

The Resource Super Profits Tax

a fair return to the nation

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Executive summary

The Australian Government will introduce a Resource Super Profits Tax (RSPT), as recommended by the *Australia's Future Tax System* review. The RSPT will ensure all Australians share in the returns from our non-renewable resources. The RSPT will commence on 1 July 2012.

The Australian community owns the mineral and petroleum resources located in Australia and the Australian exclusive economic zone.

The *Australia's Future Tax System* review found that the current system of resource use charges and taxation could be substantially improved.

Current taxes and charges on our non-renewable resources could serve the Australian community better. They provide a relatively small return to the community when prices rise and do not recognise the different investment levels required for different projects.

The Australian Government's RSPT will ensure the community receives a more consistent share in the returns from our non-renewable resources. It will also provide a more efficient mechanism for collecting a share of these returns and remove impediments to mining investment and production.

The RSPT is world class. It sets a new benchmark for resource taxation. The RSPT will be a relatively neutral tax, with minimal distortions to investment and production decisions.

The RSPT will be payable at a rate of 40 per cent on the realised value of resource deposits, measured as the difference between the revenues generated from resource extraction and associated costs.

The RSPT will be a deductible expense for income tax purposes, so that after income tax, the effective rate of RSPT will be less than 40 per cent.

Unlike company income tax, under the RSPT the Australian Government will guarantee to credit firms for the tax value of their extraction and exploration costs, and will even refund that credit when a project winds up.

Where there are delays in receiving a credit for exploration or production costs (for example, through depreciation or loss carry forward arrangements) entities will be compensated by an RSPT allowance.

The Australian Government will provide resource entities with a refundable credit for state royalties paid. The credit will be available at least up to the amount of royalties imposed at the time of announcement, including scheduled increases. Refunding royalties allows the States to continue to collect a stable stream of revenue from royalties, while removing the effects they have on investment and production.

The net effect of applying the RSPT and refunding royalties will be that highly profitable projects will pay additional tax, and less profitable projects will pay less tax than at present.

The RSPT will not discourage investment. The RSPT will only tax super profits. In fact, 60 per cent of the super profits will still be available to investors.

As commodity prices vary, the RSPT will ensure the community receives a constant share of super profits. This will be less pro-cyclical for investors than under the current tax and royalty regime, where the effective tax rate rises when commodity prices fall and vice versa.

Existing resource projects will be transitioned into the new scheme, with the exception of Petroleum Resource Rent Tax projects for which opt-in arrangements will be developed in consultation with industry.

The transitional arrangements will provide a tax credit in recognition of previous investment made or committed to before the introduction of the RSPT. To reduce the impact of the RSPT on cash flows in the early years of the scheme, the Australian Government will also allow previous investment to be depreciated at accelerated rates. These arrangements will provide a 'soft start' that substantially reduces RSPT liabilities in the early years of the scheme.

To ensure investment decisions are not distorted in the period before the RSPT commences, capital investment (investment and exploration) undertaken between announcement and commencement will be treated the same as post-commencement investment.

The RSPT will fund a package of measures to promote growth in the resource sector and across the entire economy, as well as to ensure we save some of the benefits from our resources.

The resource sector will be supported by new infrastructure funding to address the potential for capacity constraints to emerge. A resource exploration rebate will also help small exploration companies search for new deposits.

The broader economy will benefit from a phased reduction in the company tax cut. Small businesses will benefit from an early start on the company tax cut and simplification of depreciation arrangements.

The package will also benefit the retirement savings of working Australians. The superannuation guarantee will be gradually increased, new superannuation concessions will be provided for lower income earners and contributions caps for people aged over 50 will be increased to allow them to make catch-up savings.

The measures within the Government's tax reform package will be implemented in a fiscally responsible way, and will be broadly revenue-neutral. Therefore, the package as a whole is contingent on implementation of the RSPT.

The Australian Government will consult extensively with stakeholders on technical design issues during the period before the scheme commences. This process will start with an initial round of consultations over coming weeks that will focus on how to finalise transitional arrangements for existing projects and other key elements of the architecture of the tax.

**PART A: INFORMATION SOURCES AND
CONSULTATION PROCESSES**

1 Stakeholder information and consultation

The Australian Government will provide stakeholders in the resource sector with information in the lead up to commencement of the Resource Super Profits Tax (RSPT) in order to minimise uncertainty and any consequent impact on new investment and production decisions.

There will be a period in excess of two years between announcement and commencement of the scheme, which will allow for extensive consultation on the details of the system and ensure technical design is settled before commencement.

1.1 Information documents

The Australian Government will release a series of information documents before the commencement of the RSPT on 1 July 2012. Subsequent to the Announcement Paper (this paper), the key documents will be:

- an Issues Paper;
- a Final Design Paper; and
- Exposure Draft Legislation and a Draft Explanatory Memorandum.

Stakeholders can also find further information on the RSPT on the Treasury website www.treasury.gov.au.

1.2 Phases of consultation

Phase 1: Preliminary consultation, based on this Announcement Paper

A Resource Tax Consultation Panel (RTCP) will be established for high level targeted engagement with key stakeholders. The RTCP will hold a short and focussed initial round of consultations immediately after announcement. The scope of this initial consultation will encompass transitional arrangements and major outstanding design parameters, as well as identifying significant industry issues. In order to increase certainty about application of the RSPT, it is envisaged that the Australian Government will make a statement about the outcomes of the initial consultation process.

Treasury will maintain an interested parties list for circulation of future correspondence with respect to the development of the RSPT. To register as an interested party, please send an email to resourcetax@treasury.gov.au.

In addition to the above, Treasury will engage with other stakeholders via a range of mechanisms. These preliminary consultations are aimed at identifying issues and possible impacts of the policy that will need to be considered in implementing the RSPT. Treasury will also seek detailed advice on individual firm and project impacts to inform the Issues Paper.

Phase 2: Further extensive consultation

Treasury will publish an Issues Paper, which expands on this Announcement Paper and clarifies technical design elements. In July 2010, Treasury will seek stakeholder submissions in response to the Issues Paper. RTCP meetings will be held with stakeholders to discuss their reactions and concerns.

The outcomes of these consultations will be used to inform the Final Design Paper.

Phase 3: Final Design Paper and Exposure Draft Legislation

A Final Design Paper will be published in late 2010 and be made available for comment. This will set out, in detail, the design of the RSPT and form the basis for the legislation.

The Exposure Draft Legislation and the accompanying Draft Explanatory Memorandum will be developed based on the Final design paper. Consultation at this stage will focus on ensuring that the legislation is consistent with the decisions in the final design paper.

1.3 Timeline to commencement

Date	Consultation	Details
May 2010	Phase 1 Announcement and Announcement paper	Announcement paper (this paper) released Formation of the Resource Tax Consultation Panel
May-June 2010	Preliminary consultation	Consultations on the fundamental architecture of the RSPT and transitional arrangements for existing projects
July 2010	Phase 2 Extensive consultation and Issues Paper	Expands on the Announcement Paper setting out further technical design issues Seek submissions from stakeholders Opportunity to provide comment on policy design
Late 2010	Phase 3 Final Design Paper	Outlines the detailed design of the RSPT Provides certainty to key stakeholders regarding the technical design of the RSPT
Mid 2011	Exposure Draft Legislation	Seek comments from stakeholders on implementation details and whether legislation is consistent with the Final Design Paper
Late 2011	Legislation introduced into Parliament	
1 July 2012	Commencement of the RSPT	

1.4 Terms of Reference of Resource Tax Consultation Panel

Purpose

The RTCP will consult with industry and other stakeholders and advise the Australian Government on issues (and their implications) that arise from the design of the RSPT.

The RTCP will consult on the design detail of the regime including transitional arrangements for existing operations. The Panel will not be consulting on the overall merits of the RSPT or the key parameters determined by the Australian Government. Rather, the purpose of the consultation is to identify any issues in the implementation of the RSPT that could undermine the Australian Government's policy intentions.

The RTCP will report to the Australian Government on the outcomes of each round of consultations. Those reports will identify the key issues that have been raised, assess the significance of those issues, and advise the Government on the implications of these issues for the design of the system.

The RTCP will have regard to the financial integrity of the Government's tax reform package such that any proposed changes which detract from RSPT revenue may have implications for the affordability of other measures.

Process

The RTCP will conduct several rounds of consultation:

- The initial round will be with key industry bodies and large resource firms and will focus primarily on discussing transitional arrangements and major outstanding design parameters, as well as identifying significant industry issues. This consultation round will conclude within three weeks after announcement.
- The second consultation round will build on the initial consultation activity with a wider focus on stakeholder issues, including; taxing point, resource coverage, deductible expenditure and depreciation rates (these arrangements are outlined in Section 5). The RTCP will conduct meetings with peak industry bodies and large resource firms that will feed into the formal Issues Paper and submission process. These consultations will allow for the preparation of a Final Consultation Paper (Issues Paper), to be released in July 2010.
- The RTCP will be involved in a third consultation round involving a public submission process in response to the Issues Paper to allow positions on the design details to be presented and argued. This consultation will provide a further input into the final design of the regime to be incorporated in legislation. These consultations will allow for the preparation of the Final Design Paper, which will be released in late 2010.
- The RTCP may be required to assist Treasury in a fourth and final round of consultation after the Exposure Draft Legislation has been released to ensure the legislation is consistent with the principles of the Final Design Paper. It is anticipated that this round of consultation would occur in mid-2011.

