



BUSINESS TAX WORKING GROUP DISCUSSION PAPER: SUBMISSION BY THE MINERALS COUNCIL OF AUSTRALIA

IN CONJUNCTION WITH:
CHAMBER OF MINERALS AND ENERGY OF WESTERN AUSTRALIA
QUEENSLAND RESOURCES COUNCIL
NEW SOUTH WALES MINERALS COUNCIL
SOUTH AUSTRALIAN CHAMBER OF MINES AND ENERGY
VICTORIAN DIVISION OF THE MINERALS COUNCIL OF AUSTRALIA
TASMANIAN MINERALS COUNCIL
NORTHERN TERRITORY DIVISION OF THE MINERALS COUNCIL OF AUSTRALIA
AUSTRALIAN COAL ASSOCIATION

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EXECUTIVE SUMMARY

The mining and minerals processing industry is Australia's principal export earner and most globalised industry. It has been a major driver of growth, investment and higher living standards in Australia over the last decade.

The minerals industry accounted for more than 50% of Australia's export income in 2011-12. Industry investment has been strong, but future investment is at risk due to weaker global conditions, sharply lower commodity prices, a high dollar and escalating costs. This competitive reality is not reflected in the Business Tax Working Group (BTWG) discussion paper.

The contribution from the minerals industry to government revenues in Australia has risen markedly over the last decade, even before the introduction from 1 July 2012 of the Minerals Resource Rent Tax (MRRT) and the Carbon Tax. Research by Deloitte Access Economics shows a high and stable industry tax ratio (calculated as Federal company tax and State royalties over taxable income before royalties) averaging 41.3% over the period from 1999-00 to 2011-12.

Securing the benefits of Australia's comparative advantage in mineral resources requires stable and globally competitive tax arrangements that encourage investment. With the minerals resources industry among the highest taxed industries in Australia, further instability in taxation arrangements carries the risk of making Australia a less attractive destination for minerals resources investment.

High levels of capital investment and long lead times before the generation of sales income and production-dependent cash flows are key characteristics of the mining industry. The amount of funding required – and the limitations on funding capacity of domestic financial institutions – means Australian mineral resources companies are heavily reliant on highly mobile, global capital for investment.

The investment economics of projects are assessed based on the overall tax burden such that it is the combination of all business tax rates and measures (not just the corporate rate or any other single tax measure) that is used to assess project viability. As well as the overall burden of taxation, predictability of fiscal regimes is a critical factor influencing commercial decision-making.

The Business Tax Working Group Process

The minerals industry considers the BTWG process, as constituted, to be marked by critical flaws when measured against criteria for genuine tax reform – strong principles, compelling empirical evidence and good process. In light of industry tax reform principles and analysis of specific options, the industry does not support an *ad hoc* “package trade-off” to deliver a (marginal) reduction in the company tax rate.

Key concerns relate to:

- The narrow Terms of Reference set for the BTWG which constrain markedly the scope for meaningful taxation reform
- The risk that piecemeal change (under the guise of addressing the “patchwork economy”) will actually worsen the fiscal regime in Australia, decreasing international competitiveness and adding to sovereign risk at a time when future minerals industry investment is highly uncertain
- The absence of a compelling case for changing those provisions identified as base broadening options
- The unbalanced nature of the savings options under consideration which seemingly impact disproportionately on capital intensive industries, in particular the resources sector.

There is a non-trivial risk that the BTWG process could leave the business tax system more complex than it found it. There is no basis for concluding this would yield a net benefit to the Australian economy.

Base Broadening Options

Exploration

Exploration expenditure incurred by mining companies is analogous with other normal operating expenses that are immediately deductible, such as those geared towards market research or marketing (e.g. advertising). Mineral exploration is “exploring for business”. Treating exploration expenditure as different from other activities which form part of ordinary operating expenses introduces, rather than removes, a distortion.

Immediate deductibility of exploration expenditure has been supported by a number of official processes over the years, including the Policy Transition Group (PTG) which reported to the Australian Government in December 2010. Both the Industry Commission (the forerunner to the Productivity Commission) and the Ralph Review concluded that it provides the least distorting and most practical way to treat exploration expenses.

