Ref: \\SERVER_ONE\VOL1\COMMON\Econ & Tax\Tax_refrm\DOCUMENT\et0357.doc

## EXECUTIVE SUMMARY

The minerals industry is one of Western Australia and Australia's most important industries. Minerals make up many of the country's most valuable exports and underpin both regional and national economies. It will continue to do so for the foreseeable future.

In recent years, investment and industry returns have been low. The intensely competitive nature of international minerals commodity markets means that players have little alternative but to accept prevailing world prices.

While strongly supporting tax reform, the minerals industry would have great concern at any changes to the industry's operating environment which would have the effect of either increasing costs or reducing access to investment. The Chamber of Minerals and Energy is concerned that aspects of the taxation reforms proposed in the recent discussion paper from the *Review of Business Taxation*, particularly the introduction of a deferred company tax regime and removal of the industry's ability to claim deductions, would have this effect. While the industry acknowledges the attractiveness and advantages of a reduced corporate tax rate, it believes that other avenues to achieve such a result have not been sufficiently explored. It is by no means clear that removal of industry deductions is the best or only way to achieve this result. Nor is it clear why any changes must be on a revenue neutral basis.

The Chamber argues that any assessment of the merits of taxation proposals, while taking into account the traditional criteria of equity, efficiency and simplicity must also look at their impact on international competitiveness. Australia is competing with other countries for investment and business activity and its taxation system is a key driver of its competitive position. Changes which degrade rather than enhance international competitiveness will ultimately damage national and regional economies, calling into question the ultimate rationale for proposed reforms.

A deferred company tax regime would increase cash flow requirements on minerals companies in order to meet the requirements of fully franked dividends. This would increase costs if dividend levels are to be maintained. However, by reducing effective returns to some shareholders, the changes would also make minerals shares less attractive to hold, reducing access to equity investment. Double taxation effects have the potential to encourage Australian companies with offshore operations to relocate overseas. If there are concerns over avoidance (and the Chamber is not convinced that these are well founded) existing provisions are adequate to cope with any problems.

Moves to limit taxation deductions currently enjoyed by minerals companies would fail to recognise the high risk nature of minerals ventures which rely on large expenditures on exploration and capital. By pushing back taxation deductions on these items to later years of a project, cash flow requirements and consequent financing costs would be increased substantially, affecting the viability of projects. The proposed changes would also make Australia's taxation regime even less internationally competitive than it currently is, effectively exporting minerals jobs and investment.

While the Chamber has major concerns over these recommendations, it recognises that there is a need for taxation reform and has supported other proposal reforms such as the introduction of a broad based consumption tax. Indeed, the *Review* paper does contain some extremely constructive suggestions and the Chamber is pleased to endorse them.

## CHAMBER OF MINERALS AND ENERGY RESPONSE TO KEY TAXATION ISSUES

| ISSUE | CHAMBER VIEW |
|---|---|
| Reduced corporate tax rate | The Chamber acknowledges the advantages of a lower tax rate although submits these should not be oversold. However, it does not believe that there should be a linkage between a reduced tax rate and deductions such as accelerated depreciation and exploration writeoffs |
| Accelerated depreciation | Accelerated depreciation is a key element in maintaining the industry's international competitiveness. The Chamber urges its retention |
| Immediate deductibility of exploration | Immediate exploration deductibility is entirely appropriate treatment of high risk activity. Removal would produce further declines in exploration and increase the shift to overseas activity |
| Balancing charges | The Chamber opposes changes to the current regime |
| Overburden removal | The Chamber opposes the options proposed and supports the retention of immediate deductibility |
| Entitlement to deductions | The Chamber supports option 1 proposed – whoever incurs the expenditure |
| Period of asset write-off | The Chamber supports retention of the current rules |
| Assessment of period of write-off | The Chamber supports retention of the current rules |
| Immediate write-off of small items | The Chamber supports an increase in the threshold level. The options put forward are opposed. |
| Method of write-off | The Chamber supports maintenance of the choice of prime cost and diminishing value |
| Blackhole expenditure | The Chamber supports the need for reform of the current treatment of blackhole expenditures |
| Loss carry back | The Chamber recommends consideration of introduction of a loss carry back mechanism as part of taxation reform |
| Trading stock | The Chamber supports the need for reform as proposed under option 1 – application of the accounting approach. Option 2 is opposed and option 3 would reduce simplicity |
| Entity taxation | The Chamber is opposed to the options proposed and does not believe a sufficient case for change has been made. The options have considerable potential to damage the minerals industry |
| Taxation of Financial Arrangements | The Chamber is proposed to the options outlined and suggests an exemption for the minerals industry |

| | |
|---|---|
| Consolidation of entities | The Chamber is opposed to the options proposed and believes no sufficient case for change has been made. Existing anti avoidance provisions can deal with any issues which arise |
| Anti avoidance provisions | To the extent that concerns about exploitation of current rules are driving the *Review*, the Chamber believes these concerns are misplaced. |
| Fringe benefits tax | The Chamber supports proposals to exempt certain items from FBT |

## 1. INTRODUCTION

The Chamber of Minerals and Energy of Western Australia is pleased to present the following submission to the Commonwealth Government's review of business taxation arrangements arising from the second discussion paper of the Review of Business Taxation (the Ralph Review).

This submission covers the Western Australian minerals industry's viewpoint on the principal matters addressed in the paper, namely:

- Proposals for a deferred company taxation (DCT) regime.
- Possible changes to the corporate taxation regime with the aim of achieving a 30% tax rate.
- Specific taxation changes canvassed in the paper.

At the outset, the Chamber wishes to place on record its support for tax reform. The current Australian taxation system is simply unsustainable. It is antiquated, complex and falls far short of international best practice. Taxation reform offers Australia a unilateral opportunity to enhance its international competitiveness which will in turn benefit all Australians. But this does not mean that all reform proposals should be uncritically accepted or will be beneficial. Business taxation reform needs to take account of Australia's economic structure, in particular the integral part played by the resources sector, in contrast to most other developed economies. The Chamber strongly endorses the objective outlined in the first discussion paper:

> *Our objective is … a system that enhances the growth performance of the Australian economy, is equitable and efficient; and is as transparent and simple as can be made.*

However, the Chamber would argue just as strongly that such an objective cannot be achieved by proposed taxation reforms that would hinder the international competitiveness of the minerals industry.

