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Mr Don Argus AC & Hon. Martin Ferguson AM MP
Co-chairs
Policy Transition Group
GPO Box 1564
CANBERRA ACT 2601
By email: ptg@ret.gov.au
Attention: Howard Dickinson

Submission to the Policy Transition Group on the Technical Design of the Government's resource taxation reforms

Dear Mr Argus and Mr Ferguson

Ernst & Young welcomes the opportunity to provide a submission to the Policy Transition Group ("PTG") in response to the issues paper "Technical Design of the Minerals Resource Rent Tax – Transitioning Existing Petroleum Projects to the Petroleum Resource Rent Tax and Policies to Promote Exploration Expenditure" (the "issues paper") released on 1 October 2010.

The issues paper raises many questions in relation to the Minerals Resource Rent Tax (MRRT), the Petroleum Resource Rent Tax (PRRT expansion) and exploration incentives. The answers will vary depending upon the individual taxpayer and the underlying project and will vary across different iron ore, coal and petroleum projects. Further issues will arise from policy decisions made in the process for introducing the resource tax reforms.

Ernst & Young does not comment in depth on all aspects of the issues paper or address all of the questions raised in the issues paper. We have been involved with various businesses and bodies in providing more detailed commentary to the PTG in processes. For this reason we do not reproduce extensive commentary in this submission which is kept at a general principle-based level. In this letter, we focus on some issues of principle associated with:

1. the broad framework of the resources taxation reform; and

2. the design of the law to implement the broad framework of the announced resource tax reform.

Broad Framework of the reform

- It is critically important that, when introduced, the resource taxes are no more onerous than the arrangements reached between the Government and the major resource companies before the last Federal election.

- The PTG needs to prepare for, and government needs to consider, an extension of the PTG involvement beyond the PTG's foreshadowed termination at the end of 2010.

- The complex principles proposed for the MRRT raise major compliance challenges for projects which have been under way for many years, unlike the PRRT which broadly dealt with prospective projects. MRRT principles must be developed in a commercially appropriate manner, aligned to ordinary commercial practices, rather than requiring a major overlay of novel and unusual concepts which have the potential to create major uncertainty and compliance costs.

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- In particular the documentation requirements of the MRRT need to be carefully considered. The PRRT documentation requirements and various rules are onerous and problematical. The experience of the PRRT illustrates uncertain law and controversial Australian Taxation Office (ATO) interpretive approaches in relation to fundamental concepts communicated as recently as 2010. So the PTG should not assume the PRRT works adequately for purposes of the MRRT or PRRT extension.

- The proposed definition of a project asset does not recognise major exploration expenditure which has already been expended and the value of exploration rights, which will have significant starting values, as being eligible for the starting base revaluation options. Various major mining projects currently being developed for production involve significant exploration expenditure which has already been incurred. Any concept of such projects not having been commenced for MRRT purposes, and not being eligible for starting base valuation of such expenditure, would in our view be flawed. As a result, the project definition needs significant revision.

- We support the use of the starting base options to deal with the issue of previously-incurred expenditure. We support, from an ongoing perspective, compliance shortcuts and safe harbours being used. Where possible, these should be aligned to financial statements and normal market practice of the mining oil and gas sectors. Tax precedents for accounting alignment include thin capitalisation, tax consolidation, taxation of financial arrangements etc. Otherwise, the law will be very difficult to administer for the ATO as well as the business sector.

- Rehabilitation deductions should not be deferred until termination of a project. The clear accounting, financial and commercial recognition of rehabilitation expenditure is throughout the life of a project. MRRT as an economic resource rent tax should follow this recognition.

- The taxable value rules will need to be developed in a principled manner with significant flexibility, as a prescriptive approach to this issue will not cover all scenarios and could lead to great uncertainty and controversy.

- Any state royalties should be credited against MRRT. This should apply to small miners in relation to the $50m exploration threshold and should also apply to larger miners. It appears to us that limiting credits only to state royalties in place at 2 May 2010 will have a significant adverse effect on states' capacity to fund their necessary expenditures and engage in other state tax reforms as envisaged under the Review of Australia's Future Tax System. Just as importantly, the prospect of higher effective Australian resource taxation on resource projects will significantly affect the competitiveness of Australia's industry and will raise equity issues.