The application of arbitrary limits (e.g. deductible over five years), thresholds (e.g. companies with a turnover of more than \$500 million) and/or the singling out of aspects of the exploration continuum (e.g. feasibility studies) for taxation purposes runs directly counter to sound tax principles of efficiency, fairness and simplicity.

The industry would be keen to participate in a detailed and considered process to examine what measures would provide “an optimal level of support” for exploration in Australia. However, the BTWG does not offer such a process. The industry strongly recommends no change to the immediate deductibility of exploration expenditure (on grounds of efficiency, practicality, spill-over benefits and international competitiveness) noting that, as the BTWG concedes, the likely result would be to “increase marginal effective tax rates for explorers”.

Tax Depreciation – Diminishing Value method

Australia’s move in 2006-07 to a Diminishing Value (DV) rate of 200% for claiming depreciation on assets (replacing a DV rate of 150%) was based on the same policy objectives articulated by the BTWG – namely, to bring the rate of depreciation for tax purposes more closely into line with economic depreciation and to encourage investment.

No evidence has been presented which would suggest that moving back to 150% would achieve closer alignment with economic depreciation or otherwise improve Australia’s international competitiveness. What is clear is that capital intensive industries (such as mining) would be adversely affected relative to other industries. Applying the reduced DV rate would have a material impact on the minerals resources industry project pipeline. For example, company modelling finds that a greenfields thermal coal project in the Hunter Valley would see its Net Present Value (NPV) reduced by 29% under this scenario.

Analysis for the MCA by KPMG concludes that the 200% rate “does not necessarily provide Australian taxpayers with an advantage relative to taxpayers in other countries sampled”. Among the countries sampled, the United States, Japan and Indonesia feature a 200% rate for diminishing value calculations. Importantly, the KPMG analysis also concludes that a number of countries which are key competitors with the Australian minerals sector (including Canada, Chile, Indonesia and South Africa) “have some accelerated depreciation arrangements for the mining sector”.

While direct comparisons are difficult due to different depreciation methodologies and effective lives, across a sample of representative assets, KPMG found that the depreciation allowed over the first five years of an asset’s life was consistently higher in countries such as Canada, Chile, Indonesia and South Africa when compared with Australia. On international competitiveness grounds alone, the industry considers that no case has been made for reducing the DV rate.

Thin Capitalisation and interest deductibility

The statement included in the BTWG Discussion Paper that Australia's thin capitalisation rules are "overly generous" has not been substantiated. Work for the MCA by KPMG suggests a much more complex picture. The BTWG paper glosses over the fact that current Australian rules apply to *all* debt, as distinct from arrangements in a number of other countries where rules apply solely to *related-party* debt.

Integrity concerns should be addressed within the current legislative framework. Tightening Australia's thin cap rules without further detailed consideration of Australia's relative position internationally could adversely affect our ability to attract capital and is likely to pose sovereign risk problems.

Alternative proposals such as capping interest deductibility to EBITDA also appear problematic, especially for cyclical industries such as mining.

The inability of Treasury to cost proposals that would change existing thin cap rules underlines concerns about the nature of the BTWG process and further cautions against precipitate change to existing arrangements.

R&D Tax Incentive

Proposed options for changing the R&D Tax Incentive are *ad hoc* and offer no clear economic benefits. Resort to provisions such as arbitrary turnover thresholds or variable rates would add more complexity to a regime that has only recently become law.

The industry considers that any piecemeal change in this area would only heighten concerns of international investors regarding the stability and predictability of Australia's taxation arrangements.

Costings Issues

Costings must be of the highest standard in terms of their credibility and transparency. Based solely on the costings inadequacies, the minerals industry finds it difficult to conclude that the BTWG process offers potential benefits to the Australian economy, much less to the Australian minerals industry.

