Review of Business Taxation
A Platform for Consultation
Discussion Paper 2 – Building on a strong foundation

Submission by the
Victorian Chamber of Mines Inc.

15 April 1999

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SUBMISSION TO THE REVIEW OF BUSINESS TAXATION
DISCUSSION PAPER 2 – BUILDING ON A STRONG FOUNDATION

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EXECUTIVE SUMMARY

The issues identified as directly impacting on the minerals industry in Victoria include *entity taxation proposals* (deferred company taxation, resident dividend withholding tax); *taxation of financial arrangements* (definition of hedging, foreign exchange gains and losses, commodity derivatives); and the *trade-off to achieve a reduced company tax regime* (accelerated depreciation arrangements, deductibility of exploration expenditure, carry forward of losses and grand fathering).

Trade-offs to Achieve a Reduced Company Tax Rate

In any reforms that are aimed at achieving an internationally competitive company taxation rate it is important that the international competitiveness of the minerals industry is not placed in jeopardy. The minerals industry is a corner stone to the Australian economy and an important part of the Victorian economy, particularly in regional Victoria.

The Victorian Chamber of Mines would encourage any plans to introduce an internationally competitive taxation system in Australia. However, exploration is the key to an ongoing viable mining industry in Victoria and Australia and any changes that could impact on the industry's ability to invest in exploration activities should be approached with extreme caution. We contend that the ability to write-off exploration expenditure immediately and to carry forward losses must be maintained. This must include both capital and operating expenditures and be irrespective of possible future ownership changes.

In addition, it is of paramount importance to the industry in Victoria, especially the brown coal industry, that the current arrangements for accelerated depreciation for existing investments is maintained. Other features of the current scheme that must be maintained into the future include the arrangements for allowable capital expenditure and the research and development concessions.

In any solution that the Government may propose for the future it is important that the long term competitiveness of the minerals industry is maintained, not only in periods with the current circumstances of low inflation and low interest rates, but also when there are different conditions, or when the commodity price and investment cycle is much more favourable.

Deferred Company Taxation

We consider that the impact of deferred company tax to be negative as its impact is to impose a minimum level of Australian tax on the company based upon dividends paid.

The Chamber recognises the interrelationship of the numerous proposals. Accordingly, if the deferred company tax scheme is ultimately adopted, our comments regarding the accelerated depreciation arrangements must be tempered, at least to the extent of distributed profits.

Definition of Hedging

We consider that the hedging definition needs to be cast in terms of risk management rather than risk reduction, as some instruments may limit risk exposure without actually reducing them. The way in which mineral producers manage their hedge portfolio needs to be taken into consideration when drafting the hedging rules. These rules need to be sufficiently flexible that a commodity instrument taken out to hedge a future sale of minerals by a related company comes within the hedging rules.

Foreign Exchange Gains and Losses

We do not consider it appropriate to apply accruals taxation to unrealised gains and losses on loans denominated in a foreign currency.

Commodity Derivatives

We consider that commodity derivatives (rollovers/extensions) should not be treated as realisations.

Native Title Payments

We consider that the tax deductibility of native title payments should be confirmed.

1 SUMMARY OF THE RBT DISCUSSION PAPER

1.1 SCOPE OF REVIEW

The discussion paper entitled *"A Platform for Consultation"* follows the release in November last year of the Review of Business Taxation (RBT) initial discussion paper entitled "*A Strong Foundation"* which proposed a series of national objectives and principles to underlie the reform of business taxation, and the release in December of An International Perspective, an information paper outlining the tax systems of other countries.

The RBT's strategy in relation to business investments is to consult on the extent of reform against the goal of achieving a 30 per cent company tax rate as well as the prospect for further Capital Gains Tax (CGT) reform. The reform objectives are to achieve better economic performance, stimulate investment and innovation, and achieve a better functioning capital market. The RBT is asked to explore opportunities for increasing the economic efficiency of taxation by bringing tax value and commercial value closer together. A requirement of the reform of business investments is that it be revenue neutral against the Government's own proposals for tax reform.

Underlying the assessment of reform options is a prime objective for the review – of achieving internationally competitive as well as economically efficient business tax arrangements. In particular, an internationally competitive and economically efficient income tax should:

- Optimise decision making so that business investments are made on the basis of sound commercial considerations, as free as possible from distorting tax influences; and
- Where government uses the tax system to further non-tax objectives, target such tax incentives in the most efficient and cost-effective manner and render them transparent.