## 2. IMPORTANCE OF MINERALS INDUSTRY TO WESTERN AUSTRALIA

To put the industry's submission in context it is perhaps useful to canvass its importance to the economies of both Western Australia and the nation as a whole.

- The minerals sector (mining and minerals processing) is a major contributor to the Western Australian economy, comprising 25 per cent of gross state product.
- Mining (not including processing) is disproportionately important in the State's economy, contributing over 15 per cent of GSP and a 5 per cent contribution to the national economy.
- Direct minerals employment in WA was 31,100 in 1997 and 82,300 across Australia.

- Minerals account for 75 per cent of the State's exports.

- Total state mineral production in 1998 was $17.3 billion.

- The industry is a significant contributor to State and Commonwealth Government revenues. This includes $1.8 billion total direct and indirect taxes in 1997/98.

- The minerals sector has higher than average multipliers. For instance, WA metallic minerals mining has an employment multiplier of 4.1 compared to the average for the State of 2.6. Therefore each 100 jobs in the minerals industry create around 300 elsewhere in the State or a total of 400 new jobs. This makes employment expansion in the minerals industry particularly effective at producing net new jobs.

- Around half of WA's growth and employment can be attributed to growth in the minerals sector.

Clearly, the minerals industry is a key contributor to both the national and State economies. It will continue to play a role for the foreseeable future. Therefore, while this submission is explicitly about putting forward a position which is in the industry's interests, the economic impact of the minerals industry means that development in the industry benefits more than just the immediate participants. Conversely, taxation policies which retard the industry will harm not only miners and owners but those elsewhere in the economy who depend on the jobs and wealth created by minerals. Government needs to take this reality into account when deciding the overall mix of tax policy.

It is also relevant to note that the industry is currently experiencing difficult times. Prices across most commodities are flat and key markets, particularly in Asia, subdued at best. These difficulties are evidenced by the low profitability of the industry (1.8% return on shareholders' funds in 1997/98) and forecast declining levels of investment — according to the Minerals Council of Australia's *Minerals Industry '98,* investment in the industry will fall by 39% in 1998/99.

Despite these challenging circumstances, the industry has performed remarkably well, with export volumes holding. However, this performance has been substantially attributable to the industry's ability to remain internationally competitive and continue production at a time of soft prices and demand. Any moves which increase industry costs will almost certainly threaten its continued viability. The international minerals commodity market is intensely competitive and survival rests on being able to operate at prices set in these markets. With such low profitability levels, there is virtually no industry ability to absorb cost increases, be they from tax changes or any other sources.

The other key requirement of a strong minerals industry is that it continues to be able to find and develop new resources. This requires exploration expenditure and capital. Access to both is currently constrained by factors such as native title and low profitability: any changes to the taxation system which result in effective cost increases or reduced access to equity markets cannot but adversely affect the industry.

## 3. TAXATION REFORM

The Chamber of Minerals and Energy has long recognised the deficiencies in Australia's taxation system. The current tax system has evolved over many decades of incremental change. As a result it is complex and distortionary. The Western Australian minerals industry, which operates in many countries and is hence exposed to various differing taxation regimes, has formed a view that Australia's current taxation system represents an impediment to its international competitiveness. Put simply, other countries have taxation regimes which are more conducive to minerals investment, production and processing.

A key feature of the minerals industry which needs to be kept in mind is that, in contrast to many other industries, it has virtually no ability to pass costs on, be they a result of an inefficient taxation system or some other factor. The effect of deficiencies in the taxation system is therefore to put the Australian minerals industry at a competitive disadvantage.

In recognition of this need for change, the Chamber has supported previous reform proposals such as the replacement of the current indirect tax system with a broad based goods and services tax.

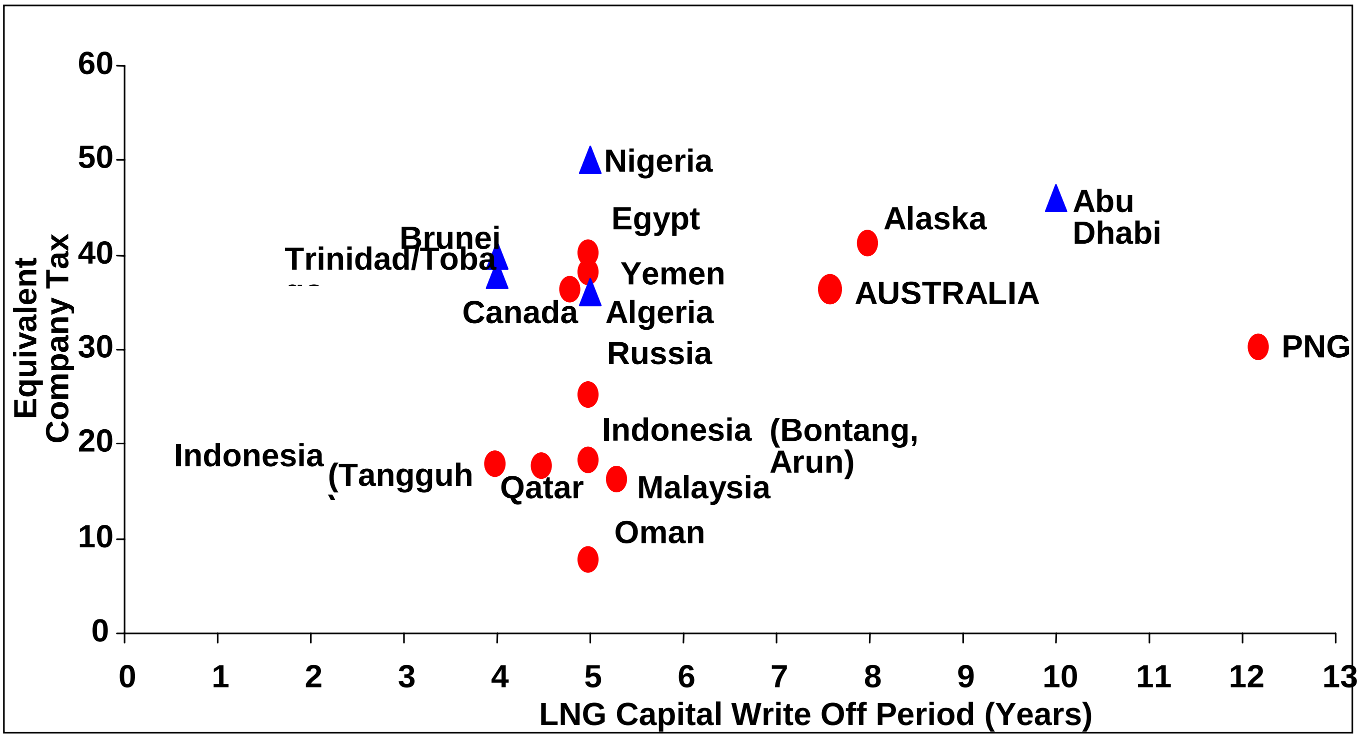
However, while taxation reform is undoubtedly necessary, this does not mean that all proposals for change are necessarily improvements. Any suggestions for reform must be scrutinised according to the criteria of efficiency, equity, simplicity and competitiveness. It is this last criterion which particularly concerns the industry.