**PART B: THE CASE FOR CHANGE — IMPROVING RESOURCE
TAX ARRANGEMENTS**

2 Introduction

Australia's substantial endowments of non-renewable resources should be of great benefit to all Australians. But Australia can do better than the current taxes and royalties on non-renewable resources. Current arrangements provide an inadequate return to the community and do not recognise the cost of resource investment and production, which can be particularly important during periods of low resource prices. The present system could respond better to the boom-bust cycle in the resource sector. A large share of the Australian economy is devoted to the resource sector so it is important to get these parts of the resource system right.

The Australian Government's Resource Super Profits Tax (RSPT) will ensure a more consistent share for all Australians in the returns from our non-renewable resources. It will provide a more efficient mechanism for collecting a share of the returns from our non-renewable resources, removing impediments to mining investment and production.

The Australian Government has accepted the recommendations from the *Australia's Future Tax System* review to introduce a tax on resource rents or 'super profits' earned by entities from the exploitation of Australia's natural non-renewable resources.

The Government will introduce a new resource tax, called the Resource Super Profits Tax (or RSPT).

The RSPT will provide the Australian community with a share of the income derived from the extraction and sale of its valuable non-renewable resources. It will improve on the current method of resource charging, and encourage investment and production activity in the resource sector.

Getting resource taxation arrangements right will have significant benefits for Australia. In particular, getting the resource tax arrangements right will improve the generation and distribution of income for all Australians. Large endowments of non-renewable resources provide Australians with a greater opportunity to raise a given amount of government revenue through more efficient taxes, and to reduce the reliance on distorting taxes.

Revenue from the RSPT will provide opportunities for broader economic reform focused on improving economic performance, productivity and growth in national income. This is particularly important given the demographic challenges Australia faces with an ageing population.

2.1 Ensuring all Australians share in the returns from our non-renewable resources

Australia has large endowments of non-renewable resources, including the world's largest economically demonstrated reserves of brown coal, lead, mineral sands (rutile and zircon), nickel, silver, uranium and zinc; and the second largest reserves of bauxite, copper, gold and iron ore (Geoscience Australia 2009). Australia's proven oil reserves are the 26th largest in the world. Australia's natural gas reserves are the 14th largest in the world under current production rates, and could continue to be exploited for the next 65 years (BP 2009).

With sustained growth of China and India, demand and prices for Australia's non-renewable resources are likely to remain strong.

Given the size of Australia’s non-renewable resource stock and expected continued strength in commodity prices, the imperative for the community to share properly in the returns from the sale of its resources has become more acute.

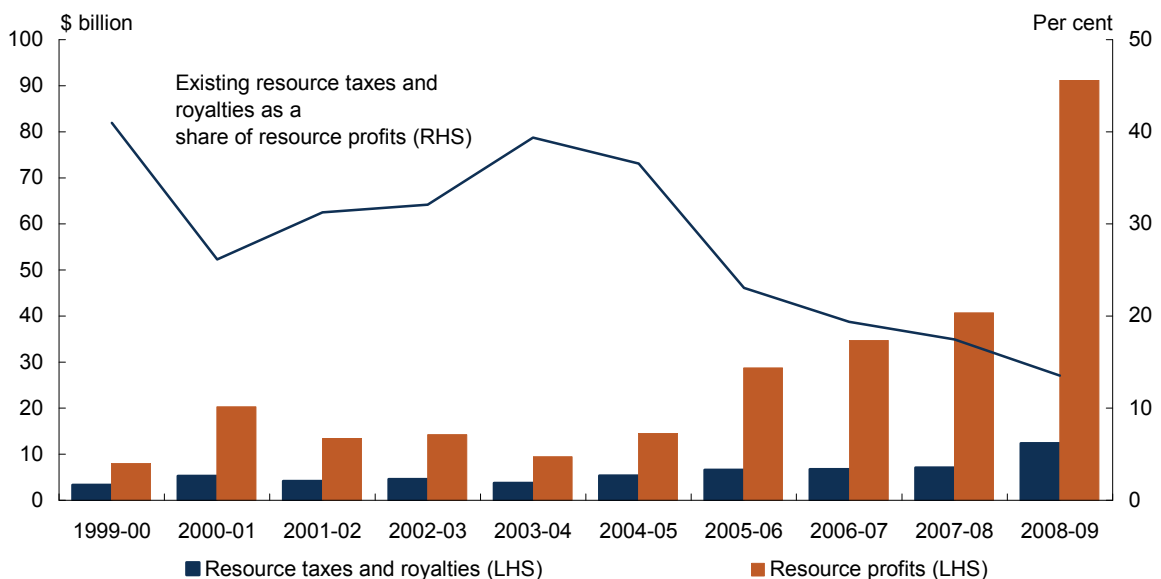
The Australian community can do better than the current structure of taxes and charges on non-renewable resources.

In Australia, governments have allowed entities to extract non-renewable resources in return for a charge, typically per unit of production or percentage of price, regardless of actual production costs. These charges have not kept pace with the increased value of Australia’s non-renewable resources.

Over the recent period of rising resource prices the community’s share in the increased value of its deposits, received through existing resource taxes and royalties, has been declining (see Figure 2.1). The effective resource charge (charges as a percentage of super profits earned) has more than halved from an average of around 34 per cent over the first half of this decade to less than 14 per cent in 2008-09. Existing resource taxes and royalties have only delivered a small share of the increased value of resource deposits. Resource profits were over \$80 billion higher in 2008-09 than in 1999-00, but governments only collected an additional \$9 billion through resource charges.

The current charging arrangements also do not recognise the costs of investment and production that are associated with resource projects. This can be an important issue during periods of low commodity prices.

Figure 2.1: Resource tax and royalties as a share of resource profits (pre-tax)



Source: Treasury estimates.

Note: Estimates of resource taxes and royalties exclude income tax.

The Government will reform the taxation of Australia’s non-renewable resources in line with the recommendations of the *Australia’s Future Tax System* review. The RSPT will apply to all of Australia’s non-renewable resources on 1 July 2012, with the exception of projects currently subject to the Petroleum Resource Rent Tax, for which opt-in arrangements will be developed in consultation with industry. Resource entities will receive a refundable credit for royalties paid, at least up to the amount of state royalties imposed at the time of announcement (including scheduled increases).

Crediting royalties against the RSPT will remove many of the existing tax impediments to mining investment. Resource projects that currently pay royalties and which do not earn sufficient profits to

be net payers of the RSPT will have an incentive to expand. Prospective projects that are expected to yield low resource profits may pay less under the RSPT than under royalties, and so the disincentive to invest in some new projects will be removed.

Box 2.1: Have other countries introduced taxes on resource super profits?

The ongoing significance of Australia's non-renewable resources to the community and the economy provides a strong argument in its own right for introducing the RSPT. It will enhance the performance of the resource sector and, at the same time, deliver a greater return to the community from the extraction and sale of its non-renewable resources.

Comparing resource taxation arrangements across countries is not straightforward. Meaningful comparisons should be based on effective 'all in' rates (rates that include income tax as well as resource taxes and royalties). In addition, effective tax rates will also depend on project profitability.

But what do other countries do? Have other countries introduced profits (or resource rent) based taxes?

IMF studies show that where countries have specific mineral taxation arrangements, these arrangements are usually royalties set at around 5 per cent of gross revenue. These are similar to the existing State and Territory based royalty rates in Australia. More recently, developed countries, with significant resource endowments (such as Canada, Norway and the United States) have moved towards tax systems based on resource rents or super profits.

Most provinces in Canada, as well as the state of Nevada in the United States, have adopted profit based charging for extracting resources. These arrangements are generally based on an income tax model, but with various allowances and deductions that begin to approximate a tax on resource super profits. The taxes under these arrangements are generally less than 20 per cent of profits. However, they are often combined with ad valorem royalties and company income tax at differing rates.

Norway's petroleum tax system approximates a super profit based tax. Though based on the company income tax system, it utilises an uplift on expenditure to exempt the normal return and reimburses the tax value of exploration expenditure for companies in a loss position. Norway imposes a total tax rate on resource super profits of 78 per cent, consisting of a 50 per cent super profit based tax rate and company income tax of 28 per cent, with no deduction at the company tax level for payments of the super profit based tax.

The fact that other OECD countries with significant resource endowments have moved towards profit based taxation sets a benchmark for Australia.