The discussion paper canvasses a wide range of issues, but to a large extent avoids recommending specific changes to the existing provisions. Nonetheless, a key theme of the report is an examination of how a 30 per cent company tax rate might be achieved through modifications to the existing provisions.

The Federal Treasurer has already signalled his clear preference for a reduction in the company tax rate from 36 to 30 per cent. This change is viewed by the Treasurer as a key factor in making the Australian system more internationally competitive.

The paper discusses a range of options that could aid the Government in achieving this objective, but it is noted that changes must be carefully assessed in terms of the broader economy wide impacts. Specifically, international competitiveness concerns for the resources sector are flagged as an important issue that will need to be taken into account by the Government.

1.2 CONSULTATION

In releasing the discussion paper, Mr John Ralph, Chairman of the RBT, expressed his hope that the successful consultation that followed the release of the first paper will be built on, in analysing the associated policy issues.

'We have been heartened by the way in which the community has taken up the challenge to consider the fundamental shortcomings of current arrangements in the context of the broad national objectives and principles proposed *in A Strong Foundation*. The further challenge now is to look at the policy options in that same context. The views of the community will be important to the Review in shaping its final report to the Government, due by 30 June.'

1.3 REVENUE NEUTRALITY

A requirement of the reform process is that it be revenue neutral against the Government's own proposals for tax reform. It is claimed in the paper that the 30 per cent company tax rate can only be achieved by eliminating 'accelerated' depreciation.

1.4 ISSUES ADDRESSED

The discussion paper lays out the issues and options for potential reforms to the taxation of business investments and entities. These areas of consideration are required by the Review's terms of reference, and stem from the Government's strategies announced in August last year.

The length of the discussion paper serves to highlight the vast range of issues and options requiring consideration.

The key issues raised in the paper include:

- the extent to which the annual tax value of investments should have more consistent regard to the commercial considerations underpinning them;
- the capacity of reforms in this area to provide for, in a revenue neutral way, reductions in the company tax rate;
- the possible need for capital gains tax reforms, to achieve a better functioning capital market, again within a revenue neutral setting;
- whether there are better approaches to taxing fringe benefits; and
- considerations around the impact on collective investment vehicles and foreign investment in Australia of the new entity tax regime proposed by the Government.

The RBT has not formulated recommendations on these issues at this stage. They have considerable significance for the business and wider community, and demand close consideration. The RBT will form its final recommendations on these issues after having heard the views of the community on them.

It is claimed that the emphasis of the RBT's final recommendations will be on practical arrangements that best suit Australia's circumstances, including the need to enhance the international competitiveness of the economy. The national objectives and policy principles outlined previously will provide an essential framework for shaping those recommendations.

There are a number of direct challenges confronting the industry arising from some of the options canvassed in the discussion paper. Potentially of greatest significance are the possible modifications to the existing depreciation provisions. The current provisions, which allow for the early write-off of certain types of expenditures, recognise the nature of long term investments in sectors such as the minerals exploration and mining industry. Indeed, the present arrangements in part respond to the risks associated with investing in long term capital activities.

Any reduction in the over-riding company tax rate, while significantly attractive, will come at a potentially high cost for some sectors if it is associated with a significant lengthening in the period over which assets can be depreciated. Indeed, marginally economic projects could be substantially disadvantaged on a net present value basis as a result of any changes.

2 ISSUES IDENTIFIED AS HAVING AN IMPACT

The issues identified as directly impacting on the minerals industry in Victoria include *entity taxation proposals* (deferred company taxation, resident dividend withholding tax); *taxation of financial arrangements* (definition of hedging, foreign exchange gains and losses, commodity derivatives); and the *trade-off to achieve a reduced company tax regime* (accelerated depreciation arrangements, deductibility of exploration expenditure, carry forward of losses and grand fathering).

2.1 ENTITY TAXATION PROPOSALS

2.1.1 Deferred Company Taxation

The RBT discussion paper propose that all distributions of profits would be fully taxed on distribution.

The Chamber consider that the impact of deferred company tax to be negative as its impact is to impose a minimum level of Australian tax on the company based upon dividends paid. The existence of deferred company taxation gives rise to the question of value of tax-preferred income such as accelerated taxation deductions. The impact on companies and shareholders would vary depending upon their tax profiles.

