability arising in respect of interests in a project prior to 2 May 2010 by providing an additional deduction after the application of project deductions, credits for State and Territory royalties and carried forward losses. To allow starting base deductions to be transferable could give rise to the situation where an entity with an existing project, that is not generating substantial profits subject to MRRT and is therefore not in need of a tax shield, would be able to effectively transfer the starting base to other projects. This could include projects commenced in the future that would not otherwise benefit from a starting base or would have only a small starting base value.

The different treatment of a market value starting base and a book value starting base reflects, in large part, the potentially significant value attributable to the value of the resource, which is only recognised under the market value option. To uplift losses arising from the market value starting base at LTBR+7, as is the case with book value starting base losses, could significantly increase the value of the market value starting base over the life of a project, with the potential to severely limit the revenue raised from existing projects where profits are deferred by new investment or reduced by a downturn in resource prices.

However, the PTG considers there to be a case for preserving the real value of market value starting base losses arising from the depreciation of a market value starting base, particularly where their use is deferred as a result of deductions arising from new investment. In the absence of such an adjustment, the real value of the starting base could differ between similar projects because they have different investment profiles.

Credits for State and Territory royalties

To reflect the fact that State and Territory mining royalties will apply alongside the MRRT, the royalties entities pay on iron ore and coal are to be credited against the MRRT liability of a project.

The recognition of State and Territory royalties under the MRRT raises a number of important issues. Generally speaking, the current State and Territory royalties levied on coal and iron ore are set at rates that the industries can afford to pay, at least during normal times, and provide the States and Territories with a relatively stable revenue stream. On the other hand, royalty regimes are inherently less flexible during a downturn and can unnecessarily damage the industries and prevent optimal resource extraction. Further, by their nature the royalty regimes do not capture the economic rents during a boom period.

Through the implementation of the MRRT, Australia has the opportunity to substantially improve the overall outcome for the taxation of coal and iron ore in this country. It provides a way to meet the needs of the States and Territories and captures more of the profits at the peak of the resources cycle, in a way royalties alone cannot, for the benefit of all Australians.

Recognising this objective as well as the importance of preserving Australia's international competitiveness, the PTG recommends that there be full crediting of all current and future State and Territory royalties under the MRRT so as to provide certainty about the overall tax impost on the coal and iron ore mining industries. Equally, the MRRT should not be used as a mechanism to enable States and Territories to increase inefficient royalties on MRRT taxable commodities. Accordingly, the PTG also recommends the Australian, State and Territory Governments put in place arrangements to ensure that State and Territory governments do not have an incentive to increase royalties on coal and iron ore. This would limit their negative impacts, while allowing the Australian Government's taxation regime to maximise the return to the community during the highpoint of the resources cycle, so achieving the balanced outcome described above.

The PTG notes that some royalties are struck in agreements between State or Territory governments and mining companies and that some of those royalties can only be varied by mutual agreement. In those circumstances the mining company party to the agreement can, at the very least, significantly influence the royalty payable by it. Responsibility to maintain the integrity and competitiveness of the resource taxation regime is therefore a shared one between the Australian, State and Territory Governments and, importantly, the companies involved.

8.2 Deduction ordering

Issue

The ordering of project deductions and transferable losses should be consistent with the intended design features of the MRRT. As noted in Section 4, the design features of the MRRT are consistent with it being a project-based tax with transferability of losses between projects being a key design feature. It is intended that royalties not be transferable and that the starting base provide a partial shield against an MRRT liability arising in respect of investment in a project prior to 2 May 2010 (Section 10). The LTBR+7 uplift rate recognises there is a prospect that some expenditure might not receive MRRT relief.

Stakeholder comments

There is a broad view among stakeholders that the order of deductions should be consistent with the MRRT being a transferable tax with elements of quarantining, rather than a project-based tax with transferability. Consistent with this view, stakeholders consider that the ordering rules should minimise the risk that royalty credits and any other non-transferable amounts are trapped within a project. There is also a general preference for any non-uplifted amounts (of which the market value starting base is considered one element) to be offset before uplifted amounts, to preserve their value.

Industry's suggested ordering (outlined below) is predicated on a requirement that taxpayers be free to choose the extent to which carried forward losses of a project and losses from other projects are used to ensure royalty credits are used to the maximum extent.

1. Project deductions.
2. Exploration expenditure.
3. Starting base deductions.
4. Carried forward losses of the project.
5. Losses transferred from other projects.
6. Credit for royalties paid.

Discussion

The PTG's recommended order of deductions (Figure 8.1) applies project amounts before transferable amounts. This ordering is commensurate with the design of the MRRT as a project-based tax with transferability of losses. It also provides a degree of consistency between projects held in separate entities and projects held within a single entity.

Applying all project amounts before transferable amounts reduces the potential for royalty credits and starting base deductions to be wasted. Offsetting project amounts before transferable amounts also provides a convenient point within the MRRT calculation to deduct eligible coal and iron ore exploration expenses that do not satisfy the *necessarily incurred* test with a particular project.

Project deductions should be the first amounts to reduce MRRT revenue. This point would also determine the amount of any current year loss available to be transferred to other profitable projects of the entity or to be carried forward.

Royalty credits (both current year and carried forward) should be applied next, followed by carried forward project losses. This ordering reduces the prospect of royalties not being used. The PTG recognises that this could result in some de-facto transfer of royalty credits due to the increase in the pool of transferable project losses.

Starting base deductions should be applied as the last project-based deduction, commensurate with the role of the starting base as a partial MRRT shield for existing investment in a project. In this order, the starting base acts to shield existing investment from a residual tax liability after the application of project deductions, credits for State and Territory royalties and carried forward losses. Applying starting base deductions last also gives effect to the limited uplift of market value starting base losses. If starting base deductions were to be applied earlier in the order, it would effectively raise the uplift rate to LTBR+7, as any otherwise carried amount would receive the higher uplift. The PTG notes this contrasts with industry's view that starting base deductions and losses should be treated like other project deductions and losses.

Of the transferable amounts (exploration expenditure and project losses), transferable exploration expenditure could be applied prior to transferable losses. This would favour the deduction of exploration expenditure, which the PTG recommends should have a limited 10-year window of uplift at the LTBR+7 (after which the uplift rate should decline to the LTBR). A method statement reflecting this is set out in Figure 8.1.

Figure 8.1: Calculating an MRRT liability

Assessable revenue	=	Value of the resource (e.g. sales proceeds or value at taxing point) + other revenue (see Section 6.4)
less		Deductible costs incurred in relation to the project, including exploration expenditure
less		Royalty credits (deduction equivalent)[11]
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 per cent	=	MRRT liability before extraction allowance
less		25 per cent extraction allowance
Total	=	**MRRT liability**

[11] Royalty credits, as a deduction equivalent, would be the amount of royalty payable multiplied by 1/0.225.

9 TRANSFERS OF MRRT LOSSES

Recommendation 43: Losses should only be transferable between projects producing the same MRRT commodity.

Recommendation 44: Losses that can be transferred should be transferred at the appropriate point under the ordering rules, to the extent that they can be used.

Recommendation 45: Project losses should only be transferable if the transferring and transferee projects were owned by the same entity (or group) from when the losses were generated until they are transferred. Historical losses should otherwise be quarantined to the project from which they originated.

Recommendation 46: Notwithstanding Recommendation 45, the Implementation Group should consider whether there are administrative and/or alternative legislative approaches to loss transferability that could apply in situations where the holder of an interest in a joint venture acquires a further interest in that joint venture. (The Implementation Group is identified in Recommendation 61.)

Recommendation 47: MRRT exploration and pre-project losses acquired with a mining tenement should be transferable to projects with MRRT profits, whether or not any ownership condition is satisfied. To avoid the possibility that this free transfer of exploration losses leads to trading in exploration deductions that have a greater economic value than the underlying tenement:

- the unused exploration losses attributable to a tenement should go with the tenement when it is transferred; and
- the part of an exploration loss that an entity acquiring a mining tenement can use should be limited by reference to the amount paid for the tenement (or an equivalent amount where the entity that owns the tenement is acquired).

Recommendation 48: If the relevant tests are otherwise satisfied, losses should be transferable to projects owned by other entities within the same consolidatable group regardless of whether the group has chosen to consolidate.

Issue

The PTG's terms of reference state that project losses will be transferable to offset MRRT profits on other projects the taxpayer owns. However, MRRT losses are not intended to be refundable. An appropriate balance in the extent to which losses can be transferred between projects is needed to meet both conditions.

Stakeholder comments

There were mixed views among stakeholders as to whether project losses should be transferable between projects producing different MRRT commodities.

Many stakeholders indicated that losses should be transferable at the discretion of the entity. Some indicated that compulsory transfer would be acceptable if royalty credits could be used before transferring losses. Many also submitted that losses should be transferable between projects of entities in the same group.

A range of proposals were proffered to define the grouping rule, including a wholly-owned group test, an income tax consolidated group and a consolidatable group. Some stakeholders suggested that the grouping test for loss transfer purposes should be the same as that for aggregating for the $50 million threshold.

There was general acceptance that there should be some form of ownership test, or other integrity rule, to limit the sale of losses, although some were of the view that all acquired losses should be transferable. One stakeholder proposed that, within majority-owned groups, losses should be transferable to the extent of the ownership, to deal with incorporated joint ventures. Another proposed that an 'available fraction' approach could be used to allow some part of an acquired loss in a joint venture to be offset against profits from the joint venture. This would be similar to the 'fraction' used for consolidation under the income tax law, but based on proportionate interest in the project rather than relative market values.

Discussion

Compulsory transfer of losses

The PTG recommends transferability of project losses be limited to projects producing the same MRRT commodity − iron ore or coal. This is intended to balance the benefit of deducting royalties before carried forward project losses (which provides for a degree of de-facto royalty transferability because other transferable losses may be commensurately increased) and the potential for projects to build large tax shields during periods of low prices through the consumer price index uplift of the market value starting base.

The PTG recommends the transfer of losses and use of transferable exploration expenditure be mandatory, but only after all other project-based and transferable amounts have been applied. This is consistent with the role of the uplift rate in compensating the investor for the risk they may not receive tax relief for an otherwise deductible amount. Where profits are available to absorb a loss, the risk of not being able to receive tax relief for the amount would not exist and so the taxpayer should not receive a benefit from the uplift.

Limits on transferring losses between projects

Allowing losses that are attached to a project interest to be transferable in the hands of the acquiring entity would be inconsistent with non-refundability. This is because the value of losses that might otherwise remain unused within the project could, in substance, be refunded through the sale of the project interest.

Similarly, an entity's (or group's) existing losses could be accessed by acquiring a profitable project to which the losses could be transferred.

The PTG recommends legislating a common ownership test to limit transfers of losses to those between projects owned by the same entity (or group) throughout the period from when the loss was generated until it is transferred. The common ownership test would not look to continuity of ultimate ownership, as is the case with the income tax continuity of ownership test. Instead it would look to the continuity of the entity (or group) that owns the project.

The common ownership test should apply both to prevent losses of an acquired project being transferred to an entity's (or group's) existing projects and to prevent losses of an entity's (or group's) existing projects being transferred to a profitable project that the entity (or group) has acquired.

For a group, the common ownership test would mean that losses of a project owned by the group could be transferred to another project in the group if the *group* owned both projects from when the loss arose until the transfer. It would not be necessary for the projects to have been owned by the same entities throughout that period, or even that the transferring and transferee entities were in the group throughout that period.

> ***Example:*** *A group has two projects, one making MRRT losses and another making profits. It would be able to transfer the losses from the loss-making project to the profitable project. If the group then acquires a new entity and moves the loss making project into it, the group would still be able to transfer that project's losses to its profitable project because the group owned both projects from the time when the loss arose until its transfer, even though the particular entity within the group that now owns the loss-making project did not own it at the time the loss was incurred.*

A common ownership test will create the need to account separately for each year's MRRT loss and will entail rules requiring losses to be used in the same order they were generated. While these rules will add to the compliance costs of some entities, requiring common ownership is the simplest way to prevent the sale of losses and is the usual tax law solution to the problem.

The issue is dealt with under the PRRT's wholly-owned group model through a similar continuity of ownership test. It limits exploration loss transfers to projects that were, at all times from the start of the year a loss arises until the end of the year the loss was transferred, held by companies in the same group (see clause 31 in Part 6 of the Schedule to the PRRT Act).[12]

The PTG acknowledges that loss quarantining reduces some of the benefit of an aggregated approach to defining a project. Accordingly the PTG recommends that the Implementation Group referred to in Recommendation 61 consider whether there is capacity to develop effective approaches to dealing with acquired projects that do not undermine the policy intent. It could also consider whether such approaches should be implemented through legislation or by an administrative approach.

Transfers of exploration losses

The PTG recognises that, if exploration losses were dealt with in the same way as losses from actual mining activities, many of them would remain unused. This is because most mineral exploration in Australia is conducted by entities that do not mine their successful discoveries themselves.

Accordingly, the PTG recommends that the use of losses attributable to exploration activities not be subject to a common ownership test when the mining tenement to which they relate is transferred. However, transfer would be limited to the same MRRT commodity under Recommendation 43.

To avoid the possibility that this free transfer of exploration losses leads to trading in exploration deductions that have a greater economic value than the underlying tenement, the PTG recommends a number of safeguards:

- the unused exploration losses attributable to a tenement should go with the tenement when it is transferred; and

[12] One exception is provided for in subclause 31(3) to allow transfers to a profitable project that did *not* exist when the loss arose if the project's ownership arrangements were consistent from the issuing of the relevant exploration permit. Something similar could be considered for the MRRT.

- the part of an exploration loss that an entity acquiring a mining tenement can use should be limited by reference to the amount paid for the tenement (or an equivalent amount where the entity that owns the tenement is acquired).[13]

If a tenement is acquired by purchasing the entity that owns it, an equivalent amount for the purchase price of the tenement should be determined, taking into account the price paid for the entity and the values of all the entity's assets and liabilities.

Transferring losses within groups

The terms of reference make it clear that some amounts should be quarantined to a particular project and not be transferable to other projects. However, they clearly contemplate that a project's losses should be transferable to an entity's other projects. To the extent that such transfers are available, there are good reasons to also allow losses to be transferred to projects held by other entities with the same ownership as the transferring entity.

Allowing MRRT losses of one entity's project to offset MRRT profits of a related entity's project would avoid any bias that might otherwise arise concerning the choice of corporate structure. If there were a prohibition on the transfer of MRRT losses within a wholly-owned group, there could be a bias towards holding projects within a single corporate structure. That may be at odds with commercial practice.

The PTG favours using the concept of a consolidatable group to establish the transfer group. Losses would be transferable between projects of a group that has elected to consolidate for income tax purposes or could consolidate if it elected to. There are several arguments in favour of this option.

- The consolidation model allows companies, trusts and partnerships to be members of a group.

- The consolidation model requires a structure under which the subsidiary entities are 100 per cent beneficially owned by the head entity but makes an exception for interests totalling up to one per cent held under employee share scheme arrangements (see section 703-35 of the ITAA 1997). This is consistent with the Government's policy of encouraging employee share schemes.

- There would be no additional compliance costs involved in applying it for MRRT purposes to a group that had already decided to consolidate for income tax purposes (ignoring the necessary adjustments to the group's accounting systems to deal with MRRT).

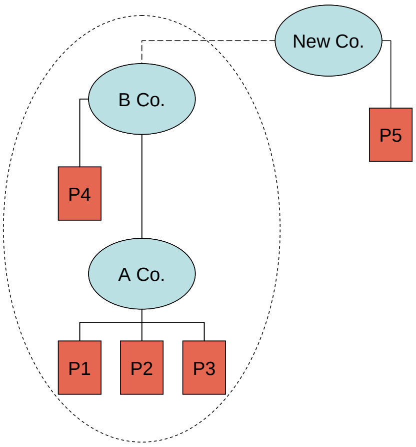
There may be circumstances where the group that has common ownership at the relevant times is not technically a consolidatable group at all those times because it is owned by other entities at some of those times. The PTG proposes applying the common ownership test to the common ownership group as if those other entities did not exist. For example in Figure 9.1 a loss arising in any of projects P1 to P4 could be transferred to the other projects because they are all held within a consolidatable group. If New Co acquired the group, the historical losses could not be transferred to New Co's project P5 but could still be transferred within P1 to P4 because, if New Co did not exist, A Co and B Co would still be a consolidatable group.

The consolidatable group model is considered superior to the wholly-owned grouping provisions in the PRRT, which are limited to companies and make no allowance for employee share schemes.

The PTG does not consider that the grouping test used for loss transfer should be the same as that used to aggregate profits for purposes of the $50 million threshold as the two grouping rules are intended to serve different objectives.

[13] The grossed-up amount is the amount paid for the tenement multiplied by 1/0.225. It ensures that the amount of MRRT saved by using the exploration losses cannot exceed the price paid for the tenement.

Figure 9.1: Transfer of losses within consolidatable group



The PTG does not support the proposal that a portion of a loss should be transferable to shareholders in majority-owned groups in accordance with their ownership levels. While it accepts that there will be incorporated joint venture cases where losses will be quarantined within the joint venture entity, fixing the problem would lead to unacceptably high complexity and compliance costs. It could also lead to the unfair treatment of some shareholders. For example, if the unused losses were transferred proportionately to all shareholders, some of them may not be able to use those losses. That would therefore waste some of the transferred losses. Alternatively, the losses could be transferred just to shareholders who could use them (assuming the company knew who those shareholders were). However, that would lead either to some shareholders getting a disproportionate benefit from the company's losses or to extensive record keeping to ensure that a portion of the company's unused losses was permanently linked to each particular share.

10 STARTING BASE

Starting base

Recommendation 49: A starting base should be available for all interests in mining tenements in existence at 1 May 2010.

Starting base election

Recommendation 50: An entity must make an irrevocable election to use market value or book value as the method for determining a starting base for each interest the entity holds in a project or other mining tenement in existence at 1 May 2010, by the due date for the filing of the first MRRT tax return. Where an election is not made by the required date, the project or mining tenement should be taken to have a book value starting base. Where an appropriate book value does not exist or cannot be reliably reproduced, there should be no starting base.

Determining the market value starting base

Recommendation 51: An entity should determine a market value starting base comprising the market value of mining assets upstream of the taxing point as at 1 May 2010 on the basis of accepted market valuation principles.

- In determining how market valuation principles should be applied, the taxpayer should take into consideration their particular circumstances and the stage of development of the project or mining tenement.
- The derivation of the market value starting base should have regard to market expectations of future iron ore and coal prices, exchange rates, interest rates, inflation and other industry reference benchmarks as at 1 May 2010, and recognised methodologies for market valuation in the mining sector. The Treasury, ATO and RET should consult industry and professionals to identify suitable reference benchmarks to reduce compliance costs and provide greater certainty to taxpayers. The existence of such benchmarks would not constrain a taxpayer's choice of valuation methods or their ability to use alternative estimates.
- Guidance as to the application of valuation methodologies should be provided through examples within the explanatory memorandum. In addition, the ATO should provide early guidance to industry regarding the practical application of this aspect of the legislation.
- The approach used in deriving the starting base should be consistent with that used to value the resource at the taxing point.
- 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 mining information.
- Where a private override royalty existed in relation to the project or tenement at 2 May 2010, the starting base should be determined as if it were unencumbered by the private override royalty liability (Recommendation 31).
- As a proxy for the market value of tenements other than a production right, an entity could elect to use the sum of their expenditure over the previous 10 years.

Applying the market value starting base

Recommendation 52: The market value starting base of a mining project or other mining tenement should not start to be depreciated until an MRRT commodity is first produced from the tenement to which the starting base relates. Where a resource does not come into production by 30 June 2037 (25 years from the commencement of the MRRT), the starting base should be immediately deductible in the year production commences.

- Depreciation of the market value starting base should be on a straight-line basis.
- The mining right and mining information should be treated as one asset and depreciated over the lesser of the life of the mine or the period to 30 June 2037.
- Other assets should be written off over the lesser of their effective life, the life of the mine or the remainder of the period to 30 June 2037.
- The market value starting base should not be uplifted. Starting base deductions that have not been used within a project should be uplifted by the consumer price index to retain their real value (Recommendation 38).
- Any undepreciated starting base amounts attributable to an interest in a project or mining tenement are to be transferred to the new owner upon sale of the interest.
- The starting base is not to be reduced to reflect any depletion in the resource between 2 May 2010 and 30 June 2012. However, where starting base assets are disposed of between 2 May 2010 and 30 June 2012, the starting base should be reduced by the market value ascribed to the asset at 1 May 2010.
- Capital and mine development expenditure incurred between 2 May 2010 and 30 June 2012 should be added to the starting base.

Determining the book value starting base

Recommendation 53: A book value starting base should be 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. Such accounts are to have been prepared in line with Australian Accounting Standards.

- Capital and mine development expenditure incurred after the date at which the audited accounts were prepared and before 1 July 2012 should be added to the starting base.
- The book value starting base should be uplifted at the MRRT uplift rate from the date at which the audited accounts were prepared until fully offset against project revenues.
- Further guidance as to the application of the book value starting base should be provided through examples within the explanatory memorandum.

Applying the book value starting base

Recommendation 54: The book value starting base of a mining project or other mining tenement should start to be depreciated from the later of the commencement of the MRRT (1 July 2012) and the date an MRRT commodity is first produced from the tenement to which the starting base relates.

- The starting base should be depreciated over five years with the following profile: 36 per cent, 24 per cent, 15 per cent, 15 per cent and 10 per cent.

- Undeducted book value starting base amounts should be uplifted and carried forward to be available as an offset against future project revenue.
- Any undepreciated starting base amounts should be transferred to a new owner if an interest in a project or mining tenement is sold.
- Where starting base assets are disposed of between the date at which the audited accounts were prepared and 30 June 2012, the starting base should be reduced by the book value ascribed to the asset at 1 May 2010.

Issue

The starting base is intended to provide a partial shield against an MRRT liability arising in respect of interests in a project that were held prior to 1 May 2010. Taxpayers are able to choose from one of two methods of establishing a starting base – market value or book value.

Stakeholder comments

Industry has supported the adoption of generally accepted methodologies and practices (where relevant) and have highlighted the market valuation guidelines released by industry, the Australian Securities and Investment Commission and the ATO, particularly those used for the purposes of consolidation. There is wide acceptance that the principles used to determine the valuation of the starting base should be consistent with those used in determining the value of the resource at the taxing point. Valuations should be consistent with the ATO market valuation guidelines and those released for the purposes of tax consolidation. There is also a preference for the PTG to prescribe guidelines with respect to the valuation methodology to avoid potential disputes.

The starting base is generally held to comprise all assets both tangible and intangible, with the resource representing the residual of the value of these assets. Stakeholders submitted that some assets were specifically listed in the Heads of Agreement to remove any uncertainty as to whether they should be included as project assets. Stakeholders queried whether mining entities could choose between straight-line or diminishing value methods to depreciate market value starting base assets.

Stakeholders considered that only providing a starting base where an investment had reached the stage of a production licence at 1 May 2010 would penalise investments that had not quite reached that stage. Some stakeholders proposed moving the test point to 1 July 2012.

Discussion

The PTG notes that the valuation of the starting base could have a significant bearing on taxpayer liabilities for MRRT, and that different valuation methodologies and assumptions can produce quite different results. While taxpayers should be free to use a starting base valuation methodology that is appropriate for the specific circumstances of their project, it should be consistent with accepted methodologies, consistent with market expectations at 1 May 2010, transparent and defensible.

Starting base eligibility

The terms of reference state that a starting base is to be available for project assets. The PTG considers that the 1 May 2010 cut off for being eligible for a starting base should include the value of potential projects that are yet to commence production. It therefore recommends that all tenements held at 1 May 2010 be eligible for a starting base. However, in recognition that production on some tenements may not commence until many years into the future, and possibly not at all, the PTG recommends that the starting base for non-producing tenements as at 1 July 2012 not be deductible until the commencement of production from the tenement.

Starting base election

The terms of reference state that the choice of market or book value is ‘at the election of the taxpayer’. The PTG is of the view that an entity should be able to make an election with regard to the method for determining the starting base for each of its mining projects and other mining tenements.

For administrative simplicity, the starting base election should be made as part of the first MRRT tax return. In instances where there is no obligation to lodge an MRRT tax return in relation to a mining interest (for example exploration leases, retention leases and other mining tenements that do not generate assessable receipts), an election should be required to be lodged with the ATO no later than the lodgment date if they were an MRRT liable entity.

Should an entity fail to make a starting base election for a project interest it held on 2 May 2010, a default position would need to be adopted. A default position of market value is almost certainly not viable, since an entity failing to make an election is most unlikely to have undertaken a market valuation exercise for the purposes of the MRRT.

Consequently, the PTG recommends that where no starting base election is made with regard to a mining tenement by the required date, the mining tenement should be deemed to have a book value starting base where audited accounts exist or can be reliably reproduced. Otherwise the tenement should have no starting base.

Determining the market value starting base

The PTG recommends that a taxpayer should use accepted market valuation principles to determine a market value starting base for assets upstream of the taxing point. The terms of reference state that the starting base should include all tangible assets, 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 mining information. Tangible assets included in the starting base should be deductible for MRRT purposes. This would exclude land and buildings associated with a head office or otherwise non-deductible assets.

The determination of the market value starting base and assessable receipts at the taxing point are interdependent. The approach used in determining the starting base will need to be consistent with that used in determining the value of the resource at the taxing point.

Determining the market value of assets that form the starting base is likely to require consideration of all activities that take place along the production value chain. That is, it may be necessary to determine the value of assets both upstream and downstream of the taxing point to determine an appropriate market value for the resource included in the starting base.

Given these interactions, an overly prescriptive approach toward the methodology for determining market value would require all possible activities to be considered and defined to achieve an appropriate outcome. Further, as the combination of assets and project circumstances will vary across industry, it is likely that situations could occur where a prescribed method would produce an outcome that would not reflect fair market value.

The PTG therefore recommends the taxpayer be allowed to select the most relevant method of valuation for their circumstances and adopt the methods and practices that are generally accepted by industry and the ATO. An approach that allows the taxpayer to select from among generally accepted and recognised methodologies for determining the starting base for their particular circumstances is more likely to facilitate an accurate value for the starting base.