- The PRRT extension requires further development. We think that the PTG should take the opportunity of aligning some concepts in the PRRT to the MRRT particularly in relation to shortcuts.

- The debate around encouraging exploration is welcome.

- The PTG should recommend that the government ensure that Treasury and ATO commit strong resources in terms of quantity and quality to the development of the law, administrative positions and tax guidance about the effect of the law during the development phase, and that transparent consultation occurs. We note that ATO practice is not to provide guidance and clear signals of its interpretive positions on the law under development until the law is legislated and receives Royal Assent. As well the transparency of consultation by Treasury varies across different measures. Such practices create uncertainty, unacceptable compliance challenges for business and lead to law which does not meet government and business objectives.

Post-Implementation Issues

- It is critical that there is ongoing monitoring and reform of the law once it is implemented, based on our experience with the PRRT and various recent reforms. The PRRT was in our view not adjusted appropriately for many years because initially there were only a few taxpayers. Consequently various ATO positions are being put and various issues are now being litigated, leading to controversy many years after the law was first implemented. Such delay is inappropriate for the much larger population of potential taxpayers under the new resource rent tax regimes. As well, the ATO interpretive positions and any divergences identified after the law is passed will only be clear after the law is passed.

- For this reason, we think the PTG must recommend that there should be a formal process of monitoring of the law and annual technical corrections to the law which in our view will be required for at least five years after the commencement of the new resource rent tax regimes, to avoid a repeat of the problems which arose under the PRRT.

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We would be pleased to meet with you to discuss our submission.

Should you have any questions in relation to this submission, please do not hesitate to contact in the first instance either Scott Grimley on (08) 9429 2265 or Andrew van Dinter on (03) 8650 7589 or Tony Stolarek on (03) 8650 7654.

Yours sincerely

Scott Grimley
Oceania Mining & Metals Leader
Partner - Taxation

Appendix

Ernst & Young detailed comments

This Appendix provides detailed comments in relation to the Policy Transition Group issues paper "Technical Design of the Minerals Resource Rent Tax – Transitioning Existing Petroleum Projects to the Petroleum Resource Rent Tax and Policies to Promote Exploration Expenditure" ("the "issues paper") released on 1 October 2010.

Ernst & Young does not intend on commenting on all aspects of the issues paper or address all of the questions raised in the issues paper, rather we have focussed our comments on issues associated with:

1. the broad framework of the resources taxation reform and the design of the law to implement the broad framework of the announced resource tax reform; and

2. implementation issues that are important to consider in undertaking significant tax reform.

Proposed resource taxes should be no more onerous than agreed before the election

The series of proposed resource taxes and other imposts are pivotal to Australia's international competitiveness in attracting new resource projects. Therefore, it is critically important that when introduced, the resource taxes are no more onerous than the arrangements reached between the Government and the major resource companies before the last Federal election. This agreement introduced a level of certainty that allowed otherwise stalled market activity to recommence.

Initial PTG letters to major resource companies restate this intention, but resource companies will need to monitor and emphasise this principle, given that some stakeholders are calling for expansion of the resource taxes.

We note recent media reporting of comments about the potential for reintroduction of a limit on credits for state taxation, to restrict this to state royalties and other resources taxes in force on 2 May 2010. It appears to us that such debates generate new concerns about the stability and intent of tax policy affecting the resources sector. In addition, we observe that:

a) The prospect of restricting the interaction of state resource taxation royalties and the MRRT raises a concern about the capacity of the resource-rich states to enhance their revenue streams over time, by comparison with other states which might be lacking in resources but might have stronger service economies providing other revenue streams. The potential limitations or state revenue entitlements raise challenges in respect of the scope to remove nuisance taxes, harmonise state taxes and create a more efficient state tax regime as foreshadowed under the Review of Australia's Future Tax System (the Henry Review)

b) The prospect of effective increases in Australia's tax impost on Australian resource projects, which could arise if certain states needed for revenue purposes to increase their royalties and charges in respect of resource projects, would in our view raise real issues in relation to the willingness of resource companies to commit to new capital investment in Australia.