If the current accelerated depreciation provisions are maintained going into the future, the value of them to companies will generally be reduced by the deferred company taxation regime. The Chamber recognises the inter-relationship between deferred company tax and accelerated depreciation. Our comments subsequently regarding accelerated depreciation are prefaced upon the adoption of a resident dividend withholding tax.

In the event of a deferred company tax (‘fully franked dividends’) regime, the Chamber is of the view that, to the extent that operating profits are distributed, it is preferable for accounting and taxable incomes to equate, at least with respect to depreciation allowances, as there is no advantage in not having such distributed profits subject to primary tax.

2.1.2 Resident Dividend Withholding Tax

It is proposed by the RBT that a withholding tax would be levied on unfranked distributions paid to resident shareholders.

The resident dividend withholding tax proposal would not overcome the difficulties we have with the deferred company tax proposal and is not supported by the Chamber.

2.2 TAXATION OF FINANCIAL ARRANGEMENTS

2.2.1 Definition of Hedging

The RBT paper does not mention the issue of company groups and it is submitted that the definition of hedging is too narrow.

The hedging definition needs to be cast in terms of risk management rather than risk reduction, as some instruments may limit risk exposure without actually reducing them. The way in which mineral producers manage their hedge portfolio needs to be taken into consideration when drafting the hedging rules. These rules need to be sufficiently flexible that a commodity instrument taken out to hedge a future sale of minerals by a related company comes within the hedging rules.

2.2.2 Foreign Exchange Gains and Losses

The RBT paper acknowledges the inappropriateness of taxing unrealised gains on loans denominated in a foreign currency. Companies can elect to mark to market if they wish. However, rollovers are deemed to be a realisation.

The minerals industry do not consider it appropriate to apply accruals taxation to unrealised gains and losses on loans denominated in a foreign currency.

2.2.3 Commodity Derivatives

The RBT paper does not appear to address the specific need to include commodity derivatives in any regime for the taxation of financial arrangements but seems to have assumed that such derivatives would be regarded as financial instruments under any such regime.

The minerals industry consider that commodity derivatives (rollovers/extensions) should not be treated as realisations.

2.3 TRADE-OFF TO ACHIEVE A REDUCED COMPANY TAX REGIME

It is proposed in the RBT discussion paper that deductions for wasting assets requires significant reform as the current tax lacks a coherent and consistent framework.

It is proposed that:

- deductions should be available to whoever bears the economic loss regardless of who is the legal owner and incurs the expenditure;
- depreciation based on effective life rather than accelerated rates are canvassed;
- a standardised model for treatment of capital allowances is proposed;

- a preference for using diminishing value write-off rather than prime cost is proposed;
- blackhole expenditure, such as feasibility studies, takeover defence costs etc, may receive immediate write-off on amortisation over a set statutory period.

The RBT is silent on the tax treatment of payments for native title expenses. The tax deductibility of such payments requires to be confirmed.

The removal of accelerated depreciation in favour of effective life write-off would be the largest revenue raiser and a key issue in tax rate trade-off. In fact the RBT see accelerated depreciation as the trade-off to achieving a company tax rate of 30 per cent.

Specific issues identified as of concern to the minerals industry in Victoria if accelerated depreciation were to be reformed include a requirement to maintain the:

- immediate deductibility of exploration and prospecting costs;
- deductions for allowable capital expenditure;
- ability to carry forward exploration losses (irrespective of ownership changes);
- R&D concession; and
- current accelerated depreciation regime for investments already made (grand fathering principle).

3 ACCELERATED DEPRECIATION

3.1 THE CURRENT SITUATION FOR THE MINERALS INDUSTRY

Expenditure on exploration for minerals is generally immediately deductible at the time incurred, irrespective of whether the expenditure is revenue or capital in nature. Exploration includes studies to evaluate the economic feasibility of mining the minerals.

Expenditure on plant and equipment is treated in the same way as for other taxpayers generally. That is, expenditure is written-off at accelerated rates applicable to the effective life of the asset.

Other capital expenditure on developing and operating a mining project (allowable capital expenditure) is generally evenly deductible over the lesser of the life of the project or 10 years. Broadly, allowable capital expenditure includes expenditure on site development, access roads, buildings and the provision or contribution to facilities such as water, light or power. Also included are expenditure on housing and welfare facilities used in carrying on mining operations and successful cash bid payments for the grant of a mining or exploration licence.