The PTG notes there are well recognised methodologies for conducting market valuations in the mining sector. In selecting a valuation methodology to be used the valuator should give consideration to such factors as:

- the nature of the valuation;
- the development status of the mineral assets; and
- the extent and reliability of available information.[14]

For example, a discounted cash flow (DCF) method may be considered appropriate for most projects at the production stage. For non-producing tenements in the pre-development or advanced exploration stage, a risk-weighted DCF method may be more appropriate. These approaches will require valuators to make a forecast of cash flows into the future at a discount rate that takes into account both entity-specific and systematic (market) risk.

For non-producing tenements at the exploration stage, that do not yet have sufficient certainty to predict future cash flow, a different market value method would be appropriate. As a proxy for the market value of an exploration or retention lease, the PTG recommends entities have the option to use the sum of their expenditure over the previous 10 years.

To undertake a market valuation, a number of input factors may need to be estimated, including resource to reserve conversion ratios, production and sales forecasts, forecasts of commodity prices, exchange rates, interest rates, inflation and costs, and various discount rate parameters. As valuations are to be undertaken as at 1 May 2010, there are some market based inputs that will be common across entities, and others that differ according to the facts and circumstances.

For some of the common factors, industry information existed at 1 May 2010 that provides a reference benchmark for individual judgments about these factors. Articulating such reference benchmarks could assist in making the valuation process more objective, consistent and transparent, and thereby reduce compliance costs and provide greater certainty to taxpayers and valuators. The PTG notes, however, that the actual forecasts and assumptions used in individual valuations are likely to differ from such reference benchmarks for a range of reasons and the existence of such benchmarks should not prevent taxpayers and valuators using different assumptions where they are justifiable.

The PTG therefore recommends that Treasury, ATO and RET consult with industry, tax and valuation professions to identify suitable reference benchmarks that can be used by industry, valuators and the ATO. These benchmarks would not constrain a taxpayer's choice of valuation methods or their ability to use alternative estimates where they are justified. In addition, the ATO should work with the Treasury, RET, industry and tax and valuation professionals, to provide early guidance regarding the practical application of market valuation for the purposes of the MRRT.

Applying the market value starting base

As per the terms of reference, the market value starting base should be written off over the lesser of 25 years or the effective life of the assets as determined at 1 May 2010. It will therefore be necessary to establish the effective life of each asset that forms part of the market value starting base. It is recommended that the mining right and mining information be treated as a single asset and depreciated over the lesser of the life of the mine or 25 years. This is consistent with the interdependent nature of the two assets and would avoid the complexity of determining separately identifiable values.

Where the market value approach is used to value the starting base, the PTG recommends each project asset be depreciated on a straight-line basis over its effective life or 25 years (whichever is the lesser).

[14] The Valmin Code 2005.

This depreciation profile is most likely to match the economic diminution of the mining right, which is the project asset from which most of the other project assets derive their value.

In recognition that production on some tenements may not commence until many years into the future, and possibly not at all, the PTG recommends that the starting base for non-producing tenements as at 1 July 2012 be first deductible at the commencement of production from the tenement. This approach is consistent with the role of the starting base as a partial shield for investments in a project.

Where a project commences after 1 July 2012 the starting base assets should be written off over the lesser of the remainder of the period to 30 June 2037, the effective life of the mine or the effective life of the underlying assets. Where a project or tenement does not come into production by 30 June 2037, the starting base should be immediately deductible in the year production commences.

Other features associated with the application of a market value starting base are provided within the terms of reference, these include:

- capital and mine development expenditure incurred between 2 May 2010 and 30 June 2012 will be added to the starting base;

- the market value starting base should not be uplifted (the treatment of starting base losses is addressed in Section 8.1); and

- any undepreciated starting base amounts are to be transferred to a new owner if an interest in a project or other mining tenement is sold.

Capital and mine development expenditure incurred between 2 May 2010 and 30 June 2012 should include capital expenditure plus any mine development expenditure expensed for accounting or income tax purposes. Specifically, this could include overburden removal, pit excavation or sinking a mine shaft, but should exclude exploration. Unlike the starting base amount determined at 1 May 2010, expenditure incurred between 2 May 2010 and 30 June 2012 should only be added to the starting base to the extent its value has not been accounted for through mining activity undertaken during that period.

Determining the book value starting base

Where the book value approach is used, the starting base will depend upon values recorded in an entity's accounts. The terms of reference are silent on the features of the book value option. However, it is reasonable to assume the intention was to base this option on the starting base rules proposed under the Government's initial resource tax proposal of 2 May 2010.

Under that proposal, the starting base was to be based on the accounting book value of existing project assets as at the most recent audited accounts available on 2 May 2010. The book value was to reflect a value consistent with Australian Accounting Standards and exclude the value of the resource.[15] Capital and mine development expenditure incurred after the book date and before 1 July 2012 was to be added to the starting base.

[15] See *The Resource Super Profits Tax*, The Treasury, Section 6.3.

Applying the book value starting base

Under the Government's initial resource tax proposal of 2 May 2010 the entire starting base was to be uplifted at the LTBR from the date of the last audited accounts through to 1 July 2012, and thereafter until fully depreciated. Depreciation was to occur over five years with the following profile:
36 per cent; 24 per cent; 15 per cent; 15 per cent; 10 per cent.

The PTG recommends the book value starting base of a mining project or other mining tenement be first deductible when an MRRT taxable resource commences to be produced from that project or tenement following the commencement of the MRRT on 1 July 2012, in line with the recommendation for the treatment of a market value starting base.

11 COSTS OF COMPLIANCE FOR SMALL MINERS

11.1 $50 Million threshold offset

Recommendation 55: The $50 million threshold offset is intended to relieve a taxpayer of any MRRT liability arising in respect of an income year when their MRRT profit is below $50 million. The offset should have the following features:

- the profit threshold should apply annually to a taxpayer's MRRT profit (revenue less expenses);
- the profit threshold should apply at an aggregate taxpayer level, defined by the small business test in Subdivision 328-C of the *Income Tax Assessment Act 1997*;
- a taxpayer's MRRT liability should be phased-in from $50 million by reducing the maximum possible tax concession provided by the threshold ($11.25 million at $50 million) by $0.225 for every $1 of MRRT profit above $50 million; and
- the actual offset available to a taxpayer with an MRRT profit of between $50 million and $100 million should be the lesser of:
    - the maximum offset reduced by creditable royalties paid and the credit equivalent of other deductible amounts (carry-forward losses and starting base deductions); and
    - MRRT otherwise payable.

11.2 Simplified MRRT obligations

Recommendation 56: Taxpayers subject to MRRT, who are unlikely to have an MRRT liability for an extended period for example, due to their lack of MRRT profits or the relativity between gross MRRT profit and creditable royalty payments, should be provided the option to elect to comply with simplified MRRT obligations to reduce their compliance burden.

Recommendation 57: The Treasury and ATO should work with industry to develop and implement one or more tests that allow a taxpayer to evidence they will not be liable for MRRT for an extended period. The test, or tests, should be designed to work with readily available data and be applied at an aggregate taxpayer level, defined by the small business test in Subdivision 328-C of the *Income Tax Assessment Act 1997*.

The PTG observes that the following tests could achieve the required outcome:

- Earnings Before Interest and Tax (EBIT) on iron ore and coal extraction plus creditable royalties less than $50 million.
- EBIT on iron ore and coal extraction plus creditable royalties less than $250 million AND creditable royalties exceed 25 per cent of such earnings plus creditable royalties.

Recommendation 58: Where a taxpayer meets the relevant test, or tests, an annual election to opt into the simplified MRRT obligations should be available.

Recommendation 59: Where an entity no longer satisfies at least one of the relevant tests, or opts to withdraw from the simplified MRRT obligations, it would need to comply with the full MRRT obligations for that year. Such taxpayers should be treated as new MRRT taxpayers and only receive a deduction for expenditure incurred in the year they fail the tests or move to the full MRRT.

11.1 $50 Million threshold offset

Issue

The $50 million threshold excludes taxpayers with resource profits below $50 million in a year from an MRRT liability in respect of that year. It is not a mechanism by which compliance costs are reduced. The PTG has recommended separate measures, one of which is based on the existence of the $50 million threshold, to relieve some non-MRRT paying taxpayers from the cost of complying (see Section 11.2).

Stakeholder comments

Industry is generally comfortable with the threshold being applied as an annual MRRT profit test at the entity level defined by the small business aggregation test. Industry generally accepts that royalty credits and other amounts should be reduced by any MRRT profits or liability that would otherwise exist in the absence of the $50 million threshold offset.

Industry has proposed that the threshold be:

- increased to up to $250 million;
- applied as a tax-free threshold, or otherwise redesigned to reduce its potential to distort business decisions; and
- automatically indexed.

Discussion

The $50 million threshold should be applied as an annual MRRT profit (receipts less expenditure) test.

The small business test for grouping entities is favoured by the PTG for the purpose of the threshold offset because it is a broader grouping test covering non-corporate vehicles and entities with less than 100 per cent common ownership.

As recommended, the $50 million threshold would provide taxpayers with less than $50 million in MRRT profits a maximum potential tax offset of $11.25 million. This will ensure they pay no MRRT in respect of that year. To ensure this concession does not also inappropriately shield taxpayers from MRRT liabilities in later years, royalty credits and other deductions are only carried forward after they have been reduced by any MRRT liability that would have existed had the $50 million threshold not applied.

It is not feasible to apply the offset as a tax-free threshold, as the benefit provided by the offset is dependent on more than the level of MRRT profit. To address industry concerns associated with the potential distortionary effect of the threshold on companies with profits marginally greater than $50 million, the PTG recommends a taxpayer's MRRT liability be phased-in from an annual MRRT profit of $50 million. This will provide a gradual imposition of the MRRT for taxpayers with MRRT profits above $50 million.

The phase-in is intended to apply by reducing the maximum possible tax concession provided by the threshold ($11.25 million at $50 million) by $0.225 for every $1 of MRRT profit above $50 million. To ensure a smooth transition from the $50 million threshold offset, the maximum offset should be reduced by any unused royalty credits, starting base deductions and carried forward losses. The concession available to the taxpayer would be the lesser of the reduced offset and the taxpayer's MRRT liability that would be otherwise payable. Figure 11.1 illustrates the phasing out of the concession and the effect on the concession of netting off royalties paid. Examples of how the threshold is intended to work are provided in Figure 11.2.

Consistent with the terms of reference, the PTG recommends that the $50 million threshold not be indexed. Automatic indexation of thresholds is not a feature of the Australian income tax system. Further, it is not apparent how the threshold should be indexed to retain its value in terms of resource profits. If considered appropriate at some future time, the Government could review the threshold as part of the budget process to ensure its relevance.

Figure 11.1: Effect of royalties and the phase-in on the size of the $50 million threshold offset

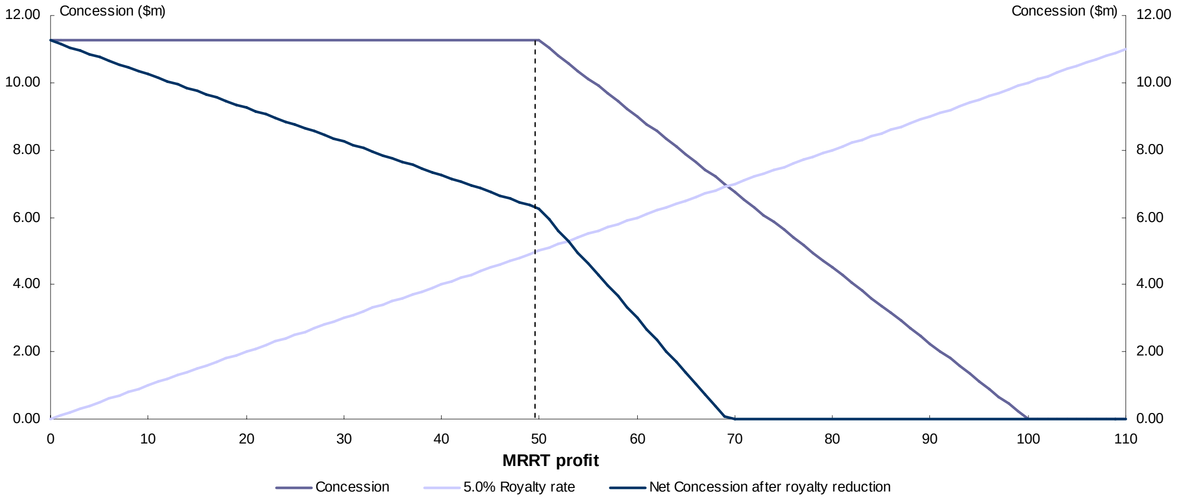


Figure 11.2: Examples of the $50 million threshold offset in operation

Example 1 - MRRT profit of $40 million	MRRT Calculation	Offset Calculation
	$ m	$ m
MRRT Revenue	$95.0	
CY Deductions (project and exploration)	$55.0	
CY MRRT Gross Profit	$40.0	
Gross MRRT Liability	**$9.0**	
Maximum $50 million threshold offset		$11.25
Reduction in Offset		$0.00
Reduced Offset		**$11.25**
Project carry forward losses (credit equivalent)	$0.10	$0.10
Royalty credits	$4.75	$4.75
Starting base deduction (credit equivalent)	$0.20	$0.20
Credits against MRRT liability and offset	**$5.05**	**$5.05**
MRRT liability	**$4.05**	
Reduced Offset less credits	$6.30	$6.30
Net MRRT Liability	**$0.00**	

Example 2 - MRRT profit of $55 million	MRRT Calculation	Offset Calculation
	$ m	$ m
MRRT Revenue	$110.0	
CY Deductions (project and exploration)	$55.0	
CY MRRT Gross Profit	$55.0	
Gross MRRT Liability	**$12.4**	
Maximum $50 million threshold offset		$11.25
Reduction in Offset		$1.13
Reduced Offset		**$10.13**
Project carry forward losses (credit equivalent)	$0.10	$0.10
Royalty credits	$5.50	$5.50
Starting base deduction (credit equivalent)	$0.20	$0.20
Credits against MRRT liability and offset	**$5.80**	**$5.80**
MRRT liability	**$6.58**	
Reduced Offset less credits	$4.33	$4.33
Net MRRT Liability	**$2.25**	

Example 3 - MRRT profit of $75 million [ii]	MRRT Calculation	Offset Calculation
	$ m	$ m
MRRT Revenue	$130.0	
CY Deductions (project and exploration)	$55.0	
CY MRRT Gross Profit	$75.0	
Gross MRRT Liability	**$16.9**	
Maximum $50 million threshold offset		$11.25
Reduction in Offset		$5.63
Reduced Offset		**$5.63**
Project carry forward losses (credit equivalent)	$0.10	$0.10
Royalty credits	$6.50	$6.50
Starting base deduction (credit equivalent)	$0.20	$0.20
Credits against MRRT liability and offset	**$6.80**	**$6.80**
MRRT liability	**$10.08**	
Reduced Offset less credits	Nil	Nil
Net MRRT Liability	**$10.08**	

Notes: i) The above examples are calculated at the entity level. Taxpayer's are required to combine all their project interests.
ii) In Example 3 the offset is nil because credits against the MRRT liability exceed the value of the reduced offset.

11.2 Simplified MRRT obligations

Issue

The PTG's terms of reference require it to consider a workable exclusion for companies where resource profits are below $50 million. The $50 million threshold described in the terms of reference does not achieve this objective (see Section 12.1). The intertemporal nature of the MRRT creates a strong incentive, even for low MRRT profit taxpayers, to maintain MRRT records as they may have an offset to future MRRT liabilities or an asset upon sale of a project. Consequently, measures to alleviate taxpayers of the need to comply with the full MRRT obligations are only likely to be effective where there is little prospect of ever paying tax. The proposed tests are targeted at such taxpayers.

Stakeholder comments

Many stakeholders, who considered themselves unlikely to be liable for MRRT, proposed there be some form of 'watching brief' or default option to allow them to elect a low compliance burden option.

However, it was also widely acknowledged by industry and their advisors that there would be a commercial incentive to keep MRRT records and undertake MRRT calculations, to establish a robust MRRT base should their operations be expanded or sold.

Discussion

Some taxpayers have a prospect of being below the $50 million threshold or otherwise unlikely to be liable for MRRT for an extended period. These taxpayers would face a significant compliance burden if they were required to fully comply with MRRT obligations and determine their starting base, calculate their assessable receipts and track unused losses and royalties.

The PTG recognises that taxpayers who are unlikely to be liable for the MRRT for an extended period should be able to avoid the additional compliance burden. The Treasury, ATO and industry should work together to develop a test, or tests, along the lines of those suggested below to provide a simplified process for determining the likelihood of an entity being liable for MRRT. The test, or tests, should be designed to remove the need for the entity to undertake a market valuation or deal with the complexity and expense of undertaking a full MRRT assessment.

The PTG observes that the following tests could be used to achieve the Government's policy intent and would be much simpler to comply with. They rely on a taxpayer's ability to determine their overall Earnings Before Interest and Tax on their mining and processing activity associated with MRRT assessable commodities (iron ore and coal) as a proxy for undertaking the full MRRT calculations. Consultation sessions and submissions indicate that most entities track or are able to easily calculate expenses and revenues associated with their coal and iron ore operations. These revenues and expenses are often reported within existing accounting, taxation or management frameworks. As with the $50 million threshold, the tests should apply at an aggregate taxpayer level, defined by the small business test in Subdivision 328-C of the *Income Tax Assessment Act 1997*.

The first test requires the entity to determine their EBIT on iron ore and coal and add back their creditable royalties, where they are deducted in the EBIT calculation. Where the result is less than $50 million there is little likelihood of the entity being liable for MRRT, and as such they could be permitted to opt into the simplified MRRT obligations.

The second test also requires the calculation of EBIT on iron ore and coal plus creditable royalties. Where this is less than $250 million, and payments of creditable royalties exceed 25 per cent of EBIT on iron ore and coal extraction, there is little likelihood of the entity being liable for MRRT, and as such they could also be permitted to opt into the simplified MRRT obligations.

Taxpayers that no longer satisfy a test, or opt to withdraw from the simplified MRRT obligations, would need to commence complying with the full MRRT obligations in that year. In doing so, these taxpayers would be treated as new MRRT taxpayers, and would only receive recognition for operational and capital expenditure incurred and royalties paid during that year. They would not receive a starting base or recognition for historical capital, operating or royalty expenditure. These taxpayers would be treated the same as any other new MRRT entrant and be subject to the instalment regime after lodging their first MRRT return.

To provide for proper administration of the MRRT, entities that meet the test, or tests, and wish to opt into the simplified MRRT obligations would need to report their election to the ATO annually. The advice to the ATO could take the form of a simplified lodgment either separate to, or as part of, the taxpayer's income tax return and include the details of the economic entity, its MRRT commodity earnings and royalties paid.

12 MRRT ADMINISTRATION

12.1 Transitional administration

Recommendation 60: The Treasury should engage with overseas jurisdictions as soon as possible, regarding the crediting of the MRRT in their jurisdictions.

Recommendation 61: The Treasury and ATO should continue to engage with industry to progress the administrative design and implementation of the MRRT, including:

- establishing an Implementation Group involving industry representatives and relevant advisors and officials from RET, the Treasury and ATO;
- providing practical early guidance on the MRRT and taxpayer obligations; and
- establishing capability in both the ATO and key intermediaries to support industry in complying with the law.

Recommendation 62: The Government should ensure the ATO is appropriately funded to provide interpretive and administrative support to industry in their transition to the MRRT.

Recommendation 63: To ensure the MRRT achieves its intended purpose efficiently and equitably, with minimal compliance and administration costs, the Board of Tax should review the operation of the MRRT within five years of its implementation.

Recommendation 64: The ATO should provide guidance on circumstances that may warrant a remission of penalties by the ATO in cases of inadvertent errors, particularly in the first two years of the MRRT.

12.2 Ongoing administration

Recommendation 65: The MRRT legislation should provide for:

- the MRRT to be designed and implemented as a self-assessed tax;
- a July−June accounting period, with substituted accounting periods in place for taxpayers who use them for income taxation;
- an instalments regime that is responsive to the potential for significant within-year variability in mining profits and a final reconciliation period that fits within entities' tax calendars;
- acceptance of functional currencies where the company meets the criteria and uses them in accounting for income taxation; and
- the ability of the ATO to obtain MRRT relevant information from third parties such as project vendors or joint venture operators.

Recommendation 66: Division 25 of the *Income Tax Assessment Act 1997* should be updated to specifically include expenditure related to management of MRRT tax affairs as an income tax deduction.

Recommendation 67: The administrative design of the MRRT should provide workable certainty to taxpayers and minimise the costs of complying with and administering the MRRT. These practices should include:

- providing for annual MRRT returns, including the option to lodge returns prior to the receipt of MRRT income to support the provision of certainty regarding historic expenditure; and
- guidelines for joint venture participants and operators, and the ATO, in relation to joint venture accounts and substantiation of expenditure.

12.1 Transitional administration

Issue

Through its consultation process the PTG has identified a number of areas where appropriate administrative support and engagement for affected entities would ease the transition to the MRRT.

Stakeholder comments

Industry stakeholders have expressed concern about the scope of change involved in transitioning to the MRRT and the ability of the ATO to respond to requests for advice and rulings in a timely manner.

Discussion

Recognition of the MRRT as a creditable tax

The PTG recognises that for some companies the treatment of MRRT payments in other jurisdictions will be an important determinant of their overall tax liability and the incentive to invest in Australian projects. The Treasury and other agencies should therefore engage with relevant jurisdictions as soon as possible regarding the crediting of the MRRT in their jurisdictions.

Industry engagement on MRRT implementation

The PTG recognises the valuable input provided by industry through the consultation process and the goodwill that has developed. The PTG encourages the Treasury and ATO to continue to consult industry both through normal consultative forums as well as through the representative bodies who engaged with the PTG. The PTG also recommends that an Implementation Group be established with industry representatives, relevant advisors and officials from the Treasury, ATO and RET. This group would be consulted on administrative design issues, the development of the MRRT and PRRT extension legislation, the implementation of the MRRT and extended PRRT, as well as the review. In addition this group could work with the ATO's National Tax Liaison Group in developing ATO guidance material, testing of administrative design aspects and assisting in implementation planning.

The PTG recognises the ATO's implementation of the GST was well regarded. The PTG suggests the Treasury and ATO look to the lessons learnt from that implementation for the planning and management of the MRRT implementation.

Elsewhere in this report, the PTG has noted several issues where the ATO should continue to consult with industry to clarify its approach – for example, in relation to determining the starting base and the value of the resource at the taxing point. The PTG strongly encourages the ATO to commence its usual consultation processes with industry and taxpayer associations at the earliest possible time to maximise industry awareness as to how it will administer the MRRT.

Recognising that some aspects of the MRRT will closely mirror existing income tax and PRRT processes and practices, the PTG recommends, where practical, the ATO provide early guidance in conjunction with the release of the exposure draft legislation. This early guidance could include valuation approaches and methodologies for the starting base, arm's length pricing of the resource at the taxing point and MRRT record keeping. Additional guidance could include ATO expectations regarding the definition of a project and deductibility of expenses (including apportionment methods).

The ATO should also ensure it develops the capability necessary to provide timely advice (including binding advice) in response to taxpayer specific enquiries, recognising that this advice cannot be provided until the legislation has received Royal Assent. This capability will need to include industry knowledge and expertise in valuation and arm's length pricing. The ATO should also consult and collaborate with industry and relevant professional bodies to ensure the taxation and valuation professions have the capability to support taxpayer requirements for professional services. This could include exploring options for a short professional development course on the valuation of mining assets.

ATO funding

The PTG recognises industry will be reliant on the preparedness of the ATO to support them in transitioning to the MRRT and the importance of ensuring the ATO is well resourced and ready for the implementation of the MRRT. The PTG recommends the Government ensure the ATO is appropriately resourced to enable it to prepare for implementation and provide the ongoing support required by industry.

Board of Tax review

In recognition of the significance of the MRRT, the PTG recommends there be a Board of Tax review of the operation of the MRRT within five years of its commencement. The focus of the review should be on the effectiveness of the legislation and administration in achieving the intended purpose efficiently and equitably with minimal compliance and administration costs.

Initial ATO compliance approach

The PTG recognises the ATO's compliance approach is focussed on supporting voluntary compliance and helping businesses meet their obligations. This approach will be critical to the implementation of the MRRT, given these obligations are to be self-assessed and the potential complexity for taxpayers in the transition period. As part of the transition process, the PTG recommends the ATO provide guidance on the circumstances that may warrant a remission of penalties in cases of inadvertent errors, particularly in the first two years of MRRT operation.

12.2 Ongoing administration

Issue

The PTG's terms of reference require the PTG to identify opportunities to minimise compliance and administration costs associated with the MRRT. Through its consultation process, the PTG has identified a range of administrative features and procedures that would reduce the compliance and administration costs of the MRRT.

Stakeholder comments

Stakeholder feedback to the PTG on the general administration of the MRRT emphasised the need to ensure the compliance burden is minimised and that MRRT is aligned to general accounting and income tax practices wherever possible. Some specific stakeholder feedback included:

- that self-assessment principles would be critical to providing simplicity and fairness;
- concern about the possible ATO approach to MRRT compliance and the approach the ATO might take towards errors; and
- concern that current irritations in the administrative design of the PRRT might be carried over into the MRRT. These included the need to keep receipts for extended periods to validate transferable expenditures, the difficulties in verifying expenditure undertaken by joint venture operators and the inability to align PRRT accounting with a substituted accounting period used for income tax purposes.

Discussion

Legislative design

The PTG recognises the important role self-assessment has in Australia's tax system. The majority of stakeholders indicated they see MRRT self-assessment as critical to providing simplicity and fairness, with some suggesting that self-assessment could provide greater certainty. The PTG therefore recommends the MRRT be designed and implemented as a self-assessed tax.

Determining MRRT liabilities is likely to rely to a large extent on the annual accounting information used to comply with accounting and other taxation obligations. For this reason, the MRRT accounting period should be aligned to the income tax accounting period, generally 1 July to 30 June. However, not all companies account for income tax on a July−June basis. The PTG recommends that taxpayers who use substituted accounting periods for income tax use the same period for the MRRT to access the same administrative efficiencies. The PTG also suggests the Treasury and ATO work with industry to ensure the form and timing of MRRT lodgments is aligned as closely as possible to current accounting processes.