The taxation system has a fundamental influence on the investment decision making process. It not only impacts on individual project decisions, but has an important bearing on Australia's ability to compete for what are often limited international exploration and development funds.

It is important to recognise that if Australia is unsuccessful in attracting minerals development, international investment funds earmarked for such activities will most likely be directed towards our competitors. They will not necessarily be invested in other activities within Australia. In this context, it is vital that business taxation is internationally competitive and as a minimum, does not act to the detriment of Australia as an investment destination. The Chamber submits that this requirement of international competitiveness must be one the most fundamental criterion for any reform proposals.

In any assessment of taxation, a clear differentiation must be made between tax concessions and the special taxation provisions which correct distortions which would otherwise be present. Where distortions exist, it is essential that provisions apply that act to minimise any potentially adverse impacts. The Chamber argues that the "concessions" which allegedly benefit the industry are in fact instances of the latter.

Australia's capital taxation regime must be competitive with those applying in countries with which Australia competes for investment capital. For example, in the LNG industry, capital expenditure is generally able to be written off against income tax over a period of four to five years compared with 7.6 years for LNG plant in Australia. This view is supported by a 1997 study of gold mining taxation conducted by the Colorado School of Mines which ranked Australia's taxation system eighteenth out of twenty three jurisdictions. The conclusion is clear: Australia already treats the minerals industry less favourably than other countries, the proposed changes would exacerbate rather than close this gap.




Sources: *Review of Petroleum Fiscal Regimes*, Petroconsultants(UK) Ltd., 1997
*Suggestions for New Terms for the Alaskan North Slope LNG Project,* Dr P H van Meurs.

One other point which requires brief discussion is that of compliance. Underlying some aspects of the Ralph proposals appears to be a perception that the current taxation system is somehow the subject of widespread avoidance. The Chamber does not believe this is the case. To the extent that some proposed changes are compliance driven, the Chamber argues that this is not sufficient justification for their introduction. Indeed, even if compliance issues are present, there are already alternatives available which can be used rather than designing a new taxation system.

## 4. PROPOSALS FOR A REDUCED CORPORATE TAX RATE

A key element of the Ralph proposals is the shift towards a 30% corporate tax rate from the current 36%, the price being sacrifice of a number of taxation measures such as accelerated depreciation.

All other things being equal, the Chamber acknowledges the benefits of a lower tax rate, although these should not be oversold. There is a widely held view (especially in political circles) that lowering the corporate tax rate will attract foreign investment. The Chamber does not support this view. Anecdotal evidence suggests that investors do not look at a nominal rate of return, rather the effective after tax rate which impacts on investment decisions. The effective tax rate will of course never equal the nominal rate.

If, however, the Government is determined to pursue this course, the Chamber submits that the current proposals do so on a too restrictive basis. Firstly, the assessed cost to Government is highly dependent on the models used. It is not clear whether the assessed cost is accurate. If it is overstated, then there is no need for removal of the items proposed. More fundamentally, however, the Chamber would query the need for a tradeoff in the first place. There are a number of alternatives other than revenue neutrality (including expenditure adjustment) which would allow a lower corporate tax rate, without the same deleterious effects on the minerals industry. The Chamber argues that the brief – to consider options on a financial year revenue neutrality basis – is far too restrictive and not a good basis for constructive reform proposals. Taking a longer view and exploring a wider range of options is likely to deliver a better outcome. The Chamber urges that these alternative options be given full and proper consideration.

## 4.1 IMPORTANCE OF ACCELERATED DEPRECIATION

As a highly capital intensive industry with long construction and payback periods, the minerals and energy sectors would be among those most affected by any adverse changes to the capital depreciation rates. A shift towards basing write off periods on the economic life of assets would have a major impact on project economics and would make it very difficult to attract new investment to Australia.

While the company tax rate becomes an important determinant of project returns once capital is written off and dept repaid, the availability of a competitive depreciation regime is a more important consideration when assessing new investment proposals for low profitability projects such as minerals projects with long capital payback periods of ten years or more.

In common with other capital intensive industries, the minerals industry depends on existing accelerated depreciation measures. Lengthening the depreciation period to economic life would have the effect of changing project fundamentals and undoubtedly reducing the number of projects which actually go ahead. The Chamber acknowledges that some businesses would benefit from a lower corporate tax rate, although these would tend to be existing projects which have already enjoyed the benefits of depreciation. It is future projects which would suffer.

The overriding objective of business tax reform is to create a competitive business environment by improving a climate for investment and productivity, and to boost investment and the standard of living in Australia. However, the Chamber considers that these objectives cannot be achieved by simply pursuing a reduced corporate tax rate at the expense of capital intensive industries. If investment on exploration and mining declines due to the proposed accelerated depreciation changes, clearly the overriding objectives of tax reform would be unattainable.

The proposed changes would be a bias against long term investment in Australia and, ultimately, exports. It has been argued that such changes would advantages service industries but it must be remembered that a reduction in investment in mining projects would also harm the service industry, offsetting any benefits from a lower corporate tax rate.

In terms of international competitiveness, other countries provide incentives to attract investment. The *Review* notes that there is enough anecdotal evidence to establish that concessions play an important part in the location of certain investments and that fiscal measures are needed to offset locational disadvantages of some countries. The Chamber believes that this is a critical point which needs to be examined in wider detail. For example, overseas investors such as US mutual and pension funds are significant investors in Australian mining companies. The reason for this is that Australia is seen as a viable investment opportunity, due in part to the concessions which impact on the projected after tax returns expected from longer term projects such as mining. Conversely, the local superannuation funds industry prefers investing in the banking, financial services and retail sector (ie service industries). A shift in Government policy could result in Australia being seen not to be internationally competitive, thus resulting in a gradual withdrawal of overseas funds without the necessary local investor support to ensure the long term viability of the mining industry.