Table 2.1: International resource arrangements

	Country	Resource type	Tax treatment
Africa	Botswana	Metals	Ad valorem on gross market value
		Minerals	Ad valorem on gross market value
		Coal	Ad valorem on gross market value
	South Africa	Copper	Negotiated: percent of market value or net profit
Gold		Negotiated: sliding scale formula	
Minerals and other metals		Negotiated: percent of market value or net profit	
Coal		Negotiated: percent of market value or net profit	
Petroleum		Royalties, profit based tax, or state equity	
Nigeria	Petroleum	Government ownership	
Asia	China	Aluminum, iron and zinc	Ad valorem and per unit royalties
		Copper and gold	Ad valorem
		Limestone	Ad valorem and per unit royalties
		Coal	Ad valorem and per unit royalties
India	Metals	Ad valorem	
	Minerals	Per unit charge for most minerals	
	Iron ore	Per unit charge	
	Coal	Per unit charge	
	Petroleum	Production sharing contract/profits	
South America	Argentina	Metals	Ad valorem on sales less deductions
		Most minerals	Ad valorem on sales less deductions
		Petroleum	Royalties
	Brazil	Iron	Ad valorem on sales less taxes, transportation and insurance
		Metals	Ad valorem on sales less taxes, transportation and insurance
		Minerals	Ad valorem on sales less taxes, transportation and insurance
Coal		Ad valorem on sales less taxes, transportation and insurance	
Petroleum	Royalty		
Chile	Copper	Ad valorem	
Mexico	Mining and petroleum	No charge	
North America	Canada (Ontario)	Iron ore	Percent of taxable profits
		Metals	Percent of taxable profits
		Minerals	Percent of taxable profits
		Coal	Percent of taxable profits
Canada (Saskatchewan)	Metals	Percent of net profit; increases at threshold level	
	Minerals	Percent of net profit; increases at threshold level	
US (Arizona)	Coal and uranium	Royalty on sales revenue	
	Metals	Ad valorem on market price	
US (Nevada)	Minerals	Ad valorem on market price: rate set by commissioner	
	Coal	Ad valorem on market price	
	Metals	Net super profit above threshold	
Europe	Denmark	Minerals	Net super profit above threshold
		Coal	Net super profit above threshold
Norway	Petroleum	Profit based tax	
	Petroleum	Profit based tax	

2.2 Promoting investment, production and employment opportunities in the resource sector

The RSPT will encourage greater investment and employment in the resource sector, as it will be more efficient than current arrangements.

Resource super profits (or resource rents) are net returns that exceed a satisfactory return to investors, from the extraction and sale of resources. Higher commodity prices are the principal mechanism that drive increases in resource super profits, as a similar cost and effort in extracting resources fetches more income.

When implemented, the RSPT will be one of the most efficient taxes levied by government. The RSPT will affect the present value of investment at risk less than royalties. This is in contrast to the current royalty arrangements which apply as soon as production commences, no matter how profitable a project might be.

Only projects generating significant super profits will pay more tax compared to current arrangements. However, highly profitable projects will still remain attractive to investors since they will continue to remain highly profitable after tax. This still leaves a significant incentive for firms to produce resources that generate super profits. Australia will also continue to remain an attractive place to invest. Australia's non-renewable resources are high quality and offer a stable business environment for long-term investment.

More resources can be developed

Some projects that are not viable under current resource tax arrangements will become viable under the RSPT because costs will be recognised. As such, the stock of economically viable Australian resources will expand. The RSPT will also provide relief to the resource sector if prices fall in the future, compared to current arrangements, as their tax liabilities will also fall.

Risks to resource companies will be reduced

Under the RSPT, the Commonwealth will guarantee to contribute 40 per cent of the investment cost (including, as a cash refund in some circumstances) of a resource project. In effect, the community will share in the costs of, and returns from, realising the value in resource deposits.

In the long term, the reforms to resource taxation will lead to more investment and jobs in the resource sector. According to independent modelling by KPMG Econtech, commissioned by the Australian Treasury, the reforms to the taxation of Australia's non-renewable resources are estimated to result in a 4.5 per cent increase in investment, a 7 per cent increase in employment and a 5.5 per cent increase in output in the resource sector in the long term. Overall, KPMG Econtech projected that resource taxation reforms could lead to an increase in GDP of around 0.3 per cent in the long run while real household consumption expenditure, which is a better measure of wellbeing, is expected to rise by around 0.2 per cent.¹

It should be noted that the modelled analysis is sensitive to assumptions used, particularly the degree of capital mobility. However, differing assumptions would only affect the size of the efficiency

1 The Australian Treasury provided the Government's policy parameters for tax reform to KPMG Econtech who then independently modelled their economic effects. KPMG Econtech was not involved in the policy development, while the modelling was independent of Treasury.

gains and not their direction. In the long run, the assumption of perfect capital mobility is likely to hold as used in the KPMG Econtech modelling.

2.3 Sharing the returns from our resources

The RSPT is an integral part of the Government's overall tax reform agenda.

The *Australia's Future Tax System* report also outlined how the structure of the tax system can affect economic growth. Recent studies show company income tax has a large adverse effect on economic growth. Taxes that are less efficient at raising revenue are levied on bases that can move or change to escape the tax. Consequently, the *Australia's Future Tax System* review recommended having a lighter tax burden on more mobile bases, such as investment — particularly in the context of continued globalisation — relative to less mobile bases, such as non-renewable resources.

Promoting investment — cutting the company tax rate

The Australian Government will use part of the revenue from the RSPT to fund a phased reduction in the company tax rate to 28 per cent. The company tax rate will be cut to 29 per cent for the 2013-14 income year and to 28 per cent from the 2014-15 income year. This change will drive economic growth.

Company tax raises the before-tax required rate of return on investment and reduces the amount of investment that companies undertake. Internationally mobile capital can be especially sensitive to tax rates. A lower company tax rate will improve incentives to invest in Australia. Increased investment in Australia will boost the capital stock available for Australians to work with. Greater capital intensity, induced by the lower company tax rate, will lead to higher labour productivity and therefore higher real wages for Australian workers, ensuring the benefits of strong resource prices are widely spread. Cutting the company tax rate will also help sectors other than the resource sector to attract investment.

This rebalancing of the taxation of the corporate sector in Australia will lead to net gains in economic performance, specifically in the amount and allocation of investment. This means higher productivity and greater long term growth, with more jobs and higher real wages.

Assisting small businesses

The Australian Government will reduce the company tax rate to 28 per cent for eligible small business companies from the 2012-13 income year. This early start to the general reduction in the company tax rate will have cash flow benefits for small business companies and enable them to reinvest more of their profits. From 2014-15 the 28 per cent company tax rate will apply to all companies.

The Government will also further simplify depreciation arrangements for small businesses. Under the new arrangements, small businesses will be immediately able to write-off assets valued at under \$5,000; and will be allowed to write-off all other assets (except buildings) in a single depreciation pool at a rate of 30 per cent.

These changes will increase the cash flow of small businesses, in addition to reducing compliance costs by removing the requirement to calculate depreciation allowances and track assets for depreciation purposes.

Investing in infrastructure

The Australian Government will use some of the proceeds of the RSPT to support States in providing the major infrastructure to improve our potential to grow the economy into the future. The total amount of the infrastructure funds will start at \$700 million in 2012-13 and will grow over time.

This fund will be used to invest in infrastructure, including that necessary to prosper from the development of Australia's natural resource wealth. The details of this fund will be settled through negotiations with the States.

Promoting superannuation savings

The Australian Government will increase retirement savings through a phased increase in the Superannuation Guarantee to 12 per cent. This will commence with a 0.25 per cent increase in 2013-14. This measure will help Australians enjoy a better lifestyle in retirement.

From 1 July 2012, the Government will provide an additional superannuation contribution of up to \$500 for workers with income less than \$37,000, by rebating the excess tax paid by low income earners on their superannuation contributions.

The Government will also allow individuals aged 50 and over with total superannuation balances below \$500,000 to make up to \$50,000 in concessional superannuation contributions. This measure will improve the equity of the existing superannuation system by targeting concessions towards those with the greatest need to build their retirement savings.

From 1 July 2013, the Government will extend the superannuation guarantee to workers who are aged between 70 and 75, to ensure they are remunerated on the same basis as their younger co-workers.

A long term reform agenda

The Australian Government recognises the magnitude of the task to reform Australia's tax transfer system. The need for tax reform is clearly far reaching and requires extensive consultation with the community. The Government recognises this and is committed to an ongoing tax reform agenda.

The Government will continue to develop its tax reform agenda over the coming years, consistent with its fiscal strategy. It will also continue to examine the transfer system to ensure it provides the best possible support to Australians in need, as well as ensuring that people who can work have the incentives to do so.

2.4 Fiscally responsible tax reform

The Government's tax reform agenda is consistent with the Government's medium-term fiscal strategy, including keeping the tax to GDP ratio on average below the 2007-08 level of 23.6 per cent.

The RSPT, along with the cut in the company tax rate and the small business arrangements, are part of the Government's integrated tax reform package. The delivery of all elements of the reform package will be contingent on the implementation of the RSPT.

Table 2.2: Budgetary impacts of Government's tax reform agenda (\$ million)^(a)

	2010-11	2011-12	2012-13	2013-14
Company tax cut	-	-	-300	-2,000
Small business instant write-off and simplified depreciation	-	-	-	-1,030
Head start on a lower company tax rate for small business	-	-50	-300	-200
State Infrastructure Fund	-	-	-700	-735
12 per cent superannuation guarantee	-	-	-	-240
Extend the superannuation guarantee up to age 75	-	-	-	15
Refund of superannuation contributions tax for low income earners	-	-	-	-830
\$50,000 concessional cap for super balances under \$500,000	-	-	-545	-785
Resource Exploration Rebate	-	-	-520	-600
Resource Super Profits Tax	-	-	3,000	9,000
Total	-	-50	635	2,595

(a) Australian Taxation Office administration costs will be reported in the 2010-11 Budget.

3 Why have a Resource Super Profits Tax?

Current royalty schemes affect mining investment and production decisions. The Resource Super Profits Tax (RSPT), as a tax on the super profits associated with the extraction of non-renewable resources, will have minimum distorting effects on investment and production decisions in the resource sector, enhancing the economic gains to Australians from extracting resources.

3.1 The community has a right to charge for extraction of resources

In Australia, the whole community owns non-renewable resources (with the exception of a few deposits that are directly owned by private interests or indigenous communities).