In recognition of the likely size of MRRT liabilities, it is appropriate that the MRRT be payable on a quarterly basis, broadly aligned with the income tax pay-as-you-go instalment system. In contrast to the PRRT, which is fully accountable on a quarterly basis, the PTG recommends applying the MRRT as an annual tax with a quarterly instalment arrangement, similar to income tax, as a compliance saving design feature. This will require an appropriate basis for determining the amount to be remitted through the instalment system. The selected mechanism will need to provide sufficient flexibility to adjust instalment payments in response to the potentially significant within-year movements in resource profits that can arise from changes in commodity prices and exchange rates. The PTG notes that it will also be necessary to develop a transitional instalment procedure to remit MRRT during the instalment periods prior to an entity's first MRRT assessment, as there will be no MRRT history.

Most companies will use the Australian Dollar in their accounting processes. However, some companies choose to use a foreign currency as their functional currency for their worldwide operations. Given that complying with the MRRT is likely to rely to a large extent on the annual accounting information used to comply with income taxation, allowing companies to use the same functional currency for income taxation purposes and MRRT would reduce their compliance costs.

The PTG recognises that for MRRT purposes some taxpayers will need information and data from third parties such as joint venture operators and project vendors. To ensure the ongoing administration of the MRRT is sustainable, the PTG recommends the Treasury consider whether there is a need to review the ATO's powers to access records of these third parties.

Best practice administrative design

Allowing some form of annual reconciliation and lodgment for all projects and pre-commencement expenditure would reduce the need for entities to substantiate expenditure and valuations many years after the fact. The annual return would start the period of review within which the Commissioner could examine any claims and provide taxpayers with a higher level of certainty over the expenditure, as the ATO cannot challenge expenditure after the review period (usually four years) except in specific circumstances. This would align the MRRT legislation with the income tax legislation.

The PTG acknowledges the concerns raised by industry regarding the difficulties joint venture partners can have in verifying expenditure undertaken by their joint venture operators. The PTG recommends the ATO work with industry to develop good practice guidance for both the industry and the ATO. This guidance should ensure joint venture accounts are structured appropriately and provide the information to support industry in complying with their obligations. The compliance burden for joint venture partners could be streamlined by working with joint venture operators to ensure their records, and the processes used to construct them, support substantiation of deductible expenditure.

Part 2
Petroleum Resource Rent Tax

13 OVERVIEW OF PRRT TRANSITION

The PRRT has been in operation for over 20 years and over this time has applied to the majority of Australian offshore petroleum projects. The North West Shelf and onshore projects are subject to a variety of government resource taxes, including Australian Government and State and Territory petroleum royalties, crude oil excise and the resource rent royalty.

On 2 July 2010, the Australian Government announced its proposal to extend the Petroleum Resource Rent Tax (PRRT) to all Australian onshore and offshore petroleum projects, including the North West Shelf and coal seam methane projects.[16]

Like the MRRT, the extension of the PRRT is to operate in addition to existing government resource taxes, raising an additional return to the community when above normal profits exist. Existing government resource taxes are to be creditable against the PRRT.

The design of the PRRT differs from that of the MRRT in several significant ways, including: a higher tax rate; the absence of an extraction allowance; a more limited transferability of project expenditures; immediately deductible starting base and the range of uplift rates available which are generally lower, with the exception of the uplift of some exploration expenditure. These features reflect important differences in the project economics of the commodities subject to each regime and these same considerations have influenced the PTG's recommendations for the extension of the PRRT. In particular the PTG has been conscious to apply the existing features of immediate deductibility and uplift to the starting base for transitioning projects.

Whilst the PTG acknowledges the industry's support for extending the MRRT $50 million threshold to the PRRT, for the reasons above the PTG has not sought to align the features of the PRRT for transitioning projects with that of projects entering the MRRT.

The PTG's terms of reference are limited to providing advice to Government on the extension of the PRRT. There is no PRRT equivalent of the MRRT Heads of Agreement that outline design features of the transition so the PTG has looked to the principles already in place in the PRRT. During its consultations, stakeholders identified a range of concerns with the existing provisions that could be expected to also arise in respect of transitioning projects if not addressed. While it is not within the PTG's terms of reference to make recommendations on these matters, in several instances, the PTG considers there is merit in improving the design of the PRRT as part of its extension to transitioning petroleum projects. This could include modernising the PRRT Act and aligning it with the tax code.

The design of the PRRT

The PRRT is levied on the profits derived from the extraction and early stage processing of petroleum (operations upstream of the taxing point) at a rate of 40 per cent. Projects currently subject to PRRT are not subject to other forms of ongoing resource taxation. The taxing point is defined as the point at which petroleum is sold or a marketable petroleum commodity (of which there may be several) exists.[17] Special provisions apply in calculating the value of the marketable commodity 'sales gas'[18] in integrated gas-to-liquids projects, such as liquefied natural gas.

[16] Projects in the Joint Petroleum Development Area are governed by the Timor Sea Treaty (2003) and are not intended to be covered by the extension of the PRRT.

[17] MPCs include: stabilised crude oil, condensate, sales gas, liquid petroleum gas or ethane and technically, a taxing point arises when a marketable petroleum commodity (MPC) becomes an excluded commodity. An excluded commodity occurs when the MPC has been sold, further processed or treated or moved away from its place of production other than to a storage site adjacent to that place or moved away from that storage site.

[18] 'Sales gas' is a defined term in the PRRT and is essentially a product that is predominantly methane in a gaseous state.

The PRRT is a project-based tax, the only transferable component being exploration expenditure. A project commences with the issuance of a production licence. Taxpayers can apply to combine several production licences into a single PRRT project where they meet certain criteria. All expenditure is immediately deductible and carried forward and uplifted where it cannot be deducted against project profits.

The uplift rate varies according to the type of expenditure and its timing relative to commencement of the project. General project expenditure is uplifted at LTBR+5 while certain exploration expenditure is uplifted at LTBR+15. In both cases expenditure is uplifted by the gross domestic product deflator where it is incurred more than five years prior to the granting of a production licence.

Undeducted expenditure is inherited by the new owner upon the acquisition of a project or interest in a project but can only be used against profits derived from that project.

Extending the PRRT

Projects transitioning to the PRRT fall within three broad categories:

- mature offshore projects (liquefied natural gas and petroleum) supplying principally offshore markets;
- mature onshore projects (domestic gas and petroleum) supplying principally domestic markets; and
- developing onshore projects (coal seam methane and tight gas) currently supplying the domestic market with planned production for offshore markets.

This diversity represents a markedly different industry profile to that contemplated when the PRRT was first put in place in 1987. In developing its recommendations, the PTG has taken this diversity into account and sought to apply a framework that provides a reasonably level playing field for existing and transitioning projects, sufficient certainty to ensure the ongoing viability of existing transitioning operations and the necessary environment for future development. In particular, the PTG has been conscious of the need for transitional arrangements that would not deter the development of new growth industries in the petroleum sector.

Recognising existing investment in transitioning projects

Unlike the MRRT, the PTG’s terms of reference were unclear as to the treatment of the starting base for projects that are to transition to the PRRT. The PTG was mindful that the MRRT arrangements were the subject of a quite specific negotiation and that PRRT transitional arrangements were to be as consistent as possible with the current framework. Accordingly, the PTG has sought to identify relevant precedent which may apply to the treatment of the starting base.

There have been two occasions on which projects have been transitioned to the PRRT – at the commencement of the tax and with the extension of the PRRT to the mature Bass Strait project. The treatment of the Bass Strait project reflected negotiations as part of an individual package within broader measures and as such is not considered an appropriate model by the PTG.

The recommended look-back arrangement reflects the provisions for existing tenements at the commencement of the PRRT with expenditure over the preceding eight years treated as if the tax had been in place and provided for the existing uplift and immediate expensing.

The PTG considers a 1 May 2010 cut-off for being eligible for a starting base should include the value of potential projects that are yet to commence production. The PTG therefore recommends that all tenements in existence at 1 May 2010 be eligible for a starting base.

For each project, the taxpayer should be able to choose between a starting base comprised of:

- the market values of the project's assets (including the resource); or
- the book value of the project's assets (excluding the value of the resource); or
- actual expenditure over the eight year period from 1 July 2002 to 1 May 2010, under a look-back method.

Consistent with the features of the PRRT, the PTG recommends the starting base be immediately deductible and uplifted at the relevant rate where carried forward. The uplift rate for a market value or book value starting base would be that applicable to general project expenditure. The uplift rate for a look-back starting base would be in accordance with the character of the expense.

As is the case with the MRRT, the PTG notes that market valuation of the starting base could have a significant bearing on taxpayer liabilities for PRRT and that different valuation methodologies and assumptions can produce quite different results. While taxpayers should be free to use a starting base valuation methodology that is appropriate for the specific circumstances of their project, it should be consistent with accepted methodologies, consistent with market expectations at 1 May 2010, transparent and defensible.

Resources subject to the PRRT

From 1 July 2012, the PRRT should apply to all Australian petroleum projects other than:

- projects within the Joint Petroleum Development Area in the Timor Sea, which are governed by the Timor Sea Treaty (2003);
- coal mining operations involving the extraction of coal or gas derived from the underground combustion of coal, which would to be subject to MRRT; and
- the extraction of coal mine methane where it is a necessary and integral part of a coal mining operation, which would also to be subject to MRRT.

Definition of a project under PRRT

A PRRT petroleum project comprises the production licence area and operations and facilities for the recovery of petroleum from the production right. Taxpayers are able to apply for ministerial approval to combine separate production rights into a single combined project, subject to several criteria. The PTG considers the existing project definition provisions to be relevant to transitioning projects, but recommends two additional criteria be added to provide greater certainty regarding the combination of individual petroleum tenements in onshore petroleum operations. The PTG also considers the current process of granting a combination certificate by ministerial approval to be more appropriate for petroleum projects than a self-assessment approach, given the low number of such projects and the potential complexity in the combination process.

Taxable profits

The PRRT liability is derived by calculating assessable receipts less deductible expenses upstream of the taxing point. Assessable receipts are clearly defined within the provisions of the PRRT and focus on the sale of petroleum or, sale or value of a marketable petroleum commodity.

The PTG considers the existing PRRT provisions for determining taxable profits to be applicable to transitioning projects, but recommends the following valuation options be available to transitioning projects to reduce compliance and administration costs:

- a State or Commonwealth royalty determination in place at 1 May 2010 that determines the value of the resource at the taxing point;
- a simplified RPM for pre-existing integrated gas-to-liquids projects, such as liquefied natural gas; and
- a modified RPM for integrated gas-to-electricity projects.

Only those expenses incurred in relation to the project and in carrying on or providing operations, facilities or other things comprising the project qualify as deductible expenses under the PRRT. During its consultations, the PTG heard stakeholder concerns regarding the application of the current PRRT deductibility provisions, particularly with respect to expenditure that is indirectly related to a particular petroleum project.

While this issue is outside its terms of reference, the PTG notes it is also likely to be of concern to transitioning projects and considers there to be merit in addressing it as part of the implementation of the PRRT extension. To do so the PTG advises the Government replaces the current general deductibility test with one based on expenditure being *necessarily incurred* in carrying on a petroleum project.

A further area of concern that is beyond the PTG's terms of reference is the interpretation applied to exploration expenditure under the PRRT, which stakeholders consider to be narrower than under income tax. The PTG advises that unifying the treatment of exploration across the PRRT, income tax and the MRRT would increase certainty and reduce the potential for disputation.

The PTG also recommends the legislation provide certainty as to the deductibility of payments made pursuant to an agreement under the *Native Title Act 1993* or a similar Act, provided they have the necessary link with upstream operations. Water treatment processes and associated facilities integral to the production of coal seam methane should also be allowed as a deduction.

The treatment of deductible amounts

As noted earlier in this section, where project expenditure, losses, government resource tax credits and starting base amounts are not able to be used immediately, they are carried forward and uplifted. The uplift rate varies according to the type of expenditure and the time it is incurred.

The PTG is of the view the existing arrangements, specifically the application of the higher uplift to exploration expenditure incurred not more than five years prior to the granting of a production right, are appropriate for the unconventional gas sector.

Commensurate with the design of the PRRT as a project-based tax with transferability of exploration expenditure, project-based amounts should be offset against project profits before exploration expenditure is transferred in.

Project deductions, whether current or carried forward as losses, should be the first amounts to reduce PRRT revenue. It is only after these amounts have been applied that a PRRT liability could arise in respect of a project. Where a potential PRRT liability remains, government resource tax credits are to be applied on a credit equivalent basis. Starting base deductions should then be applied to shield existing investment from any residual tax liability. Where a residual PRRT liability exists, transferable exploration expenditure is to be applied in accordance with the existing provisions.

Transfer of losses between projects

Consistent with the Australian Government's press release of 2 July 2010, to which the terms of reference refer, general project expenditure, government resource tax credits and starting base amounts should be non-transferable. Undeducted expenditure attached to a project when it is sold is to be transferred to the purchaser in accordance with the existing provisions.

Government resource taxes

To reflect the fact that existing Government resource taxes will apply alongside the extended PRRT, the resource taxes that entities pay are to be credited against the PRRT liability of a project.

The recognition of Australian, State and Territory government resource taxes under the extended PRRT raises a number of important issues. Generally speaking, the current resource taxes are set at rates that industry can afford to pay, at least during normal times, and provide the governments with a relatively stable revenue stream. On the other hand, these existing regimes are less flexible during an industry downturn and can unnecessarily damage the industry and prevent optimal resource extraction. Further, by their nature, some existing resource taxation regimes do not capture the economic rents during a boom period.

Through the extension of the PRRT, Australia has the opportunity to substantially improve the overall outcome of resources taxation in this country. It provides a way to meet the needs of the States and Territories and captures more of the profits at the peak of the resources cycle, in a way royalties cannot, for the benefit of all Australians.

Recognising this objective as well as the importance of preserving Australia's international competitiveness, the PTG recommends that there be full crediting of all current and future resource taxes under the PRRT so as to provide certainty about the overall tax impost on the petroleum sector. Equally, the PRRT should not be used as a mechanism to enable States and Territories to increase inefficient petroleum royalties on PRRT taxable commodities. Accordingly, the PTG also recommends the Australian, State and Territory Governments put in place arrangements to ensure that State and Territory governments do not have an incentive to increase petroleum royalties. This would limit their negative impacts, while allowing the Australian Government's taxation regime to maximise the return to the community during the highpoint of the resources cycle, so achieving the balanced outcome described above.

Administration

The PTG has made several recommendations to simplify the administrative and compliance burden of both the taxpayer and the ATO.

The PTG recognises the value of engaging industry on the implementation of the extended PRRT. Treasury and the ATO are encouraged to consult industry both through normal consultative forums as well as the representative bodies that engaged with the PTG. The PTG recommends establishing an 'Implementation Group' with industry representatives, relevant advisors and officials from RET, the Treasury and the ATO. This group would consult on the development of the legislation extending the PRRT, its administrative design and implementation, and its eventual review.

The PTG also recommends that the ATO provide early guidance in the application of the extended PRRT, its administration and compliance and that the Australian Government ensure the ATO is appropriately funded to provide interpretative and administrative support to industry.

14 DEFINITION OF THE PROJECT

Recommendation 68: The definition of a project transitioning into the PRRT should be based on the granting of a production licence and the definition of a production licence within the PRRT legislation should be extended to cover production licences granted under relevant State and Territory legislation.

Recommendation 69: The existing criteria for combining offshore projects should be applied to the combining of onshore projects. However, the criteria that the Minister has 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; and
- the aggregated interests 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 production from the production rights.

Recommendation 70: Given the need to provide certainty to the North West Shelf (NWS) project, it should be specified in the legislation that the licence areas associated with the project can be considered one project, as was the case when the Bass Strait project transitioned to the PRRT.

Recommendation 71: The Minister for Resources and Energy should continue to issue combination certificates under Section 20 of the *PRRT Assessment Act 1987* for both onshore and offshore projects.

Issue

A PRRT petroleum project needs to be defined so that the PRRT is applied consistently across different projects and taxpayers. It needs to be defined in such a way that PRRT receipts, expenditure and government resource taxes can be uniquely allocated, gaps are not created and ambiguity is minimised. Finally, it needs to be defined pragmatically to operate consistently with government resource taxes and other State requirements.

Coal seam methane and other unconventional gas projects may involve a much larger number of tenements and wells, and a broader geographic boundary than conventional petroleum projects. The ability to combine tenements which feed a common processing facility is appropriate.

Stakeholder comments

Most industry stakeholders were of the view that petroleum projects should continue to be based on production rights and defined in accordance with the geographic location and level of integration of the entire project. Some stakeholders, however, preferred that a project be defined with the issuance of a petroleum tenement, to enable a broader range of tenements to be combined into one project.

Stakeholders proposed that production rights that are managed as a single operation, around common processing and transportation facilities and common customers, should be treated as one project. They proposed that existing operational and ownership criteria in the legislation should be appropriate, subject to the ownership test recognising related companies as a single owner, but the geological test should be removed as not all relevant production licences will be located near each other.

Some stakeholders suggested the test for project combination should be capable of self-assessment by taxpayers.

Several stakeholders expressed a preference for certain petroleum areas to be defined as a single project in legislation, as was the case for the Bass Strait project. Similar requests were made in respect of tenements related to the Cooper Basin and the Gladstone liquefied natural gas processing hub.

Some stakeholders stated that a default position should be included to reduce uncertainty. For example, projects should be allowed to be combined if they meet the following tests:

- a specified percentage of common ownership across adjoining production rights; and
- common production or downstream facilities.

Discussion

The request by entities to have a project commence at the issuance of an exploration tenement stems from a concern that there could be expenditure, in particular exploration expenditure, that would not attract the higher exploration uplift rate if a project were to commence upon the granting of a production right. However, as noted in Section 18.5, essentially the character and nature of the expenditure is what determines whether expenditure is considered exploration for the purpose of the PRRT.

The existing PRRT provisions allow the combination of production rights only, and it is at this point that a project comes into existence. This is a more appropriate stage to initiate the application for a combination certificate than other types of petroleum tenements.

The issuing of a production right represents a significant step toward the development of a petroleum project. Many tenements do not result in the issuing of a production right or can take many years before becoming production rights. Issuing combination certificates for these tenements could create an unnecessary administrative burden.

Current criteria for combining petroleum projects

Currently, taxpayers can apply to the Minister for Resources and Energy to combine two or more offshore projects.

A certificate is issued where the Minister considers the production rights to be sufficiently related to be treated as a single project. In deciding whether to grant a combination certificate, the Minister must have regard to the following:

(a) the respective operations, facilities and other things that comprise, have comprised or will comprise the petroleum project in relation to the eligible production licence and any other petroleum project or projects existing at the time at which the eligible production licence came into force;

(b) the persons by whom or on whose behalf the operations, facilities and other things referred to in paragraph (a) are being, have been or are proposed to be carried on or provided; and

(c) the geological, geophysical and geochemical and other features of the production licence areas in relation to the projects.

Advice from Geoscience Australia indicates that the current offshore criteria appear to be sufficiently flexible and generally applicable to allow the Minister to combine onshore production licences into a single petroleum project for the purpose of the PRRT.

The PTG recommends the existing criteria for combining offshore projects be applied to the combining of onshore projects. However, to give greater certainty to integrated operations, the PTG recommends the Section 20 criteria that the Minister has regard to 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; and

- the aggregated interests 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 production from the production rights.

Defining some projects in legislation

It is important to provide the North West Shelf (NWS) project with a level of certainty that will ensure continued and ongoing investment. The relevant NWS production rights are in close proximity to each other, within Commonwealth waters and all are derived from the same exploration permits. The NWS project will transition from one Australian Government tax regime to another and the PTG is mindful of providing as much certainty as possible. The PTG therefore recommends that the legislation specify that the NWS production rights be considered one project, as was the case when the Bass Strait project transitioned into the PRRT.

The production tenements relating to the Cooper Basin and Gladstone liquefied natural gas processing hub are not confined to a particular geographical area and the tenements are at various stages of development (exploration and production). These two areas are less suited to a legislated declaration because the tenements have been issued by state regulators, the basins are geologically diverse and the petroleum tenements are likely to be developed in a more complex manner. In addition, the PTG considers the recommended additional combination criterion to be sufficient to allow production rights in these regions to be combined.

Combination Certificate Assessment

The granting of offshore combination certificates is currently undertaken by the Minister for Resources and Energy. This process is well understood by the offshore petroleum industry and provides the certainty of a Ministerial determination. The PTG recommends this process be retained for both onshore and offshore projects. It is the PTG's view that the relatively small number of petroleum projects, combined with the potential complexity of some (for example, coal seam methane liquefied natural gas projects and the Cooper Basin) warrants the certainty of ministerial certification over the flexibility of a taxpayer defined approach.

15 RESOURCES SUBJECT TO THE EXTENSION

Recommendation 72: 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 shale projects. 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; and
- the extraction of coal mine methane where it is a necessary and integral part of a coal mining operation.

Issue

The PTG's terms of reference state that the PRRT is to apply to all onshore and offshore Australian petroleum projects, including coal seam methane. Projects within the Joint Petroleum Development Area in the Timor Sea are to remain exempt.

Generally speaking, any naturally occurring hydrocarbon or naturally occurring mixture of hydrocarbons whether in a gaseous, liquid or solid state are considered to be petroleum and assessable under the PRRT. This would include coal.

Clarity is therefore required regarding the application of the MRRT and PRRT to the extraction of coal, coal extracted in gaseous form through underground combustion of the coal resource, coal mine methane extracted as part of a coal mining operation, and oil shale.

Stakeholder comments

Stakeholders generally accept that the extension of the PRRT should include all oil and gas projects, including coal seam methane.

There is general agreement that coal seam methane extracted as an incidental part of a coal mining project should be taxed under the MRRT, rather than the PRRT. Suggested definitions of 'incidental' include less than 10 or 20 per cent of the extracted resource value over the life of a mine.

Most stakeholders who commented on the treatment of coal converted to gas *in situ* were of the view that the MRRT should apply, rather than the PRRT, on the basis that the underlying coal resource is consumed in the process and this should determine the taxation regime. One stakeholder took an alternative view, arguing that the state of the resource at its first saleable point should determine its taxation treatment.

Some stakeholders sought confirmation that the mining of oil shale would not be included in PRRT, as it involves the mining of shale which is subsequently processed into oil.

Discussion

The PTG is of the view that the PRRT should apply to all onshore and offshore oil and gas projects other than projects within the Joint Petroleum Development Area in the Timor Sea, which are subject to the Timor Sea Treaty (2003).

The PRRT should not apply to the mining of coal. Similarly, mining operations involving the *in situ* conversion of coal to gas, often referred to as underground coal gasification (UCG), should fall within the MRRT. While there are tax neutrality arguments in favour of positioning UCG within either the MRRT or the PRRT, the PTG considers it more important to achieve tax neutrality in the competition for the coal resource rather than in competition for the products derived from the UCG process.

A necessary and integral part of underground coal mining operations is the extraction of coal mine methane for mine safety. In the future, methane extraction may become an integral part of surface coal mining as an environmental requirement. The methane extracted from a coal mine is equivalent to coal seam methane, which is to be subject to the PRRT. Hence, there is a prima facie argument for taxing coal mine methane under the PRRT.

However, stakeholders argue that the sale value of coal mine methane is roughly the same as the cost of its extraction, if not lower. Rather than subject coal mining entities to both the MRRT and the PRRT, with the consequent compliance costs involved in apportioning the costs of extracting the two products, the PTG recommends that coal mine methane extracted as a necessary and integral part of a coal mining operation be taxed under the MRRT. Such treatment should not extend to extensive gas extraction in advance of coal mining, such as that which occurs in the production of commercial quantities of coal seam methane.

In contrast, the PRRT should apply to oil shale as it is an oil like substance requiring minimal processing.

16 TAXING POINT

Recommendation 73: The existing PRRT provisions determining the point at which petroleum, or products produced from petroleum, become taxable (the taxing point) are sufficient to accommodate all types of petroleum projects, onshore and offshore, conventional and unconventional, and should therefore be retained.

Issue

Under the PRRT, the taxing point is where petroleum is sold, or where a marketable petroleum commodity (MPC) becomes an excluded commodity.

An MPC means stabilised crude oil, sales gas, condensate, liquefied petroleum gas, ethane produced from petroleum and any other product declared by the regulations to be an MPC.

An MPC becomes an excluded commodity, and therefore taxable, when it:

- has been sold; or
- after being produced has been further processed or treated; or
- has been moved away from its place of production, other than to a storage site adjacent to that place; or
- has been moved away from a storage site adjacent to the place of its production.

Different MPCs require different levels of processing. Consequently, the position of the taxing point within the value chain varies according to where an MPC becomes an excluded commodity.

Stakeholder comments

Stakeholders indicated they are generally comfortable and familiar with the concepts defining the taxing point within the PRRT. However, the PTG is aware there is litigation underway in this area.

Discussion

The PRRT approach to defining the taxing point appears sufficiently broad and flexible to accommodate the different types of onshore and offshore projects, both conventional and unconventional.

17 TAXABLE REVENUE

Recommendation 74: The existing PRRT provisions for valuing the resource at the taxing point should be applied to projects transitioning into the PRRT, subject to the following considerations:

- where a State or Commonwealth royalty determination that sets the value of the resource at the taxing point is in place the taxpayer should be able to seek a determination from the Minister for Resources and Energy to allow the taxpayer to elect that value in determining their PRRT receipts;
- taxpayers developing onshore gas resources within an integrated gas-to-liquids project, such as liquefied natural gas, should have the option of using the existing RPM as a default methodology for calculating the value of the resource at the taxing point;
- taxpayers with existing integrated gas-to-liquids projects, such as liquefied natural gas, at 1 May 2010 that are to transition to the PRRT should have access to a simplified RPM as a default methodology. This should provide a single agreed phase point and capital base determined by an agreed valuation methodology for existing assets; and
- existing RPM provisions within the PRRT should be amended to provide for integrated gas-to-electricity projects. Industry should be consulted in relation to the amendments required to ensure appropriate functionality of the methodology.

Issue

Where an arm's length sale occurs downstream of the taxing point it will be necessary to apply an appropriate methodology to determine the value of the resource at the taxing point. The PRRT clearly defines assessable receipts, with a focus on the sale or value of MPCs. Special provisions apply to determine the value of MPCs produced within an integrated gas-to-liquids project, such as liquefied natural gas, where there is no arm's length sale of the gas prior to its liquefaction. However, these provisions may not suit some transitional projects.