## 4.2 EXPLORATION EXPENDITURE

Exploration is an essential element of conducting business in the minerals and energy sectors. Put simply, without exploration, the new mines of the future will not be found and future investment will suffer. For reasons unconnected with the taxation debate, exploration is already at disturbingly low levels. Exacerbating this trend by increasing the effective cost would be highly inappropriate and fundamentally damage the industry.

The current immediate and full write-off of expenditures associated with exploration correctly acknowledges the nature and importance of such activities. Such outlays are a direct ongoing cost of conducting the business and their immediate deductibility is appropriate.

The consequence of removing the immediate deductibility would be a highly distortionary disincentive to risk-taking that would ultimately reduce the overall exploration effort in Australia, particularly in those areas where risks are perceived to be higher. Exploration would likely be reduced in ‘greenfields’ areas and increased on ‘brownfields’ where the odds of success are seen as being higher. Brownfields exploration, however, while it may improve productivity at an existing site, will not deliver new projects.

## 4.3 BALANCING CHARGES

Current taxation provisions require a balancing adjustment to be calculated for depreciable plant if it is lost or destroyed. The Act provides for assessable or deductible balancing adjustments where the “termination value” exceeds or is less than the written down value of the plant respectively. “Termination value” in the case of plant lost or destroyed is defined as the amount or value received or receivable under an insurance policy or otherwise for the loss of destruction.

Where an insurance recovery exceeds the written down value, the excess is only assessable to the extent of previously claimed deductions. If the insurance recovery exceeds the original cost, it will be subject to the ordinary CGT provisions. Taxpayers can effectively defer any assessable balancing charge by instead reducing the cost, or written down value of replacement or other plant by the otherwise assessable balancing charge.

The Chamber of Minerals and Energy firmly believes that these provisions should be maintained in the event of involuntary disposals. For instance, in the event of the total loss of a facility, under the above stated provisions, any insurance proceeds received would be offset against the cost of the replacement facility. If these provisions were removed and the insurance proceeds became assessable upon receipt, 36% of the proceeds would have to be paid in tax, leaving insufficient funds to rebuild the facility. This situation would be clearly unacceptable.

### 4.4 OVERBURDEN REMOVAL

Currently costs associated with removal of overburden to expose the ore body are treated as a revenue cost as part of the method of extracting mineral deposits. For gold companies in particular, these costs and their taxation treatment can be significant.

The *Review* options proposed are either capitalising overburden costs and depreciating the cost over the life of the ore body, or valuing and absorbing the cost into the ore as it becomes trading stock.

The Chamber strongly argues that the current taxation treatment should be maintained. Any changes would have a negative impact on the industry, particularly the gold sector which generally has a high stripping ratio. The effective increase in costs from either of the two proposed options would likely call into question the viability of a number of potential and existing projects.

## 5. WRITE-OFF OF WASTING ASSETS

### 5.1 CURRENT POSITION

Wasting assets are assets that, at the time that they are acquired or created, can be expected to decline in value over time. The taxation treatment of wasting assets is a significant issue for the mining industry, as mining assets such as plant and tenements deplete in value over time. Capital expenditure incurred on mine development and operation is a typical example of a wasting asset.

Various rules govern the taxation treatment of wasting assets. For example, the mining industry can deduct Allowable Capital Expenditure over the lesser of 10 years or the life of the mine, even if the mine life is greater than 10 years.

### 5.1.1 Review Options and Submission

The *Review* argues that the present system of dealing with wasting assets is complex, inconsistent and involves significant duplication. Significant reform options are summarised below and the Chamber's preferred position advanced.

#### 5.1.1.1 Who should be entitled to deductions?

- Option 1 - whoever incurs the expenditure to produce assessable income should be entitled to the deduction.

- Option 2 - the taxpayer's entitlement to a deduction would be in accordance with accounting principles.

Option 1 is the preferred option. It recognises the significant problems currently associated with expenditure incurred by a taxpayer on plant that is affixed to land not legally owned by the taxpayer. This is a significant ongoing problem for the mining industry which affixes plant to land which it does not legally own. Under common law in these circumstances the landowner would be the owner of the plant. Accordingly, the taxpayer who incurred the expenditure would generally not be entitled to a deduction for depreciation.

Rules that were introduced to deal with this problem, in particular in relation to mining companies operating on crown leased land, are inadequate, complex and often provide outcomes that do not reflect the true nature of the commercial transaction.

#### 5.1.1.2 Over what period should assets be written off?

- Option - assets would be written-off over their effective life.

The current rules are equitable and the adoption of a standardised effective life regime for **all** taxpayers is opposed.

The Chamber considers that the current rules are equitable because they recognise that significant investment in wasting assets is required by capital intensive industries, such as mining. Low capital industries such as the service sector would be no worse off under the proposed measures. However, the mining industry will be severely impacted. For example, under the proposed measures where a mine life was estimated to be 15 years, ACE deductions would be allowable over 15 years. Under the present system these deductions would be allowable over 10 years.

The timing of deductibility for wasting assets is a significant issue for mining companies due to the impact on cash flows. Any changes would represent a major shift in successive Government policy and would significantly effect investment in mining projects.

#### 5.1.1.3 How should the period of write-off be assessed?

- Option 1 - retain the existing system of self assessment.

- Option 2 - effective life would be based on the Commissioner's schedule, with the option for taxpayers to seek variation in particular cases.

Option 1 would see the retention of the current rules which allow a taxpayer to determine the effective life of an asset. These rules should be retained as they are consistent with the self assessment system which applies in Australia.

Option 2 is opposed. Under this option the effective life of an asset would be determined by the Commissioner. A taxpayer could seek a variation in particular cases. This would most likely see a significant volume of requests for variation being lodged with the Commissioner on an ongoing basis. This would result in an extremely inefficient use of ATO resources. It is unclear whether the ATO would have the necessary resources to deal with the determination requests.