Allowance for Corporate Equity

The industry considers that the risks of Australia moving towards an ACE significantly outweigh any theoretical benefits. This is in line with the conclusion of the BTWG. Work commissioned by the MCA based on international experience with ACE and ACE-type regimes has confirmed the difficult design issues, practical complexities and questionable effectiveness associated with such systems.

1. MINERALS INDUSTRY TAXATION: AN OVERVIEW

1.1 INTRODUCTION

The Minerals Council of Australia (MCA) is the peak national body representing Australia's exploration, mining and minerals processing industry. It represents the minerals industry both nationally and internationally in its contribution to sustainable economic and social development.

This Submission is made by the MCA in conjunction with the Chamber of Minerals and Energy of Western Australia, the Queensland Resources Council, the New South Wales Minerals Council, the South Australian Chamber of Mines and Energy, the Victorian Division of the MCA, the Tasmanian Minerals Council, the Northern Territory Division of the MCA and the Australian Coal Association. This Submission does not restrict the scope for any of the aforementioned organisations to make further submissions on matters specific to the interests of their respective memberships.

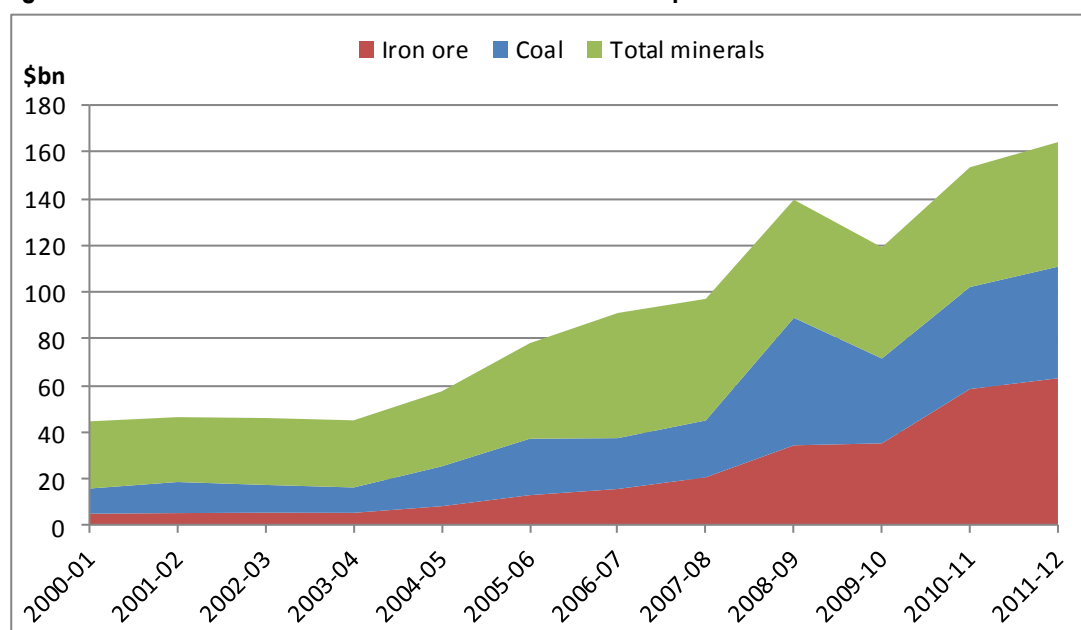
1.2 AUSTRALIA'S MINERALS INDUSTRY: A SNAPSHOT

The minerals industry (encompassing exploration, extraction and processing) is Australia's principal export earner and most globalised industry. It has been a major driver of growth, investment and higher living standards in Australia over the last decade as rapid growth in emerging Asia has led to higher demand for mineral commodities.

One of the world's leading mining nations, Australia ranks in the top six producing nations of 15 important minerals including: iron ore, coal, copper, gold, nickel, uranium, bauxite and alumina, silver, lead, zinc, manganese and mineral sands such as rutile and zircon.

In 2011-12, Australia's mineral resources earned \$164 billion in export revenue (Figure 1). This was 52% of Australia's total export revenue, up from around 29% in 2001-02. Two mineral commodities – iron ore (\$63.0 billion) and coal (\$47.9 billion) – together accounted for 35% of Australia's total export income in 2011-12. Other major mineral export earners included gold (\$15.4 billion), copper – ore and refined (\$8.5 billion), alumina (\$5.1 billion) and nickel (\$4.0 billion).

