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Tax Brief

10 August 2011

Minerals Resource Rent Tax

On 10 June, the government released for public comment preliminary and still incomplete Exposure Draft legislation for the proposed minerals resource rent tax ('**MRRT**'). This Tax Brief summarises the main provisions of the draft legislation in its current form.

1. Background

The MRRT is the successor to the resource super-profit tax ('**RSPT**'), first proposed by the Henry Review of Australia's Future Tax System in May 2010. The RSPT proposal was superseded by the MRRT in July 2010, announced in the lead-up to the August 2010 federal election. After the election, work on refining the MRRT proposal was passed to the Policy Transition Group ('**PTG**') headed by Don Argus and Martin Ferguson, which submitted its report to the Government in December 2010. The Government released the report to the public and in March 2011 announced that it would accept all of the recommendations made by the PTG. The Exposure Draft legislation just released reflects the culmination of almost 12 months effort to get the MRRT in place by the scheduled start date of 1 July 2012. Once operative, the MRRT will apply to new and existing projects in Australia.

There is some political uncertainty about the future of the MRRT given that the Opposition parties have stated they will oppose the passage of the legislation in Parliament and, if it is passed, will repeal the tax if elected. However, with the Greens now controlling the Senate it is considered likely the Government will have enough support to have the legislation passed. In addition, given the probable composition of the Senate for the foreseeable future, the imminent repeal of the tax is generally considered unlikely.

2. Key design features

2.1 The key concepts in the legislation

The draft MRRT legislation has the 'look and feel' of Australia's modern tax legislation. Structurally, the key steps in calculating the amount of MRRT ultimately payable are:

- the miner must determine the amount of '**mining revenue**' arising from its mining project interest;
- from this figure is subtracted the '**mining expenditure**' in respect of that project (but not any '**excluded expenditure**');
- the net figure is the '**mining profit**' from that project;
- from which is subtracted any of the seven 'allowances' that might be available;
- tax is imposed on the resulting amount at the legislated rate, adjusted to reflect the '**extraction factor**';
- the tax ultimately payable to the Commonwealth is the sum of this figure for all of the mining projects undertaken by the miner for the year;
- form which, in the case of small miners, can be deducted a tax offset.

Expenditures v. allowances. The structure of the legislation creates a curious distinction between 'expenditures' and 'allowances.' The intuition behind the distinction is that 'expenditure' refers to current-year cash outflows while 'allowances' are, for the most part, adjustments that do not reflect cash payments and are made to deal with issues such as the transition to the new tax ('starting base allowance'), the transition from the exploration to mining phase of a project ('pre-mining allowance'), the carry forward of prior year losses ('mining loss allowance') and transfers between a miner's different mining projects ('transferred mining loss allowance'). The special treatment of mining royalties paid to State governments is also handled through an 'allowance' (although the intended effect is more akin to a tax offset than an allowance).

And there are other differences between 'expenditure' and 'allowances.' One is that unused allowances may be transferable while excess expenditures are not; unused and untransferred allowances are generally carried forward and uplifted by an interest factor, while expenditures *per se* are not; another difference is in the rather subtle way that 'allowances' and 'expenditures' operate in the case of losses.

The seven allowances are the royalty allowance, transferred royalty allowance, pre-mining loss allowance, mining loss allowance, starting base allowance, transferred pre-mining loss allowance and transferred mining loss allowance.

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The meaning of these terms is described below. They are applied in this sequence to reduce the MRRT liability for a mining project down to zero.

2.2 The tax base

Which minerals? MRRT is imposed on profits arising from a 'taxable resource.' This is defined to mean coal, iron ore, coal seam gas produced in the process of mining coal and other by-products of mining iron ore and coal.