Extended consultation process needed and then 'piloting' of the Bill before implementation

The PTG should recommend and the government needs to consider, an extension of the PTG timeline beyond the PTG's foreshadowed termination at the end of 2010. We note that:

a) this submission is lodged to comply with a submissions deadline operative even before consultations finish in relation to core principles;

b) further consultations will be needed after the December release of the PTG's recommendations – we suggest that these should be released as an Exposure Draft for

comment as positions taken at that point on the treatment of existing expenditure, setting taxable value, valuation of projects and other key issues will raise new questions; and

c) we submit that a somewhat independent body, not just the Treasury and Department of Resources and Energy (DRE), should play an ongoing role in providing oversight and independence to the Government and public service in finalising the detail of the MRRT.

After the law is first drafted, before it is presented to parliament, it needs to be piloted through a selection of resources companies to:

a) identify unforeseen technical issues which will only emerge from first draft law;

b) identify compliance challenges that will need further development of shortcuts and other compliance; and

c) ensure the rules work satisfactorily.

This pilot project phase is critical to head off unworkable aspects of the law. There are various precedents of tax and other law which, without pilot projects, have proved problematical to administer.

Shortcuts and safe harbours where possible

We agree with the PTG that the resource taxes will need to operate efficiently to avoid excessive compliance costs. For example, the prospect of extensive MRRT/PRRT tax value rules for Australian resources companies with integrated mining operations could lead to very costly compliance. Businesses should identify, and the PTG should adopt, shortcuts and safe harbours where possible.

We submit that the development of shortcuts should be the focus after the December initial recommendations. Shortcuts might apply to the starting base elections and the ongoing compliance tasks. We submit that it is too early for final development and workshopping of shortcuts at this stage as resources companies are focused on qualitative input, i.e. major policy issues, but they will turn their mind to shortcut development when the core policy has been refined.

Project definition, commencement and termination

Our comments in this area are more detailed because some significant policy issues need to be considered.

The concept of a project for MRRT purposes will be challenging for their resources sector and may involve a complete overhaul of the IT systems of Australian resource companies.

This systems re-engineering task is magnified if the project definition does not align to generally accepted accounting and tax recognition concepts. The challenges in project definition, and the resulting compliance with other requirements of the MRRT, will be increased to the extent that resources projects use joint venture structures, with varying levels of information being available to different joint venture participants. There will be challenges with identifying and capturing the relevant information for project definition and for the taxable value and taxing point for:

a) minority joint venture participants holding say a 5% or 10% stake, who might often lack access to various strategic documentary requirements. This issue has already been identified in the context of PRRT;

b) later acquirers of joint venture interests, in circumstances where they might also lack underlying records in relation to the history of particular projects. The 'tax archaeology' issues are reduced to the extent that starting base valuations will be available, but the frequent use of acquisitions and transfers of mining joint venture interests among participants will raise documentation challenges.

As a result, the approach to project definition, and the approach to taxable value determination and the taxing point, will need to be flexible in order to accommodate proxies and estimates produced on a best endeavours basis.

Project definition and appropriate treatment of exploration expenditure

The discussion about the definition of project assets and their commencement for MRRT purposes in Chapter 4 heeds to deal appropriately with exploration expenditure on a prospective basis and in relation to the valuation of exploration rights for purposes of the starting base.

Many projects, which have not yet commenced production or received production licences, have commenced in a commercial sense, with resources companies having incurred significant exploration expenditure. Exploration expenditure should be eligible for the starting base valuation options because the expenditure has resulted in the discovery and development of resource projects to a substantial extent. It would be quite inequitable for the expenditure not to benefit from the starting base concessions applicable to other expenditure leading to mine production.