Figure 1: Australia's minerals resources exports



Source: BREE

The mining industry as a whole (including oil and gas) accounts directly for 8 to 10% of gross domestic product (GDP) as measured by industry gross value added. However, recent estimates put mining-related economic activity in the Australian economy at between 15 and 20% of GDP.¹ The direct effects of higher mining activity include stronger demand for inputs, including construction, equipment, infrastructure and services.

Investment in the mining industry has grown strongly in recent years with minerals sector investment ranging between 20 and 30% of total investment. But while that investment is expected to contribute strongly to economic growth over the next couple of years, weaker global conditions, sharply lower commodity prices, a high exchange rate and escalating costs create significant downside risks to mining investment from mid-2014.

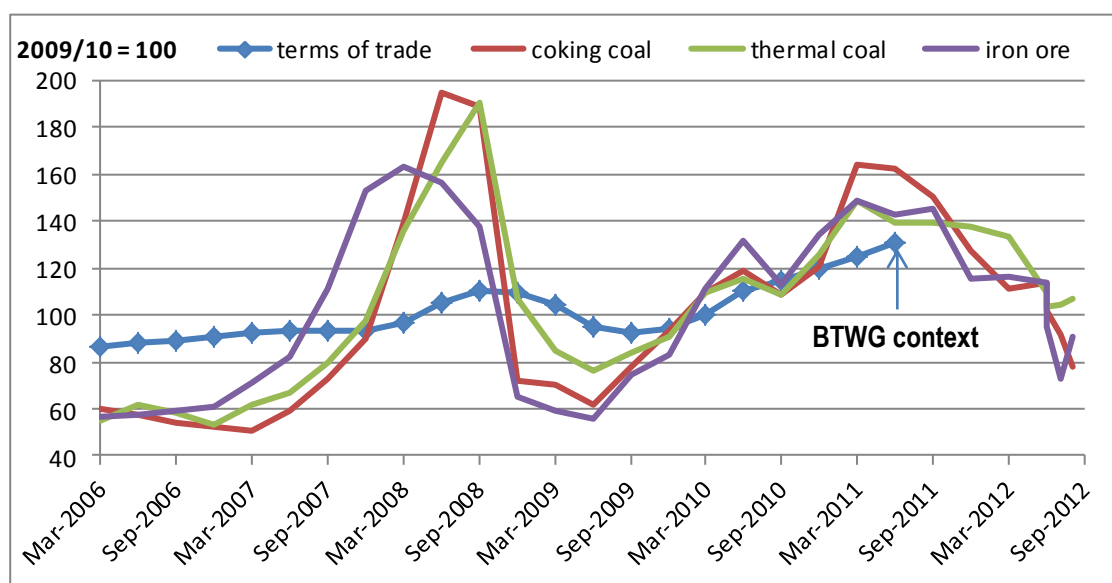
A report for the MCA by Port Jackson Partners released in September 2012 details the competitive challenge confronting Australia’s minerals industry and the degree to which future investment is now at risk. The report concludes, *inter alia*, that:

- Large market share gains over earlier decades have been replaced by stagnation or share losses
- Rising operating and capital costs mean that Australian projects have become less attractive just as new, strong rivals have begun emerging
- 75% of all projects included in the Bureau of Resources and Energy Economics (BREE) major projects list remain uncommitted
- Policies today can create or destroy an opportunity equal to more than 5% of GDP in 30 years’ time
- As part of immediate and coordinated action to regain Australia’s competitive edge in minerals resources, governments at all levels should commit to stable and internationally competitive tax and royalty arrangements.

This competitive reality is not reflected in the “economic context” section of the BTWG Discussion Paper. More broadly, the industry is concerned that the Terms of Reference and context defined for the BTWG’s deliberations – centred on the so-called “patchwork economy” – are time-specific and already out-dated, as well as being flawed as a foundation for tax reform.