The subject of the MRRT. In general terms, the tax is intended to fall on the value of a taxable resource, measured at the 'taxing point', reduced by any upstream costs. This general statement implies a few important consequences –

- the tax base is thus a net figure – the value of the mineral reduced by the direct costs of bringing it to the surface;
- some of the value of the resource brought to the surface is considered to reflect the miner's mining skill and expertise rather than the inherent value of the mineral. Because this value is not intended to be within the tax base, an exclusion happens through the 'extraction factor' procedure described below;
- profits made from (and expenses attributable to) downstream processing of taxable resources are intended to be excluded from the tax base;
- although the tax is intended to fall on the value of the mineral at the taxing point, the system does not (generally) work using valuations. Instead, the taxing point (a '**mining revenue event**') will most often occur when the miner sells the mineral. Adjustments then have to be made to the amounts received to exclude the portion of the price which reflects value added downstream of the taxing point and an arm's length price will be required if the sale is not between parties dealing at arm's length; and
- there are, however, some cases where the tax can be crystallised without a sale – that is, where the miner consumes the mineral itself without a sale or where the miner exports the mineral and the sale occurs offshore. In these cases, an arm's length sale price is determined at that time and this value is then adjusted to exclude the portion of that value added downstream of the taxing point.

Taxing Point. The tax is crystallised on the value at the '**taxing point**.' This is defined in the legislation to meet a variety of circumstances. For coal, iron ore and by-products, it will usually be the point just before the mineral is removed from the run of mine stockpile. If the mineral is not removed from the site, the taxing point will be the point at which the mineral enters the first beneficiation process (assuming that process occurs adjacent to the point of extraction). If neither of those situations applies, the taxing point is the point at which the resource is moved away from the immediate point of extraction.

Determining the value at the taxing point. As was just noted, MRRT will usually be triggered when the miner sells the mineral. Where the miner sells a processed mineral it is necessary to adjust the price received to exclude from the amount received the profit attributable to downstream activities (eg, processing and transportation costs). This step is likely to prove an ongoing source of headaches for miners as it requires, in essence, the kind of price estimation that happens in transfer pricing. The Explanatory Memorandum which accompanies the Exposure Draft legislation devotes an entire chapter to this process.

Smaller miners and miners with vertically integrated operations as at 2 May 2010 are able to irrevocably elect to use an 'alternative valuation method' to calculate the value at the taxing point. The advantage of this method is that it will not require miners to perform the sort of transfer pricing analysis outlined above. This potentially saves compliance costs and provides greater certainty without the need for a private ruling.

Relevant and excluded expenses. The legislation permits the miner to exclude from the assessable amount the expenses incurred in bringing the mineral to the surface ('**mining expenditure**'). The legislation operates in two steps.

First, the miner is permitted to deduct all expenditure 'necessarily incurred … in carrying on upstream mining operations for the mining project interest …' In this respect, the legislation makes it clear that the miner is entitled to deduct immediately any expenditure of a capital nature – that is, there is no capitalisation or amortisation of costs. There are also apportionment words which allow the miner to deduct a portion of a single outlay that relates to, say, both upstream and downstream activities or to general overheads. Practically, this apportionment may prove difficult for miners and become another compliance headache. Non-operators of a JV may also need to rely on the operator of a JV in order to perform the apportionment which could also lead to difficulties. The apportionment may be less critical if the alternative valuation method outlined above is used – in this case, essentially, both upstream and downstream operating costs are deductible.

Embedded in this provision are two other ideas:

- '**mining operations**' includes activities stretching from exploration to rehabilitation and closure of mine sites; and
- '**upstream**' operations can extend quite broadly to include, for example, training, staff accommodation, a share of administration expenses and computer systems.

However, the miner is not permitted to deduct a long list of '**excluded expenditure**.' The list of denied deductions includes expenditures on financing costs, hedging profits and losses, forex profits and losses and certain payments for land and buildings. Special rules deny a deduction for State royalty payments, but operate so that the effect of the royalty payment is made an 'allowance' instead, and assimilated to the effect a tax credit against the MRRT.

Timing rules. The timing rules for the MRRT depart slightly from the general timing terms used in income tax – mining revenue is assessable when it is 'received or receivable,' while mining expenditure is deductible when 'incurred.'