On a final point, it is clearly the taxpayer who incurs expenditure on an asset who is best suited to determine the effective life of the asset. A simple example relevant to the mining industry is the effective life of plant which is measured not in terms of a standard schedule, rather in terms of the geographic location and intended use of the asset. A standard schedule cannot possibly provide for the permutations of plant used for mining purposes.

### 5.1.1.4 Should there be immediate write-off for small items?

Currently an immediate write-off is allowed for items of plant costing $300 or less (in some case $500).

- Option 1 - deductions would be limited to a specified number of items of the same class each costing less than the *de minimus* threshold.

- Option 2 - an annual limit (say $10,000) for immediate write-off on the aggregate of purchases of items each costing less than the *de minimus* threshold.

Current rules allow for the immediate write-off of assets which cost $300 or less (currently $500 in some cases). This amount is too low and creates immense difficulties in terms of the associated compliance costs. In the mining industry small amounts may not be capitalised as they are often seen as immaterial. This means that under the current laws a separate register must be maintained for tax depreciation purpose. A fixed asset reconciliation between accounting and tax must also be performed on an annual basis. This is a significant compliance burden.

The Chamber supports a higher threshold level (say $1,000). This threshold would be more consistent with modern business practices and significantly reduce taxpayer compliance costs. The *Review* options are opposed as they would raise the level of complexity and the level of records that a taxpayer would be required to retain. Also, limiting deduction entitlements based on a class or overall aggregate system is inconsistent with the goal of a simplified system as compliance costs are likely to be similar under the current regime and reform options.

#### 5.1.1.5 What write-off method should apply?

The *Review* noted that the choice between the diminishing value or prime costs methods should depend on which is more likely to match the actual pattern of decline in the value of the asset.

The choice of prime cost and diminishing value should be maintained. This choice enables an asset's decline in value to be correctly matched to the method of depreciation chosen by the taxpayer.

## 5.2 'BLACKHOLE' EXPENDITURES

### 5.2.1 Current Position

'Blackhole' expenditure is a reference to a range of expenditures that currently fall within a grey area in terms of their treatment for tax purposes. The Chamber notes that blackhole expenditure is subject to inconsistencies and tax outcomes that are both unrealistic and inequitable.

### 5.2.2 Review Options and Submission

The taxation treatment of a range of 'blackhole' expenditures is considered by the *Review*. Significant expenditures that are relevant to the mining industry include the treatment of costs relating to feasibility studies, native title claims and mine closures.

The Chamber supports the need for reforming the current taxation treatment of blackhole expenditures. A consistent framework that recognises that the majority of these expenditures are deductible as incurred is seen as a necessary move forward. In particular, the outright deductibility of costs associated with native title claims is important. These costs are likely to become more and more significant over the coming years.

The Chamber also sees the need for a limited form of loss carry back mechanism in relation to certain blackhole expenditures as discussed below.

## 5.3 LOSS CARRY BACK

Currently there are no rules which allow for a loss carry back. Mine closure costs are an example of the need for a limited form of loss carry back mechanism. These costs can be significant for mining companies.

Broadly, a loss carry back mechanism would allow taxpayers to carry back certain expenditure in limited circumstances (eg mine closure costs). This would ensure the correct matching of revenues against expenses. Using the above example, mine closure costs would be carried back and deductible over the life of the mine to which the closure costs relate.

The Chamber notes that a loss carry back is provided in various countries and recommends consideration of its introduction in Australia as part of the tax reform measures put to Government.

## 6. TRADING STOCK

The *Review* argues that the current income tax law which provides taxpayers with the annual option of valuing each item of trading stock at its cost, its market selling value or its replacement value is inconsistent and allows excessive flexibility.

### 6.1 REVIEW OPTIONS AND SUBMISSION

The Chamber agrees that the current system is in need of improvement and that the option proposed to require all trading stock to be valued on a consistent basis is a reasonable one.

#### 6.1.1 Option 1: Apply the accounting approach

This option would adopt the accounting approach that generally requires inventories to be valued at the lower of cost or net realisable value. This is the preferred option. It is simple and convenient as it utilises accounting information. It also eliminates the flexibility inherent in the current arrangements.

#### 6.1.2 Option 2: Value stock at net realisable value

This option is opposed. The vast majority of the industry presently values stocks at cost. A valuation at net realisable value is only undertaken for accounting purposes in the unusual circumstances where it is envisaged that this may result in a lower figure. Valuations at net realisable value are time consuming and difficult to undertake and often involve some degree of estimation (as the costs to the stage of completion have not yet been incurred). The considerable compliance costs involved in performing the numerous difficult valuations for all stock which would be required under this option render it untenable.

#### 6.1.3 Option 3: Allow taxpayers to select one basis of valuation

This option would allow taxpayers to select one of the current options for all stock and only allow a change in the method selected if the taxpayer could make a sound case based on non-tax considerations. This option is preferred over option 2 but does not offer the simplicity of the first option. It is noted that this procedure may conflict somewhat with the notion of self-assessment in the need for the taxpayer to approach the ATO in order to complete their tax return in the event that a change in valuation method was envisaged.

#### 6.1.4 What should be the treatment of assets with trading stock characteristics?

The *Review* suggests that amounts expended on removing overburden in excess of immediate needs could be treated in a manner similar to trading stock.

Alternatively, it is suggested that overburden expenditure could be treated as capital and depreciated over the life of the orebody. The Chamber opposes either of these alternatives to the present treatment.

It is well recognised that expenditure incurred in the removal of overburden does not result in the creation of trading stock. Further, it is well established in both Australian case law (see income tax ruling TR95/36) and international case law that the removal of overburden relates to the working or extraction of the ore-body and is correctly classified as revenue expenditure, not capital expenditure.

Any effort to categorise expenditure incurred in the removal of overburden as trading stock or capital would require the creation of artificial concepts to remove this type of expenditure from its 'natural' classification. This would increase the complexity of the tax system whilst at the same time undermining international competitiveness.

## 7. ENTITY TAXATION

### 7.1 REVIEW PROPOSAL

The proposed changes to entity taxation are apparently aimed at achieving a fairer and more consistent treatment of entity distributions. It is envisaged that achieving consistency in the treatment of income earned in different business entities under a redesigned imputation system would provide for simplicity, fairness in treatment and improve the integrity of the business tax system. The paper proposes three options for improving integrity through the entity chain:

1. The first option is a Deferred Company Tax ("DCT") regime, allowing for full franking of profits (including distributions of tax-preferred profits) and a credit to shareholders for company tax paid. Excess imputation credits would be refundable to both resident individual taxpayers and complying superannuation funds.