The options for project asset recognition in section 4 hinge around production licences or environmental approvals which occur after a project has reached the production phase. These proposals mean that exploration expenditure is treated as an 'add on' to the project expenditure. This leads to various queries about how to handle the recognition at paragraphs 89ff. As well, the delayed recognition of a project appears to prevent the use of starting base optional treatment in relation to exploration expenditure incurred prior to announcement of the MRRT.

Further, it is inconsistent with the income tax treatment of mining expenditure which integrates the exploration phase.

We recommend that a project should be recognised for MRRT purposes when exploration expenditure has been incurred. This is the approach for income tax purposes, in the definition 'mining, quarrying or prospecting right' which is defined[1] as:

> *"(a) an authority, licence, permit or right under an *Australian law to mine, quarry or prospect for minerals, *petroleum or quarry materials; or*
> *(b) a lease of land that allows the lessee to mine, quarry or prospect for minerals, petroleum or quarry materials on the land; or*
> *(c) an interest in such an authority, licence, permit, right or lease; or*
> *(d) any rights that:*
> *(i) are in respect of buildings or other improvements (including anything covered by the definition of housing and welfare) that are on the land concerned or are used in connection with operations on it; and*
> *(ii) are acquired with such an authority, licence, permit…"*

We submit that this integration of exploration expenditure into the project definition and project commencement is critical to allow exploration expenditure incurred prior to the commencement of the MRRT to be properly valued for purposes of the starting base transitional rules for commencement of the MRRT.

We reiterate that exploration expenditure incurred prior to the commencement of MRRT will raise major starting base valuation issues, over the next decade or more, as new mines and projects which will reach production will be based on such exploration expenditure already incurred, which in many cases will have major strategic value which is clear and determinable in 2010.

[1] *Income Tax Assessment Act 1997*, section 995-1(1)

Mine site rehabilitation expenditure

We agree that expenditure on mine site rehabilitation, which occurs after the production phase in relation to a project, should not indefinitely carry forward if the miner has no other MRRT income (This should occur at least optionally, to cover situations of miners without a portfolio of producing projects which could absorb deductions after one project ends for MRRT purposes, and a compensation approach by way of rebate or credit or other cash amount are various appropriate techniques). Otherwise there would be inequity if a miner had previously incurred MRRT on a mine site, the mine had ceased or shut down and the miner was unable to be appropriately compensated for the rehabilitation costs in reducing the MRRT payable.

However we think that the correct recognition for mine site rehabilitation expenditure should not be at the end of the project. The concept of deferred recognition of rehabilitation expenses flows from conventional income tax analysis based around 'deductions incurred'.

The MRRT, however, is intended to be an economic resource rent by Australia on attributable to the **profits** or resource rents of mining projects (emphasis added), and is not a conventional income tax. In our view it is quite inappropriate to levy the MRRT on mine profits which do not recognise future rehabilitation expenditure.

For accounting purposes, notably under AASB137 and AASB116, miners are required to estimate their future rehabilitation expenditure, produce a discounted cash flow calculation of this cost, and then annually amortise that future rehabilitation cost as a period cost in their published profit and loss accounts. Accounting has recognised that for financial statement purposes the annual profit determination in relation to a mine would be artificially inflated without a charge for the future rehabilitation expenditure. And valuers assessing the value of mining companies take account of the rehabilitation obligations.

We therefore submit that the rehabilitation expenditure should be recognised for MRRT purposes on a basis consistent with the amortisation of rehabilitation provisions which is recognised through the financial statements of a miner. This recognition basis should involve a 'true up' mechanism to recognise the actual rehabilitation expenditure when it is spent, and to adjust this for amounts previously recognised for MRRT purposes through amortisation of provisions.

The PRRT expansion should also offer such an accounting-aligned recognition of rehabilitation expenditure. To date, PRRT policy has been largely focused on offshore projects, which involve an entirely different economic and resource project environment to that of onshore projects. The PRRT expansion to onshore projects and resources means that rehabilitation expenses will become a much more significant issue there also.

Taxable value determinations

The MRRT and PRRT will cover a very broad field of Australia's resources sector, with many different facts and circumstances.