The community, being the owner, has a right to charge for the extraction of its valuable resources. If the community undercharges for the use of their non-renewable resources, it is akin to under-pricing the sale of a public asset.

3.2 Extraction of resources ‘releases’ resource profits

The value of a non-renewable resource is equal to the expected receipts from the sale of the resource less any expected exploration and production costs.

Non-renewable resources generate what is often referred to as resource rents (or super profits). Resource rents arise because of the scarcity of non-renewable resources, which allows them to earn more in revenue than it costs to extract them, including the normal return on invested capital.

$$\text{Resource super profits} = \text{Receipts} - \text{Expenditure} = \text{Realised value of deposits}$$

3.3 The current method of charging is based on royalties

State and Territory governments exercise the right, on behalf of the community, to charge for the extraction of non-renewable resources. These charges take the form of royalties.

The Australian Government also imposes a charge with respect to oil and gas extraction from offshore reserves through the Petroleum Resource Rent Tax (PRRT). The PRRT is different to royalties, and is closer in character to the RSPT.

3.4 Royalties tax production rather than profit

Royalties affect investment and production decisions. This can lower the return to the community collected through its resource charges. Royalties are levied irrespective of the cost of exploration and production. This may mean some of the more risky deposits, or those that are more costly to develop, are not pursued. It may also lead to the early closure of resource projects. This affects how

much of Australia’s resources are utilised, and the return available to be collected through resource charges.

Royalties are a ‘fixed’ charge ...

Royalties are typically charged on a volume basis (a specific rate per quantity of resource extracted) or as a proportion of the revenue received (an ad valorem rate).

... but the returns from extraction vary across deposits and time

Royalties do not recognise variations in profit across deposits and over time. This is because royalties do not account for differences in extraction costs or prices across deposits or over time (see Box 3.1).

The resource rents (or super profits) that can be realised from a project will vary according to the characteristics of the deposit — the nature and grade of the resource they contain, and the ease of extraction — or, simply, according to their value. For example, two deposits could yield the same amount and grade of ore, and therefore the same revenue. However, if it is more costly to extract the ore from one deposit, the value of that deposit and the super profits that can be derived from it will be lower.

Box 3.1: An illustration of the varying burden of royalties

Royalties impose a burden that varies, depending on the value of deposits — whether they are high or low profit and whether the resource sector is in the up or down phase of a cycle.

Royalties are related to the volume of the material extracted or to the revenue received.

To illustrate the variable burden of royalties, take the example of three projects, all involved in the extraction of the same mineral. In this example, differences in the value of the deposits are determined by extraction costs. Three different price scenarios are examined. An ad valorem royalty of 5 per cent (that is, 5 per cent of revenue) is considered in all scenarios.

Table 3.1: Royalties as a percentage of resource profits^(a)

Project	Extraction costs <i>\$per tonne</i>	Strong demand <i>\$20 per tonne</i>	Average demand <i>\$15 per tonne</i>	Low demand <i>\$10 per tonne</i>
High profit	\$4	6 per cent	7 per cent	8 per cent
Average profit	\$6	7 per cent	8 per cent	13 per cent
Low profit	\$8	8 per cent	11 per cent	25 per cent

(a) Percentage of the realised value in a year (revenue received less costs of extraction).

Table 3.1 shows how the burden of royalties is greater for the low-profit deposit. The burden for all deposits increases when prices weaken.

Taxing production can discourage worthwhile investment and production

Taxing production rather than profit changes the relative returns that resource entities can earn across project options. Imposing a proportionally higher burden on low-profit deposits can increase the likelihood that some projects that are more risky or less profitable, but nevertheless worthwhile, will be rejected. This comes at the cost of relatively marginal project options, which would otherwise be viable.

Reducing investment in worthwhile projects means the community does not make the most of the value inherent in its resource deposits.

Taxing production can also affect production decisions on projects that are underway. Taxing production imposes a higher burden as returns fall, as arises when prices fall, or when costs rise (such as when projects reach a mature stage). This can increase the possibility of rendering a project unviable and can therefore lead to the premature closure of otherwise viable resource projects.

Royalties provide stable revenue for the States

Royalties provide the States with a relatively stable revenue base. This is in contrast to a profit based system, which would yield a more volatile revenue stream over the course of the commodity price cycle, albeit at a constant tax rate. Royalties also deliver an earlier revenue stream in a project's life than a profit based tax.

The more stable and earlier revenue stream from royalties allows the States to fund necessary infrastructure investment for particular projects in a relatively straightforward way.

The Government's proposed reforms to resource taxation will allow the States to continue to collect a stable stream of royalties, thus meeting their resource tax objectives, but remove the effects these royalties have on investment and production.

3.5 A tax on super profits will do better

The Australian Government will introduce the RSPT on 1 July 2012, with a 'soft start'. The RSPT will increase the community's share in the value realised from resource deposits.

As the scheme 'matures', the RSPT will capture a stable share of the increases, and decreases, in resource profits as they occur. This is because the RSPT relates the community's resource charge to the value of each resource deposit. The RSPT only taxes super profits.

By only taxing super profits, the RSPT will not alter the pattern of returns to resource companies. These returns form the basis upon which they assess investment options and make production decisions. The RSPT will therefore not lead to a bias against investment in otherwise viable projects or the premature closure of some projects.

3.6 A properly structured Resource Super Profits Tax will bring widespread gains

A tax structured on super profits, rather than systems of royalty charges, will minimise the current adverse effects that resource charging has on investment and production decisions, and provide a clear and stable means for the community to receive its share of the value of its non-renewable resource deposits.

Impact on investment

The switch to profit taxation under the RSPT is likely to positively impact on the amount and allocation of investment in the resource sector through its impact on returns. These effects are likely to be different in the short and long term as markets adjust. In particular, much of the expansion in the resource sector will only occur as capital and labour constraints are reduced over time.

First, the number of projects meeting or surpassing investment hurdle rates of return in the resource sector will increase compared to current royalty arrangements.

Second, the RSPT rate of 40 per cent still leaves investors the opportunity to capture profits at a rate of 60 per cent of the value of deposits that are high quality and high volume by international standards. Sixty per cent of the super profits will still be attractive to investors given that only 60 per cent of their investment is at risk.

Furthermore, the profits are location-specific — indeed, the profits pertain to resources in specific deposits in specific locations — and comparable sources of super profit are not readily available in other industries in Australia or, with the same conditions favourable to long term investment, in the resource sector in other countries.

Box 3.2: But won't moving to a new system create sovereign risk?

Sovereign risk is the risk that the government will reduce the value of private investment by changing government policy arrangements in the future. Investors factor such potential changes into their investment decisions.

Going forward, the RSPT is likely to lower sovereign risk as the government will capture a stable share of the value of resources under varying economic conditions in a clear and foreseen way, without the need to adjust the resource tax arrangements.

The *Australia's Future Tax System* report notes that evidence of the stability of profit based taxes is provided by Australia's PRRT and by Norway's profit like petroleum taxation system. Both of these systems have been stable over many years.

Impact on mining activity

The RSPT is not expected to adversely effect the level of mining activity in the medium term, while it is likely to lift activity in the long run.

Short to medium term

The RSPT will tend to extend extraction activity on lower profit deposits. Since RSPT liabilities will become very low or even fall to zero in times of weaker prices or high costs, production rates could be maintained for longer in the mature phase of projects, and projects could be kept operational for longer in lean times.

While the RSPT will potentially tax existing projects located on higher profit deposits more, the design of the tax means this is unlikely to lead to adverse production effects. With the RSPT set at 40 per cent of resource super profits, there will still be substantial profits available to maintain incentives for high rates of production. Further, in lean years, the RSPT will take less.

Long term

In the long term, the RSPT is likely to make more projects viable. This is because it charges less than royalties for lower profit, and more marginal, projects. An increase in investment in projects in turn means that overall activity is likely to be higher than under existing arrangements.

Variations in commodities prices will remain the main influence on activity over time, but less so than now.

PART C: THE RESOURCE SUPER PROFITS TAX EXPLAINED

4 The Resource Super Profits Tax

The idea of taxing super profits on resource projects is not new. It has long been discussed in tax policy literature and has been advocated many times as a basis for policy reform. Some elements of the taxation of resource super profits are evident in overseas schemes and in the Petroleum Resource Rent Tax (PRRT) applied to offshore oil and gas projects in Australia since 1986.

The Australian Government's Resource Super Profits Tax (RSPT) scheme is different. It will be world leading, being a form of resource super profit tax that has relatively few distortions.

4.1 The Resource Super Profits Tax

It has long been recognised by tax policy specialists that a tax will not impact on investment decisions if it falls on the net cash flows, since any investment behaviour that maximises the present value of cash flows after tax will also maximise the present value of before-tax cash flows. This type of tax is often referred to as a Brown tax (after American economist Carey Brown).

While a Brown tax is often seen as ideal for taxing resource profits, one significant problem is that the government is required to contribute to additional investment immediately (that is, the government needs to immediately provide a rebate for all negative cash flows). This could result in significant pressure on government cash flows because such payments are not able to be foreseen by governments. This could impose stress on the government's ability to budget whenever the sector undertakes significant investment.

The Australian Government's RSPT broadly implements the Allowance for Corporate Capital system recommended in the *Australia's Future Tax System* review. The RSPT achieves the same economic outcome as a Brown tax, while providing policy stability as it allows the government to better plan for large expenses.