The most striking anomaly is that the data on Australia’s terms of trade cited in the BTWG paper (released as recently as 13 August 2012) are roughly 12 months out of date. As shown in Figure 2, with coal and iron ore prices down in the order of 30% to 50% from 2011 peaks, relying on the high point of the terms of trade conveys a distorted view of the economic and commercial context in Australia in late 2012.

Figure 2: The economic context

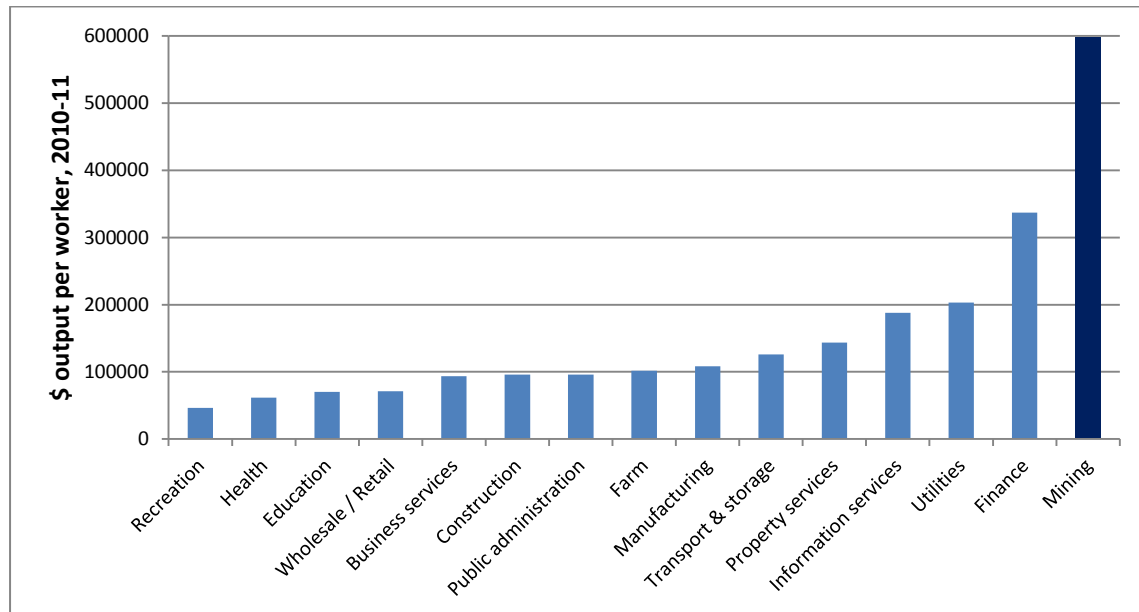


Source: RBA, ANZ.

Mining is highly capital intensive.

According to Productivity Commission estimates, capital inputs account for about half the total costs in mining production (or around 80% of value added), whereas the average for the economy as a whole is 21% (or around 44% of gross value added).ⁱⁱ High capital intensity translates into high levels of productivity (as measured by value added per worker) with labour productivity around four times the all industry average (Figure 3). Wages, workplace training and skills development expenditure are all higher than the national average. Average weekly earnings in the minerals sector are more than double the all industries average.

Figure 3: Mining productivity is high



Source: Deloitte Access Economics

Direct employment in the minerals resources industry has risen strongly in recent years reaching 275,200 jobs in May 2012, before easing more recently. The minerals resources industry is a major source of jobs and economic activity in regional and remote Australia, with the industry accounting for 30% of employment in some regions. The industry is also the largest private sector employer of Indigenous Australians. The Australian Government's National Resources Sector Employment Taskforce has estimated that each additional job in the mining industry generates up to three jobs in other industries.ⁱⁱⁱ

Australia's position as a premier minerals producer is heavily dependent on continuing investment in exploration. Minerals exploration expenditure in Australia has risen off the back of higher commodity prices in recent years. In 2011-12, mineral exploration expenditure (excluding oil and gas) was almost \$4 billion. This compares with average expenditure of \$2.3 billion over the previous five years. However, much of the increase in nominal exploration expenditure reflects rising costs. Based on measures such as metres drilled as well as cross-country comparisons, Australia's exploration performance remains down on that recorded in the 1990s.