Stakeholder comments

Industry has generally supported the view that the existing provisions of the PRRT would accommodate existing and future projects' transition to the PRRT regime.

Proponents of coal seam methane projects have proposed several methodologies in relation to the treatment of integrated gas-to-liquids projects that would provide greater certainty to industry and simplify compliance and administration. Their key proposals relating to the valuation of the resource at the taxing point are that:

- the RPM should be provided as a default option for onshore integrated gas-to-liquid projects that transition to PRRT;
- there should be provision for a determination under regulation that specifies a fixed percentage of free-on-board price as a basis to determine PRRT assessable receipts for the life of the project; and
- where a project has a determination for royalty purposes in place with a State government, that this should be able to be used as the basis of determining assessable receipts for the purpose of the PRRT.

Participants with transitioning projects who are likely to use the existing RPM to determine assessable receipts have raised concerns relating to their ability to identify and provide the necessary level of detail relating to historical capital expenditure. Two alternatives have been proposed to address this issue and provide future certainty, those being:

- a fixed percentage of free-on-board price to determine assessable receipts for the life of the project; or
- a simplified version of the RPM.

Discussion

Assessable receipts are clearly defined within the provisions of the PRRT and focus on the sale of petroleum or sale or value of an MPC when it becomes an excluded commodity. The definition of an MPC should capture all products produced by a petroleum project and can therefore be applied without amendment to the projects covered by the extension of the PRRT.

Where an MPC is produced within an integrated gas-to-liquids project, such as liquefied natural gas, and no arm's length sale occurs, the assessable receipts are to be calculated under the existing PRRT provisions as:

- if an Advance Pricing Arrangement (APA) applies to the transaction — the amount calculated in accordance with the arrangement;
- if no APA applies to the transaction, but a comparable uncontrolled price exists for the transaction — the comparable uncontrolled price amount for the transaction; and
- if no APA and no comparable uncontrolled price exist for the transaction — the RPM.

To provide greater certainty and administrative simplicity to projects transitioning to the PRRT, the PTG recommends the following options:

- for on-shore integrated gas-to-liquids (such as liquefied natural gas) projects the RPM be provided as a default method that can be chosen by the taxpayer in place of the existing hierarchy;
- where a State or Commonwealth royalty determination that sets the value of the resource at the taxing point is in place, the taxpayer be able to seek a determination from the Minister for Resources and Energy to use that value in determining their PRRT receipts; and
- a simplified version of the RPM be developed in conjunction with industry that provides for a single agreed phase point and a capital base determined by an agreed valuation methodology for existing assets. Such an approach would retain the characteristics of the existing RPM but enable it to be applied with greater certainty to both the taxpayer and administrators.

Integrated electricity generation

The integrated nature of electricity generation from gas resources bears similarities to that of gas-to-liquids production, such as liquefied natural gas. The PTG recommends the RPM methodology be extended to integrated gas-to-electricity generation projects. However, industry consultation should be undertaken to ensure that the existing mechanics of the methodology are applicable.

18 DEDUCTION ORDERING AND DEDUCTIBLE EXPENDITURE

18.1 Deduction ordering rules

Recommendation 75: The existing PRRT deductibility rules should apply to transitioning projects with amendments to accommodate starting base amounts and government resource tax credits.

18.2 Transition deductible expenditure

Recommendation 76: The legislation should ensure that native title payments made pursuant to an agreement under the *Native Title Act 1993* or a similar Act in settlement of an indigenous land use agreement should be deductible to the extent they relate to upstream operations.

Recommendation 77: The costs of water treatment processes and associated facilities integral to the production of coal seam methane should be treated as deductible expenditure.

Recommendation 78: The existing PRRT treatment of private override royalties as non-deductible/non-assessable amounts should be extended to projects transitioning into the PRRT. Where such royalties exist, the market value starting base should be determined as if unencumbered by the royalty.

18.3 Exploration for unconventional gas

Recommendation 79: The PTG recommends existing treatment of exploration expenditure under PRRT be extended to unconventional gas projects.

18.4 Deductible expenditure issues

Advice to Government 1: While it is not within the PTG's terms of reference to make recommendations in respect of the design of the PRRT, other than in relation to transitioning projects, the PTG advises that the test for deductibility could be amended to one of expenditure *necessarily incurred* in carrying on activities in relation to a petroleum project (upstream of the taxing point) from 1 July 2012.

18.5 Exploration deductions

Advice to Government 2: While it is not within the PTG's terms of reference to make recommendations in respect of the design of the PRRT, other than in relation to transitioning projects, the PTG advises aligning the definition of exploration under the PRRT to that under income tax.

18.1 Deduction ordering

Issue

The deduction ordering rules determine the sequence in which current year expenses and carried forward losses are applied in calculating a project's PRRT liability. The press release of 2 July 2010, referred to in the terms of reference, states that the standard features of the PRRT are to apply to projects transitioning to the extended PRRT. The existing deduction ordering rules will, however, need to be altered to accommodate the starting base amount and resource tax credits.

Stakeholder comments

Stakeholders have suggested that the deduction ordering rules should remain unchanged and that royalty credits and starting base amounts should be treated in the same manner as general project expenditure.

Discussion

Under PRRT, deductible expenditure is offset against current and future assessable receipts, in accordance with a specific order (Figure 18.1). Non-transferable project related expenditure (current and carried forward) is deducted prior to transferable project related expenditure (current and carried forward).

The PTG recommends that starting base amounts and resource tax credits be accommodated within the existing loss ordering rules in the following manner:

- general expenditure (current and carried forward);
- resource tax credits;
- starting base amounts; and
- transferred-in exploration expenditure.

Project related deductions, whether current or carried forward as losses, should be the first amounts to reduce PRRT assessable receipts. Only after these amounts have been applied could a PRRT liability arise in respect of a project. Resource tax credits should be applied next to reduce any PRRT liability arising from project cash flows.

The starting base is intended to provide a partial tax shield against a PRRT liability arising in respect of interests in a project prior to 2 May 2010. It acts to shield existing investment from any residual tax liability after the application of project deductions and resource taxes credits. In this role, it is appropriate that starting base amounts be deducted as the last project amount before transferred-in exploration expenditure.

The PRRT legislation will need to be amended to allow the starting base amount and resource tax credits to be treated in the same manner as deductible expenditure.

Figure 18.1: Ordering of deductions in the current PRRT legislation

The ordering of deductions under the current PRRT regime is as follows:

1. Class 1 ABR General – general project expenditure incurred prior to 1 July 1990 and within five years of the granting of a production licence, uplifted at the LTBR+15;

2. Class 1 ABR Exploration – exploration expenditure incurred prior to 1 July 1990 and within five years of the granting of a production licence, uplifted at the LTBR+15. This amount is not transferable.

3. Class 2 ABR General – general project expenditure incurred from 1 July 1990 and five years within the date specified in the notice issued by the Designated Authority acknowledging the provision of sufficient information to support a successful production licence application, uplifted at the LTBR+5.

4. Class 1 GDP – general project expenditure incurred in any year and exploration expenditure incurred prior to 1 July 1990 that were both incurred more than five years before the production licence came into force, uplifted at the GDP factor rate. The undeducted exploration amount is not transferable.

5. Class 2 ABR Exploration – exploration expenditure incurred after 30 June 1990 and within five years of the granting of the production licence, uplifted at the LTBR+15. Undeducted amounts are transferable. 'Inherited' amounts are not transferable.

6. Class 2 GDP – exploration expenditure incurred after 30 June 1990 and more than five years from the granting of a production licence, uplifted at the GDP factor rate. Undeducted amounts are transferable. 'Inherited' amounts are not transferable.

7. Undeducted Exploration Expenditure – undeducted exploration expenditure will be transferred in from other projects if there are assessable receipts after the classes of deductions 1-6 above have been fully used

8. Closing Down Expenditure – closing down expenditure and deductible expenditure in excess of assessable receipts will be credited to the taxpayer in accordance with existing PRRT provisions.

18.2 Transition deductible expenditure

Issue

Under the current PRRT provisions, native title payments that are not directly incurred in relation to a petroleum project are not deductible expenditure. Nor would expenditure pertaining to a coal seam methane or tight gas petroleum project be where the expenditure is not directly incurred in relation to the project or is outside the taxing point. This is of potential relevance to water treatment expenditure. Private override royalties are specifically excluded under PRRT.

The treatment of exploration expenditure for unconventional gas is discussed in Section 18.4.

Stakeholder comments

Industry has stated that native title and related access payments should be deductible regardless of the form in which they are made, as operations cannot be conducted without access to land.

There is broad agreement amongst stakeholders in the coal seam methane industry that the costs of water treatment processes and associated facilities should be deductible expenditure, as they are an integral part of the coal seam methane production process.

Some stakeholders expressed a view that private royalty payments are a cost in generating profits from a resource and should therefore be deductible. Some suggested that private royalties in existence before 1 May 2010 should be deductible, rather than being accounted for through an adjustment to the starting base value, with royalties agreed after 1 May 2010 being non-deductible.

Others expressed the view that all private royalty payments could remain excluded as per the current PRRT treatment.

Discussion

Native title payments

Native title payments can be paid under legislation or pursuant to privately negotiated agreements. They can involve a flat amount, a share of petroleum revenues, or a combination of the two. The payments can be in cash or in kind (such as shares in the petroleum company or the provision of community facilities).

The High Court has confirmed that native title rights and interests, even if found to exist over an area of land, will not extend to most commercially produced minerals that exist in the land.[19] It follows that a payment pursuant to an agreement under the *Native Title Act 1993* or a similar Act in settlement of an indigenous land use agreement, should be deductible to the extent they relate to upstream operations and should be properly recognised as a downstream cost when deriving the value of the resource at the taxing point from a sale price.

The PTG recommends native title payments be treated in a similar manner to that proposed under the MRRT. That is, a payment pursuant to an agreement under the *Native Title Act 1993* or a similar Act in settlement of an indigenous land use agreement, should be deductible to the extent they relate to upstream petroleum operations.

It is the PTG’s view that if the *necessarily incurred* test is not adopted, such payments should be made deductible under a specific provision in the deductible expenditure provisions.

Coal seam methane

Water is produced as a by-product of extracting natural gas from coal seams. The extraction process of coal seam methane requires the water removed from the coal seam to be treated. The treated water is then either discharged or sold.

Under the existing PRRT provisions, the expenditure incurred in the water treatment process may not meet the deductibility conditions. It is recognised, however, that the water treatment process and associated facilities (such as ponds and pipelines transporting the treated water) are an integral part of the coal seam methane process.

[19] This is because native title holders do not have native title rights over those mineral resources (*Western Australia v Ward* (2002) 191 ALF 1), and so payments to native title holders could not be characterised as consideration for the disposal of their interest in the resource or as profit sharing.

The PTG recommends that such expenditure be deductible and the PRRT be amended to include a provision to ensure expenditure incurred in relation to the water treatment process and associated facilities is deductible where it is a necessary and integral part of the recovery of petroleum. Any receipts from the sale of the water should be PRRT assessable receipts. Whether the expenditure is treated as exploration or general project expenditure should depend on the nature of the expenditure.

Private override royalty payments

Private override royalty arrangements differ from State and Territory imposed royalties. In substance they are a profit sharing agreement in respect of the exploitation of a resource, rather than the sale of the resource by the owner (the State or Territory).

The PTG recommends private override royalties paid on transitioning projects be non-deductible to the payer and non-assessable to the recipient in accordance with the existing PRRT provisions. This approach recognises their nature as a profit sharing arrangement, while avoiding the need to assess individual royalty recipients on their share of a project's proceeds. With knowledge of the taxation treatment, the parties to the sale can negotiate acceptable sale terms taking into account the taxation treatment.

For private override royalties agreed prior to 2 May 2010 it may not be possible for the entity paying the royalty to renegotiate the terms of the royalty agreement, in which case they could bear a PRRT liability in respect of profits they do not earn.

The PTG recommends this be addressed by valuing any production right included in the starting base for the petroleum project as if it were unencumbered by the private override royalty liability. This would provide an equivalent tax shield to that otherwise available to the royalty recipient.

18.3 Deductible expenditure issues

Issue

The PTG's terms of reference do not extend to a review of the existing PRRT deductibility provisions. However, during the consultation process, industry raised several concerns with the existing provisions that could be expected to arise in respect of transitioning projects if not addressed. The PTG considers that extending the approach recommended for the MRRT to the PRRT would address these concerns and provide a more workable approach that would be simpler for taxpayers to apply and the ATO to administer.

One such issue is that, to be deductible under the PRRT, expenditure needs to be directly related to project activities. The application of this test has given rise to disputes, as it does not appear to provide certainty as to whether or not some expenditure is deductible.

A second issue of concern to taxpayers is the application of the exploration expenditure provisions under the existing PRRT. This issue is dealt with in Section 18.5.

Stakeholder comments

Stakeholders have requested that the PRRT deductibility provisions be amended to replace the current 'direct relationship' test with a purpose test. Stakeholders in the existing PRRT regime expressed concern that the close connection required between assessable receipts and deductible expenditure is applied too narrowly by the ATO. Stakeholders also said it is difficult to meet the evidentiary requirements of the ATO, as they are not aligned to normal business reporting systems. They requested clearer guidance on how the PRRT deductibility rules should apply.

Industry requested the provision of clear guidance for classifying and apportioning expenditure, particularly, indirect administration and accounting costs. A particular area of contention relates to certain overhead costs that are incurred in an entity's head office. The ATO approach where an entity has diverse interests, only one of which is assessable under PRRT, allows only those head office expenses solely attributable to the project to be deductible. This requires apportionment of such costs. The apportionment requirement for PRRT is applied more strictly than for income tax. Stakeholders state that it is difficult for entities to meet the ATO's evidentiary requirements under this strict application.

Stakeholders have stated that the excluded expenditure provisions within the PRRT, other than in respect of indirect administration and accounting costs, should not be altered.

Discussion

General deduction test

There are three pre-conditions that must be met for expenditure to be deductible under the PRRT. The expenditure must:

- be incurred by the person in relation to the petroleum project;
- be incurred in carrying on or providing the operations, facilities or other things of a kind referred to as exploration expenditure, general project expenditure, and closing down expenditure; and
- not be excluded expenditure.

These pre-conditions distinguish deductibility under the PRRT from allowable deductions for income tax and from a commercial or business view of project related expenditure. For example, the income tax approach allows for a wider nexus between assessable income and allowable deductions.

In Woodside Energy Ltd v Commissioner of Taxation (No 2) [2007] FCA 1961, French J stated in his decision that the PRRT contemplates a close connection between the expenditure and the actual activities involved. Citing *Robe River Mining Co Pty Ltd 21 FCR 1*, French J quoted the Full Federal Court which said:

> *The use of the phrase 'in carrying on prescribed mining operations' suggests a quite direct relationship between the expenditure and the operations, to be distinguished from the looser relationship which would be expressed by the words 'in connection with'.*

The PTG proposes that the existing general deduction provisions be replaced with the income tax concept of an expense being necessarily incurred. Expenditure would qualify as a PRRT deduction to the extent it is necessarily incurred in carrying on activities in relation to a petroleum project (upstream of the taxing point). As the words necessarily incurred are judicially well tested, and familiar to taxpayers through their use in income tax, they should deliver a high degree of certainty regarding the deductibility of expenses. This concept also supports the apportionment of costs on a fair and reasonable basis.

The necessarily incurred test could apply to expenditure incurred from 1 July 2012 on any project, existing and transitioning. The existing deductibility provisions should continue to apply to expenditure incurred by projects in the existing regime up until 1 July 2012.

The PTG acknowledges that the suggested changes may have the effect of extending the range of expenses that would be deductible under the PRRT, with an associated cost to revenue, but is of the view that the benefits from a more transparent and administrable approach to the law warrant such a change.

In the absence of such a change, the ATO should provide clearer guidance on the policy and application of the existing PRRT deductibility provisions to assist entities currently in the PRRT regime and those transitioning to it on 1 July 2012.

18.4 Exploration for unconventional gas

Issue

In extending the PRRT to transition projects, one objective is to not unduly favour existing PRRT projects relative to transitioning projects and vice versa. One aspect of the design of the PRRT that could create a bias in the treatment of conventional oil and gas projects relative to less conventional projects, such as coal seam methane and tight gas, is in the exploration expenditures eligible for uplift at the higher rate of LTBR+15 (Class 2 augmented bond rate exploration expenditure).

Stakeholder comments

Proponents of coal seam methane and tight gas expressed concern about the relevance of the definition of exploration under the PRRT for their projects. Of particular concern is that exploration and appraisal activity may continue beyond the time a production licence is issued and after a final investment decision has been made. They contended that the current provisions for the higher uplift rate for exploration expenditure do not adequately recognise exploration expenditure in these operations. Some proponents proposed that all their exploration expenditure should receive an uplift of LTBR+15.

Discussion

Class 2 augmented bond rate exploration expenditure is defined as exploration expenditure incurred in a year not more than five years before a production licence comes into force. In conventional oil and gas projects the issuance of a production licence tends to broadly coincide with a final investment decision, by which point the project economics have been proved. Most exploration expenditure is incurred prior to this time, with the greatest expenditure typically being incurred in the years immediately prior to the issue of the production licence. This approach, in effect, provides an incentive to bring a petroleum project into production over a short period of time to gain the benefit of the higher uplift rate, which is made available to exploration expenditure. However, exploration may continue within a production licence and in some circumstances may be a condition of the production licence being issued.

Unconventional gas projects require a large number of wells to extract the resource, with the potential for significant variation in the amount of gas recovered from each well. As part of the exploration process it is necessary to operate a number of wells within a field to simulate the development of the field and gain an understanding of the flow rates and potential for resource recovery. This occurs before a final investment decision is made to develop the field for the production of commercial quantities of gas. It is typically necessary to obtain a production licence in order to undertake this stage of the exploration process.

Under the existing PRRT provisions the higher uplift rate of LTBR+15 is available to exploration expenditure incurred in a year commencing not more than five years before a production licence is granted and continuing after the production licence is granted. This means that where expenditure that is in the nature of exploration occurs after a production licence is issued, the expenditure is still treated as Class 2 augmented bond rate exploration expenditure. Such expenditure is uplifted at LTBR+15 until it has been offset against assessable receipts.

In the case of unconventional gas projects, exploration expenditure will continue after a production licence has been issued and ongoing exploration is possible after a decision has been taken to develop a field or an area within a production licence for commercial production of gas. The PTG understands that this exploration would be treated as Class 2 augmented bond rate exploration expenditure (see draft ATO ruling TR 2010/D4) and, where the value of this exploration exceeds assessable receipts, it would be carried forward and uplifted at the LTBR+15 rate.

Therefore, the existing treatment of exploration expenditure can be directly applied to unconventional gas projects and adequately recognises exploration expenditure in line with the treatment provided to offshore projects. On this basis, the PTG recommends the existing treatment of exploration expenditure be extended to unconventional gas projects.

18.5 Exploration deductions

Issue

The PTG's terms of reference do not extend to a review of the existing PRRT provisions. However, during the consultation process, industry raised several concerns with the existing provisions that could be expected to arise in respect of transitioning projects if not addressed. The ATO's characterisation and treatment of exploration expenditure under the PRRT was one such concern.

Stakeholder comments

Stakeholders are concerned there are items of expenditure that are considered exploration expenditure under income tax, but not under the PRRT. Under the PRRT, such expenditure is treated as general project expenditure.

Stakeholders are concerned that, if this expenditure is not treated as exploration under the PRRT, not only would any unused amount be uplifted at the lower rate of LTBR+5, as opposed to LTBR+15, but if a project does not proceed, the expenditure would not be transferable to other projects.

Stakeholders do not agree with the ATO's interpretation of the PRRT exploration expenditure provisions. They argue this type of expenditure should be treated as exploration expenditure under both the income tax and PRRT regimes. To this end, most stakeholders have called for the PRRT provisions to be amended to mirror the income tax definition, to provide the necessary certainty that the treatment of exploration expenditure is the same under the PRRT and income tax regimes.

Stakeholders have also requested that a clear policy statement be provided, clarifying that exploration activity can occur after a project has commenced production.

Discussion

There is clearly a degree of confusion as to the application of the exploration provisions under the PRRT and income tax.

The discussion below is intended to clarify the differences between the application of the PRRT and the income tax provisions. The PTG observes that the provisions could be aligned across the income tax, the PRRT and the MRRT to increase certainty and avoid future disputes. This would also benefit companies through a broadening of expenditure subject to uplift at LTBR+15 which would be transferable. The PTG acknowledges this would represent a concessionary policy change that would involve a cost to revenue.

The ordinary meaning of 'exploration'

Exploration expenditure is not defined in the PRRT and therefore takes on the ordinary meaning of the term. The ordinary meaning is also used to characterise exploration or prospecting expenditure under income tax. This means that amounts considered to be exploration expenditure within the ordinary meaning of the term under income tax will also be exploration expenditure within the ordinary meaning of that term under the PRRT.

Under PRRT, expenditure incurred in carrying on activities in the exploration or recovery area can be considered exploration expenditure. The petroleum recovery area is a reference to the area covered by the petroleum tenement.

Expenditure may still be considered exploration expenditure if it is incurred after a production right comes into force. Similarly, under income tax, expenditure on exploration or prospecting can continue to occur after a decision to mine or quarry has been made. Whether or not expenditure is considered to be exploration or prospecting is a matter of fact and regard needs to be had to the nature and purpose of the expenditure incurred.

Extension to the ordinary meaning of exploration

The PRRT extends the meaning of exploration expenditure to that incurred in recovering petroleum from an eligible exploration or recovery area, moving and storage of that recovered petroleum, its further processing or treatment to produce an MPC, the moving or storage of the MPC, and services and employee amenities in relation to these activities. Payments made to another person to stabilise, transport, store, recover or process petroleum recovered from the eligible exploration or recovery area (but not if it is incurred in relation to a production licence area) can also be exploration expenditure.

This extension under PRRT includes recovery and production expenditure that might not otherwise be part of exploration in its usual meaning. Should this same expenditure be incurred after a production licence comes into force, it would be considered general project expenditure. This type of expenditure is not included in the income tax extension of exploration or prospecting.

Characterisation of expenditure

The characterisation of expenditure under PRRT impacts not only on the uplift rate but also whether or not certain unused expenditure can be transferred to other projects.

Exploration expenditure incurred in an exploration permit or retention lease area is transferable to another project, subject to the transferability criteria. Expenditure characterised as general project expenditure would not be transferable if an entity were to choose not to proceed with a project.

Transfer of exploration expenditure

The transferability of undeducted exploration expenditure was not part of the PRRT's original design. Initially, both exploration expenditure and general project expenditure were quarantined to the project and, for both categories of expenditure, undeducted amounts were uplifted at LTBR +15.

From the 1991 PRRT tax year, a concessionary treatment was introduced allowing petroleum exploration expenditure incurred from 1 July 1990 to be transferred to other projects that would otherwise have a PRRT liability. For company groups, amendments allowed for the transferability on a group wide basis. In recognition of the transferability of exploration expenditure, the undeducted general project expenditure uplift rate was reduced to LTBR+5, to reflect the increased likelihood of recovering project expenditure.

The 1991 amendments also provided for an order of deductions that would ensure project specific expenditure was written off first.

19 STARTING BASE

Starting base election

Recommendation 80: An entity must make an irrevocable election to use either market value, book value or the look-back method for determining a starting base for each interest the entity holds in a project or other petroleum tenement in existence at 1 May 2010, by the due date for the filing of the first PRRT tax return. Where an election is not made by the required date, the project or petroleum tenement should be taken to have a look-back starting base. Where an appropriate look-back does not exist or cannot be reliably reproduced, there should be no starting base.

Determining the market value starting base

Recommendation 81: An entity should determine a market value starting base comprising the market value of petroleum assets upstream of the taxing point as at 1 May 2010 on the basis of accepted market valuation principles.

- In determining how market valuation principles should be applied, the taxpayer should take into consideration their particular circumstances and the stage of development of the project or petroleum tenement.

- The derivation of the market value starting base should have regard to market expectations of future petroleum prices, exchange rates, interest rates, inflation and other industry reference benchmarks as at 1 May 2010, and recognised methodologies for market valuation in the petroleum sector. The Treasury, ATO and RET should consult industry and professionals to identify suitable reference benchmarks to reduce compliance costs and provide greater certainty to taxpayers. The existence of such benchmarks would not constrain a taxpayer's choice of valuation methods or their ability to use alternative estimates.

- Guidance as to the application of valuation methodologies should be provided through examples within the explanatory memorandum. In addition, the ATO should provide early guidance to industry regarding the practical application of this aspect of the legislation.

- The approach used in deriving the starting base should be consistent with that used to value the resource at the taxing point.

- 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.

- Where a private override royalty existed in relation to the project or tenement at 2 May 2010, the starting base should be determined as if it were unencumbered by the private override royalty liability (Recommendation 78).

- The starting base is not to be reduced to reflect any depletion in the resource between 2 May 2010 and 30 June 2012. However, where starting base assets are disposed of between 2 May 2010 and 30 June 2012, the starting base should be reduced by the market value ascribed to the asset at 1 May 2010.

- Capital expenditure incurred between 2 May 2010 and 30 June 2012 should be added to the starting base.

Recommendation 82: A default methodology should be considered for taxpayers that acquired or disposed of a portion of an interest in a project or petroleum right with an identified coal seam methane resource in the 3 years to 1 May 2010. The default should determine a proxy for the market value starting base, based on known reserves as at 1 May 2010 and a value derived from a recent comparable market transaction or transactions.

Applying the market value starting base

Recommendation 83: The market value starting base should be immediately deductible for projects transitioning to the PRRT. For other petroleum tenements the starting base should be immediately deductible upon becoming part of a project.

- The market value starting base should be uplifted in line with the provisions provided for general project expenditure, with the expenditure deemed to be incurred on the 1 July 2012.
- Where eligible expenditure is incurred between 1 May 2010 and 1 July 2012, it will be added to the starting base.
- The starting base and losses generated from the starting base should not be transferable between projects.
- Any undeducted starting base amounts attributable to an interest in a project or petroleum tenement are to be transferred to the new owner upon acquisition of the interest.