Under the RSPT, the Government will provide a guaranteed tax credit for all expenditure. However, instead of recognising expenditure at the time it is incurred, recognition is deferred through depreciation and loss carry forward arrangements. To ensure investors are not made worse off by this deferral, the RSPT will provide entities with an uplift allowance that compensates for the delay in accessing the credit.

Like the Brown tax, the RSPT only taxes the profits associated with the value realised from Australia's non-renewable resources. The normal return on invested capital (both domestic and foreign) is not taxed over time under the RSPT. The company tax will remain, and will tax the normal return, but the effective tax rate on the normal return will be reduced by the proposed cut in the company tax rate.

4.2 The Resource Super Profits Tax rate

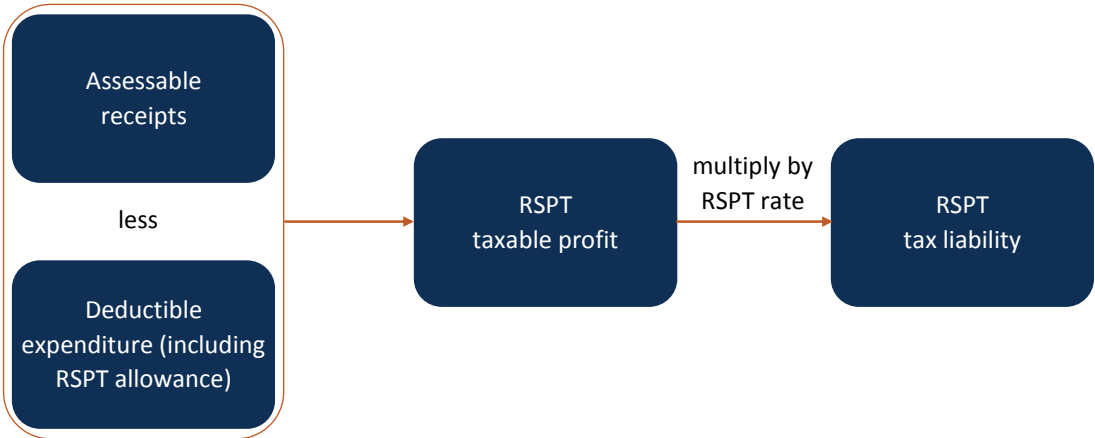
The RSPT will be charged at a rate of 40 per cent of assessable resource profits (assessable revenue less deductible expenses including an allowance for capital expenditure). This is in line with the Australia's Future Tax System recommendations. The RSPT rate provides an appropriate balance

between: ensuring the community receives a fair return for its non-renewable resources while maintaining incentives for resource firms to invest and to improve their productivity by leaving them with 60 per cent of the super profits (reflecting that only 60 per cent of their investment is at risk). It also reflects difficulties in accurately measuring resource super profits.

The effective resource charge has almost halved from an average rate of 34 per cent in the first half of this decade to less than 14 per cent in 2008-09, due to unresponsive royalty regimes. Although the statutory rate for RSPT is higher than current statutory royalty rates, this reflects the fact that RSPT is levied on net returns and will remain deductible for income tax purposes. The RSPT also applies to a more efficient tax base, which allows the RSPT to be levied at a higher rate without introducing substantial economic distortions.

Resource companies will still benefit from reductions in company income tax.

Chart 4.1: The Resource Super Profits Tax, tax calculation²



4.3 The Resource Super Profits Tax capital account

The RSPT capital account is a tax account that records undepreciated tangible capital expenditure and unutilised losses. Essentially, it keeps record of the tax credit carried forward.

The closing balance of the RSPT capital account from the previous tax year is used to calculate the RSPT allowance, which is deducted from revenue to determine the RSPT liability. The RSPT allowance compensates investors for the deferred tax credit. The allowance rate is discussed in section 4.5.

2 Losses can be carried forward to offset against future RSPT assessable receipts.

Box 4.1: Calculation of the RSPT capital account

- The closing RSPT capital account balance in a year is equal to the undepreciated value of tangible capital, plus any unutilised losses made in previous years.
- Tangible capital is depreciated annually at the applicable capital allowance rate for determining RSPT taxable profits.
- Losses can be used to offset an RSPT profit in subsequent years or transferred to other projects owned by the entity.

Chart 4.2: The Resource Super Profits Tax capital account and allowance



Box 4.2: The Resource Super Profits Tax calculation

Assessable revenue	
<i>less</i> deductible expenditure (including depreciation)	
<i>less</i> RSPT allowance	RSPT opening balance x RSPT rate
<i>less</i> any prior year project losses	
= RSPT project profit or loss	
+/- losses transferred	Project losses can be transferred
= RSPT net profit or loss	
RSPT liability = 40 per cent of RSPT net profit	If net loss, loss is carried forward
Closing RSPT capital account = undepreciated value of tangible capital, plus any unutilised losses	

Box 4.3: Is the Resource Super Profits Tax the same as the Petroleum Resource Rent Tax?

The RSPT is not the same as the current PRRT. Key differences between the RSPT and the PRRT are outlined in Table 4.1.

Table 4.1: Comparing the Resource Super Profits Tax and Petroleum Resource Rent Tax

Resource Super Profits Tax	Petroleum Resource Rent Tax
Most capital expenditure written-off over time	Capital expenditure is immediately expensed
Transferable expenditure	Limited transferability of exploration expenditure
Refundability of unutilised expenditure	No refundability of unutilised expenditure
One allowance (uplift) rate for all capital expenditure	Eight uplift rates for capital expenditure

Box 4.3: Is the Resource Super Profits Tax the same as the Petroleum Resource Rent Tax? (continued)

Like the PRRT, the RSPT being profits based, is a superior regime to royalty arrangements.

To provide certainty for projects already covered by the PRRT the Australian Government will consult with industry on arrangements that would allow an irrevocable election into the RSPT.

Projects within the scope of the PRRT will remain in the PRRT unless they elect to transfer into the RSPT.

The Government anticipates that, over time, many projects within the scope of the PRRT will migrate to the RSPT.

4.4 The treatment of Resource Super Profits Tax losses

RSPT losses will be carried forward with interest to preserve their real value. An RSPT loss occurs when project costs, including the RSPT allowance, are greater than the project's receipts in a given year.

While losses may not be immediately refunded, the government will guarantee to provide a tax credit for unutilised losses even if the entity goes out of business.

Qualifying expenditure incurred within a year can be transferred from the loss making project to other profitable projects within the entity or company group. Where there are no other profitable projects, the loss will be carried forward.

Carry forward losses, included in the RSPT capital account, can be used to offset future assessable resource super profits within the entity or wholly owned company group. The amount that can be transferred out in a year is limited by the amount of assessable RSPT profit in other projects owned by the entity or within the company group. That is, transferred losses cannot drive the RSPT assessable profit below zero.

The RSPT value of losses will be refunded on a reasonable basis. For example, losses would be refunded when a project is closed and the loss cannot be transferred to another project.

Under the RSPT, the government effectively guarantees to give resource firms the benefit of 40 per cent of their extraction costs on the equivalent of a cash-flow basis (the RSPT allowance preserves the real value of the benefit). That is, it guarantees to provide relief for expenditures incurred on a project, including the possibility of a cash refund. In return, it will receive 40 per cent of the resource super profits.

4.5 The Resource Super Profits Tax allowance rate

The RSPT (deemed interest) allowance rate is the rate used to uplift the RSPT capital account to ensure its real value is maintained over time.

The RSPT allowance rate will be set annually at the 10 year government bond rate. This rate was recommended by the *Australia's Future Tax System* review. This rate is appropriate given that the government guarantees to give resource entities a refund of any unutilised losses at the RSPT rate.

The required rate of return or weighted average cost of capital for a particular company is not an appropriate rate for this purpose. The allowance rate compensates investors for the delay in the government's recognition of the tax credit. As the government guarantees to recognise the tax credit when a project winds up, the required rate of return to compensate investors for the delay of tax credit is independent of the riskiness of the project. Instead, the required rate of return is the risk free rate for which the government bond rate is a proxy.

Using a rate higher than the government bond rate would result in a significant subsidy to the resource sector, which would distort investment away from other sectors of the economy.

Box 4.4: The Resource Super Profits Tax — a worked example

The table below shows the RSPT calculation for a project interest.

The project commences at the start of year 1, when \$100 is spent on capital. The government recognises capital expenditure through depreciation arrangements — allowing in this example \$60 to be claimed as depreciation in year 1 and \$40 to be claimed as depreciation in year 2.

In year 1, the project does not have any receipts. As such, the project makes an RSPT loss of \$60 in year 1. The unutilised loss, \$60, will be carried forward with undepreciated assets, \$40, to make the RSPT capital base \$100 in total.

In year 2, the project has \$150 of receipts. The project is able to utilise the depreciation deduction in year 2 (\$40) and losses carried forward from the previous year (\$60) as well as the RSPT allowance (\$6).

The investor will have assessable profit of \$44 in period 2 and pay the government \$18 in RSPT.