We agree with the broad concept of mine gate determination of taxable value. However there will be many different scenarios, as the Issues Paper identifies, where post mine gate expenditure is relevant to the MRRT value. In our view there cannot be one single method appropriate for determining the taxable value for MRRT purposes of every project. We submit that the PTG should recommend:

a) a principle-based approach to the determination of taxable value and the taxing point; and

b) a flexible approach in the legislation to determination of that value.

We recognise some attraction in having black letter law which is finely detailed and precise. Unfortunately however, in our experience the more prescriptive the tax law is in specifying compliance and valuation rules, the more problematical it becomes from a compliance viewpoint, and the more it results in controversies and creases new uncertainties. We can share with you recent tax laws which have been over-engineered, have resulted in extreme uncertainty which the business community and even the ATO finds very problematical to administer and which require ongoing adjustment.

Equitable working solution for $50 million threshold required

We support the use of shortcuts for smaller miners in calculating their $50m threshold and in their compliance tasks. It would be highly problematical to impose huge compliance tasks onto small miners when small miners do not have large in-house tax functions in the same way as do larger miners.

In our view a smaller miner should not have to undertake the entire highly complex MRRT calculation regime simply to determine whether their profits exceed the $50m MRRT threshold. There should be a shortcut method to determine whether they are eligible or required to comply with MRRT. The same shortcuts should apply for calculation of their MRRT.

Ernst & Young recommends:

a) the maximum use of compliance based on financial accounting records, representing existing accounting procedures and systems for such small miners.

b) an option to use deemed MRRT profit ratios, as follows. Statistical analysis allowing estimated MRRT taxable amounts might be developed by the DRE, Australian Bureau of Statistics (ABS) or other agencies, to determine an eligibility threshold calculated on gross revenue or gross profit of smaller miners. If, for example, the statistical analysis showed that the MRRT profit for smaller miners approximated 37% of their gross revenues, then an option might be granted to smaller miners to deem the MRRT profit of $50 million to arise only when revenues of $135 million ($50 million divided by 37%) are generated. This revenue-based proxy could be used for purposes of MRRT entry (the $50m rule) and ongoing MRRT compliance for smaller miners.

   Basing the compliance approaches and calculations on the gross revenue of a small miner could generate major compliance enhancements.

   Such deemed MRRT profit ratios could be adjusted periodically, perhaps every three years. Precedents for the use of such standard rules of thumb include various rates used for FBT purposes, or for regulating the involvement of private companies and their shareholders.

c) the use of rules of thumb should be optional, as some small miners will calculate actual MRRT liability using the 'long form' MRRT compliance processes.

We also highlight that smaller miners will be disappointed with the initial view of the PTG on the operation of the $50m threshold to exclude any notional depreciation of the starting base and carry forward losses when considering the threshold for being subject to the MRRT (paragraph 276). However we assume that any notional depreciation of the starting base and carry forward losses will be available when MRRT is calculated. It is imperative from an equity and competitiveness perspective to allow such adjustments.

Exploration incentives debate welcomed

Given the Government announced on 2 July 2010 that they would not proceed with the Resource Exploration Rebate, we welcome the renewed debate around exploration incentives and encourage continued robust discussions on the topic.

We suggest that the PTG should clarify this in its recommendation package - the appropriate incentives for exploration expenditure should not be subject to the same revenue neutrality requirement as applies to the detailed design aspects of the MRRT and PRRT extension itself. That is, the economic case for exploration incentives deserves to be analysed in an unconstrained manner, and should not be bound up in a revenue equalisation analysis pursuant to the MRRT and PRRT extension proposals.

This is particularly relevant if the cost of exploration incentives might be quite small.

In particular, the reference in the Issues Paper to 'market failure' as a requirement for Government intervention requires clarification and debate.

The exploration incentive is, in our view, a separate issue, affecting the broader resources sector rather than just the parties subject to the MRRT and PRRT expansion and needs unconstrained analysis.