Allowable capital expenditure also includes expenditure on acquiring mining or exploration rights and information to the extent of amounts agreed to by the vendor and the purchaser of the right or information.

Unless an election is made, deductions for exploration expenditure and allowable capital expenditure are limited to the amount of available income. The excess deductions are carried forward for deduction in the following year, subject to there being sufficient income in that year to absorb deductions. Excess deductions can be carried forward indefinitely until fully absorbed.

If an election is made, the limits do not apply, and any resultant losses are available for transfer under the company group loss transfer provisions.

Expenditure (whether revenue or capital) on restoring the site of mining operations is deductible at the time incurred. Expenditure on plant and buildings used in such activities is eligible for write-off under the provisions for plant and buildings respectively. Australian Accounting Standard 1022 ‘Accounting for the Extractive Industries’ allows the establishment of a provision for restoration work.

Expenditure on infrastructure for transporting minerals away from the mine site is evenly deductible over 10 years, irrespective of the effective life of the property. Facilities eligible for write-off include railways, roads, pipelines and certain port facilities. Also eligible for write-off are payments to landlords as compensation or for construction rights.

3.2 THE CASE FOR ACCELERATED DEPRECIATION

The RBT define accelerated depreciation as the allowance of deductibles for declines in the value of an asset at higher rates than are expected to occur in practice. Accelerated depreciation does not increase the nominal entitlement to taxation depreciation over the life of an asset. Rather it brings forward deductions. This results in tax being deferred during the early years of an asset's useful life and increases tax in the later years.

An examination of international taxation systems by the RBT has demonstrated that effective tax rates for investments in wasting assets, such as plant and mining expenditures, are generally lower than for other investments. This reflects the position that most jurisdictions provide tax benefits for investments in such activities.

It is stated by the RBT that possible rationales to support accelerated depreciation are as follows:

- industries using assets eligible for accelerated depreciation may produce externalities, such as benefits for other industries etc;
- investments in wasting assets are inherently riskier than other investments and so accelerated depreciation is justified as a rough offset for other tax system biases against risk; and
- other countries provide such concessions and so we need to match them in order to maintain international competitiveness.

3.2.1 Externalities

Flow-on benefits in the form of non related taxation revenue are created by the externalities generated by mining, manufacturing and some infrastructure industries such as power generation. These industries are probably the largest beneficiaries of the accelerated depreciation allowances. It is argued that the extent of any externalities will differ markedly from one industry to the next and from one region to the next. Therefore, consideration may be warranted as to whether a broad ranging concession for investment in capital assets is an appropriate means of addressing such externalities.

3.2.2 Long-term risks

There is a possibility that if accelerated depreciation were not available, or it was made less generous in regard to long-life assets, significant prospective investments may be located in other counties in preference to Australia. The extent to which such investments may be lost to Australia is difficult to judge. It is also possible that if reductions in the company tax rate were funded by removing accelerated depreciation that investment, albeit of a different kind, would be attracted to Australia.

3.2.3 International Competitiveness

Clearly national taxation regimes do have an impact on international investment decisions. Equally, clearly many other factors also bear on such decisions. Surveys in the past have suggested that general demand for the end product, direct input costs, access to markets and political and macro-economic stability are equally or more important than tax influencing location.

An examination of international tax regimes conducted by the RBT concluded that Australia provides accelerated depreciation for short-lived assets more or less in line with the average for the countries considered. However, Australia’s depreciation tends to be more favourable for assets with lives beyond about 8-10 years.

A reduction in company tax rate would also have a favourable impact on Australia’s international competitiveness, in terms of both attracting foreign investment, and the ability of Australian industries to compete overseas.

3.3 THE OPTIONS PUT BY THE RBT

Two reform options are put forward by the RBT in place of the accelerated depreciation arrangements. Option 1 is to replace accelerated depreciation with an effective life regime; Option 2 is to apply effective life depreciation with a loading. Both these options provide equal advantage to all wasting assets to which it applies regardless of their asset lives.

An effective life regime would move the taxation treatment of wasting assets closer to their accounting treatment. It would make investment in wasting assets less attractive than at present.