Description	Item	Year 1	Year 2
Revenue	(1)	0	150
<i>less</i> Expenses (such as depreciation)	(2)	60	40
<i>less</i> RSPT Allowance (6 per cent applied to RSPT capital base)	(3)	0	6
<i>less</i> Unutilised losses carried forward from previous year	(4)	0	60
Net RSPT profit (item 1 less items 2, 3, 4)	(5)	-60	44
Taxable RSPT profit (nil if item 5 is negative)	(6)	0	44
Tax @ 40 per cent	(7)	0	18
Initial investment (1 July in year 1)	(8)	100	n/a
Carry forward losses (item 5 if negative)	(9)	60	0
Undepreciated assets	(10)	40	0
RSPT capital base (items 9 + 10)	(11)	100	0

5 The ongoing system — detailed design issues

The Resource Super Profits Tax (RSPT) will apply to the resource super profits on a project interest basis. While operating costs will be deductible in the year in which they occur, capital expenditures will be spread over a number of years. However, as discussed in the previous section, delays in accounting for capital costs will be compensated through an interest allowance.

RSPT payments will be deductible for income tax purposes. Conversely, RSPT loss refunds on project closure will be assessable for income tax purposes.

The Government will also explore mechanisms to minimise the compliance burden for small businesses and micro operators (such as one person prospectors).

5.1 Who will be liable for Resource Super Profits Tax

The RSPT will apply to all legal entities (companies, partnerships and trusts) directly involved in the exploitation of Australia's non-renewable resources with the exception of projects already covered by the Petroleum Resource Rent Tax (PRRT). The RSPT will not be levied on shareholders in a company or beneficiaries of a trust that are involved in exploitation of non-renewable resources.

In principle, RSPT will only be payable on resource extraction activities.

The RSPT will be calculated separately for each project interest. This is important for joint ventures where partners contribute different capital to a project.

5.2 Which resources will be subject to the Resource Super Profits Tax

RSPT will apply to all mining and petroleum projects, with the exception of PRRT projects, for which opt-in arrangements will be developed in consultation with industry. This differs from the Australia's Future Tax System recommendation that the RSPT replace the PRRT and that certain low-value commodities be excluded from application of the RSPT on the grounds that compliance costs would likely exceed the benefits from application of the scheme.

To provide certainty for projects already covered by the PRRT, the Government will consult with industry on arrangements that would allow an election into the RSPT.

In relation to marginal low-value projects, it is important that they are included in the RSPT scheme, as these projects are likely to benefit the most from a switch from a royalty regime to the RSPT.

Difficulties arise in determining meaningful boundaries for exclusion. For example, many projects may produce several resources with different degrees of profitability.

Exemptions would also create problems over time if, for example, a project were excluded because it fell below a size threshold but then subsequently were to grow above that threshold. Unlike income tax, the RSPT is an inter-temporal tax — the RSPT capital account, including losses, needs to be calculated and carried forward over the life of a project.

A further problem with exemptions is that they increase the complexity of the law and typically require integrity rules, increasing tax operating costs for both taxpayers and administrators.

5.3 Taxing point

The taxing point is the point at which revenues and costs are determined for assessing RSPT.

The *Australia's Future Tax System* review suggests that, in principle, the taxing point be set close to the point of extraction of the resource — for example, the mine gate or well-head — to be consistent with taxing the market value of the underlying non-renewable resource. It notes, however, that the value of a resource at this stage in the production process is sometimes not observable and may need to be derived.

A practical approach would be to set the taxing point where a saleable commodity exists (the earliest point that a world-price or arms-length sale occurs), similar to the case under the existing PRRT. For some commodities this may include processing and transportation.

Extending the taxing point may reduce compliance costs and recognise the co-dependency of the value of extracted resources with resource transport or processing in integrated operations. Extending the taxing point could also prevent insufficient recognition of capital costs.

Consultation with industry will explore the feasibility of a flexible approach to setting the taxing point.

5.4 Assessable receipts and deductible expenditure

The objective of the RSPT is to ensure the Australian community receives a fair share of the realised value of Australia's non-renewable resources.

The RSPT will assess receipts from the sale of the resources. The RSPT will exclude receipts from the transfer of ownership in the resource project among shareholders. Assets leaving a project will be subject to a balancing adjustment.

The RSPT will allow deductions for the cost of extracting resources and getting them to the taxing point. The RSPT will not allow deductions for the following types of expenditure:

- payments of interest and financing costs, including the cost of issuing shares, the repayment of equity, the payment of dividends, and financial hedging costs;
- payments to acquire an interest in an existing exploration permit, retention lease, development licence, production licence, pipeline licence or access authority;
- payments to acquire interests in projects subject to the RSPT; and
- payments of income tax or GST.

Industry will be consulted about the details of defining receipts and expenditure that fall within the RSPT, including ways to apportion expenses between project and non-project activity as well as operational hedging gains and costs.

Capital allowances and asset revaluations

Where possible the capital allowance arrangements used for income tax purposes could also be used under the RSPT. But, unlike an income tax, under the RSPT accelerated write-off provisions will not distort investment decisions. As such industry will be consulted on the potential to streamline capital allowance arrangements for RSPT purposes.

The RSPT capital base will not change with ownership. Where a project or entity is sold the RSPT will continue to operate based on the original tax value. That is, the residual value of assets for RSPT purposes will not be re-valued when a project or entity is sold.

Royalties to landholders and indigenous communities

In some areas of Australia, legal ownership of certain non-renewable resources rests with the land owner so private, rather than government, royalties are charged. Where private royalties are paid, for example, to Indigenous communities, such royalties should continue unaffected. However, it will be important to ensure that the super profits from the resource are not transferred to third parties.

Land owners and private royalty holders will still be able to charge private royalties or accept in-kind payments.

Consultation will explore ways to best meet these two objectives and ensure that the overall wealth of indigenous owners is not affected by these arrangements.

5.5 State and territory royalties

The Australian Government will provide a refundable credit to resource entities for state royalties paid to State governments following commencement of the RSPT. The objective of the credit is to reduce the impact of state royalties and negate concerns that the resource profits tax is a 'double' tax.

The Government will discuss with the States on what royalty rates to credit, given that some royalty rates are in nominal dollars and need to be increased from time to time, while others are applied on a mine by mine basis. The refundable credit will be available at least up to the amount of royalties imposed at the time of announcement, including scheduled increases and appropriate indexation factors.

5.6 Interaction with income tax

RSPT payments will be deductible for income tax purposes. This is consistent with the current income tax arrangements for state royalties, crude oil excise, resource rent royalty and PRRT.

Conversely, RSPT refunds will be assessable for income tax purposes.

Resource entities will continue to be subject to income tax on their exploration and production activities.

5.7 Arrangements for small business

The RSPT may impose a relatively higher compliance burden on small entities. Consultation will explore better mechanisms to deal with small businesses and micro operators (such as one person prospectors), including the possibility of allowing capital expenditure, up to a cap, to be immediately expensed. This would provide many small businesses with cash flow treatment, which may assist with reducing compliance costs and providing cash flow benefits.

For micro operators, such as one person prospectors, an alternative approach is to exclude them from the system, but require them to pay an access charge. Most states currently have similar arrangements under their existing royalty systems.

Industry will be consulted on minimising the compliance burden for small businesses and micro operators, recognising that this must be balanced against maintaining the integrity of the RSPT and minimising compliance and administration costs.

5.8 Exploration expenditure

Exploration expenditure will be immediately deductible under the RSPT.

Exploration undertaken under an exploration licence is a precursor to the discovery of a deposit, determining its characteristics and establishing feasible and efficient methods of extraction.

The immediate deduction will be available for the same range of exploration expenses that have access to the refundable exploration rebate under company income tax.

The resource exploration rebate

The Australian Government will introduce a new resource exploration rebate, within the company income tax system, to deliver on its election commitment to promote exploration.

Under the resource exploration rebate companies can receive a refundable tax offset at the prevailing company tax rate for their exploration expenditure. The rebate will apply to the same range of exploration expenses currently immediately deductible under the tax law, provided the exploration is undertaken in Australia.

Expenditure incurred in exploring for geothermal energy will be eligible for the new resource exploration rebate to provide a further boost to this sector.

The resource exploration rebate is a simpler and more effective way to promote investment in exploration than a flow-through shares scheme.

The new rebate will significantly benefit small, pre-profit exploration companies. Compared to larger more diversified companies, these smaller companies face a competitive disadvantage because losses they generate from exploration often cannot be used to offset other taxable income.

6 Transitioning to the Resource Super Profits Tax

Bringing existing projects into the RSPT will ensure that the future expansion of existing projects would be treated in the same way as the development of new projects. This is important as a significant part of the expected growth in resource sector output is likely to come from the expansion of existing projects. In designing transitional arrangements it will be important to minimise the impact on investment decisions.

6.1 Existing projects and the Resource Super Profits Tax

Existing resource projects will be brought into the RSPT, with the exception of projects already covered by the PRRT.

If other existing projects were excluded from the RSPT, the community would not reap the full efficiency of the RSPT, especially in terms of encouraging projects to produce for longer. This means less resource sector activity, and lowers the returns to the community.

Bringing existing projects into the RSPT will ensure that future expansion would be treated in the same way as the development of new projects. A significant part of the expected growth in resource sector output is likely to come from the expansion of existing projects.

These problems could endure, as some existing projects have the potential to continue for a very long time.

The *Australia's Future Tax System* report suggested that the Government should not compensate investors for changes in the value of projects or companies associated with resource rights or the change in expected benefits from future expenditure and investment. The report noted that where transitional assistance is provided, it should be directed toward recognising previous expenditure that has not yet been recouped.

In order to transition existing projects into the RSPT, the Government will allow entities to enter the new arrangements with an RSPT starting base. The base will provide a credit to reduce future RSPT liability in recognition of existing investment.