The mining industry is a major contributor to investment in research and development (R&D). At \$3.8 billion in 2010-11, mining industry R&D accounted for 21% of business R&D investment; second only to manufacturing at 27%. Mining's share of total business R&D investment has roughly doubled since 2001-02.

Australia's comparative advantage in mining coupled with the growth in emerging economies such as China has ensured widespread benefits from higher mining activity in Australia over the last decade.

Australia enjoys a comparative advantage in mining. This is reflected in international trade patterns with export earnings from the minerals sector providing the means to pay for imported goods and services that Australia

does not have a comparative advantage in producing. In the last decade, structural shifts in the global economy centred on the re-emergence of China and India as major centres of global economic power have underlined and enhanced this comparative advantage.

Australia's higher terms of trade, as mineral commodity prices rose to levels well above the long-run average, increased national income, directly increasing the buying power of Australian consumers and industries. According to Deloitte Access Economics, the terms of trade boost to national income in 2010-11 was about \$165 billion, the equivalent of 12% of nominal GDP. In other words, national income was estimated to be \$165 billion higher than it would be had the terms of trade remained at 2002-03 levels.

Growth in mining activity – driven largely by a rebound in coal and iron ore exports through 2009 – helped to cushion Australia's economy from the global recession in the wake of the Global Financial Crisis. But for the performance of the mining sector, the economic downturn in the latter part of 2008 and 2009 would have been far more severe.

Treasury analysis has shown that corresponding with the “mining boom” there has been a narrowing in the dispersion of regional unemployment rates – with a smaller proportion of regions experiencing high unemployment. Compared with the late 1990s when less than 15% of local regions had unemployment rates of less than 5%, by September 2010 the figure had risen to around half.^{iv}

In a series of papers, the Reserve Bank has outlined the various channels by which the benefits of mining sector growth have been distributed widely throughout the economy. Based on this work, Deputy Governor Phillip Lowe concluded in February 2012 that:

The indirect effects come through a variety of channels. Day to day, they can be hard to see but they do percolate through the economy. In effect, there is a chain that links the investment boom in the Pilbara and in Queensland to the increase in spending at cafés and restaurants in Melbourne and Sydney. This chain starts with the high terms of trade that has pushed up the Australian dollar. In turn, the high dollar has meant that the prices that Australians pay for many manufactured goods are, on average, no higher than they were a decade ago, despite average household incomes having increased by more than 60 per cent over this period. The stable prices for many goods, combined with strong disposable income growth means there is more disposable income to be spent on services in the cities and towns far from where the resources boom is taking place. As I said, this chain can be hard to see, but it is real, and it is one of the factors that have had a material effect on the Australian economy over recent years.^v