Determining the book value starting base

Recommendation 84: A book value starting base should be 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. Such accounts are to have been prepared in line with Australian Accounting Standards.

- Capital expenditure incurred after the date at which the audited accounts were prepared and before 1 July 2012 should be added to the starting base.
- Where starting base assets are disposed of between 2 May 2010 and 30 June 2012, the starting base should be reduced by the book value ascribed to the asset at 1 May 2010.

Applying the book value starting base

Recommendation 85: The starting base should be immediately deductible for projects transitioning to the PRRT. For other petroleum tenements the starting base should be immediately deductible upon becoming part of a project.

- The book value starting base should be uplifted in line with the provisions provided for general project expenditure, with the expenditure deemed to be incurred on the valuation date of 1 May 2010 or, where eligible expenditure is incurred between 1 May 2010 and 1 July 2012, the date when the expenditure is incurred.
- The starting base and losses generated from the starting base should not be transferable between projects.
- Any undeducted starting base amounts attributable to an interest in a project or petroleum tenement are to be transferred to the new owner upon acquisition of the interest.
- Further guidance as to the application of the book value starting base should be provided through examples within the Explanatory Memorandum.

Determining the look-back starting base

Recommendation 86: A look-back starting base should be available based on deductible expenditure incurred in the exploration and development of a project or other petroleum tenement between 1 July 2002 and 2 May 2010.

- Capital and exploration expenditure incurred after 1 May 2010 and prior to the commencement of the extension of the PRRT on 1 July 2012 should be added to the starting base.
- Where starting base assets are disposed of between the date at which the audited accounts were prepared and 30 June 2012, the starting base should be reduced by the book value ascribed to the asset at 1 May 2010.

Applying the look-back starting base

Recommendation 87: The starting base should be immediately deductible for projects transitioning to the PRRT. For other petroleum tenements the starting base should be immediately deductible upon becoming part of a project.

- The book value starting base should be uplifted in line with the provisions provided for general project expenditure, with the expenditure deemed to be incurred on the date at which the audited accounts were prepared or, where eligible expenditure is incurred between the date at which the audited accounts were prepared and 1 July 2012, the date when the expenditure is incurred.
- The starting base and losses generated from the starting base should not be transferable between projects.
- Consideration should be given to allowing the inclusion of relevant acquisition costs as they relate to project assets upstream of the taxing point. If acquisition costs are included:
  - they should be allocated to the existing PRRT expenditure categories, with appropriate methods to apportion the starting base to be developed in consultation with industry; and
  - the period of uplift at LTBR+15 on the portion allocated to exploration expenditure should be limited to five years.
- Further guidance as to the application of the look-back value starting base should be provided through examples within the explanatory memorandum.

Issue

The terms of reference state that companies may elect to use market value as the starting base for project assets, including oil and gas rights. Though not mentioned, it is presumed that the alternative election would be to use a book value in line with the arrangements under MRRT. An additional option is a look-back approach based on existing PRRT principles.

Stakeholder comments

Industry has supported the adoption of generally accepted methodologies and practices (where relevant) and has highlighted the market valuation guidelines released by industry, the Australian Securities and Investment Commission and the ATO, particularly those used for the purposes of consolidation.

Several stakeholders noted a lack of specificity in relation to the options available to determine a starting base, other than the market value approach. Industry identified a look-back approach, in addition to book value, as providing a suitable alternative that would provide simplicity of administration and compliance, while recognising past investment.

Proponents of coal seam methane projects have raised a number of issues in relation to the market valuation of integrated gas-to-liquids projects, the key issues being:

- the starting base should reflect the value of historical investment (including capitalisation) in the project; and

- short-cut approaches should be developed where market based transactions have occurred within a reasonable period before 1 May 2010. It was suggested that a value could be established per unit of 2P[20] or 3P[21] resource to be applied across all coal seam methane liquefied natural gas projects and tenements.

However, it was noted by a proponent that such a short-cut approach may not provide an equitable outcome for all coal seam methane liquefied natural gas projects due to the variability in the quality of underlying resources between projects not being reflected in the resulting valuation.

The allocation of the starting base between exploration and general expenditure was raised by some proponents. It was suggested that the starting base be apportioned across the categories of expenditure available within PRRT, with associated uplift rates to be applied to the relevant portion, to recognise their risk profile.

Discussion

Starting base eligibility

The terms of reference state that a starting base is to be available for project assets. Consistent with its deliberations on the MRRT, the PTG considers that the 1 May 2010 cut off for being eligible for a starting base should include the value of potential projects that are yet to commence production. It therefore recommends that all tenements held at 1 May 2010 be eligible for a starting base. However, in recognition that production on some tenements may not commence until many years into the future, and possibly not at all, the PTG recommends that the starting base for non-producing tenements as at 1 July 2012 not be deductible until the commencement of production from the tenement.

Starting base election

The terms of reference state that companies may elect to use market value as the starting base for project assets, including oil and gas rights. The PTG is of the view that an entity should be able to make an election with regard to the method for determining the starting base for each of its petroleum projects and other petroleum tenements.

For administrative simplicity, the starting base election should be made as part of the first PRRT tax return. In instances where there is no obligation to lodge a PRRT tax return in relation to a petroleum interest (for example petroleum tenements that do not generate assessable receipts) an election should be required to be lodged with the ATO no later than the lodgment date that would apply if they were a PRRT liable entity.

[20] Proved plus probable.

[21] Proved plus probable plus possible.

Should an entity fail to make a starting base election for a project interest they held on 2 May 2010, a default position would need to be adopted. A default position of market value is almost certainly not viable, since an entity failing to make an election is most unlikely to have undertaken a market valuation exercise for the purposes of the PRRT extension.

Consequently, the PTG recommends that where no starting base election is made with regard to a project interest by the required date, the project interest should be deemed to have a look-back value starting base where it can be reliably reproduced. Otherwise the interest should have no starting base.

Determining the market value starting base

The PTG recommends a taxpayer use accepted market valuation principles to determine a market value starting base for assets upstream of the taxing point. The Government's press release of 2 July 2010, referred to in the terms of reference, states that the starting base should include project assets, including oil and gas rights. In order to be included in the starting base, the tangible assets should be those that would be deductible for PRRT purposes in the future. This would exclude assets such as land and buildings associated with a head office or otherwise non-deductible assets.

The determination of the market value starting base and assessable receipts at the taxing point are interdependent. The assets and assumptions included in the starting base need to reflect those that are used in determining the value of the resource at the taxing point.

Determining the market value of assets that form the starting base is likely to require consideration of all activities that take place along the production value chain. That is, it may be necessary to determine the value of assets both upstream and downstream of the taxing point in order to determine an appropriate market value for the resource included in the starting base.

Given these interactions, an overly prescriptive approach towards the methodology for determining market value would require all possible activities to be considered and defined to achieve an appropriate outcome. Further, as the combination of assets and project circumstances will vary across industry, it is likely that situations could occur where a prescribed method would produce an outcome that would not reflect fair market value.

An approach that allows the taxpayer to select from among generally accepted and recognised methodologies for determining the starting base for their particular circumstances is more likely to facilitate an accurate value for the starting base.

The PTG notes there are well-recognised methodologies for conducting market valuations in the petroleum sector. In selecting a valuation methodology to be used the valuator should give consideration to such factors as:

- the nature of the valuation;
- the development status of the petroleum assets; and
- the extent and reliability of available information.[22]

For example, a discounted cash flow (DCF) method may be considered appropriate for most projects at the production stage. For non-producing tenements in the pre-development or advanced exploration stage a risk-weighted DCF method may be more appropriate. These approaches will require valuators to make a forecast of cash flows into the future at a discount rate which takes into account both entity-specific and systematic (market) risk.

[22] The Valmin Code 2005.

For non-producing tenements at the exploration stage, that do not yet have sufficient certainty to predict future cash flow, a different market value method would be appropriate.

To undertake a market value methodology a number of input factors may need to be estimated or forecast, including resource to reserve conversion, production and sales, commodity prices, costs, exchange rates and various discount rate parameters. As valuations are to be undertaken as at 1 May 2010, there are some market based inputs that will be common across entities, and others that differ according to the facts and circumstances.

For some of the common factors, industry information existed at 1 May 2010 that provides a reference benchmark for individual judgments about these factors. Articulating such reference benchmarks could assist in making the valuation process more objective, consistent and transparent, and thereby reduce compliance costs and provide greater certainty to taxpayers and valuators. The PTG notes, however, that the actual forecasts and assumptions used in individual valuations are likely to differ from such reference benchmarks for a range of reasons and the existence of such benchmarks should not prevent taxpayers and valuators using different assumptions where they are justifiable.

The PTG therefore recommends the Treasury, ATO and RET consult with industry and tax and valuation professions to identify suitable reference benchmarks. In addition, the Treasury, ATO and RET should work with industry and professionals to provide early guidance regarding the practical application of market valuation for the purposes of the PRRT extension.

Default methodology to establish market value

A number of taxpayers with interests in coal seam methane liquefied natural gas projects have commented on the methodology to be applied in establishing a market value starting base. Of particular concern has been the way in which recent arm’s length transactions may be applied in determining the market value of assets and whether those that have acquired assets would be placed at an advantage over those who have developed the resource through exploration.

In determining a market value starting base, accepted market valuation principles would take into consideration recent arm’s length market transactions, in respect of the interests held and those for similar assets. Therefore, it is likely that the valuation of project interests or petroleum rights that have been recently traded will, to varying degrees, reflect the valuation implied by these transactions. Providing a default methodology for taxpayers that hold such assets would increase certainty, be more neutral between competing projects, and potentially simplify administration and compliance. This would be of particular benefit to the coal seam methane sector, given the stage of industry development and the number of projects seeking to take a final investment decision prior to 1 July 2012.

There are, however, several drawbacks associated with such an approach. Firstly, the starting base should only represent the market value of upstream assets, whereas market transactions effectively value the entire enterprise. The prices realised may not provide a true representation of the market value of upstream assets. Secondly, the characteristics of each enterprise may vary substantially. For example, the quality of the resource, contractual off-take arrangements and the split between upstream and downstream assets would be likely to vary between projects. A deemed price based on one or multiple transactions is, therefore, unlikely to result in an accurate reflection of upstream market value.

The PTG therefore recommends that a default methodology be considered for entities that have acquired or disposed of a portion of an interest in a project or tenement with an identified coal seam methane resource. The default methodology could be based on the known reserves of the project as at 1 May 2010 multiplied by a value derived from recent arm’s length transactions, potentially discounted to take into account assets downstream of the taxing point.

Applying the market value starting base

The terms of reference do not specify a period over which the starting base should be written off. However, the Government's press release of 2 July 2012, referred to in the terms of reference, states that the 'standard features of the current PRRT will otherwise apply, including the range of uplift allowances for unused losses and capital write-offs immediate expensing for expenditure and limited transfer of the tax value of losses.' To be consistent with this, the PTG recommends the market value starting base be deemed to be general project expenditure on 1 July 2012 and be immediately expensed in line with the current PRRT arrangements.

An alternative to deeming the starting base to be general project expenditure would be to apportion the starting base across the various categories of expenditure and apply the relevant uplift rules. However, it is not apparent that this would be an appropriate way to attribute a value that represents the future profits of the project.

In recognition that production on some tenements may not commence until many years into the future, and possibly not at all, the PTG recommends the starting base for non-producing tenements as at 1 July 2012 be first deductible at the commencement of production from the tenement. This approach is consistent with the role of the starting base as a partial shield for investments in a project.

The PTG recommends that other features associated with the application of a market value starting base be aligned with the treatment provided under MRRT, these include:

- adding any capital and other development expenditure incurred between 2 May 2010 and 30 June 2012 to the starting base, and

- transferring to a new owner any undepreciated starting base amounts where an interest in a project or other petroleum tenement is sold.

Determining the book value starting base

Where the book value approach is used, the starting base will depend upon values recorded in an entity's accounts. As the terms of reference are silent on the alternatives to a market value starting base, the PTG considers it appropriate to align the PRRT book value approach with that proposed for the MRRT.

Under that proposal, the starting base would be based on the accounting book value of existing project assets as at the most recent audited accounts available on 2 May 2010. The book value would reflect a value consistent with Australian Accounting Standards and exclude the value of the resource.[23] Capital expenditure incurred after the book date and before 1 July 2012 would be added to the starting base.

Applying the book value starting base

To be consistent with the design of the PRRT, the book value should be immediately deductible – that is, immediate capital write-off and an uplift rate in line with the relevant class of expenditure. The PTG also recommends that a book value starting base be deemed to be general project expenditure on the date of the last audited accounts.

The alternative of allocating a book value starting base across the various categories of expenditure in order to apply the relevant uplift rules is not considered a workable alternative. During consultation, stakeholders raised issues relating to the treatment of exploration expenditure and impairment of book values. Such issues would make an appropriate allocation between the various categories of expenditure difficult. The proposed look-back provides a more appropriate method for expenditure to be allocated across the available categories.

[23] See *The Resource Super Profits Tax*, The Treasury, Section 6.3.

The PTG recommends the book value starting base of a petroleum project or other tenement be first deductible when petroleum commences to be produced from that tenement (following the commencement of the extension to the PRRT on 1 July 2012), in line with the recommendation for the treatment of a market value starting base.

Determining the look-back starting base

The PTG recommends that a look-back starting base also be provided as an alternative starting base, covering expenditure incurred between 1 July 2002 and 1 May 2010. There may be circumstances where market value or book value cannot be determined reliably. Consideration should be given to the inclusion of relevant acquisition costs for upstream assets, in recognition that for some recently acquired projects it may not be possible to document the historical expenditure of previous owners.

The look-back approach to determining the starting base would make use of current PRRT cost recognition rules, which allow an entity to look-back to investment prior to 1 May 2010. Past expenditure would be uplifted to 1 July 2012 and thereafter, until offset against assessable receipts. The expenditure would retain its character as exploration or general project expenditure and the relevant uplift applied.

This approach would not recognise the true value of underlying assets for most operations, but it could be a relatively simple and effective approach for new projects that have only recently incurred expenditure. To more closely reflect the value of underlying assets within this approach, it would be appropriate to allow entities to include the cost of acquiring tenements, and the project assets associated with them, that have occurred during the look-back period (to the extent they reflect the value of assets upstream of the taxing point). Such an approach would provide greater certainty to holders of such assets and provide an alternative to full market valuation.

Applying the look-back starting base

Consistent with other starting base valuation methods, the look-back starting base of a petroleum project or other tenement should be first deductible when petroleum commences to be produced from that tenement (following the commencement of the extension of the PRRT on 1 July 2012).

To provide the appropriate uplift treatment, the look-back starting base should be allocated to existing PRRT expenditure categories in accordance with the nature of the expenditure at the time it was incurred and be uplifted from that time in accordance with the existing principles within the PRRT.

If acquisition costs incurred within the look-back period are to be included within the starting base, an appropriate method for determining the portion that relates to assets upstream of the taxing point and for apportioning these amounts across the existing PRRT expenditure categories will need to be established. One approach would be to use the allocation applied for income tax purposes to determine the nature of relevant amounts. However, other more suitable approaches may exist. The PTG recommends that appropriate methods for apportioning acquisition costs be developed in conjunction with industry.

Exploration expenditure acquired through a market transaction has a lower risk profile than exploration expenditure incurred by a taxpayer, as the outcome of the acquired expenditure is known at the time of acquisition. Therefore the uplift rate should be below that for exploration expenditure. However, there remains a level of risk as to whether exploration tenements will progress to production, suggesting a higher uplift rate than that for general project expenditure. Balancing these considerations, the PTG recommends that amounts derived in this manner that are exploration expenditure be provided with the higher uplift rate available to exploration for a maximum of five years, after which the uplift rate should revert to that for general expenditure.

20 Treatment of the starting base and credits for government resource taxes

Recommendation 88: Starting base amounts should be treated in the same manner as general project expenditure, being immediately deductible, non-transferable and non-refundable, with undeducted amounts uplifted in accordance with the existing augmentation provisions. An exception would be the exploration expenditure component of a look-back starting base, which should be treated in accordance with the existing provisions relating to exploration expenditure.

Recommendation 89: Government resource taxes should be creditable against PRRT liabilities and treated in the same manner as general project expenditure, being immediately creditable, non-transferable and non-refundable, with unused amounts uplifted in accordance with the existing augmentation provisions.

Recommendation 90: It is important to ensure that the taxation of Australia's petroleum resources preserves our international competitiveness and ensures Australians receive a greater benefit from these resources and that this is reflected in the treatment of royalties under the PRRT. The extension of the PRRT should not be used as a mechanism to enable States and Territories to increase inefficient royalties on petroleum activities. All current and future resource taxes on petroleum should, therefore, be credited and it is imperative that the Australian, State and Territory Governments put in place arrangements to ensure that the States and Territories do not have an incentive to increase royalties.

Issue

The Government's press release of 2 July 2010, referred to in the PTG's terms of reference, states that, other than the market value starting base option and crediting arrangements for government resource taxes, the standard features of the current PRRT would apply, including the uplift allowance, immediate expensing of expenditure and limited transfer of losses. This implies that starting base amounts are to be expensed and any unused amounts quarantined to a particular project.

Government resource taxes are to be credited against current and future PRRT liabilities of a project. Any unused royalty credits are to be uplifted each year until offset against a future PRRT liability. Unused royalty credits are not transferable.

Stakeholder comments

Most stakeholders are of the view that the starting base for transitioning projects should be treated as general project expenditure and be immediately deductible, with undeducted amounts uplifted and carried forward. Some suggested the starting base be separated into general project and exploration expenditure and treated according to the respective PRRT provisions.

Most stakeholders are of the view that government resource taxes should be fully creditable. They proposed that credits for government resource taxes be grossed up and treated as general project expenditure, as this would eliminate the need for new loss ordering rules (assuming the starting base were treated in an equivalent manner). Some suggested there should be an immediate refund of government resource taxes to ensure entities are not cash flow disadvantaged.

Discussion

Starting Base

The PTG's terms of reference are silent in relation to the treatment of the starting base for projects that are to transition to the PRRT. This is in contrast to the PTG's terms of reference for the MRRT which specifically identified the starting base treatment as part of the Heads of Agreement. This has required the PTG to identify matters that should be taken into account in the establishment of the proposed treatment of the starting base for projects transitioning to the PRRT. Key factors in the PTG's consideration have been international competitiveness, consideration of prior taxation arrangements (including tax paid and the impact on long term contractual arrangements), historic transitional look-back arrangements and advice from Government in relation to discussions held with industry prior to the announcement on 2 July 2010.

International competitiveness of the taxation regime is a key factor. It is important to compare the Australian, State and Territory government taxation regimes in existence (along with the proposed PRRT extension) with petroleum taxation regimes in countries that compete with Australia for resource development.

Of the projects to be transitioned to the PRRT several are liquefied natural gas projects, both existing and planned, in which investments have been made according to the existing tax regimes. Any significant change in tax regimes will potentially impact on the viability of those projects which have secured customers but are yet to reach a final investment decision to proceed, or that have in place long term fixed contractual arrangements.

A further relevant factor is the overall amount of tax paid by, and the rates of taxation applying to, existing petroleum operations which are to be transitioned to the PRRT regime. Had these projects been subject to the PRRT from inception, taxation returns to government would have commenced only once the projects' outlays had been recovered in full. That is, the projects would have paid less tax than they did in the early phases and would pay more in later stages. The PTG believes it is therefore important that projects are not disadvantaged in an overall sense through the application of any new arrangements.

A further factor the PTG has had regard to is the transitional arrangements put in place on the initial introduction of PRRT in 1987. At the commencement of the PRRT a look-back arrangement was provided for existing tenements. Under this arrangement expenditure over the eight years preceding the commencement of the tax was treated as if the tax had been in place and provided with the existing uplift and immediate expensing.

Finally, the PTG has been advised that the Government had held a series of discussions with industry prior to the announcement of 2 July 2010. The PTG considered it was important to take these into account in its deliberations to ensure that good faith is maintained in the process.

Credits for State and Territory resource taxes

To reflect the fact that existing Government resource taxes will apply alongside the extended PRRT, the resource taxes that entities pay are to be credited against the PRRT liability of a project.

The recognition of Australian, State and Territory government resource taxes under the extended PRRT raises a number of important issues. Generally speaking, the current resource taxes are set at rates that industry can afford to pay, at least during normal times, and provide the governments' with a relatively stable revenue stream. On the other hand, these existing regimes are less flexible during an industry downturn and can unnecessarily damage the industry and prevent optimal resource extraction. Further, by their nature, some existing resource taxation regimes do not capture the economic rents during a boom period.

Through the extension of the PRRT, Australia has the opportunity to substantially improve the overall outcome of resources taxation in this country. It provides a way to meet the needs of the States and Territories and captures more of the profits at the peak of the resources cycle, in a way royalties cannot, for the benefit of all Australians.

Recognising this objective as well as the importance of preserving Australia's international competitiveness, the PTG recommends that there be full crediting of all current and future resource taxes under the PRRT so as to provide certainty about the overall tax impost on the petroleum sector. Equally, the PRRT should not be used as a mechanism to enable States and Territories to increase inefficient petroleum royalties on PRRT taxable commodities. Accordingly, the PTG also recommends the Australian, State and Territory Governments put in place arrangements to ensure that State and Territory governments do not have an incentive to increase petroleum royalties. This would limit their negative impacts, while allowing the Australian Government's taxation regime to maximise the return to the community during the highpoint of the resources cycle, so achieving the balanced outcome described above.

21 PRRT ADMINISTRATION

21.1 Transitional administration

Recommendation 91: The Treasury and ATO continue to engage with industry to progress the administrative design and implementation of the extension of the PRRT to all petroleum projects, including:

- establishing an Implementation Group involving industry representatives, relevant advisors and officials from RET, the Treasury and ATO;
- providing practical early guidance on the extension of PRRT and taxpayer obligations; and
- establishing capability in both the ATO and key intermediaries to support industry in complying with the law.

Recommendation 92: That Government should ensure the ATO is appropriately funded to provide interpretive and administrative support to industry in their transition to the extended PRRT.

Recommendation 93: To ensure the extension of the PRRT achieves its intended purpose efficiently and equitably with minimal compliance and administration costs, the Board of Tax should review the operation of the extended PRRT within five years of its implementation.

Recommendation 94: The ATO should provide guidance on circumstances that may warrant a remission of penalties by the ATO in cases of inadvertent errors, particularly in the first two years of the extended PRRT.

21.2 Ongoing administration

Advice to Government 3: As part of extending the PRRT, the Australian Government could consider amending the PRRT legislation to provide for:

- substituted accounting periods for taxpayers who use them for income taxation;
- an instalments regime that is responsive to the potential for significant within-year variability in petroleum profits and a final reconciliation period that fits within entities' tax calendars;
- the ability of ATO to obtain PRRT relevant information from third parties such as project vendors or joint venture operators.

Advice to Government 4: The ATO could consider adapting the administrative design of the PRRT, to provide workable certainty to taxpayers and minimise the costs of complying with and administering the extended PRRT. These practices should include:

- providing for annual PRRT returns, including the option to lodge returns prior to the receipt of PRRT income, to support the provision of certainty regarding historic expenditure; and
- guidelines for joint venture partners and operators, and the ATO in relation to joint venture accounts and substantiation of expenditure.

21.1 Transitional administration

Issue

Through its consultation process the PTG has identified a number of areas where appropriate administrative support and engagement with affected taxpayers would make the extension of the PRRT an easier transition.

Stakeholder comments

Industry stakeholders have expressed concern about the overall scope of change created by the extension of the PRRT and the new MRRT regime. Some stakeholders commented on the PRRT issues that remain in dispute after many years and expressed concern regarding the ability of the ATO to provide early guidance and support in respect of projects entering the PRRT on 1 July 2012.

Discussion

Industry engagement on PRRT implementation

The PTG recognises the valuable input provided by industry through the consultation process and the goodwill that has developed. The PTG encourages the Treasury and ATO to continue to consult industry both through normal consultative forums and through the representative bodies who engaged with the PTG. The PTG also recommends that an Implementation Group be established with industry representatives, relevant advisors and officials from the Treasury, ATO and RET. This group would be consulted on administrative design issues, the development of the MRRT and PRRT extension legislation, the implementation of the MRRT and extended PRRT, and the review. In addition, this group could work with the ATO's National Tax Liaison Group in developing ATO guidance material, testing of administrative design aspects and assisting in implementation planning.

The PTG recognises the ATO's implementation of the GST was well regarded. The PTG suggests the Treasury and ATO look to the learnings of that implementation in the planning and management of the implementation of the extension to PRRT.

The PTG has noted earlier in this report many issues on which it will be important that the ATO continue to consult with industry to clarify its approach – for example, in relation to determining the starting base and determining the value of the resource at the taxing point. The PTG strongly encourages the ATO to commence its usual consultation processes with industry and taxpayer associations at the earliest possible time to maximise industry awareness as to how it will administer the extension of the PRRT.

Recognising that many aspects of the extension of the PRRT will utilise existing processes and practices already in use in the PRRT, and others will mirror income tax processes and practices, the PTG recommends, where practical, the ATO provide early guidance in conjunction with the release of the exposure draft legislation. This early guidance should include those areas where existing PRRT processes and practices will be extended and could include valuation approaches and methodologies for the starting base, arm's length pricing of the resource at taxing point and record keeping. Additional guidance should include ATO expectations regarding the deductibility of expenses (including apportionment methods). In addition RET should consult with industry to explore whether there is a need for further guidance on project combination in the extended PRRT.

The ATO should also ensure it develops the capability necessary to provide timely advice, including binding advice, in response to taxpayer specific enquiries, recognising that this advice cannot be provided until the legislation has received Royal Assent. This capability will need to include industry knowledge and expertise in valuation and arm's length pricing. The ATO should also consult and collaborate with industry and relevant professional bodies to ensure the taxation and valuation professions have the capability to support taxpayer requirements for professional services. This could include exploring options for a short professional development course on the valuation of oil and gas assets.

ATO funding

The PTG recognises the reliance industry will have on the preparedness of the ATO to support them in transitioning to the extended PRRT and the importance of ensuring the ATO is well resourced and ready for the implementation. The PTG recommends the Government ensure the ATO is appropriately resourced to enable it to prepare for implementation and provide the ongoing support required to industry.