In principle, 100 per cent of the accounting book value of existing capital will be included in the RSPT starting base and this value will be taken into account when calculating resource super profits.

Investment (including exploration) undertaken between announcement and commencement (interim period) will be treated the same as post-commencement investment. This is to avoid investment decisions being distorted prior to the commencement of the RSPT.

The first phase of consultation with industry will focus on the design of the transitional arrangements to ensure they are fair on firms while maintaining the integrity of the RSPT objectives.

6.2 Projects subject to Petroleum Resource Rent Tax

To provide certainty for projects already covered by the Petroleum Resource Rent Tax (PRRT) the Australian Government will consult with industry on arrangements that would allow an irrevocable election into the RSPT.

Projects within the scope of the PRRT will remain in the PRRT unless, and until, they elect to transfer into the RSPT.

The Government anticipates that, over time, many projects within the scope of the PRRT will migrate to the RSPT.

The Government will consult with the Western Australian Government on the future transfer of the Resource Rent Royalty project.

6.3 Transition for projects into the Resource Super Profits Tax

Pre-announcement investment

The Government will recognise, in the RSPT starting base, the accounting book value of existing project assets as at the most recent audited accounts available at the time of announcement. The book value will be required to reflect a value consistent with Australian Accounting Standards. In principle, the RSPT starting base will exclude the value of the resource.

Market valuation could be used where audited accounting book values are not available.

For assets acquired after the accounts were audited but before announcement of the RSPT, the asset's historical cost will be included in the RSPT starting base.

The RSPT starting base will be indexed at the RSPT allowance rate.

Where an asset is disposed of, or taken out of the project during the interim period, the asset's indexed-RSPT base value will be removed from the RSPT starting base.

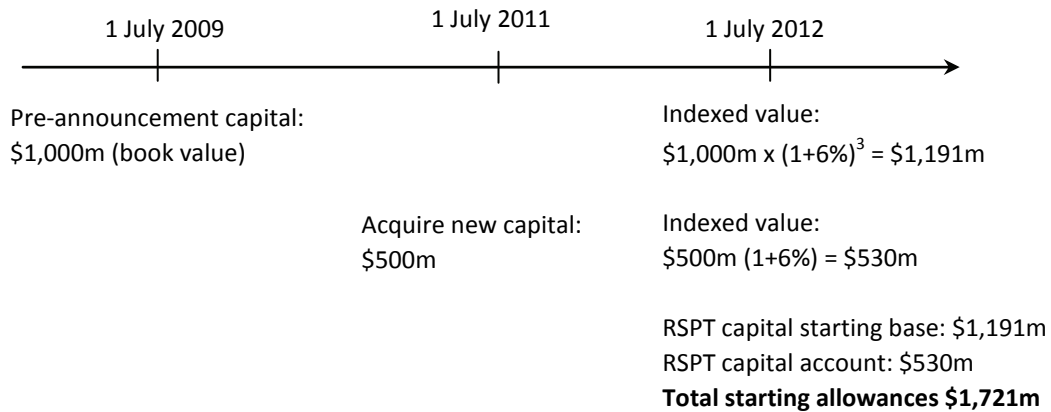
The RSPT starting base from pre-announcement investment will not be transferable or refundable.

Investment during the interim period

To avoid any distortions to investment during the interim period, the Government will treat investment during this period the same as it would under the new system.

Taxpayers will be able to increase their RSPT capital account to account for the acquisition of new capital. To do this, all acquisitions of capital and exploration expenditure during the interim period will be included in the RSPT capital account valued at its historical cost and indexed, from the time of purchase, at the RSPT allowance rate. Acquisitions of capital and exploration expenditure will not be depreciated for RSPT purposes during the interim period. Such expenditure will be entitled to the RSPT loss transfer rules and loss refund rules following commencement.

Where an asset is disposed of during the interim period, the asset's indexed RSPT capital account value will be removed from the RSPT capital account.

Chart 6.1: Transition to the Resource Super Profits Tax

6.4 Early access to the Resource Super Profits Tax starting base

The Government recognises that the introduction of the RSPT will increase the tax paid by a number of resource entities. The Government will provide additional assistance, beyond recognising the book value of existing assets, to provide a smooth transition for existing resource entities. To soften the impact on cash flows in the years following commencement, the Government will allow firms early access to the tax credit through accelerated depreciation provisions. This will assist firms to manage cash flow requirements following the RSPT.

The Government will allow the RSPT starting base to be written off over five years, at the rate of 36 per cent in the first year, 24 per cent in the second year, 15 per cent in the third year and fourth years and 10 per cent in the final year. Where the project does not earn sufficient RSPT profit to fully utilise the deduction, the loss can be carried forward to offset future taxable profit. Losses from the RSPT starting base will not be transferable to other projects and will not be refundable if the project closes.

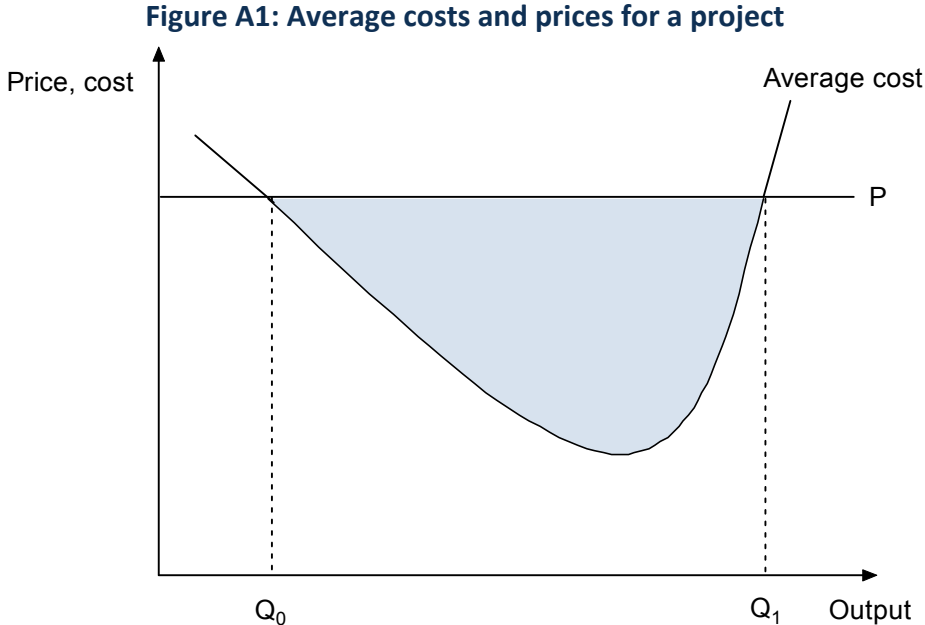
These arrangements are expected to provide a significant cash-flow benefit to resource entities in the first five years of the scheme.

Appendix: Illustration of the differences between royalties and the Resource Super Profits Tax

The Resource Super Profits Tax (RSPT) will operate quite differently from royalties. This appendix uses a graphical method to illustrate the effects of a royalty and an RSPT at the level of an individual project. The analysis extends the work of Hogan (2003) to examine the impact of royalties and profit based taxes, using both average and marginal cost curves.³ The general results of Hogan are however unchanged.

Differences in the operation of royalties and the Resource Super Profits Tax

Figure A1 shows the average cost curve for a project. As the project becomes operational and increases its rate of production, average costs fall — principally because fixed costs are spread over higher rates of output. The average price received for output is given by the line marked 'P'. The price line is horizontal because the operator is a price taker. Higher rates of production and sales will have no influence on prices.

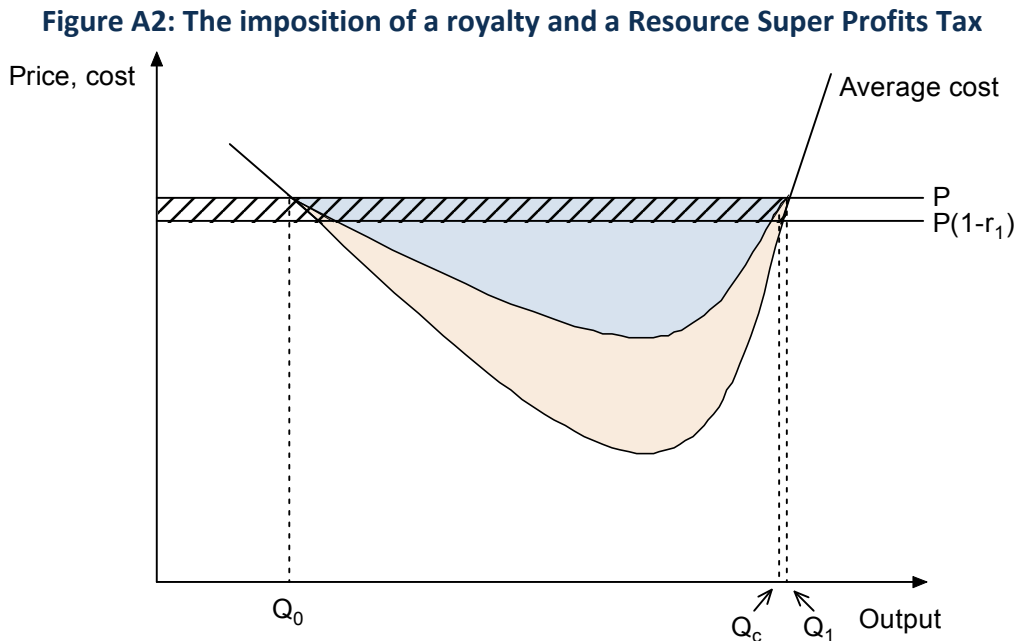


The project reaches a breakeven point once output reaches Q_0 , where average price equals average cost.