Full involvement of the ATO to reduce uncertainty and controversy

The PTG should recognise and make recommendations in relation to the role of the ATO in the law design on these measures, to ensure that the ATO will commit strong resources in terms of quantity and quality to the development of the law, development of administrative positions and development of tax rulings about the effect of the law, **prior to its passage**. The ATO practice is not to provide guidance and clear signals of its interpretive positions on the law under development to the taxpayer community and (in some cases) even to those involved in the consultative process until the law is legislated and receives Royal Assent.

As well, Treasury transparency in the consultations around law development vary across different measures.

These practices can result in uncertainty and compliance challenges for business after the law is released. We have just seen the issue of significant tax law affecting the business community (tax consolidation) released after more than two years' consultation, where the delayed ATO guidance and lack of has provided to be a major challenge for the business community and may require further amendments of the law.

We suggest that the PTG should recommend that the government prescribe a high level of transparency for the involvement of Treasury as well as the ATO in the law development process. Otherwise there is a risk that this legislative design will create uncertainty and reputational issues for Australia.

This is why we recommend that a continuing independent oversight is needed after the PTG ends its term in 2010, based on current announcements.

Post-Implementation issues will arise and refinements of the law after implementation will need to be formally scheduled

It is critical that there is ongoing monitoring and reform of the law once it is implemented. The PRRT was neglected for many years and consequently many issues are now being litigated 20 years after the law was first implemented.

There will be a need for post-implementation adjustment and rectification of the law to deal with issues not properly considered in the initial law design. That need will arise even if the law design process is excellent, as inevitably the diversity of the resources sector and practical application of the concepts in the law will raise issues not previously identified.

The process should learn from the experience of the comparative lack of adjustment of the PRRT. The listing of tax rulings issued by the ATO in relation to the PRRT indicates that there have been few if any authoritative Tax Office guidance products issued until the last few years. This is due, in our view, to a combination of problematic law and ATO positions inconsistent with industry practices.

The delay in the issue of guidance products has meant that industry practices have developed, and recent ATO draft rulings, particularly three which issued in 2010, are inconsistent with those practices. These rulings are:

TR 2010/D4	Petroleum resource rent tax: general pre-conditions common to deductibility of expenditure of a kind referred to in sections 37, 38 and 39 of the Petroleum Resource Rent Tax Assessment Act 1987 (As at 30 June 2010)
TR 2010/D5	Petroleum resource rent tax: excluded expenditure under paragraphs 44(j) and 44(k) of the Petroleum Resource Rent Tax Assessment Act 1987 - administrative, accounting, wages, salary, other work costs, and overhead expenditure; land or buildings for use in accounting or administration not adjacent to the operations site (As at 30 June 2010)
TR 2010/D6	Petroleum resource rent tax: deductibility of expenditure to procure the carrying on or providing of operations, facilities or other things by another person in relation to a petroleum project, as provided by section 41 of the Petroleum Resource Rent Tax Assessment Act 1987 (As at 30 June 2010)

Even the correct application of "administrative, accounting, wages, salary, other work costs, and overhead expenditure; land or buildings for use in accounting or administration not adjacent to the operations site" continues to represent an area of controversy with the ATO. This is not best practice in our view.

Additionally, various major disputes before the courts relate to the interpretation of key rules in respect of the PRRT. The disputes demonstrate the challenges arising from insufficient ongoing post implementation review and amendment of the law.

It is clear that the ATO interpretive positions and any divergences identified after the law is passed will only be clear after the law is passed.

As mentioned earlier, the PRRT involves only a small population of taxpayers but the MRRT and PRRT extension will see a much larger group of taxpayers involved.

In the circumstances it is imperative to have a well-structured approach to post-implementation review and improvement of the law. In particular we suggest that:

a) a mechanism (perhaps the Board of Taxation or the PTG or its successor) should undertake a post-implementation review of the MRRT two years after it is legislated; and

b) the Department of Resources and Environment, together with Treasury, should review the operation of the law together with the industry sectors and the business community on an annual basis, for a five year 'shake down period', with a readiness by government to make such amendments as such will be identified in practice.