Treatment of mining losses. Where mining expenditure for a mining project exceeds the mining revenue, the miner will have a mining loss and will be entitled to a '**mining loss allowance**' – the term used for a loss carry forward in the MRRT legislation.

Mining losses can be carried forward indefinitely – in the Exposure Draft there are no rules equivalent to the continuity of ownership test in the income tax. Losses are increased by a notional interest rate (the government long term bond rate plus 7 percentage points) to reflect both the time value of money and the risk that the project may never be profitable.

Instead of being carried forward, mining losses can also be transferred to reduce the MRRT payable on other mining projects involving the same taxable resource conducted by the same taxpayer.

Treatment of exploration losses. It was noted above that special rules in the legislation create seven 'allowances.' One of these is the '**pre-mining loss allowance**.' This essentially allows a loss for exploration and other expenditure incurred prior to the grant of a mining right.

Like a mining loss allowance, a pre-mining loss allowance can be used to offset profits from other profitable projects and, if not immediately used, can be uplifted and carried forward.

Separating pre-mining losses from other mining losses is done for a number of reasons:

- it recognises that a loss is available even though no mining project exists at the time;
- unlike mining losses, pre-mining losses can be transferred to other projects and are not subject to the restriction that the miner held an interest in each project at the time of the transfer;
- to prevent trafficking in pre-mining losses, these losses are only transferred to an acquirer of a whole or part interest in an exploration tenement to the extent consideration is provided for the transfer of the tenement at least equal to the tax value of the losses. (This could be an issue for a farm-in where the parties would be arguing that the money spent by the party farming in is not consideration for the tenement);
- pre-mining losses are only uplifted at the government's long term borrowing rate plus 7 percentage points for 10 years. Thereafter, they are uplifted only at the government's long term borrowing rate.

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Transfers of (unused) allowances. The seven allowances operate in a strict sequence to reduce the MRRT liability for each mining project to nil. The treatment of any unused allowances can be complex.

First, unused allowances can be increased by a specified interest rate and used in a subsequent year to reduce the mining profit from the same mining project. The uplift rate in most cases is the long-term government borrowing rate, plus 7 percentage points.

Secondly, unused allowances for State mineral royalties, pre-mining losses and mining losses can also be 'transferred' – that is, applied in the current year against the mining profit of a different mining project being undertaken by the same entity. The ability to 'transfer' unused State mining royalties is very restricted – the two mining projects must be fully integrated, meaning, in general terms, that they use the same infrastructure and involve the same resource. (It seems from the examples in the Explanatory Memorandum that the income tax consolidation rules will be invoked in this context to treat members of the same consolidated group as the same entity for the purpose of transferring unused, transferrable MRRT allowances.)

Thirdly, unused allowances for pre-mining losses and mining losses can also be 'transferred' and applied in the current year against the mining profit of a different entity provided that both entities satisfy common ownership-type tests at the time of transfer. For unused mining loss allowances, a continuity of ownership test must also be met.

Notice that some of the strictness of the rules limiting 'transfers' of unused credits may, in fact, be relieved, by other rules, discussed below, dealing with combining related mining project interests.

Small miners. Some miners also have the option of calculating their MRRT liability under a 'simplified' method. To call this a 'method' is more than a little odd – the operative provision in the Draft simply says that the miner's MRRT liability is zero, and its allowances are extinguished.

Not surprisingly, the option not to pay MRRT is offered only to miners who are unlikely to owe MRRT. The requirements to use this method limit it to miners that are members of a group of related mining companies which either –

- have a mining profit under $50m for the year. These companies ought not have any MRRT liability for the year because of the tax offset discussed below; or
- have a mining profit under $250m for the year but owe State mining royalties which exceed 25% of their mining profit for every mining interest. These companies are unlikely to owe any MRRT for the year because the State mining royalties will likely eliminate their entire MRRT liability.

Nor is it surprising that there are downsides for small miners who elect not to pay MRRT. In particular, expenditure and allowances incurred during the period of the election or prior to making the election are not able to be carried forward and are lost forever. This may make it unattractive for many miners who would want to preserve the entitlement to this expenditure and allowances which could be of potential value to an acquirer who might not also qualify for the simplified method.