Resource profits are realised at outputs above Q_0 . Resource profits are amounts received above costs incurred. They are represented in the diagram by the vertical distance between the average cost curve and the price line, P. This depicts the average rate of resource super profit for rates of output between Q_0 and Q_1 . Q_1 is the maximum viable output. Above this rate of output, average costs exceed average revenues.

3 Hogan L, 2003, *Australia's Petroleum Resource Rent Tax: An Economic Assessment of Fiscal Settings*, ABARE eReport 3.1, Prepared for the Department of Industry, Tourism and Resources, Canberra, January.

The imposition of royalties and the RSPT is illustrated in Figure A2.



Royalties are depicted as applying at a rate of r_1 , so that prices received by the resource entity after royalties are shown by the line $P(1-r_1)$. The feasible amount of royalties is depicted by the hashed area. Royalties are payable for any rate of production over the range from zero to Q_1 .

The RSPT is depicted as the vertical intervals in the light blue area in the diagram. The average amount of RSPT payable at outputs above Q_0 is 40 per cent of the average resource profit realised.

Unlike royalties, the Resource Super Profits Tax only becomes payable once projects become profitable

Figure A2 shows that royalties are payable from the first stages of production, even before the project becomes profitable. At rates of output below Q_0 royalties add to the losses made on the project.

On the other hand, the RSPT only becomes payable once a project becomes profitable — that is, only once it produces more than Q_0 .

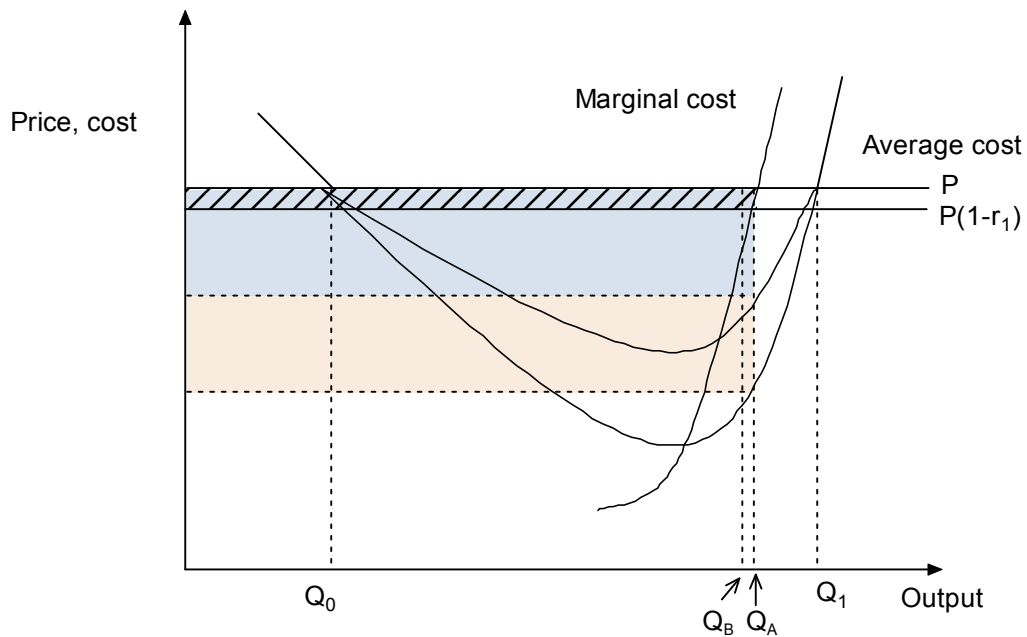
Unlike royalties, the Resource Super Profits Tax is closely related to resource profits

It is also clear from Figure A2 that royalties are generally not related to the magnitude of resource profits. The average amount of royalty remains fixed at all rates of output, whereas the average amount of resource super profit can vary greatly over different rates of output.

The RSPT, on the other hand, is closely related — by definition — to the size of resource profits released.

This difference between royalties and the RSPT is now illustrated, with the aid of Figure A3, for the full-production stage of the project.

Figure A3: Royalty and Resource Super Profits Tax amounts at full production



The marginal cost curve is introduced for the purpose of determining the rate of output that the operator would select. In the absence of taxes and royalties, the full-production rate of output would be determined by the intersection of the marginal revenue curve (line P) and the marginal cost curve. This occurs at Q_A . With the introduction of a royalty, output would fall to Q_B , where the marginal cost curve intersects with the marginal revenue line, $P(1-r_1)$. With the RSPT, however, the selected output would remain at Q_A , since the price line P describes the relevant marginal revenues.

The amount collected in royalties is given by the hashed area, which is the rate of output Q_B multiplied by the royalty rate r_1 .

In the circumstances depicted in the figure, the amount of royalties collected is low in comparison to the amount of resource super profit realised at the full-production rate of output. The amount of resource super profit released is shown by the combination of the two coloured areas, which is the rate of output Q_A multiplied by the average rate of resource super profit $(P-AC_A)$.

The amount of RSPT payable is, by definition, 40 per cent of the amount of resource super profit. The amount of RSPT payable is shown by the light blue area, which is Q_A multiplied by $0.4 \times (P-AC_A)$.

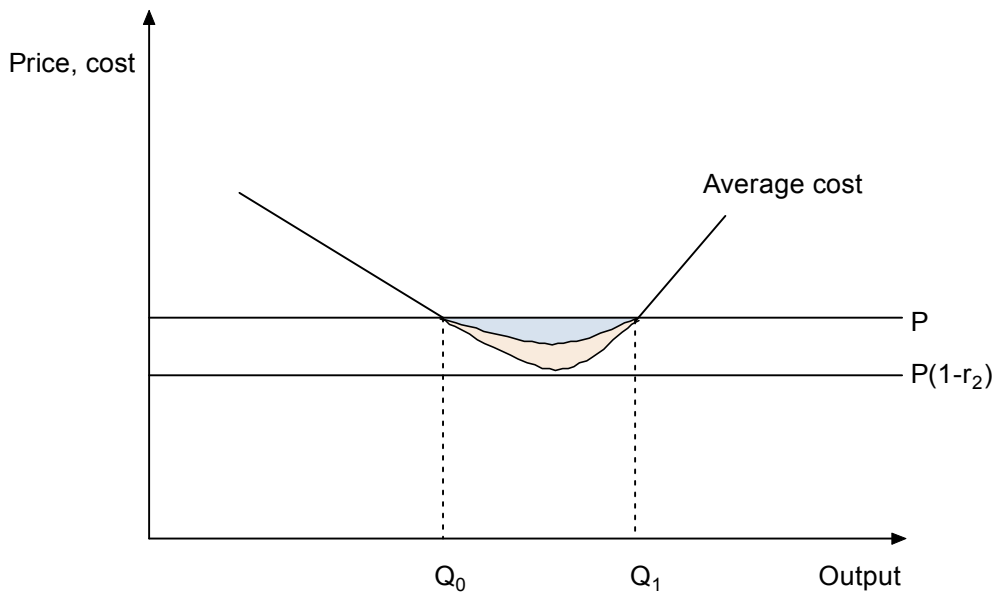
Effects on investment decisions

Royalties can mean some low-profit projects do not go ahead. This is illustrated in Figure A4 which, for convenience, shows a higher rate of royalty, r_2 . At prevailing prices, this is a low-profit project, with a relatively small area of resource profit shown in the blue areas between the interval of production between Q_0 and Q_1 .

In this case, the project would not proceed under the royalty regime. Average costs are above average revenue, $P(1-r_2)$ at all points.

On the other hand, the project would go ahead under the RSPT. Not only that, the project would realise resource profits and would contribute tax revenue again represented by the light blue shaded area.

Figure A4: Royalties and RSPT on a low-profit project



Effects on production decisions

Royalties can have two adverse effects on production decisions.

First, they can reduce the full-production rate of output. It was shown in Figure A3 above, that the imposition of royalties would reduce the full-production rate of output from Q_A to Q_B . As depicted, this effect is not very large, because of the sharply-rising marginal cost curve. This reflects a fairly likely situation in which a mine operates at or near capacity when fully operational; and further increases in production can only be achieved at relatively high incremental cost. This might mean, for example, using proportionately more labour in more labour-intensive activities, given that capital is subject to capacity bottlenecks. In the longer term, additional capacity may be installed. Marginal costs, however, could still be substantially higher than they were around the previous full-capacity level.

Second, royalties could lead to the premature closure of mines when they become relatively 'low-profit'. There could be a reduction in expected prices, leading to a reduction in expected resource profits. This can be depicted as a change from Figure A3 to Figure A4, where the fall in resource profits is due to a drop in output prices. In these circumstances and with royalties payable, the mine would be closed (Figure A4) whereas, with RSPT payable, the mine would remain open and would continue to contribute RSPT. Resource profits could also decline as a result of higher costs of production. This might occur as a mine reaches depletion, when the resource becomes mixed with more impurities or becomes more difficult to extract. Again there can be circumstances when a royalty would induce an operator to cease production whereas production would continue under an RSPT. Production would cease if production reached Q_C in Figure A2 under a royalty regime, but would continue up to Q_1 under the RSPT. Once again, this production effect would not be that large in circumstances in which costs rise rapidly with increases in output.