2. The second option is to use the existing franking account system to administer a resident dividend withholding tax, applying the company tax rate to distributions of tax-preferred income to Australian resident investors. Unfranked distributions to non-resident investors would continue to be subject to the existing withholding tax system (generally levied at the rate of 15 per cent).

3. The third option involves the taxing of unfranked entity distributions of tax-preferred income in the hands of resident recipients (except consolidated groups) and replaces the inter-corporate rebate on unfranked distributions. Again, dividend withholding tax would continue to apply to distributions to non-residents.

## 7.2 SUBMISSION

### 7.2.1 ECONOMIC IMPACT OF OPTIONS

The *Review* states that the existing company imputation system is overly complex, however the Chamber considers that the proposed system is as complex, if not more so than the current rules. There is no compelling need for change as the current system is working. There is also a compelling argument that the economic impact of the measures will far outweigh any argument put forward as a reason to implement either of the *Review* options. A summary of the potential economic consequences on mining companies is discussed below.

- The reported after tax profits of entities who pay DCT will fall.
- Shareholders will receive reduced cash distributions, making their investment less attractive.
- Falling dividend yields will adversely impact on a company's share price.
- Foreign investors may withdraw funds from Australian capital markets due to the falling dividends.
- Reduced share prices will affect a company's ability to access debt and equity.
- A tightening of access to debt or equity will adversely impact a company's cash flows.
- A reduction in a company's ability to access debt and equity will result in a significant decline in investment.

It should be noted that, while these effects can be expected to occur across the economy, they will particularly impact on the minerals industry which, due to low levels of profitability and high expenses is often paying an effective rate lower than the full rate and thus would not ordinarily fully frank dividends. Low profit levels also mean that minerals returns are already lower than elsewhere in the economy. Any changes which reduce the attractiveness of minerals equities will severely impact on the industry's ability to access capital.

### 7.2.2 DCT

The Chamber considers the DCT regime as likely to have the most negative impact of the entity distribution reform options. The DCT comprises the most fundamental shift of tax from the shareholder to the entity level. The full franking of distributions of tax preferred profits will have significant implications for the mining industry as a significant proportion of investors are non- resident investors who will suffer under the DCT measures.

The *Review* argues that a move to fully franking of dividends would allow for the removal of current anti-dividend streaming rules together with required franking rules. The Chamber considers that the current anti-avoidance rules are sufficiently wide sweeping and could be applied to remedy any dividend streaming arrangements.

Through the introduction of fully franked dividends, the Australian tax paid by foreign investors on unfranked dividends would increase to the corporate rate (currently 36%) compared with the current 15% withholding tax where a treaty is in existence. Furthermore, as there is no guarantee of a refund of tax in the home country, the net result is that foreign investors will be penalised for investing in Australian companies.

The DCT regime could provide an incentive for Australian companies to move their headquarters offshore as the tax would not apply to international companies operating in Australia. The justification for such a move is the result of DCT impacting on a company by reducing after tax profits which would result in reduced dividend payments. With a lower dividend yield share prices would be driven down, thus resulting in obvious economic consequences.

Internationally the DCT would tend to go against established international trends as it discourages offshore acquisitions and rewards Australian shareholders at the expense of non resident shareholders. Proposals that are similar in nature to those proposed by the paper have been debated in other parts of the world but have been dismissed as being disadvantageous to the county’s resident companies. The UK last year scrapped proposals equivalent to those discussed in the *Review*.

### 7.2.3 Impact of DCT on moves offshore and foreign investors

#### 7.2.3.1 Offshore investors

Principal objectives of the *Review* are to encourage foreign capital investment and discourage Australian residents moving offshore These objectives would not be met under a DCT. The most significant impact of DCT is that it will trigger a charge to the profit and loss and is, therefore, particularly unpalatable. Except for distribution to non residents the DCT proposal produces a result for shareholders similar to the current system. However, tax payments are accelerated to the extent to which tax preferred Australian sourced income is distributed to shareholders.

Under the proposals Australian companies could be forced to move offshore because DCT would not apply to international companies operating in Australia.

Australian multi-nationals that have expansion opportunities in Australia will be double taxed as profits from offshore operations which have been fully taxed overseas are taxed again upon distribution to shareholders in Australia.

The *Review* fails to address the following issues in relation to Australian multinationals:

1. The high levels of withholding tax paid by Australian entities in foreign jurisdictions under the double tax treaties.

2. The inability of Australian shareholders to claim foreign tax credits in respect of withholding and underlying tax paid in foreign jurisdictions where income received is exempt from Australian tax, thus, resulting in an additional layer of costs for Australian entities.

The consequence is that Australian multinationals would continue to operate at a competitive disadvantage to foreign multinationals.

#### 7.2.3.2 Foreign Investors

Franked dividends paid to non residents are currently exempt from withholding tax. Dividends paid out of untaxed profits termed tax preferred income to non residents are unfranked dividends which are currently subject to a withholding tax of 30% or 15% where a double tax agreement is in place. Under the proposed DCT system, however, non residents who presently enjoy a 15% final withholding tax will be subjected to a higher amount of Australian tax on the receipt of unfranked dividends. The DCT regime would fully frank all distributions at the current corporate tax rate of 36%. Even if the rate should reduce to 30% this still represents an increase in 15% on the distribution of unfranked dividends paid to non residents in countries with double tax agreements with Australia. This proposal would result in discouraging foreign investment in this country and be counterproductive to the governments stated aim of ensuring that Australia remains competitive.

To alleviate this negative impact upon non-resident investors the paper suggests two options. The first option proposes that fully franked dividends are made exempt from withholding tax. As all dividends will effectively be fully franked under a DCT regime it is noted that this would limit the level of Australian tax on income distribution to non-residents to the company tax rate. The Report acknowledges, however, that this option would not relieve the additional tax burden imposed on non-resident investors.

In addition, the adoption of a DCT regime may give rise to the possibility that the tax may not be creditable in the non-resident investor's home country or, if the DCT is viewed as a withholding type tax, to a possible breach or Australia's treaties which generally impose a 15% limitation to dividend withholding tax.