2.3 The taxpaying unit

Unlike the income tax, the taxpayer for MRRT is not the mining company *per se*. Rather, every entity that is a miner must pay MRRT on the profits derived from 'each of its mining project interests …' The mining project is in most cases the area in respect of which the production permit was granted and the interest in that project is the miner's share of the output from that project.

This means that a single company involved in several projects will have to compute several MRRT liabilities. Once the mining company has calculated its liability for each mining project, the debt it owes the Commonwealth is the sum of the MRRT payable in respect of each profitable mining project.

Where more than one mining company participates in a mining project, the taxpayer is each mining company individually. That is, each company calculates its MRRT position separately for its share of the project. But complex issues will arise where the entity to which the mining permit was granted creates multiple interests in the project. Sometimes these sub-interests will mean there are multiple participants each with their own mining project interest; in other cases, the nature of the interests conferred will mean the first entity no longer has a right to share in the output and ceases to be liable to MRRT – for example, a sub-lease given in exchange for a royalty, rather than a share of output.

Special provisions in the Draft can require the consolidation of 'integrated' mining projects interests so that they are treated as a single mining project. The requirement to combine arises when the same entity owns more than one interest in the same production right and the upstream mining processes are integrated. Circumstances which could require the combination of separate interests would include:

- two subsidiary members of the same (income tax) consolidated group having mining interests in the same project; and
- a company with an existing mining interest in a project buying out another participant.

The effect of combining several mining interests is to permit the full offsetting of allowances and credits.

This way of setting up the taxpaying unit has been the subject of some criticism. Many miners have argued that the formal linking of the mining project interest to the production licence is too narrow – many projects which companies regard as a single economic investment are based on multiple permits. While the combination and splitting rules offer some alleviation when the issue is calculating the MRRT liability, those rules do not solve other concerns such as the impact of this definition on the starting base allowance regime.

2.4 The tax rate

The tax rate for the MRRT is 30%.

One of the recommendations which emerged from the consultation process undertaken by the PTG was the idea of a special allowance (the '**extraction factor**') of 25%. The adjustment was said to 'recognise the profit attributable to the extraction process' and to 'recognise the contribution of the miner's expertise to profits at the mine gate …' This extraction factor is built into the tax rate calculation so that the rate for the MRRT is in effect reduced from the headline rate of 30% to a rate of 22.5%.

2.5 Tax offset

The legislation includes one explicit tax offset to reduce the amount of MRRT.

Small miners are entitled to a tax credit if the mining profits are less than $50m in a tax year. For the purposes of this rule, the mining profits of all of the mining projects undertaken by this entity, as well as the mining profits (though not any mining losses) of related and associated entities, are aggregated in counting to $50m. The tax credit eliminates the MRRT liability entirely where group's mining profits are $50m or less. For miners with group profits between $50m and $100m, a partial tax credit is available – the maximum tax offset is reduced by 22.5c for each dollar of mining revenue in excess of $50m. The benefit of the (reduced) tax offset is then shared by all the (profitable) members of the group based on their portion of the total mining profit.

This treatment has been subject to some criticism in the press because small miners are still required to undertake full the compliance with the MRRT, only to discover that they have a no tax liability. The Explanatory Memorandum to the legislation is disarmingly frank that the tax offset, 'is not a mechanism for reducing compliance costs.' Whilst the so-called 'simplified method' described above may relieve compliance costs it may prove unattractive for many miners due to the disadvantages already outlined.

In addition, there is a special regime for handling State mineral royalty payments which, in effect, turns them from a deduction into a tax credit. Unused royalty payments – ie, where the State mineral royalty exacted exceeds the MRRT liability – can be carried forward (increased by an uplift) or applied to reduce the MRRT liability of the same taxpayer for another project. As was noted above, unused royalty payments cannot, however, be transferred to related entities to reduce their MRRT liabilities.