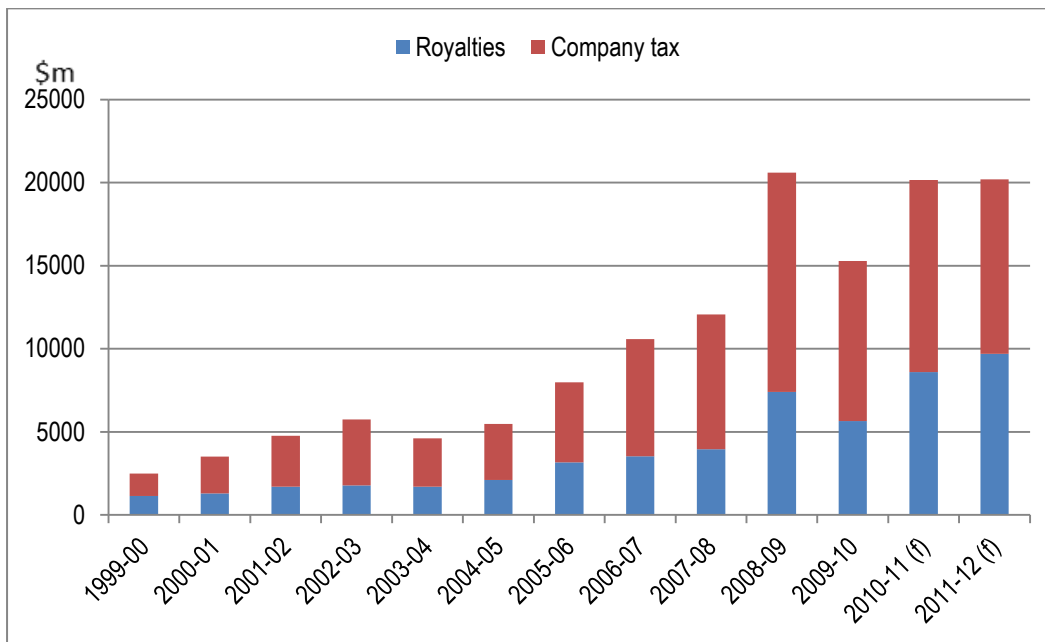
1.3 INDUSTRY TAX CONTRIBUTION (AND TAX EXPENDITURES)

Strong growth in revenues to government is one of the channels by which Australians have benefited from higher mining industry activity. The minerals sector is among the highest taxed industries in Australia, even before the introduction from 1 July 2012 of two new taxes – the MRRT and the Carbon Tax.

Minerals resources companies have been Australia's highest company income taxpayers in recent years. The industry's indirect tax contribution is also significant. Higher average wages in the industry have resulted in higher average tax rates, higher average tax payments per person and higher tax collections by the Commonwealth. Returns to the Australian community also come via payroll tax, fringe benefits tax, GST and other indirect taxes, charges and levies.

Total revenue from the two primary sources of returns from the minerals industry – Federal company income tax and State royalties – has increased four-fold over the last decade and amounted to close to \$120 billion (estimates for 2010-11 and 2011-12 by Deloitte Access Economics). The sharp rise in the revenue contribution to Australian governments from these sources is shown in Figure 4. Notwithstanding claims to the contrary, higher commodity prices have seen returns to the community from minerals revenues move commensurately higher.