The second option involves limiting the level of Australian tax on distributions to non-residents by instituting a mechanism which involves refunding part of the entity tax to non-resident portfolio investors. The relief is actually provided at the entity level while retaining the non-resident dividend withholding tax, thereby restoring the creditability of the tax to the non-resident investors home country. By providing the benefit at the entity level, it becomes necessary to ensure that it flows through only to non-residents and not to all shareholders. This is effected by the proposed requirement that the refund be distributed as a supplementary dividend to non-resident portfolio investors.

### 7.3 PROBLEMS WILL NOT BE OVERCOME

Each option outlined in the paper has the potential to effectively impose double taxation. Various mechanisms have been proposed to counter this. The options currently considered are refunding franking account surpluses on liquidation, allowing prepayments of tax and adjusting the cost base of assets where distributions are made from unrealised gains. At this stage it is by no means certain that a solution will be adopted which does not significantly erode the true value of the credit because of excessive deferral of the compensation.

The report also proposes mechanisms addressing the potential for double taxation which may arise from implementation of the proposed tax systems. The report focuses on the potential for double taxation caused through the distribution of tax-preferred income being temporary timing differences while little regard it had to the possibility of the impact of double taxation arising from offshore tax exempt profits.

### 7.3.1 Option 1 - Impose a DCT

The rationale for reform of entity taxation, apart from aiming to reduce complexity, appears to be to minimise the potential for taxpayers to stream franked and unfranked dividends. In reality, few taxpayers would undertake dividend streaming as most are discouraged by the anti-avoidance rules relating to such arrangements. If there is a perceived problem with the streaming of dividends, then the application of the anti-avoidance provisions should be pursued.

It is doubtful that the proposed DCT system is any less complex, it has been shown internationally to be a disadvantage to resident companies and could have a considerable economic impact. With the current system of entity taxation not overly complicated and working well the change to the DCT regime is not a compelling one.

### 7.3.2 Option 2 - Apply a resident dividend withholding tax

Resident dividend withholding tax would apply on all dividends between resident entities paid out of untaxed profits. This regime, as with each of the options outlined, has the potential to effectively impose double taxation. The discussion paper states that the anti-streaming rules would still be required under this regime while it may also be necessary to re-negotiate some of Australia's double tax treaties to provide foreign investors with a foreign tax credit. Such a collection system would clearly impose further compliance burden on Australian payers who will have the obligation to withhold and may in fact be penalised if not so withheld. This is a measure clearly designed to extract more tax and to push the boundaries of existing taxing rights under the double tax agreements. Again, there is no significant case for a change to be made.

### 7.3.3 Option 3 - The taxing of unfranked inter-entity distributions

An effect of taxing inter-entity distributions is that a mechanism is required to prevent double taxation through the entity chain. One option discussed in the paper is the gross up and credit approach which would replace the existing section 46 inter-corporate dividend rebate. Distributions would be grossed up for tax paid by the distributing entity and would be taxable in the receiving entity's hands. The approach would prevent double taxation on distributions as imputation credits attached to distributions would be available to offset company tax payable by the entity, even if the credits are not needed to offset company tax payable on the distribution itself.

When comparing the existing inter-corporate dividend rebate the following example where the receiving entity has a loss exposes a significant issue. Where an entity has a carry forward loss of $100 and receives fully franked distribution of $64, the gross up and credit approach would gross up the distribution in the receiving entity's hands to $100. The result will be to reduce the loss to nil. The current rules concerning the inter-corporate dividend rebate result in receiving a fully franked distribution of $64. This amount included in the entity's income would reduce the carry forward loss to $36. Therefore, the example would indicate that there is a detrimental impact upon an entity's losses for no positive benefit in income. Particularly in the resources sector, faster utilisation of losses for no upside on the income side is not a positive outcome.

## 8. TAXATION OF FINANCIAL ARRANGEMENTS

Proposed changes to TOFA are unworkable in their present form. Financial instruments such as hedging and options are important risk management tools and have underpinned the Australian gold industry in recent years. The Chamber would strongly argue that the minerals industry should be expempted from any changes, as hedging and options in the industry are used as a risk management tool.

The Chamber's position on specific TOFA items is as follows.

### 8.1 COMMODITY DERIVATIVES

These rollovers / extensions should not be treated as realisations.

### 8.2 DEFINITION OF HEDGING

The hedging definition needs to be cast in terms of risk management rather than risk reduction, as some instruments may limit risks 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.

### 8.3 FOREIGN EXCHANGE GAINS AND LOSSES

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

### 8.4 COMMODITY LOANS AND COMMODITY-BASED LOANS

The Chamber's view is that they should not be included. If they are, it is essential they should benefit from the hedging rules.

# 9. CONSOLIDATION OF ENTITIES

## 9.1 CURRENT POSITION

Corporate groups have developed since 1985 on the basis that losses can be claimed and assets can be acquired without concern for which entity incurs the losses and which entity owns the assets. As a result current groups have evolved into structures which ensure efficient utilisation of existing carried forward losses into the future based on the current law. Business, lending and investment decisions have been made based on current loss availability.

Mining and petroleum companies especially use special purpose entities to hold different exploration or producing projects and to undertake lending on behalf of a group. A number of multinational mining and petroleum groups have structured into Australia without a single Australian holding company on the basis of loss and asset transfer transparency.

Specific anti-avoidance provisions operate to prevent cascading and duplication of losses. Although complex, the existing law is well understood.

## 9.2 REVIEW OPTIONS AND SUBMISSION

The *Review* does not give an option to taxpaying groups to continue with the current position, even for a reasonable transitional period. To lose the benefit of carried forward losses altogether or choose not to consolidate and lose the ability to transfer assets and losses is not a fair or equitable option. In fact, it is not an option. Either choice will have a substantial revenue cost to the taxpayer group.

### 9.2.1 If no election grouping continues or all losses continue.

The proposals do not provide an option which ensures the ability to utilise all available existing carried forward losses in a manner anticipated prior to consolidation.

Taxpayers should be entitled to continue under the current tax regime at their option. Alternatively, consolidation should have transitional provisions which allow the existing loss profile to continue within the consolidated group until current losses are utilised.

### 9.2.2 No requirement for Single Australian Holding Company.

The proposals would require multinational companies without a single Australian holding company to restructure prior to the introduction of consolidation. Such a restructure, whilst available under current capital gains tax rollover provisions may run into problems, for example, arising from stamp duty costs or constraints/covenants under existing debt facilities.