Replacement of the accelerated depreciation provisions by an effective life regime with loadings would result in more uniform treatment of wasting assets with differing effective lives. This approach would work by determining the rate of depreciation based on expected effective life of the asset and then increasing this rate by a fixed percentage loading, say 20 per cent, to determine the rate of depreciation allowed for taxation purposes.

The extent of any loading would be determined by its revenue cost and the advantage conferred relative to other investments. A loading with an equivalent revenue cost to the current system as it relates to plant and equipment would approach 100 per cent. That is, it would allow assets to be written-off over approximately half of their effective lives. An equivalent revenue neutral loading for mining investments would approach 55 per cent.

There would be an issue as to which class of assets would benefit from accelerated depreciation.

3.4 IMPACT OF LOSS OF ACCELERATED DEPRECIATION

3.4.1 Impact on Companies

Accelerated depreciation is the allowance of deductions for declines in the value of an asset at higher rates than are expected to occur in practice. Accelerated depreciation does not increase the nominal entitlement to taxation depreciation over the life of an asset. Rather it brings forward deductions. This results in tax being deferred during the early years of an asset's useful life and increases tax in the later years.

The benefit to the tax payer of accelerated depreciation is confined to tax deferral and permanency. In after-tax terms, accelerated depreciation increases the net present value of an investment, or its rate of return, above what it would be in the absence of accelerated depreciation.

In the current environment, mining companies value accelerated depreciation because it provides important cash flow benefits which helps justify project feasibility and enables them to reinvest in exploration and working capital. Where a company has made a substantial up-front capital expenditure early positive cash flows are important in determining the overall rate of return on the project.

3.4.2 Impact on Government

The revenue cost of accelerated depreciation flows from the tax deferral property. For any particular asset, accelerated depreciation is the equivalent of the government providing an interest free loan to the taxpayer; revenue collections are lower in the early years but this is entirely offset in later years. The real cost to the government is therefore the 'interest' on this 'loan' less any revenue from taxation of the extra income earned by the taxpayer as a result of the 'loan' The actual impact on revenue flows will be a significant negative in early years of the asset's life reflecting the making of the 'loan', offset by a positive impact in the later years of the asset's life as the 'loan' is repaid.

3.5 MODELLING STUDIES OF THE IMPACT

The Chamber's tax committee has modelled the impacts of the option for a company tax rate of 36 per cent and the accelerated depreciation allowances compared to a company tax rate of 30 per cent and effective life depreciation allowances. These studies were done with the current low interest rates, low inflation and with the low commodity prices. In addition, the 'tight' capital investment plans of the industry were modelled. Should any of these circumstances change, which invariably they will, the model outcomes will change.

Two prime examples we studied, one based on the development and operation of a relatively small open pit gold mine as a green field site and the other based on the expansion of and existing integrated open pit and underground mine. Both are relatively short lived projects.

The modelling of both cases has assumed the following:

- the immediate write-off of exploration expenditure;
- the carry forward of accumulated losses from the exploration period; and
- the depreciation of existing investments continues as previously (grand fathering).

Our studies show that it is only when the above assumptions are applied to both cases that the impact of the loss of the accelerated depreciation arrangements become neutral in a DCF basis.

4 THE CHAMBER'S POSITION

4.1 TRADE-OFFS TO ACHIEVE A REDUCED COMPANY TAX RATE

In any reforms that are aimed at achieving an internationally competitive company taxation rate it is important that the international competitiveness of the minerals industry is not placed in jeopardy. The minerals industry is a corner stone to the Australian economy and an important part of the Victorian economy, particularly in regional Victoria.

The Victorian Chamber of Mines would encourage any plans to introduce an internationally competitive taxation system in Australia. However, exploration is the key to an ongoing viable mining industry in Victoria and Australia and any changes that could impact on the industry's ability to invest in exploration activities should be approached with extreme caution. We contend that the ability to write-off exploration expenditure immediately and to carry forward losses must be maintained. This must include both capital and operating expenditures and be irrespective of possible future ownership changes.

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4.2 OTHER MATTERS

<u>Deferred Company Taxation</u>

We consider that the impact of deferred company tax to be negative as its impact is to impose a minimum level of Australian tax on the company based upon dividends paid.

The Chamber recognises the interrelationship of the numerous proposals. Accordingly, if the deferred company tax scheme is ultimately adopted, our comments regarding the accelerated depreciation arrangements must be tempered, at least to the extent of distributed profits.

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