Board of Tax review

Whilst the PRRT has been in place and operating for some time, the PTG recommends the Board of Tax review of the operation of the MRRT incorporate a review of the extension of the PRRT. As with the MRRT review, the focus should be on the effectiveness of the legislation and administration in achieving the intended purpose efficiently and equitably with minimal compliance and administration costs.

Initial ATO compliance approach

The PTG recognises that the ATO's compliance approach is focussed on supporting voluntary compliance and helping businesses meet their obligations. This approach will be critical to the successful implementation of the extension of the PRRT, given these obligations are to be self-assessed and the potential complexity for taxpayers in the transition period. As part of the transition process, the PTG recommends the ATO provide guidance on the circumstances that may warrant a remission of penalties in cases of inadvertent errors, particularly in the first two years of extended PRRT operation.

21.2 Ongoing administration

Issue

The PTG's terms of reference require the PTG to identify opportunities to minimise compliance and administration costs associated with the extension of the PRRT. Through its consultation process, the PTG has identified a range of administrative features and procedures that would reduce the ongoing compliance and administration costs of the extended PRRT.

Stakeholder comments

Stakeholder feedback identified a number of areas where stakeholders consider the administration of the PRRT could be improved. In addition, stakeholder feedback on the potential administration of the MRRT identified some areas of concern that the PTG believes should be considered in the extension of the PRRT.

Discussion

Whilst only a few PRRT stakeholders raised issues regarding substituted accounting periods, the PTG recognises that not all companies account for income tax on a July−June basis and that it would be beneficial for taxpayers to align their PRRT with other accounting obligations. As such, the PTG suggests the Government consider amending the PRRT legislation to provide for substituted accounting periods where taxpayers use them for income tax.

The PTG recognises the PRRT is currently reconciled on a quarterly basis and this creates administration issues for some stakeholders. The PTG suggests the Government consider administering the PRRT as an annual tax with a quarterly instalment arrangement, similar to income tax and that proposed for MRRT, as a compliance saving measure. This change would require an appropriate basis for determining the amount to be remitted through the instalment system. The selected mechanism will need to provide sufficient flexibility to adjust instalment payments in response to the potentially significant within-year movements in resource profits that can arise from changes in commodity price and exchange rates.

The PTG recognises that for PRRT purposes some taxpayers need information and data from third parties such as joint venture operators and project vendors. To ensure the ongoing administration of the PRRT is sustainable, the PTG recommends the Treasury consider whether there is a need to review the ATO's powers to review records of these third parties.

Many stakeholders identified issues with the provision of information to substantiate eligible expenditure for the PRRT, particularly when that expenditure may have been incurred many years earlier. The PTG believes this irritant could be substantially addressed by allowing some form of annual reconciliation and lodgment for all projects and pre-commencement expenditure. This would reduce the need for entities to substantiate expenditure and valuations many years after the fact. The annual return would start the period of review within which the Commissioner could examine any claims and provide taxpayers with a higher level of certainty over the expenditure, as the ATO cannot challenge expenditure after the review period (usually four years), except in specific circumstances. This would align the PRRT legislation with the income tax legislation. In considering this issue the PTG recognised there is likely to be a number of taxpayers with historic expenditure yet to be brought to account in a PRRT return. The PTG suggests the ATO work with industry and their intermediaries to put in place a process to deal with this potential backlog.

The PTG acknowledges the concerns raised by industry regarding the difficulties joint venture partners can have in verifying expenditure undertaken by their joint venture operators. The PTG recommends the ATO work with industry to develop good practice guidance for both the industry and the ATO. This guidance should ensure joint venture accounts are structured appropriately and provide the information to support industry in complying with their obligations. The compliance burden for joint venture partners could be streamlined by working with joint venture operators to ensure their records, and the processes used to construct them, support substantiation of deductible expenditure.

Part 3
Attachments

ATTACHMENT A: PTG TERMS OF REFERENCE

Purpose

The purpose of the PTG is to advise the Australian Government in the development of the technical design of the Minerals Resource Rent Tax (MRRT) and transition of existing petroleum projects to the Petroleum Resource Rent Tax (PRRT) regime as announced by the Government on 2 July 2010.

In developing this advice, the PTG will consult with directly affected companies, relevant government departments and stakeholders on the implementation of the new MRRT and the extension of the PRRT to ensure the new tax arrangements are implemented as efficiently and consistent with the design principles as possible.

The design principles of the MRRT are attached.

Particular issues for consideration for iron ore, coal, oil, gas and coal seam gas include:

- the taxing point and valuation method to be used for the commodity;
- the definition of a project and interest in a project;
- eligible project expenditure;
- the definition of exploration expenditure;
- the determination and calculation of the starting base for existing projects including the rules for electing a particular starting base;
- tax treatment of the starting base and of capital expenditure incurred between 2 May 2010 and 1 July 2012;
- a workable exclusion where resource profits are below $50 million per annum;
- crediting of State and Territory royalties;
- integrity rules supporting the policy underpinning the new resource taxation arrangements; and
- identifying opportunities to minimise associated compliance and administration costs.

The Government has stated that the resource exploration rebate will not be pursued with resource exploration costs continuing to be deductible in the normal way. However the PTG will consider the best way to promote future exploration and ensure a pipeline of resource projects for future generations.

The PTG will consider the best way to achieve smooth interaction between the MRRT, PRRT and State and Territory royalty regimes.

The Committee’s recommendations will be consistent with the Government’s fiscal strategy as stated in the 2010/11 Budget. Any policy deviation from the Government’s announcement of 2 July 2010 is to be fully offset within the recommendations in terms of impacts on revenue or costs.

Process

The PTG will be led by the Minister for Resources and Energy, Martin Ferguson AM MP and Mr Don Argus AC.

In order to protect the integrity of the process, the PTG will be supported by representatives of Treasury, RET, the ATO and, as required, the resources industry. The PTG will also obtain advice as appropriate from other independent experts.

The PTG is to provide its advice to the Government by the end of 2010 to allow for the legislation supporting the MRRT and extension of the PRRT to be introduced into Parliament in accordance with Government's announced timetable.

The Design of the Minerals Resource Rent Tax

The new resource tax will apply from 1 July 2012 only to mined iron ore and coal. All other minerals are excluded.

The rate of tax will be 30% applied to the taxable profit at the resource.

Taxable profit is to be calculated by reference to:

- The value of the commodity, determined at its first saleable form (at mine gate) less all costs to that point.
- An extraction allowance equal to 25% of the otherwise taxable profit will be deductible to recognise the profit attributable to the extraction process (i.e. to only tax the resource profit).
- Arms length principles on all transactions pre and post first saleable form.

MRRT is to be calculated on an individual taxpayer's direct ownership interest in the project.

There will be no MRRT liability for taxpayers with low levels of resource profits (i.e. $50 million per annum).

All post 1 July 2012 expenditure is to be immediately deductible for MRRT on an incurred basis. Non-deductible expenditure will be broadly consistent with PRRT.

MRRT losses will be transferable to offset MRRT profits the taxpayer has on other iron ore and coal operations.

Carried forward MRRT losses are to be indexed at the allowance rate equal to the LTBR plus 7 per cent.

The MRRT will be an allowable deduction for income tax.

All State and Territory royalties will be creditable against the resources tax liability but not transferable or refundable. Any royalties paid and not claimed as a credit will be carried forward at the uplift rate of LTBR plus 7 per cent.

Starting Base

The starting base for project assets is, at the election of the taxpayer, either:

- Book value (excluding the value of the resource) or

- Market value (as at 1 May 2010).

All capital expenditure incurred post 1 May 2010 will be added to the starting base and depreciated against mining operations from 1 July 2012.

‘Project assets’ for the purpose of the MRRT will be defined to include tangible assets, improvements to land and mining rights (using the Income Tax definition).

Where book value is used to calculate starting base, depreciation will be accelerated over the first 5 years. The undepreciated value will be uplifted at LTBR plus 7 per cent.

Where market value is used to calculate starting base, there will be no uplift and depreciation will be based on an appropriate effective life of assets, not exceeding 25 years.

Any undepreciated starting base and carry-forward MRRT losses are to be transferred to a new owner if the project interest is sold.

PRESS RELEASE – 2 July 2010

BREAKTHROUGH AGREEMENT WITH INDUSTRY ON IMPROVEMENTS TO RESOURCES TAXATION

Today the Gillard Government is proud to announce a breakthrough agreement on improved resource tax arrangements that addresses the concerns of the resource industry.

The new tax arrangements will underpin major economic reforms that will strengthen our economy so we can move forward together with confidence.

These arrangements will fund an historic boost to superannuation, new and better infrastructure, and business tax cuts including an up-front tax break and less red tape for small businesses to help them grow and thrive.

This agreement provides certainty to the resources industry, to mining communities right around the country, and to the broader Australian economy. It sends a very clear message to the world that the Australian resources sector is strong and its future is secure.

The breakthrough agreement keeps faith with our central goal from day one: to deliver a better return for the Australian people for the resources they own and which can only be dug up once. It is the result of intense consultation and negotiation with the resources industry.

The improved resource taxation reforms focus on the most profitable resources, raise the uplift factor for tax losses, remove refundability and offer generous depreciation arrangements to promote new investment. They are more generous to industry in some respects, while industry has given ground in other areas. The improved profits-based taxation reforms will apply from 1 July 2012.

The improved resource tax reforms involve:

- a new Minerals Resource Rent Tax (MRRT) regime applying to iron ore and coal in Australia; and

- extending the current Petroleum Resource Rent Tax (PRRT) regime to all Australian onshore and offshore oil and gas projects, including the North West Shelf. This will provide certainty for oil and gas projects and ensure all oil and gas projects are treated equitably.

The Government will focus the resource tax reforms on our biggest and most profitable commodities: iron ore, coal, oil and gas. These represent three-quarters of the value of our exports and resource operating profits and account for an even greater share of resource rents in the mining industry. They also represent the vast bulk of growth in the sector over the coming decades.

Since the beginning of the mining boom, prices for iron ore have increased by over 400 per cent and prices for black coal have increased over 200 per cent.

Other commodities will not be included, which reduces the number of affected companies from 2,500 to around 320. These commodities were not expected to pay significant amounts of resource rent tax, and excluding them will allow many companies to remain in their existing taxation regimes.

The agreement also provides certainty for projects in the emerging industry of converting coal seam gas to LNG, by including all Australian onshore and offshore oil and gas projects, including the North West Shelf, in the PRRT.

Including all oil and gas projects in the one regime will ensure equitable tax treatment between competing projects.

To ensure the smooth implementation of the new arrangements the Government is establishing a Policy Transition Group (PTG) led by Resources Minister Martin Ferguson AM and Mr Don Argus AC to consult with industry and advise the Government on the implementation of the new MRRT and PRRT arrangements.

Further detail on the improved resource tax reforms is contained in the Attachment.

The improved resource tax reforms are estimated to reduce revenue by $1.5 billion over the forward estimates. As the Government has always said, all elements of the tax reform package are dependent on the package being balanced by the revenues from resource taxation.

The reduced revenue makes necessary the following revisions to the associated reforms:

- The company tax rate will continue to be cut to 29 per cent from 2013-14 but will not be further reduced under current fiscal conditions. Small companies will benefit from an early cut to the company tax rate to 29 per cent from 2012-13.

- The resource exploration rebate will not be pursued. Resource exploration costs will continue to be deductible in the normal way and the PTG will consider the best way to promote future exploration and ensure a pipeline of resource projects for future generations.

We believe these improved reforms offer the best chance of delivering for hard-working families and small businesses around Australia while protecting and growing our great mining industry.

All along, our objective has been to deliver Australians a better return for the resources they own, which can only be extracted once, and this plan will deliver on that commitment.

We came together as a nation to stare down the worst of the global recession and now we come together to reform our economy, improve our tax system, and move forward with confidence.

Contact:	Russell Mahoney (PM)	0407930687
	Matt Coghlan (Treasurer)	0415098050
	Fiona Scott (Minister Ferguson)	0407294620

Attachment

Agreed principles for Australia's resource rent tax arrangements

Today the Government announces new resource rent tax arrangements which will apply from 1 July 2012 to Australia's most highly profitable non-renewable resources; oil, gas, iron ore and coal.

The changes recognise the views of industry about how they would like new investment to be treated – through higher uplift factors and faster depreciation of new investment, rather than guaranteed refundability of unused tax deductions.

The new resource tax arrangement will apply to the value of the resource, rather than the value added by the miner. It will do this by setting the taxing point at the mine gate where possible, and using appropriate pricing arrangements to ensure only the value of the resource is taxed.

The MRRT will apply an internationally competitive rate of 30 per cent.

The new arrangements also recognise the preference of industry for more generous recognition of past investment, through a credit that recognises the market value of that investment written down over a period of up to 25 years. For companies that prefer to use their current written down book values a generous accelerated depreciation over 5 years will be available.

MRRT – Bulk commodity resource tax arrangements

- Iron ore and coal will be subject to a new profits-based Minerals Resource Rent Tax (MRRT) at a rate of 30 per cent.
  - MRRT assessable profits are calculated on the value of the commodity, determined at its first saleable form (at mine gate), less all costs to that point.
  - Projects will be entitled to a 25 per cent extraction allowance that reduces taxable profits subject to the MRRT. This allowance recognises the contribution of the miner's expertise to profits at the mine gate.
  - Small miners with resource profits below $50 million per annum will not have an MRRT liability.
  - Miners may elect to use the book or market value as the starting base for project assets, with depreciation accelerated over 5 years when book value, excluding mining rights, is used; or effective life (up to 25 years) when market value at 1 May 2010, including mining rights, is used. All post 1 May 2010 capital expenditure will be added to the starting base.
  - A book value starting base will be uplifted with the long term bond rate plus 7 per cent. However, a market value starting base will not be uplifted.
  - Investment post 1 July 2012 will be able to be written off immediately, rather than depreciated over a number of years. This allows mining projects to access the deductions immediately, and means a project will not pay any MRRT until it has made enough profit to pay off its up front investment.
  - The deductibility of expenditure under MRRT will be broadly based on the categories used in the PRRT regime.

- MRRT losses will be transferable to other iron ore and coal projects in Australia. This supports mine development because it means a company can use the deductions that flow from investments in the construction phase of a project to offset the MRRT liability from another of its projects that is in the production phase.

- Unutilised MRRT losses will be carried forward at the government long term bond rate plus 7 per cent.

- Unused credits for royalties paid will be uplifted at the government long term bond rate plus 7 per cent, as per other expenses. Unutilised royalty credits will not be transferrable or refundable.

PRRT – A national taxation system for all oil and gas, onshore and offshore Australia

- The Petroleum Resource Rent Tax (PRRT) regime, which currently only applies to offshore petroleum projects will be extended to cover all oil, gas and coal seam methane projects, onshore and offshore Australia. The PRRT will apply at a rate of 40 per cent.

  - 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 current and future PRRT liabilities from a 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 expensing for expenditure and limited transfer of the tax value of losses.

Policy Transition Group

- A Policy Transition Group, led by Resources Minister Martin Ferguson AM and Mr Don Argus AC and comprising credible, respected industry leaders will oversee the development of more detailed technical design to ensure the agreed design principles become effective legislation. This will have the objective of ensuring the agreed principles are effected in line with their intent in a commercial, practical manner.

ATTACHMENT B: PTG MEMBER BIOGRAPHIES

The Hon Martin Ferguson AM MP, Minister for Resources and Energy, Minister for Tourism

Martin was elected to Federal Parliament as the Member for Batman in 1996 and served as a Shadow Minister for a number of portfolios including Employment, Training, Immigration, Regional Development, Infrastructure, Transport and Primary Industries. Following the 2007 election Martin was appointed to Cabinet as Minister for Resources and Energy and Minister for Tourism. Prior to entering Parliament, Martin was the president of the Australian Council of Trade Unions (1990-96) and vice-president (1985-90).

Don Argus AC

Don Argus is Chair of the Australia Advisory Board of Bank of America Merrill Lynch. Don retired from his role as Chairman of BHP Billiton, the world's largest diversified resource company, on 30 March 2010. When Don assumed the role as Chairman in April 1999 the market capitalisation was A$17.28 billion; at the time of his retirement it had a combined market capitalisation of A$226.5 billion. Don is a Director of Australian Foundation Investment Company Limited. He has more than 40 years experience in the banking industry and a strong record in international business and management. His CV records involvement in Government reviews, industry groups and he was a member of the International Advisory Councils of the New York Stock Exchange and Allianz Insurance until mid 2009. Don was made a Companion of the Order of Australia for eminent service to business and commerce through leadership in the mining and finance industries, and to the community through the promotion of philanthropy, and executive roles in conservation, health, charitable and sporting organisations. He is a Senior Fellow of the Financial Services Institute of Australasia (Finsia) and a Fellow of Certified Practising Accountants Australia (CPA).

Keith Spence

Mr Spence retired from Woodside Petroleum in 2008 after a 14 year tenure in top executive positions in the company, including Chief Operating Officer. Most recently, he was Executive Vice President Enterprise Capability, responsible for ensuring the business operated with the best people, technology and processes. Mr Spence has gained a broad knowledge across the industry having over 30 years experience in the oil and gas industry including 18 years with Shell. He is the Chair of the State Training Board of Western Australia and the Australian Institute of Management (WA). He chairs the Advisory Boards of the Critical Skills Investment Fund and the National Offshore Petroleum Safety Authority. He is a member of the board of Skills Australia and Verve Energy. He is Chairman and Non-Executive Director of Clough Limited and Geodynamics Limited. Mr Spence is also a fellow of the Australian Institute of Management.

David Klingner

Dr G D Klingner was employed by Rio Tinto for 38 years serving in a number of roles including exploration, project development and operations. He was a Group Executive with Rio Tinto (then CRA Limited) in charge of Coal and Gold Mining. His last role with Rio Tinto prior to retirement in 2004 was as Head of Worldwide Exploration based in London. He is presently Chairman of Energy Resources of Australia and Chairman of Codan Limited.

Chris Jordan AO

Mr Jordan is Chairman of KPMG New South Wales and Deputy Chairman of the Board of Taxation. He was previously Partner in Charge of the New South Wales Tax and Legal Division of KPMG and the former Chairman of the New Tax System Advisory Board as well as the State Chairman of the New South Wales Division of the Taxation Institute of Australia. Mr Jordan is a member of the Sydney Children's Hospital Foundation Board and is also a member of the Board of the Bell Shakespeare Company. He was appointed by the NSW Government to the Games Advisory Committee of the Sydney 2009 World Masters Games.

Ms Erica Smyth

Ms Smyth is the Chair of Toro Energy Ltd, ScreenWest, Scitech, Ochre Energy and the Diabetes Research Foundation of WA. She is also a non-executive director of ANSTO, the Australia Korea foundation and the Royal Flying Doctor Service (Western Operations). Ms Smyth has had extensive experience in the mining and petroleum industry having held a number of senior appointments with Woodside Petroleum Ltd, including on the North West Shelf Gas Project, BHP Petroleum as Manager Gas Business Development WA and BHP Minerals as the Beenup Project Manager. Ms Smyth is a qualified geologist and is a Fellow of both the Australian Institute of Management and the Australian Institute of Company Directors. Ms Smyth's contribution to the industry was recognised this year when she was awarded the WA Chamber of Minerals and Energy's Inaugural Women in Resources – Lifetime Achievement Award.

David Parker

Mr Parker is a member of the Executive Board of the Treasury and Chair of the Treasury Audit Committee. His particular responsibility as Executive Director of Revenue Group, Treasury, is to lead the Group responsible for policy and legislation relating to taxation and retirement incomes. Mr Parker joined the Treasury in 1984 and has since worked on financial sector liberalisation, tax reform, macroeconomic forecasting and policy, competition policy, energy policy and international economic issues. Mr Parker has also worked for the OECD in Paris.

Attachment C: Consultation activities

The PTG undertook a consultation approach that maximised the opportunity for stakeholders to engage with the PTG and its secretariat to provide input into the PTG deliberations.

The consultation approach included;

- Publication of the PTG Issues Paper on the technical design of the Minerals Resource Rent Tax and transitioning existing petroleum projects to the Petroleum Resource Rent Tax and policies to promote exploration expenditure on 1 October 2010. Two models that showed the potential workings of the MRRT and PRRT were also released.

- Consultation sessions in major capital cities with affected companies, their representative associations, taxation and accounting associations, relevant Australian Government agencies and State and Territory Governments on:

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

- Review of stakeholder feedback from 88 formal submissions received in response to the issues paper.

- Specific issue testing with relevant companies and associations.

ATTACHMENT D: CONTRIBUTING STAKEHOLDERS

Ahava Group

Alcoa

Altona Energy

Ambre Energy

AMEC-MINPROC

ANDEV

Anglo American

Apache

API

Apollo Minerals

Aquila Resources

Arrow Energy

Asia Iron

Asia Iron Holdings

Association of Mining and Exploration Companies (AMEC)

Aston Resources

Atlas Iron

ATNS (Agreements Treaties and Negotiated Settlements Project, University of Melbourne)

AusIMM

Australasian Railway Association (ARA)

Australian Constructors Association (ACA)

Australian Geothermal Energy Association (AGEA)

Australian Petroleum Production and Exploration Association (APPEA)

Australian Syngas Association

Australian Workers Union

Auzex Resources

AWE

Bandanna Energy

BC Iron

BDO

Beach Energy

BG Group

BHP Billiton

Blake Dawson

Bow Energy

Bowen Central Coal

BP

Brockman Resources

Buru Energy

Carbon Energy

Cazaly Resources

CB Richard Ellis

Centennial Coal

Central Petroleum

Centrex Metals

Chamber of Commerce & Industry Queensland (CCIQ)

Chamber of Commerce & Industry WA

Chamber of Minerals and Energy of Western Australia (CME)

Chamber of Mines & Energy SA (SACOME)

Chevron

CITIC Pacific

Comet Ridge

ConocoPhillips

Construction, Forestry, Mining and Energy Union (CFMEU)

Cooper Energy

Cougar Energy

CPA Australia

Crosslands Resources

CTA

Deloittes

Diatreme

DO

DomGas Alliance

Eastern Star Gas

Encounter Resources

Endocoal

Energy Supply Association of Australia (ESAA)

EPL

Ernst and Young

Exxaro

ExxonMobil

FerrAus

Ferrowest

Fielding, John (individual)

Finlaysons Lawyers

Fortescue Metals Group

General Electric Energy (GE)

Geraldton Iron Ore Alliance (GIOA)

Gindalbie Metals

Golden West Resources

Grange Resources

Griffin Group

Guildford Coal

Hancock Prospecting

Heemskirk Consolidated

HESS

Idemitsu

Ignite Energy

IMX Resources

Inpex

Institute of Chartered Accountants Australia (ICAA)

Intergen Australia

International Power Australia

Ironclad Resources

Itochu

Ivahoe Australia

Japan Australia LNG (MiMi)

Jellinbah Group

Karara

KPMG

Latent Petroleum

Law Council of Australia

Liberty Resources

Linc Energy

Lincoln Minerals

Loy Yang Power

Macarthur Coal

Magellan Petroleum

Magnetite Network (MagNet)

Maritime Union of Australia

McKenzie Moncrieff Lawyers

Metallica Minerals

Metgasco

Metgasco and Eastern Star Gas (Joint submission)

Metro Coal

Minerals Council of Australia (MCA)

Minerals Council of Australia (MCA) – Victorian Division

Minerals Exploration Advisory Group (MEAG)

MinEx Consulting (AIG)

Minotaur Exploration

Mitsubishi Development

Mitsui & Co

Moly Mines

Mount Gibson Iron Ore

National Low Emissions Coal Council

NewHope

Nexus Petroleum

North West Iron Ore Alliance (NWIOA)

North West Shelf (Operator: Woodside Energy)

NSW Government

NSW Minerals Council

NT Government

Oil Search

OneSteel

Origin Energy

Peabody

Petronus

PricewaterhouseCoopers (PwC)

QCoal

QER

QGC/BG

Queensland Government

Queensland Government Owned Corporation Generators (QGOCG)

QGOCG – CS Energy

QGOCG – Stanwell Corporation

QGOCG – Tarong Energy

Queensland Resources Council (QRC)

Rex Minerals

Rey Resources

Rio Tinto

Royal Resources

SA Government

Santos

Shell

Sinosteel Midwest

Sojitz

Somerton Energy

Sonoma Mine Management

Southern Uranium

Strike Energy

Subsea Energy Australia (SEA)

Superior Resources

Syngas Ltd

Syntech Resources

TapOil

Tasmanian Government

Tax Institute of Australia

Terra Search

Territory Resources

Tokyo Gas

Total E&P

Tru Energy

Uranex NL

UWA / CET

Vale

Vermillion

VIC Department of Primary Industries

Victoria Petroleum

WA Department of Treasury & Finance and WA Mines & Petroleum

Wesfarmers

Western Mining Services (AIG)

Whitehaven Coal

Wicher Range

Woodside

WPG Resources

Xstrata

Yancoal Australia

ATTACHMENT E: STAKEHOLDER FEEDBACK

The PTG received a broad range of feedback through its consultation and submission processes. Not all of this feedback is publicly available. This attachment summarises the key messages received from stakeholders in greater detail than is provided in the body of this paper. It is not intended to be an exhaustive listing of every comment made to the PTG or every perspective made on an issue.

MRRT

3. Scope of the MRRT

Submissions generally agree that ‘iron ore’ and ‘coal’ have well understood meanings and do not need to be legislatively defined. Some submissions propose excluding magnetite from the MRRT on the basis that magnetite projects are unlikely to be liable for MRRT, and that compliance costs associated with the MRRT could damage a nascent industry.

Some submissions advocate the exclusion of mining operations whose output is consumed in a vertically integrated operation, such as a power station or steel mill.

Most submissions suggest excluding by-products of iron ore and coal mining operations along with an equivalent portion of mining expenses, although some support applying the MRRT to by-products.

Submissions support taxing coal seam gases extracted as an incidental part of a coal mining project under the MRRT rather than the PRRT.

Of those submissions which consider the treatment of coal that is converted to gas in situ, most are of the view that the MRRT should apply rather than the PRRT, on the basis that the underlying resource should determine the taxation regime; an alternative view given is that the state of the resource at its first saleable point should determine its taxation treatment.