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3. Project exits, sell-downs and farm-ins

The Draft Legislation has detailed rules about the MRRT consequences that will arise when:

- a new participant enters an existing mining project;
- a miner sells a part-interest in an existing project; or
- a miner sells all its interest in a project.

The rules make a distinction between the transfer of an entire interest in a mining project and the splitting of a single project interest into several smaller interests.

Where a miner transfers its entire interest in a mining project to another single entity, whether by sale or gift, the transferee will inherit the MRRT consequences for the entire year – that is, all mining revenue, mining expenditure, allowances and credits for the project for the entire year will become sole the responsibility of the transferee. Special rules re-allocate to the incoming miner the tax consequences of any amounts that happen to be received or paid by the seller after the transfer has been effected. Because the MRRT liability for the entire year is shifted, special rules require detailed notices to be provided to the buyer by the outgoing miner.

All other transactions are mining 'splits.' For example, a mining project interest is split where:

- a miner transfers part only of its interest in a mining project and retains a part, or
- a miner transfers its entire interest in a mining project, but to more than one buyer.

A split is also deemed to occur where an election to combine related mining projects ceases. For these rules, a transfer can occur by sale, gift or sub-lease of a mining right.

In the case of a split, each participant in the split project becomes separately liable for the tax consequences. The MRRT liability for the entire year (and the individual items of mining revenue, mining expenditure, allowances and credits which constitute it, whether occurring both before or after the split) is divided between the surviving participant (if any) and the incoming participant(s) based on the market value of the share that each has in the mining project interest. The market value is determined immediately after the split occurs.

Special rules exist for both 'transfers' and 'splits' to limit the ability of these rules to generate losses in the hands of incoming participants.

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4. Handling transition to the new tax

One area of significant dispute during the consultation process on the design of the MRRT was the proper recognition of sunk costs incurred prior to the commencement of the tax.

The resolution of that dispute was the concept of the '**starting base allowance**' – a special deduction from mining profits for the value of existing investments as at 1 May 2010. For these purposes, the miner has the choice to value its existing investments using either:

- the value recorded in the miner's most recent audited accounts for the upstream assets (excluding the value of the resource itself). If this option is chosen, the value of the assets is deducted equally over 5 years. If the entire amount of the allowance cannot be used in a particular year, the unused component is carried forward and uplifted and the long-term bond rate plus 7 percentage points, to be used in a future year; or
- to undertake a special valuation to determine the market value of the upstream assets (including the actual resource) at that date. If this option is chosen, the value of the assets is deducted over 25 years. If the entire amount of the allowance cannot be used in a particular year, the unused component is carried forward and uplifted at the consumer price index rate, to be used in a future year.

It is expected many miners will avail themselves of the market value approach which for many will involve significant work and potential uncertainty inherent in any valuation process. Under the PTG's recommendations, the ATO is to provide early guidance on the starting base which will presumably cover issues such as the ATO approach to valuations.

Those holding a mining tenement that does not permit production (eg, an exploration tenement) will be entitled to elect to deduct expenditure over the past 10 years. This is a significant concession from both a compliance perspective and potentially a value perspective (eg, a tenement on which a miner has spent significant amounts prior to 2 May 2010 may have been worthless at 2 May 2010 if a discovery had not been made at that time).

5. Next steps

The Exposure Draft legislation is being circulated for comment. The closing date for submissions on this tranche has already closed. The consultation on the design of the MRRT may prove more fruitful, as Treasury has, to date, taken the view that its brief was to prepare legislation which implemented – and implemented only – the recommendations of the PTG.

It is worth noting also that the Exposure Draft legislation is still incomplete. Notes to the Explanatory Memorandum foreshadow more legislation dealing with a miscellany of issues ranging from the complex (interaction with income tax consolidation, functional currency rules and transfer pricing adjustments) to the mundane (substituted accounting periods, returns and assessments.) Moreover, there is still no legislation to expand the scope of the petroleum resources rent tax to onshore oil and gas projects. No date is indicated for the release of subsequent tranches of legislation.

The Government has indicated that it expects to introduce a formal Bill into the Parliament 'toward the end of 2011.'

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