There should be no requirement to have one company at the head of an Australian Group as a representative of the notional single consolidated entity. The shares in more than one entity could be treated as equity in the notional consolidated entity and profit repatriation and capital payments treated accordingly.

### 9.2.3 Receipt of franked dividends must not reduce consolidated losses

Currently, corporate groups are entitled to manage their existing losses by ensuring an entity in receipt of dividends does not incur losses. This ensures the intended benefit of the dividend rebate is retained.

Consolidated groups with a pool of net losses should be able to receive fully franked dividends into the group without a requirement to offset the losses. The method of ensuring that no additional corporate tax is paid will depending on which corporate method of tax is chosen. If no change is made a dividend rebate should continue to be available.

### 9.2.4 Allocation of expenses

Currently the deductibility of expenses is determined by reference to the nature of the income to which they relate. Expenses may be non-deductible on the basis that they relate to exempt income or no income at all. Separate entity taxation allows simple determination of deductibility.

Deductibility of expenses will need to be addressed. Single entities should continue to be recognised for the purpose of identifying expense deductibility. Expenses should not be allocated on a pro-rata basis.

### 9.2.5 Stamp Duty should be abolished for all intra group transactions

Currently, stamp duty is a significant cost to transactions within a wholly owned group. Existing restructure exemptions differ across States and their application is limited.

Consistent with the consolidation concept, stamp duty should be abolished on <u>all</u> transactions within a consolidated tax group.

### 9.2.6 Capital Losses deductible against all assessable income

The worth of capital losses is currently limited as they are only deductible against capital gains. The *Review* suggests that the denial of certain unrealised or realised losses will not be an inequitable result on the basis that the losses will ultimately be deductible on disposal of the shares in the loss entity. However, it does not recognise the different treatment of capital and revenue losses in these circumstances.

If certain realised or unrealised losses are to be denied to ensure single deductions for all economic losses, capital losses should be made deductible against all assessable income.

# 10. ANTI AVOIDANCE PROVISIONS

The Chamber is concerned at an apparent view within the *Review* that current rules relating to the minerals industry are being exploited and that this is driving some of the recommendations. In the Chamber's view, such a concern is without foundation.

## 10.1 CURRENT POSITION

Special rules currently enable resource companies to carry forward excess mining deductions. Excess deductions include expenditures incurred during the exploration and mine development stages of a mining project. Such expenditures would typically consist of geological mapping, surveys, and drilling costs incurred in the exploration stage, and site preparation costs at the development stage.

The *Review* appears to consider that the rules on excess deductions are open to exploitation. This view results from the fact that unlike the company and trust loss provisions, there are no safeguarding measures in relation to continuity of ownership and income injection (same business test). This could allow the trafficking of excess deductions of the type that the company and trust loss provisions seek to prevent for losses generally.

The minerals industry has considered the points raised by the *Review*. However, the industry believes that the rules are not open to exploitation. The reasoning behind the initial introduction of these rules must be considered.

## 10.2 BACKGROUND TO MINING LEGISLATION

The mining legislation contained in Division 10 of the Income Tax assessment Act 1936 ("the 1936 Act") provided for the preservation of tax deductions for exploration and prospecting costs incurred in the development of resource projects in Australia when a mining or exploration project was sold. This policy was adopted by Parliament to recognise the high risks associated with the development of resource projects and to encourage exploration and development activity in Australia.

The Chamber believes that the excess deduction rules are not being exploited. If this were the case the wide sweeping anti-avoidance provisions (Part IVA) would have been applied to eliminate the proposed exploitation of the current rules. Even if it can be argued that the current system is being inappropriately used by the industry, it is by no means clear that this should drive the reform proposals as there alternative measures to deal with anti avoidance such as Part IVA which should certainly be examined first.

# 11. FRINGE BENEFITS TAX

The *Review* proposes a number of changes to the fringe benefits tax (FBT) system. Proposals to exempt car parking and meal entertainment from FBT are supported. The current rules relating to meals are quite complex and require detailed review of the expenditure to determine whether it is subject to FBT and tax deductible, non tax deductible and not subject to FBT or tax deductible and not subject to FBT. The position will vary depending on the circumstances and the people involved. In relation to car parking, for instance, to determine the correct FBT liability it is necessary to maintain on a daily basis records of the usage of car parking bays provided to employees. This can be quite onerous. The exemption of car parking and meal entertainment from FBT will result in administrative cost savings to business.

The proposal to exempt miming industry employers from FBT on remote area housing is strongly supported. The industry has for many years argued that the provision of housing to employees in remote areas is not a benefit intended to substitute cash salary paid to employees but a necessity to attracting and retaining a skilled workforce. In many cases employers have had no option but to build and provide housing and associated infrastructure themselves due to the lack of it in remote areas. In addition remote areas are already at a cost disadvantage in providing basic amenities without the additional impost of FBT.

A recent study titled " The Impact of the Fringe Benefits Tax on the Pilbara Region of Western Australia" demonstrated that FBT has had a significant negative impact on the development of the Pilbara since the introduction of the tax in 1986. Gross output, employment, investment and consumption expenditure have all been adversely impacted.

The tax also places Australian miners at a cost disadvantage compared to many of their overseas competitors who do not impose an FBT. This is particularly relevant at a time of depressed commodity prices.

## 12. CONCLUSION

Australia's taxation system requires reform. In its current form it is complicated, inefficient and distortionary. At a time of intense international competition and low cyclical commodity prices, the nation's taxation system impedes the minerals industry's international competitiveness. The industry has in the past and will continue to support taxation reform as a means of improving the industry and nation's international competitiveness. However, this does not mean all proposals for reform must be accepted uncritically.

High among the various factors in assessing reform proposals must be the extent to which they aid or hinder the industry's international competitiveness. While some elements of the *Review* are positive and would be supported by the industry, there remains great concern over proposals relating to entity taxation and industry deductions such as accelerated depreciation. Introduction of the proposed measures in these areas would have a severe and negative impact on the minerals industry and ultimately the Australian economy. While a 30% corporate tax rate would be an advantage to some industries, it is by no means clear that it should come at the cost of taxation treatment which underpins the minerals industry. The Chamber strongly urges that the Commonwealth consider alternative means of introducing a lower corporate tax rate if it considers it is warranted.