Some submissions propose that all of a group’s interests in a project should be treated as a single project, even if held by separate entities, and that all of the group’s MRRT revenue, expenses and royalty credits should be combined for that purpose.

Several submissions oppose the idea that the entities in a group should be jointly and severally liable for the group’s MRRT liabilities in the way they would be for income tax purposes.

4. Definition of a project

Some submissions advocate a definition that would align itself with relevant State and Territory royalty regimes. An alternative was put forward that an appropriate mechanism for defining projects is alignment with the income tax definition.

Most submissions support a flexible definition that allows the use of a range of commercial considerations to define the boundaries of a project. Views on the relative weighting to be applied to these considerations vary, with some placing a greater emphasis on the role of management than others. It is contended that this has the benefits of:

- the effective transferability of starting base and royalty credits within a project;
- lower compliance costs through removing the need to apportion shared costs; and

- greater certainty as to the deductibility of indirect expenditure not directly attributable to a particular mine. For greater certainty, some submissions propose a private binding ruling mechanism.

Many submissions propose that a project should commence when the first mineral tenement is granted and recognise all costs incurred to deliver a project to production. Some submissions also propose that a project should be considered to cease at the conclusion of rehabilitation and exploration on the project area of interest.

5. Taxing point

Submissions generally support setting the taxing point in a way that is relatively neutral in how it influences the MRRT liability of different iron ore and coal mining operations.

Submissions broadly support a definition of the taxing point that provides taxpayers flexibility in selecting the point within a given range of possible taxing points for a particular project. Submissions argue that this would allow the taxing point to be aligned with existing business practices, thereby reducing compliance costs.

Some submissions from the coal industry indicate that the point after crushing and screening may be difficult to identify due to the integrated nature of some processing operations. Run of mine (ROM) coal is suggested as an alternative that would be applicable to all coal operations.

Other possible taxing points were noted, which primarily gave consideration to aligning the taxing point with mining technology or operations, or to draw on existing accounting procedures.

6. Taxable revenue

Submissions support an arm's length valuation approach for the resource at the taxing point, where there is no arm's length sale to a third party at that point.

Deductive methods and the comparable uncontrolled price method were identified as alternative arm's length valuation approaches.

On the deductive method, several submissions note the need for any netback calculation to use arm's length values, which should include appropriate returns to capital employed in downstream activities. Specifically, the rate of return provided to downstream capital should generate a capital charge consistent with the return an arm's length investor requires to invest in the asset if it is not regulated.

Submissions generally consider an RPM is appropriate if a default methodology is to be adopted. Further to this concept, some stakeholders submit that the gap between the cost plus and netback value should be allocated based on the capital intensity of the upstream and downstream operations.

Several stakeholders note a preference for project commencement being aligned with the granting of the first exploration licence, with all exploration expenditure incurred preceding discovery and development deductible for the purposes of MRRT. Stakeholders also suggest that exploration within the project area and in surrounding areas should be deductible and exploration losses should be transferable.

Some stakeholders suggest the uplift rate for MRRT exploration expenditure should be increased in line with the PRRT. Others suggest that exploration expenditure deductibility within income tax creates an inequality between mature and junior companies and there is a need to clarify how this would apply in MRRT.

Some submissions propose that gains and losses from hedging and foreign exchange movements should not be assessable or deductible under MRRT. Others suggest they should be accounted for if they are effective hedges of the underlying sale under the accounting standards.

Several submissions suggest that amounts received under take or pay agreements should not be assessable if they are not for actual delivery of the resource.

Submissions generally accept that balancing adjustments for disposal, or change in use, of project assets should be assessable or deductible, although some contended that this should be only for changes in predominant use. Some submissions consider that all asset transfers within a group should be ignored.

It was also proposed that amounts an entity earns for allowing others to use its project assets should also be assessed.

7. Deductible expenses

Submissions in general propose that all expenditure related to a mining operation should be deductible as either an MRRT expense, or through the derivation of the value of the resource at the taxing point.

Submissions note concerns about the general deductibility test used in the PRRT, in that it may exclude expenditure related to a mining activity merely because the activity is remote from the mining operation, or because there is not a sufficiently close connection between an expense and a particular project.

Submissions prefer clarity in defining which expenses are deductible when calculating an MRRT liability. Many have concerns about the ambiguity in the PRRT legislation, and propose that deductible expenditure be defined broadly and augmented with specific exclusions for expenses that would not be deductible.

Some submissions request that capital investment in mining and transport infrastructure; investment in social infrastructure; office and administration costs; compliance costs; cost of employees; and carbon costs all be made deductible.

Submissions generally prefer using methods to assess, apportion and allocate expenses that align with standard business practices or other existing legislative requirements to reduce compliance costs.

Submissions propose that exploration costs be included as deductible expenditure.

Submissions generally accept that private override royalty payments should not be deductible (and not assessable to the royalty recipient), as they are a payment for the resource rather than a cost of extracting the resource. However, submissions contend that setting the starting base for an existing project as if it were unencumbered by an existing private override royalty to deal with transitional cases may not fully compensate the mining entity for disallowing a deduction for the royalty payments.

Submissions broadly support a specific deduction for native title payments, to clarify that such payments are deductible regardless of the form in which they are made, being a cost of land access.

Several submissions have conflicting views regarding whether or not hedging and foreign exchange gains and losses relating to the resource should be excluded from the MRRT.

Submissions also have conflicting views regarding financing costs and whether or not they should be deductible for MRRT. A possible bias against finance leasing if the MRRT were to exclude finance costs in a similar manner to the PRRT was noted.

There is also concern that there is a bias in favour of outsourcing if the whole amount of outsourcing payments (including any embedded finance costs) were be deductible, as finance costs would not be deductible if the same services were provided by the mining entity. However, there is the opposite concern, that is a bias against outsourcing, if outsourcing firms do not receive an immediate deduction for capital expenditure.

Some submissions propose that rehabilitation bonds and rehabilitation trust payments be deductible, with the return of the bond or any trust distribution (together with any investment return) assessable. There are divided views as to whether provisions for rehabilitation costs should be deductible.

8. Treatment of deductions

Submissions propose that starting base losses should receive equivalent treatment to normal losses, whether or not they relate to a market value or book value starting base.

Some submissions contend that the intent underlying the terms of reference is to provide mining entity-level compensation for investment decisions already made, rather than project specific compensation.

Submissions also contend that the terms of reference do not contemplate a separate class of losses arising from starting base deductions.

Some submissions propose that if starting base losses are to be quarantined to prevent them from shielding new projects, transferability between other starting base projects should be permitted.

Submissions generally prefer non-uplifted amounts (of which the starting base is considered one element) to be offset before uplifted amounts to preserve their value.

Many submissions contend that the MRRT is less a project-based tax due to the transferability of losses between projects, and so the need for project accounting of amounts in the MRRT should be greatly reduced.

Many submissions propose that the ordering rules should minimise the risk that royalty credits and any other non-transferable amounts are trapped within a project.

Some submissions contend that the use of losses should not be limited by any loss ordering rules in the legislation.

Several submissions suggest that losses should be transferable at the discretion of the entity. There was also the suggestion that if loss transfer is mandatory, then there should be no requirement to transfer any losses until all other available project specific amounts have been used against applicable projects in any period.

9. Transfers of MRRT losses

Some submissions propose that losses should be transferable at the discretion of the entity. Some submissions contend that compulsory transfer would be acceptable if royalty credits could be used before transferring losses.

Some submissions also propose that losses should be transferable between projects of entities in the same group.

Submissions identify a range of proposals to define the grouping rule, including a wholly-owned group test, an income tax consolidated group and a consolidatable group. Of those submissions, some stakeholders suggest that the grouping test for loss transfer purposes should be the same as that for aggregating for the $50 million threshold.

Submissions broadly accepted that that there should be some form of ownership test, or other integrity rule, to limit loss trafficking, although some submissions propose that all acquired losses should be transferable.

It was also proposed that, within majority-owned groups, losses should be transferable to the extent of the ownership to deal with incorporated joint ventures.

10. Starting base

Submissions broadly support the adoption of generally accepted methodologies and practices (where relevant) and have highlighted the market valuation guidelines released by industry, the Australian Securities and Investment Commission and the ATO, particularly those used for the purposes of consolidation.

Most submissions accept that the principles used to determine the valuation of the starting base should be consistent with those used in determining the value of the resource at the taxing point.

Some submissions show a preference for the PTG to prescribe guidelines with respect to the valuation methodology to avoid potential disputes.

Submissions proposed to include within the starting base all assets, both tangible and intangible, with the resource representing the residual of the value of these assets. Submissions propose that some assets are specifically listed in the terms of reference to remove any uncertainty as to whether they should be included as project assets.

Some submissions also noted uncertainty about whether mining entities could choose between straight-line or diminishing value methods to depreciate market value starting base assets.

Several submissions consider that only providing a starting base where an investment had reached the stage of a production licence at 1 May 2010 would penalise investments that had not quite reached that stage. Some submissions propose moving the test point to 1 July 2012.

Some submissions do not agree that the value of the resource in the starting base should be reduced in accordance with any depletion between 2 May 2010 and 1 July 2012. A suggestion was made that the value of resource should increase where new resources are identified through exploration activities undertaken between 1 May 2010 and 1 July 2012.

11. Costs of compliance for small miners

Submissions generally support the threshold test being applied as a gross annual cash flow at the entity level using the small business aggregation test.

Several submissions propose that companies who breach the threshold in any given year be treated as if they had always paid MRRT, and that annual royalty credits be computed, carried forward, and uplifted whether MRRT is payable or not in any year. They also request that the $50 million threshold be based on the same measure of profit as MRRT, using starting base and unused losses.

Many submissions propose that the threshold be:

- increased to $250 million;
- applied as a tax free threshold or otherwise redesigned to reduce its potential to distort business decisions; and
- automatically indexed.

Some submissions suggest that the $50 million threshold be extended to onshore PRRT projects.

Submissions propose that mining entities be allowed to elect into a low compliance burden regime if they consider themselves unlikely to be liable for MRRT. Alternatives identified include commercial ‘safe harbours’, high level calculations, or a 3-4 year rolling average to assess whether a mining entity is within the $50 million threshold.

Many submissions recognise that there would be a commercial incentive to keep records and undertake calculations to establish a robust MRRT base should their operations be sold or expanded.

12. MRRT administration

Submissions generally propose that the MRRT operate under existing tax and accounting systems. They consider that the introduction of new processes and concepts would lead to increased compliance costs, greater tax operational risk, and uncertainty.

Submissions also contend that definitions used for MRRT should be consistent with those used in other compliance regimes, including accounting, taxation and royalty definitions.

Some submissions identify advantages in allowing a consolidated group to lodge a single MRRT return.

A number of submissions express concern about significant compliance costs where there may not be an MRRT liability, particularly relating to the time-frame for assessment and the requirement to keep documentary evidence.

Submissions broadly propose that the MRRT should be determined and paid on a self-assessed basis, subject to the standard four year limitation period.

PRRT Transition

14. Definition of a project

Submissions generally propose that petroleum projects should continue to be based on production licences and defined in accordance with the geographic location of the entire project. Some submissions, however, prefer that a project be defined by the issuance of an oil and gas tenement, including an exploration permit or retention lease, thereby enabling a number of production licences, sub licences, retention leases and exploration leases to be combined into one project.

Some submissions propose that the combination of multiple production licence areas which are managed as a single operation, around common processing and transportation facilities and common customers, should be treated as one project (a single economic enterprise). Existing operational and ownership criteria should be appropriate (subject to the ownership test recognising related companies as a single owner) but the geological test should be removed as not all relevant production licences will be positioned near each other.

Some submissions suggest a revised test for project combination based on the above and that this test should be capable of self-assessment by taxpayers.

Several submissions prefer defining certain petroleum areas as a single project in legislation, as was done for the Bass Strait project. Similar requests were made in respect of the tenements related to the Cooper Basin and the Gladstone liquefied natural gas hub.

Some submissions propose that a default position ‘safe harbour’ should be included to reduce uncertainty. For example, if the following tests are met, then projects may be combined:

- where there is a specified percentage of common ownership across adjoining production licence areas; and
- common production or downstream facilities.

Submissions from the coal seam methane and tight gas industry note concern about the relevance of the definition of exploration under the PRRT for their projects. Of particular concern is that exploration and appraisal activity may continue beyond the time a production licence is issued and after a final investment decision has been made.

Several submissions propose that the current provisions for the higher uplift rate for exploration expenditure do not adequately recognise exploration expenditure in coal seam methane and tight gas operations.

Some submissions suggest that all coal seam methane and tight gas exploration expenditure should receive an uplift of LTBR+15.

15. Resources subject to the extension

Submissions broadly accept that the extension of the PRRT should include all oil and gas projects, including coal seam methane.

Submissions also broadly agree that coal seam gases extracted as an incidental part of a coal mining project should be taxed under the MRRT, rather than the PRRT. Suggested definitions of 'incidental' include less than 10 or 20 per cent of the extracted resource value over the life of a mine.

Of those submissions which consider the treatment of coal that is converted to gas in situ, many contend that the MRRT should apply, rather than the PRRT, on the basis that the underlying resource should determine the taxation regime. An alternative view was made that the state of the resource at its first saleable point should determine its taxation treatment.

Some submissions propose not including the mining of oil shale in the PRRT, as it involves the mining of shale which is subsequently processed into oil.

Some submissions propose that, to ensure the domestic competitiveness of gas, fuels used in electricity generation should have the same tax status while recognising the difference between the PRRT regime applying to gas and the MRRT applying to coal.

16. Taxing point

Submissions broadly agree that the current criteria for establishing the taxing point within the PRRT is appropriate. Several submissions propose additional flexibility in establishing the taxing point to reflect the variety of onshore operations.

A suggestion was made that the criteria establishing the taxing point should be clarified, and several stakeholders propose additional criteria to allow for the calculation of receipts for sales gas, or the entrance of gas into transmission infrastructure.

17. Taxable revenue

Submissions generally support the view that the existing provisions of the PRRT would accommodate existing and future projects under an extended PRRT regime.

Proponents of coal seam gas projects propose several methodologies in relation to the treatment of integrated gas-to-liquids projects that would provide greater certainty to industry and simplify compliance and administration.

Of those submissions proposing differing methodologies, most view the key issues to be: the RPM being provided as a default option for onshore integrated gas to liquid projects transitioning to the PRRT; existence of provisions for a determination under regulation that specifies a fixed percentage of free-on-board price as a basis to determine PRRT assessable receipts for the life of the project; and where a project has a determination for royalty purposes in place with a state government, the utilisation of this as the basis of determining assessable receipts for the purpose of the PRRT.

Some submissions note the difficulty in identifying and providing the necessary level of historical capital expenditure detail which would be required within the RPM.

Of those submissions that raise the historical capital expenditure issue, some propose two alternatives to address this concern and provide future certainty, those being: a fixed percentage of free-on-board price be used to determine assessable receipts for the life of the project; or a simplified version of the RPM be available.

18. Deduction ordering and deductible expenditure

Some submissions propose amending the PRRT deductibility provisions to replace the current 'direct relationship' test with a purpose test. Several submissions also request the provision of clear guidance for classifying and apportioning expenditure, in particular, indirect administration and accounting costs.

Submissions propose that the PRRT deduction rules, as extended to onshore conditions, to take into account all additional costs required for onshore production.

Submissions also propose deductibility for native title and related access payments, noting that operations cannot be conducted without access to land.

While accepting that changes to the PRRT deduction rules are not within the scope of the terms of reference, most submissions propose that the rules applying to onshore projects be changed to provide greater clarity.

19. Starting base

Submissions broadly support the adoption of generally accepted methodologies and practices (where relevant), and have identified the market valuation guidelines released by industry, the Australian Securities and Investment Commission and the ATO, particularly those used for the purposes of consolidation.

Several submissions note a lack of specificity in relation to the options available to determine a starting base, other than the market value approach. A suggestion was made to allow a look back approach, in addition to book value, as providing a suitable alternative that would provide simplicity of administration and compliance while recognising past investment.

Proponents of coal seam gas projects identify a number of issues in relation to the treatment of integrated gas to liquids projects, the key issues relating to the market valuation are:

- the starting base should reflect the value of historical investment (including capitalisation) in the project; and
- short-cut approaches should be developed where market based transactions have occurred within a reasonable period before 1 May 2010. It is suggested that a value could be established per unit of 2P[24] or 3P[25] resource to be applied across all CSG projects and tenements.

It was suggested that a short-cut approach may not provide an equitable outcome for all CSG projects due to the variability in the quality of underlying resources between projects not being reflected in this valuation approach.

Some submissions address the allocation of the starting base between exploration and general expenditure, so that the starting base can be apportioned across the categories of expenditure available within PRRT with associated uplift rates to be applied to the relevant portions to recognise their risk profiles.

20. Treatment of the starting base and credits for government resource taxes

Submissions propose that the starting base should have its own category of expenditure and be immediately and fully deductible.

Some submissions propose that the starting base be separated into general project and exploration expenditure and treated according to the respective PRRT provisions.

Of those submissions that raise starting base separation as an issue, most contend that the starting base for mature projects should receive equivalent treatment as that of general project expenditure.

Submissions propose that the starting base losses unused in any given year be uplifted and carried forward.

[24] Proved plus probable.

[25] Proved plus probable plus possible.

Some submissions propose that royalty and excise amounts are treated as general project expenditure and receive equivalent uplift treatment. Of those submissions that raise this issue, some contend that this approach would eliminate the need for new loss ordering rules.

Submissions propose that there should be an immediate refund of royalties and excise to ensure entities are not cash flow disadvantaged.

Submissions suggest that royalties should be fully creditable against future PRRT liabilities with unused amounts uplifted.

21. PRRT administration

Several submissions note concern about the overall scope of change created by the extension of the PRRT to all Australian onshore and offshore oil and gas projects, including the North West Shelf.

A suggestion was made that a detailed review of the administration, interpretation and application of the PRRT be undertaken, including confirming the legislative intent of the PRRT.

Some submissions note that small companies do not have the resources to fully comply with the PRRT and support simplified arrangements for small miners. A concern is also noted about the possible imposition of duplicative compliance requirements, including an obligation to report to multiple regulators.

Some submissions comment on the PRRT issues that remain in dispute after many years and express concern regarding the ability of the ATO to provide early guidance and support.

A suggestion was made that, in order to ease entities into the PRRT regime, no PRRT instalments should be payable for a defined period. It was also suggested that no penalties should be applied to adjustments for a defined period due to the complexities and time intensiveness associated with the transition process.

Several submissions propose that starting base values be agreed and finalised by no later than 30 June 2013 and not subject to future ATO compliance audits.

Several submissions propose that corporate groups should be entitled to lodge one consolidated return.

Some submissions propose that joint venture billing statements (for unincorporated ventures) or financial statements (for incorporated ventures) issued by a project operator should form the basis for the substantiation of costs incurred by a project operator in relation to a petroleum project.

A suggestion was made that entities with a PRRT threshold lower than a defined amount for a project be exempt from the quarterly instalment requirements. This should also ease the cash flow difficulties where both existing resource taxation and PRRT is payable.

A number of suggestions regarding the ongoing administration of the PRRT are also made, including:

- the creation of a full time Deputy Commissioner position to have responsibility for the ATO's compliance activity;
- priority up-skilling of ATO staff responsible for compliance and audit activity;
- reinvestment of a small proportion of PRRT proceeds into up-skilling small entities in areas such as OH&S, environmental regulation and taxation compliance;
- providing taxpayers the option to lodge a return as soon as a project comes into existence;
- sign-off of records process for 'old' expenditure to be undertaken by a party external to the ATO and once verified, the ATO cannot go back and audit those amounts.
- the creation of an oversight body with representatives from RET, Treasury and industry, to both monitor and provide support to the ATO's administration of the PRRT regime and resolve policy issues raised by either the ATO or taxpayers;

- an independent review of the implementation and operation of the new arrangements be completed within three years and the results to be tabled in Federal Parliament.

A suggestion was made that ATO Draft Practice Statement PS LA 3326, released in September 2009, should apply to the ATO Draft PRRT Rulings issued in the second half of 2009.

Attachment F: List of recommendations

MRRT Recommendations

3 Scope of the MRRT

3.1 Resources subject to the MRRT

Recommendation 1: The MRRT should apply to all mining operations resulting in the depletion of naturally occurring coal or iron ore. For the avoidance of doubt, the following activities should be covered by the MRRT rather than the PRRT:

- coal mining operations involving the extraction of gas derived from the underground conversion of coal; and
- coal mine methane extracted as a necessary and integral part of a coal mining operation.

Recommendation 2: Where there is incidental production of coal or iron ore as part of a mining project, the proceeds from the sale of the coal or iron ore should be assessable under the MRRT, with allowance for a reasonable apportionment of mining costs.

Recommendation 3: Where there is incidental production of other minerals or products as part of an coal or iron ore project, the proceeds from the sale of the other minerals or products should not be assessable under the MRRT and the reasonable apportionment of mining costs associated with those minerals or products should not be deductible under the MRRT.

Recommendation 4: The terms ‘iron ore’ and ‘coal’ should take their ordinary meanings in the legislation, rather than being defined terms.

3.2 Who is the taxpayer

Recommendation 5: An income tax consolidated group should be permitted to elect to be treated as a single entity for MRRT purposes. Only such a group should be permitted to combine mining interests held by more than one entity into the same project.

Recommendation 6: The head company of a consolidated group that makes that election should be responsible for paying the MRRT of the group, but each entity in the group should be jointly and severally liable for the group’s unpaid MRRT.

4 Definition of a project

Defining a project

Recommendation 7: A project must consist of at least one production right. A project should commence when a production right is granted or acquired.

Recommendation 8: Where separate production rights that produce the same commodity exhibit a degree of integration in the extraction and processing operations, and other activities that occur prior to the taxing point, they should be considered a single project (a single mine).

Recommendation 9: The taxpayer should be allowed to elect to define a project as the aggregated interests 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. Where a taxpayer elects to aggregate production rights, the project must encompass the full extent provided by the criteria.

Recommendation 10: A project would need to be re-defined to reflect changes in circumstances relating to the production rights in which the taxpayer holds an interest, such as where:

- an interest in a new production right is acquired, or an existing mining tenement in which the taxpayer has an interest becomes a production right, and is part of a project defined under Recommendations 8 or 9;
- an interest in a production right that is part of a project defined under Recommendations 8 or 9 is sold or relinquished; or
- the configuration of the taxpayer's mining operations change, such that one or more production rights satisfy, or no longer satisfy, the tests under Recommendations 8 or 9.

Applying the definition of a project

Recommendation 11: The taxpayer should be allowed to self-assess a project in accordance with the defining criteria. Decisions would be reviewable by the ATO and rulings available for those seeking certainty.

Recommendation 12: Entities that are consolidated for income tax purposes and elect to also be consolidated for MRRT purposes (see Recommendation 5) should apply Recommendations 8 and 9 to production rights held by members of the consolidated group under the single entity rule. In that case, the head company of the consolidated group will be the taxpayer for each aggregated project within the group.

Recommendation 13: Exploration for an MRRT commodity and pre-project expenditure relating to upstream activities, incurred on or after 1 July 2012, would be immediately deductible against assessable revenue generated by any project producing the same commodity held by a taxpayer who incurred the expenditure, in accordance with Recommendation 26.

Defining when a project ends

Recommendation 14: A project should be deemed to cease to exist when a production right is rescinded by or relinquished to the issuing authority, or 10 years after production of a commercial quantity of coal or iron ore from the mine ceases, or when the taxpayer elects to close the project, whichever occurs first.

Recommendation 15: Expenditure incurred in undertaking rehabilitation of a mine site after a project has ceased production should be deductible. To the extent that the rehabilitation costs cannot be offset against assessable revenue, or transferred to another project in the wholly-owned group, the taxpayer will be eligible for an immediate tax credit up to the amount of MRRT paid over the life of the project.

5 TAXING POINT

Recommendation 16: The taxing point is 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 (for example loading onto a conveyor belt to a processing unit or loading into an in-pit crusher); 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 17: The ATO should work with industry to develop acceptable administratively efficient approaches to allocating costs at the taxing point where existing accounting and administration systems are not aligned to that point.

6 TAXABLE REVENUE

6.1 Resource revenue

Recommendation 18: The value of the resource at the taxing point should be determined by:

- an 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, the amount determined using the most appropriate and reliable arm’s length method.

Recommendation 19: The value of the resource should be determined at the time of supply of the resource, but no later than when the resource is loaded for export.

Recommendation 20: The explanatory memorandum should provide guidance as to the type of valuation methodologies that are suitable and be detailed enough to provide certainty to taxpayers and guidance to the ATO and the courts. In addition, draft ATO guidance on acceptable resource valuation methodologies and procedures should be developed, in parallel to the legislative process, to be available prior to the MRRT coming into effect.

Recommendation 21: A ‘safe harbour’ method to calculate the value of the resource at the taxing point where there is no arm’s length supply to a third party at the taxing point should be available to:

- 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 operations in existence at 1 May 2010.

Recommendation 22: Taxpayers eligible to apply the ‘safe harbour’ method may calculate the value of the resource at the taxing point as the value derived from the first arm’s length supply to a third party less:

- operating costs incurred between the taxing point and the point of sale;
- an allowance for capital employed between the taxing point and the point of supply, calculated as the depreciated optimal replacement cost of the capital employed multiplied by LTBR+7; and
- deductible and creditable amounts attributable to the use of the ‘safe harbour’ method should not be available to offset assessable receipts generated from other resource sales from the mining project or be transferable to other projects of the taxpayer.

6.2 Annual calculations

Recommendation 23: The MRRT should be assessed on an annual basis that includes MRRT deductions incurred throughout the year and all MRRT revenue receivable during the year.

Recommendation 24: The MRRT income should be deemed to be derived at the time of supply of the resource, but no later than when the resource is loaded for export.

Recommendation 25: The approach outlined in Recommendation 23 should apply from 1 July 2012, recognising that some resources supplied after that date will have been extracted prior to 1 July 2012.

6.3 Exploration and other pre-project expenditure

Recommendation 26: MRRT exploration and other pre-project upstream expenditure incurred in respect of mining tenements other than a production right should be:

- transferable to other projects producing the same MRRT commodity held by a taxpayer, subject to Recommendation 44; and
- transferable to projects producing the same MRRT commodity within an entity acquiring the tenement on which the expenditure is incurred, subject to Recommendation 47.

Recommendation 27: The uplift rate applying to eligible exploration and other pre-project expenditure incurred in respect of mining tenements other than a production right should reduce from the LTBR+7 to LTBR 10 years after the expenditure is incurred.

6.4 Other revenue and deductions

Recommendation 28: Project revenue and deductions should include other amounts relating to changes in the use of project assets and amounts previously assessed or deducted. These include:

- balancing adjustments when a project asset (whether in the starting base or acquired from 1 July 2012) leaves the project or the extent of its use in the project changes;
- compensation for the loss of an asset or an MRRT deductible expense (for example, an insurance payout);
- explicit or implicit reimbursements, reductions or subsidies of deductible expenditure; and
- amounts arising under a risk sharing arrangement embedded in a contract entered into by the taxpayer where the counterparty is the purchaser of the resource or supplier of a service or input to an upstream activity (for example, under a take or pay arrangement).

Recommendation 29: Amounts received from contract mining services which an MRRT entity provides to a third party, such as extraction services, should not be MRRT assessable receipts to the entity and the costs of providing those services should not be MRRT deductible to the entity.

7 DEDUCTIBLE EXPENSES

Recommendation 30: 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, subject to the exclusions listed in Recommendation 31.

Recommendation 31: The following payments should be excluded for the purposes of Recommendation 30:

- 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.

Recommendation 32: The Implementation Group should investigate the treatment of expenses associated with plant and equipment included in head office expenditure.

Recommendation 33: Private royalties payable in respect of a period after 30 June 2012 to a State or Territory body under an agreement entered into prior to 2 May 2010 should be deductible but otherwise treated in an equivalent manner to State and Territory royalties. Recommendation 31 would not apply in respect of such royalties.

Recommendation 34: The legislation should ensure that native title payments made pursuant to an agreement under the *Native Title Act 1993* or a similar Act in settlement of an indigenous land use agreement, should be deductible to the extent they relate to upstream operations.

Recommendation 35: The definition of exploration under the MRRT should be aligned with that used for income tax.

Recommendation 36: The time of recognition of an expense should be aligned with that under income taxation.

8 TREATMENT OF DEDUCTIONS

8.1 Starting base losses and royalties

Recommendation 37: Losses arising from unused depreciation of the starting base (starting base losses) should not be transferable to other projects.

Recommendation 38: Starting base losses should be uplifted in the following manner:

- market value starting base – by the consumer price index to retain their real value; and
- book value starting base – by the MRRT uplift rate consistent with the design announced on 2 May 2010.

Recommendation 39: State and Territory mineral and gas royalties (including those raised on behalf of private land owners holding mineral rights) should be:

- creditable against MRRT liabilities;
- non-transferable and non-refundable; and
- carried forward and uplifted where they are unable to be used.

Recommendation 40: It is important to ensure that the taxation of Australia's resources preserves our international competitiveness and ensures Australians receive a greater benefit from mineral resources and that this is reflected in the treatment of royalties under the MRRT. The MRRT should not be used as a mechanism to enable States and Territories to increase inefficient royalties on MRRT taxable commodities. All current and future State and Territory royalties on coal and iron ore should, therefore, be credited and it is imperative that the Australian, State and Territory Governments put in place arrangements to ensure that the States and Territories do not have an incentive to increase royalties.

Recommendation 41: Private royalties imposed by the States and Territories on behalf of private land owners should be treated in the same manner as State and Territory royalties and therefore be creditable and uplifted but not transferable.

8.2 Deduction ordering rules

Recommendation 42: MRRT revenue should be reduced by deductions, losses and royalty credits in the following order:

1. Project deductions.
2. Royalty credits (current year and carried forward).
3. Carried forward losses of the project.
4. Starting base depreciation deductions and starting base losses.
5. Transferable exploration expenditure.
6. Transferred-in project losses.

9 TRANSFERS OF MRRT LOSSES

Recommendation 43: Losses should only be transferable between projects producing the same MRRT commodity.

Recommendation 44: Losses that can be transferred should be transferred at the appropriate point under the ordering rules, to the extent that they can be used.

Recommendation 45: Project losses should only be transferable if the transferring and transferee projects were owned by the same entity (or group) from when the losses were generated until they are transferred. Historical losses should otherwise be quarantined to the project from which they originated.

Recommendation 46: Notwithstanding Recommendation 45, the Implementation Group should consider whether there are administrative and/or alternative legislative approaches to loss transferability that could apply in situations where the holder of an interest in a joint venture acquires a further interest in that joint venture. (The Implementation Group is identified in Recommendation 61.)

Recommendation 47: MRRT exploration and pre-project losses acquired with a mining tenement should be transferable to projects with MRRT profits, whether or not any ownership condition is satisfied. To avoid the possibility that this free transfer of exploration losses leads to trading in exploration deductions that have a greater economic value than the underlying tenement:

- the unused exploration losses attributable to a tenement should go with the tenement when it is transferred; and
- the part of an exploration loss that an entity acquiring a mining tenement can use should be limited by reference to the amount paid for the tenement (or an equivalent amount where the entity that owns the tenement is acquired).

Recommendation 48: If the relevant tests are otherwise satisfied, losses should be transferable to projects owned by other entities within the same consolidatable group regardless of whether the group has chosen to consolidate.

10 STARTING BASE

Starting base

Recommendation 49: A starting base should be available for all interests in mining tenements in existence at 1 May 2010.

Starting base election

Recommendation 50: An entity must make an irrevocable election to use market value or book value as the method for determining a starting base for each interest the entity holds in a project or other mining tenement in existence at 1 May 2010, by the due date for the filing of the first MRRT tax return. Where an election is not made by the required date, the project or mining tenement should be taken to have a book value starting base. Where an appropriate book value does not exist or cannot be reliably reproduced, there should be no starting base.

Determining the market value starting base

Recommendation 51: An entity should determine a market value starting base comprising the market value of mining assets upstream of the taxing point as at 1 May 2010 on the basis of accepted market valuation principles.

- In determining how market valuation principles should be applied, the taxpayer should take into consideration their particular circumstances and the stage of development of the project or mining tenement.
- The derivation of the market value starting base should have regard to market expectations of future iron ore and coal prices, exchange rates, interest rates, inflation and other industry reference benchmarks as at 1 May 2010, and recognised methodologies for market valuation in the mining sector. The Treasury, ATO and RET should consult industry and professionals to identify suitable reference benchmarks to reduce compliance costs and provide greater certainty to taxpayers. The existence of such benchmarks would not constrain a taxpayer's choice of valuation methods or their ability to use alternative estimates.
- Guidance as to the application of valuation methodologies should be provided through examples within the explanatory memorandum. In addition, the ATO should provide early guidance to industry regarding the practical application of this aspect of the legislation.
- The approach used in deriving the starting base should be consistent with that used to value the resource at the taxing point.
- 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 mining information.
- Where a private override royalty existed in relation to the project or tenement at 2 May 2010, the starting base should be determined as if it were unencumbered by the private override royalty liability (Recommendation 31).
- As a proxy for the market value of tenements other than a production right, an entity could elect to use the sum of their expenditure over the previous 10 years.

Applying the market value starting base

Recommendation 52: The market value starting base of a mining project or other mining tenement should not start to be depreciated until an MRRT commodity is first produced from the tenement to which the starting base relates. Where a resource does not come into production by 30 June 2037 (25 years from the commencement of the MRRT), the starting base should be immediately deductible in the year production commences.

- Depreciation of the market value starting base should be on a straight-line basis.
- The mining right and mining information should be treated as one asset and depreciated over the lesser of the life of the mine or the period to 30 June 2037.
- Other assets should be written off over the lesser of their effective life, the life of the mine or the remainder of the period to 30 June 2037.
- The market value starting base should not be uplifted. Starting base deductions that have not been used within a project should be uplifted by the consumer price index to retain their real value (Recommendation 38).
- Any undepreciated starting base amounts attributable to an interest in a project or mining tenement are to be transferred to the new owner upon sale of the interest.
- The starting base is not to be reduced to reflect any depletion in the resource between 2 May 2010 and 30 June 2012. However, where starting base assets are disposed of between 2 May 2010 and 30 June 2012, the starting base should be reduced by the market value ascribed to the asset at 1 May 2010.
- Capital and mine development expenditure incurred between 2 May 2010 and 30 June 2012 should be added to the starting base.

Determining the book value starting base

Recommendation 53: A book value starting base should be 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. Such accounts are to have been prepared in line with Australian Accounting Standards.

- Capital and mine development expenditure incurred after the date at which the audited accounts were prepared and before 1 July 2012 should be added to the starting base.
- The book value starting base should be uplifted at the MRRT uplift rate from the date at which the audited accounts were prepared until fully offset against project revenues.
- Further guidance as to the application of the book value starting base should be provided through examples within the explanatory memorandum.

Applying the book value starting base

Recommendation 54: The book value starting base of a mining project or other mining tenement should start to be depreciated from the later of the commencement of the MRRT (1 July 2012) and the date an MRRT commodity is first produced from the tenement to which the starting base relates.

- The starting base should be depreciated over five years with the following profile: 36 per cent, 24 per cent, 15 per cent, 15 per cent and 10 per cent.

- Undeducted book value starting base amounts should be uplifted and carried forward to be available as an offset against future project revenue.

- Any undepreciated starting base amounts should be transferred to a new owner if an interest in a project or mining tenement is sold.

- Where starting base assets are disposed of between the date at which the audited accounts were prepared and 30 June 2012, the starting base should be reduced by the book value ascribed to the asset at 1 May 2010.

11 COSTS OF COMPLIANCE FOR SMALL MINERS

11.1 $50 Million threshold offset

Recommendation 55: The $50 million threshold offset is intended to relieve a taxpayer of any MRRT liability arising in respect of an income year when their MRRT profit is below $50 million. The offset should have the following features:

- the profit threshold should apply annually to a taxpayer's MRRT profit (revenue less expenses);

- the profit threshold should apply at an aggregate taxpayer level, defined by the small business test in Subdivision 328-C of the *Income Tax Assessment Act 1997*;

- the offset should be phased-down between $50 million and $100 million, such that the maximum possible tax concession provided by the threshold ($11.25 million at $50 million), is reduced by $0.225 for every $1 of MRRT profit above $50 million; and

- the actual offset available to a taxpayer with an MRRT profit of between $50 million and $100 million should be the lesser of:

  - the maximum offset reduced by creditable royalties paid and the credit equivalent of other deductible amounts (carry-forward losses and starting base deductions); and

  - MRRT otherwise payable.

11.2 Simplified MRRT obligations

Recommendation 56: Taxpayers subject to MRRT, who are unlikely to have an MRRT liability for an extended period for example, due to their lack of MRRT profits or the relativity between gross MRRT profit and creditable royalty payment, should be provided the option to elect to comply with simplified MRRT obligations to reduce their compliance burden.

Recommendation 57: The Treasury and ATO should work with industry to develop and implement one or more tests that allow a taxpayer to evidence they will not be liable for MRRT for an extended period. The test, or tests, should be designed to work with readily available data and be applied at an aggregate taxpayer level, defined by the small business test in Subdivision 328-C of the *Income Tax Assessment Act 1997*.

The PTG observes that the following tests could achieve the required outcome:

- Earnings Before Interest and Tax (EBIT) on iron ore and coal extraction plus creditable royalties less than $50 million.

- EBIT on iron ore and coal extraction plus creditable royalties less than $250 million AND creditable royalties exceed 25 per cent of such earnings plus creditable royalties.

Recommendation 58: Where a taxpayer meets the relevant test, or tests, an annual election to opt into the simplified MRRT obligations should be available.

Recommendation 59: Where an entity no longer satisfies at least one of the relevant tests, or opts to withdraw from the simplified MRRT obligations, it would need to comply with the full MRRT obligations for that year. Such taxpayers should be treated as new MRRT taxpayers and only receive a deduction for expenditure incurred in the year they fail the tests or move to the full MRRT.

12 MRRT Administration

12.1 Transitional administration

Recommendation 60: The Treasury should engage with overseas jurisdictions as soon as possible, regarding the crediting of MRRT in their jurisdictions.

Recommendation 61: The Treasury and ATO should continue to engage with industry to progress the administrative design and implementation of the MRRT, including:

- establishing an Implementation Group involving industry representatives and relevant advisors and officials from RET, the Treasury and ATO;
- providing practical early guidance on the MRRT and taxpayer obligations; and
- establishing capability in both the ATO and key intermediaries to support industry in complying with the law.

Recommendation 62: The Government should ensure the ATO is appropriately funded to provide interpretive and administrative support to industry in their transition to the MRRT.

Recommendation 63: To ensure the MRRT achieves its intended purpose efficiently and equitably, with minimal compliance and administration costs, the Board of Tax should review the operation of the MRRT within five years of its implementation.

Recommendation 64: The ATO should provide guidance on circumstances that may warrant a remission of penalties by the ATO in cases of inadvertent errors, particularly in the first two years of the MRRT.

12.2 Ongoing administration

Recommendation 65: The MRRT legislation should provide for:

- the MRRT to be designed and implemented as a self-assessed tax;
- a July–June accounting period, with substituted accounting periods in place for taxpayers who use them for income taxation;
- an instalments regime that is responsive to the potential for significant within-year variability in mining profits and a final reconciliation period that fits within entities’ tax calendars;

- acceptance of functional currencies where the company meets the criteria and uses them in accounting for income taxation; and
- the ability of the ATO to obtain MRRT relevant information from third parties such as project vendors or joint venture operators.

Recommendation 66: Division 25 of the *Income Tax Assessment Act 1997* should be updated to specifically include expenditure related to management of MRRT tax affairs as an income tax deduction.

Recommendation 67: The administrative design of the MRRT should provide workable certainty to taxpayers and minimise the costs of complying with and administering the MRRT. These practices should include:

- providing for annual MRRT returns, including the option to lodge returns prior to the receipt of MRRT income to support the provision of certainty regarding historic expenditure; and
- guidelines for joint venture participants and operators, and the ATO, in relation to joint venture accounts and substantiation of expenditure.

PRRT RECOMMENDATIONS

14 DEFINITION OF THE PROJECT

Recommendation 68: The definition of a project transitioning into the PRRT should be based on the granting of a production licence and the definition of a production licence within the PRRT legislation should be extended to cover production licences granted under relevant State and Territory legislation.

Recommendation 69: The existing criteria for combining offshore projects should be applied to the combining of onshore projects. However, the criteria that the Minister has 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; and
- the aggregated interests 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 production from the production rights.

Recommendation 70: Given the need to provide certainty to the North West Shelf (NWS) project, it should be specified in the legislation that the licence areas associated with the project can be considered one project, as was the case when the Bass Strait project transitioned to the PRRT.

Recommendation 71: The Minister for Resources and Energy should continue to issue combination certificates under Section 20 of the *PRRT Assessment Act 1987* for both onshore and offshore projects.

15 RESOURCES SUBJECT TO THE EXTENSION

Recommendation 72: 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 shale projects. 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; and
- the extraction of coal mine methane where it is a necessary and integral part of a coal mining operation.

16 TAXING POINT

Recommendation 73: The existing PRRT provisions determining the point at which petroleum, or products produced from petroleum, become taxable (the taxing point) are sufficient to accommodate all types of petroleum projects, onshore and offshore, conventional and unconventional, and should therefore be retained.

17 TAXABLE REVENUE

Recommendation 74: The existing PRRT provisions for valuing the resource at the taxing point should be applied to projects transitioning into the PRRT, subject to the following considerations:

- where a State or Commonwealth royalty determination that sets the value of the resource at the taxing point is in place the taxpayer should be able to seek a determination from the Minister for Resources and Energy to allow the taxpayer to elect that value in determining their PRRT receipts;
- taxpayers developing onshore gas resources within an integrated gas-to-liquids project, such as liquefied natural gas, should have the option of using the existing RPM as a default methodology for calculating the value of the resource at the taxing point;
- taxpayers with existing integrated gas-to-liquids projects, such as liquefied natural gas, at 1 May 2010 that are to transition to the PRRT should have access to a simplified RPM as a default methodology. This should provide a single agreed phase point and capital base determined by an agreed valuation methodology for existing assets; and
- existing RPM provisions within the PRRT should be amended to provide for integrated gas-to-electricity projects. Industry should be consulted in relation to the amendments required to ensure appropriate functionality of the methodology.

18 DEDUCTION ORDERING AND DEDUCTIBLE EXPENDITURE

18.1 Deduction ordering rules

Recommendation 75: The existing PRRT deductibility rules should apply to transitioning projects with amendments to accommodate starting base amounts and government resource tax credits.

18.2 Transition deductible expenditure

Recommendation 76: The legislation should ensure that native title payments made pursuant to an agreement under the *Native Title Act 1993* or a similar Act in settlement of an indigenous land use agreement should be deductible to the extent they relate to upstream operations.

Recommendation 77: The costs of water treatment processes and associated facilities integral to the production of coal seam methane should be treated as deductible expenditure.

Recommendation 78: The existing PRRT treatment of private override royalties as non-deductible/non-assessable amounts should be extended to projects transitioning into the PRRT. Where such royalties exist, the market value starting base should be determined as if unencumbered by the royalty.

18.3 Exploration for unconventional gas

Recommendation 79: The PTG recommends existing treatment of exploration expenditure under PRRT be extended to unconventional gas projects.

18.4 Deductible expenditure issues

Advice to Government 1: While it is not within the PTG's terms of reference to make recommendations in respect of the design of the PRRT, other than in relation to transitioning projects, the PTG advises that the test for deductibility could be amended to one of expenditure *necessarily incurred* in carrying on activities in relation to a petroleum project (upstream of the taxing point) from 1 July 2012.

18.5 Exploration deductions

Advice to Government 2: While it is not within the PTG's terms of reference to make recommendations in respect of the design of the PRRT, other than in relation to transitioning projects, the PTG advises aligning the definition of exploration under the PRRT to that under income tax.

19 STARTING BASE

Starting base election

Recommendation 80: An entity must make an irrevocable election to use either market value, book value or the look-back method for determining a starting base for each interest the entity holds in a project or other petroleum tenement in existence at 1 May 2010, by the due date for the filing of the first PRRT tax return. Where an election is not made by the required date, the project or petroleum tenement should be taken to have a look-back starting base. Where an appropriate look-back does not exist or cannot be reliably reproduced, there should be no starting base.

Determining the market value starting base

Recommendation 81: An entity should determine a market value starting base comprising the market value of petroleum assets upstream of the taxing point as at 1 May 2010 on the basis of accepted market valuation principles.

- In determining how market valuation principles should be applied, the taxpayer should take into consideration their particular circumstances and the stage of development of the project or petroleum tenement.
- The derivation of the market value starting base should have regard to market expectations of future petroleum prices, exchange rates, interest rates, inflation and other industry reference benchmarks as at 1 May 2010, and recognised methodologies for market valuation in the petroleum sector. The Treasury, ATO and RET should consult industry and professionals to identify suitable reference benchmarks to reduce compliance costs and provide greater certainty to taxpayers. The existence of such benchmarks would not constrain a taxpayer's choice of valuation methods or their ability to use alternative estimates.

- Guidance as to the application of valuation methodologies should be provided through examples within the explanatory memorandum. In addition, the ATO should provide early guidance to industry regarding the practical application of this aspect of the legislation.
- The approach used in deriving the starting base should be consistent with that used to value the resource at the taxing point.
- 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.
- Where a private override royalty existed in relation to the project or tenement at 2 May 2010, the starting base should be determined as if it were unencumbered by the private override royalty liability (Recommendation 78).
- The starting base is not to be reduced to reflect any depletion in the resource between 2 May 2010 and 30 June 2012. However, where starting base assets are disposed of between 2 May 2010 and 30 June 2012, the starting base should be reduced by the market value ascribed to the asset at 1 May 2010.
- Capital expenditure incurred between 2 May 2010 and 30 June 2012 should be added to the starting base.

Recommendation 82: A default methodology should be considered for taxpayers that acquired or disposed of a portion of an interest in a project or petroleum right with an identified coal seam methane resource in the 3 years to 1 May 2010. The default should determine a proxy for the market value starting base, based on known reserves as at 1 May 2010 and a value derived from a recent comparable market transaction or transactions.

Applying the market value starting base

Recommendation 83: The market value starting base should be immediately deductible for projects transitioning to the PRRT. For other petroleum tenements the starting base should be immediately deductible upon becoming part of a project.

- The market value starting base should be uplifted in line with the provisions provided for general project expenditure, with the expenditure deemed to be incurred on the 1 July 2012.
- Where eligible expenditure is incurred between 1 May 2010 and 1 July 2012, it will be added to the starting base.
- The starting base and losses generated from the starting base should not be transferable between projects.
- Any undeducted starting base amounts attributable to an interest in a project or petroleum tenement are to be transferred to the new owner upon acquisition of the interest.

Determining the book value starting base

Recommendation 84: A book value starting base should be 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. Such accounts are to have been prepared in line with Australian Accounting Standards.

- Capital expenditure incurred after the date at which the audited accounts were prepared and before 1 July 2012 should be added to the starting base.
- Where starting base assets are disposed of between 2 May 2010 and 30 June 2012, the starting base should be reduced by the book value ascribed to the asset at 1 May 2010.

Applying the book value starting base

Recommendation 85: The starting base should be immediately deductible for projects transitioning to the PRRT. For other petroleum tenements the starting base should be immediately deductible upon becoming part of a project.

- The book value starting base should be uplifted in line with the provisions provided for general project expenditure, with the expenditure deemed to be incurred on the valuation date of 1 May 2010 or, where eligible expenditure is incurred between 1 May 2010 and 1 July 2012, the date when the expenditure is incurred.
- The starting base and losses generated from the starting base should not be transferable between projects.
- Any undeducted starting base amounts attributable to an interest in a project or petroleum tenement are to be transferred to the new owner upon acquisition of the interest.
- Further guidance as to the application of the book value starting base should be provided through examples within the Explanatory Memorandum.

Determining the look-back starting base

Recommendation 86: A look-back starting base should be available based on deductible expenditure incurred in the exploration and development of a project or other petroleum tenement between 1 July 2002 and 2 May 2010.

- Capital and exploration expenditure incurred after 1 May 2010 and prior to the commencement of the extension of the PRRT on 1 July 2012 should be added to the starting base.
- Where starting base assets are disposed of between the date at which the audited accounts were prepared and 30 June 2012, the starting base should be reduced by the book value ascribed to the asset at 1 May 2010.

Applying the look-back starting base

Recommendation 87: The starting base should be immediately deductible for projects transitioning to the PRRT. For other petroleum tenements the starting base should be immediately deductible upon becoming part of a project.

- The book value starting base should be uplifted in line with the provisions provided for general project expenditure, with the expenditure deemed to be incurred on the date at which the audited accounts were prepared or, where eligible expenditure is incurred between the date at which the audited accounts were prepared and 1 July 2012, the date when the expenditure is incurred.
- The starting base and losses generated from the starting base should not be transferable between projects.
- Consideration should be given to allowing the inclusion of relevant acquisition costs as they relate to project assets upstream of the taxing point. If acquisition costs are included:
  - they should be allocated to the existing PRRT expenditure categories, with appropriate methods to apportion the starting base to be developed in consultation with industry; and
  - the period of uplift at LTBR+15 on the portion allocated to exploration expenditure should be limited to 5 years.
- Further guidance as to the application of the look-back value starting base should be provided through examples within the explanatory memorandum.

20 TREATMENT OF THE STARTING BASE AND CREDITS FOR GOVERNMENT RESOURCE TAXES

Recommendation 88: Starting base amounts should be treated in the same manner as general project expenditure, being immediately deductible, non-transferable and non-refundable, with undeducted amounts uplifted in accordance with the existing augmentation provisions. An exception would be the exploration expenditure component of a look-back starting base, which should be treated in accordance with the existing provisions relating to exploration expenditure.

Recommendation 89: Government resource taxes should be creditable against PRRT liabilities and treated in the same manner as general project expenditure, being immediately creditable, non-transferable and non-refundable, with unused amounts uplifted in accordance with the existing augmentation provisions.

Recommendation 90: It is important to ensure that the taxation of Australia's petroleum resources preserves our international competitiveness and ensures Australians receive a greater benefit from these resources and that this is reflected in the treatment of royalties under the PRRT. The extension of the PRRT should not be used as a mechanism to enable States and Territories to increase inefficient royalties on petroleum activities. All current and future resource taxes on petroleum should, therefore, be credited and it is imperative that the Australian, State and Territory Governments put in place arrangements to ensure that the States and Territories do not have an incentive to increase royalties.

21 PRRT ADMINISTRATION

21.1 Transitional administration

Recommendation 91: The Treasury and ATO continue to engage with industry to progress the administrative design and implementation of the extension of the PRRT to all petroleum projects, including:

- establishing an Implementation Group involving industry representatives, relevant advisors and officials from RET, the Treasury and ATO;
- providing practical early guidance on the extension of PRRT and taxpayer obligations; and
- establishing capability in both the ATO and key intermediaries to support industry in complying with the law.

Recommendation 92: That Government should ensure the ATO is appropriately funded to provide interpretive and administrative support to industry in their transition to the extended PRRT.

Recommendation 93: To ensure the extension of the PRRT achieves its intended purpose efficiently and equitably with minimal compliance and administration costs, the Board of Tax should review the operation of the extended PRRT within five years of its implementation.

Recommendation 94: The ATO should provide guidance on circumstances that may warrant a remission of penalties by the ATO in cases of inadvertent errors, particularly in the first two years of the extended PRRT.

21.2 Ongoing administration

Advice to Government 3: As part of extending the PRRT, the Australian Government could consider amending the PRRT legislation to provide for:

- substituted accounting periods for taxpayers who use them for income taxation;
- an instalments regime that is responsive to the potential for significant within-year variability in petroleum profits and a final reconciliation period that fits within entities' tax calendars;
- the ability of ATO to obtain PRRT relevant information from third parties such as project vendors or joint venture operators.

Advice to Government 4: The ATO could consider adapting the administrative design of the PRRT, to provide workable certainty to taxpayers and minimise the costs of complying with and administering the extended PRRT. These practices should include:

- providing for annual PRRT returns, including the option to lodge returns prior to the receipt of PRRT income, to support the provision of certainty regarding historic expenditure; and
- guidelines for joint venture partners and operators, and the ATO in relation to joint venture accounts and substantiation of expenditure.