Figure 4: Revenues from the minerals industry have grown markedly

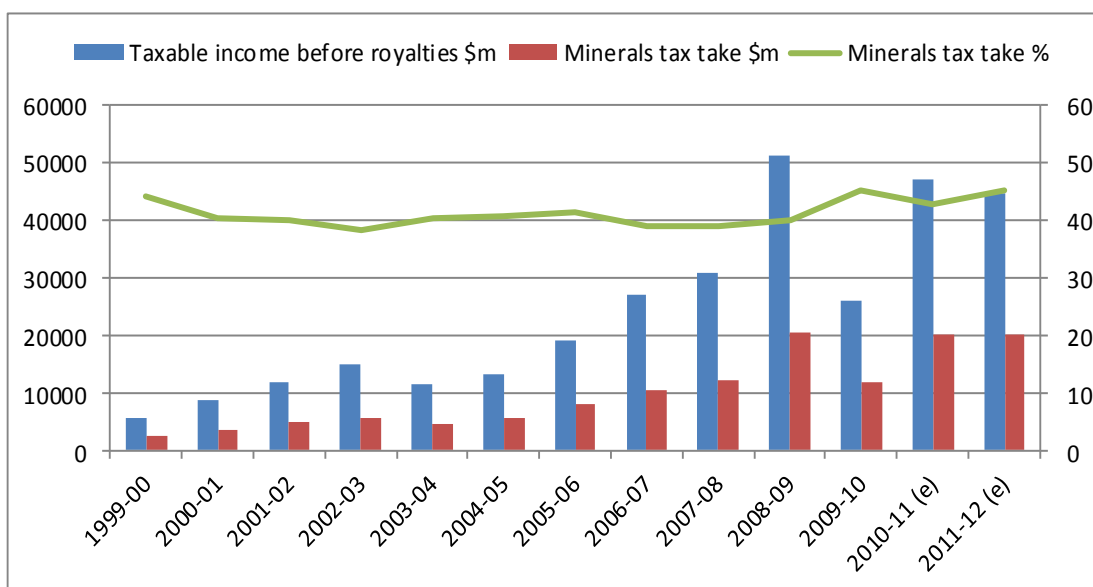


Source: Deloitte Access Economics

Deloitte Access Economics has concluded based on official data (using taxable income before royalties as the corporate tax base) that the average tax ratio from the minerals industry was 40.8% over the 11 years from 1999-00 to 2009-10. Incorporating estimates for 2010-11 and 2011-12, the average tax ratio over the full period is 41.3%, with the estimated percentage tax take moving higher in more recent years.

Hence, as shown in Figure 5, the industry tax ratio has been high and relatively stable over the last decade as industry profitability has fluctuated with prevailing global economic conditions. This is contrary to many of the claims made during the 2010 resource taxation debate.

Figure 5: The minerals industry tax take ratio has remained high and stable



Source: Deloitte Access Economics

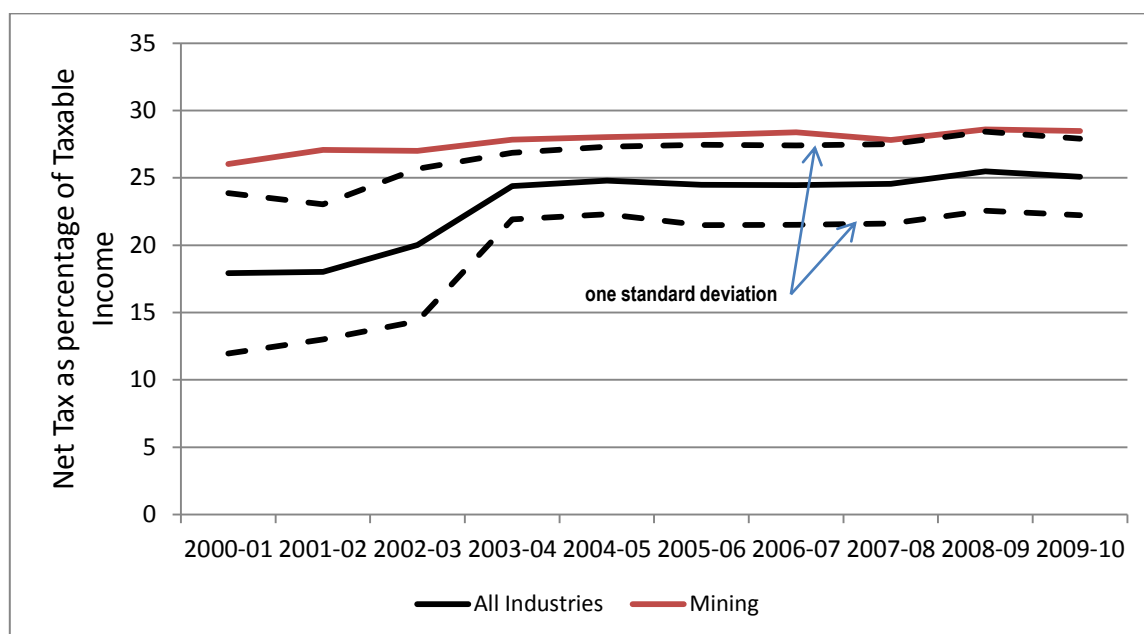
Deloitte Access Economics note that the stability in the minerals industry tax ratio is “no surprise”.

On the one hand company tax is a steady share of profit. On the other hand royalties – typically levies on production volumes or values – have seen their rates rise across the period over which the mining of minerals in Australia has been more profitable...State Governments have lifted royalty rates (and the composition of minerals mined has shifted towards those with higher royalties) to such an extent that royalties have lifted faster than profits over the past decade.^{vi}

Australian Taxation Office (ATO) data for net company tax confirm that mining is among the highest taxed industries in Australia. After refunds and credits, the net corporate tax rate on mining (including oil and gas) has been consistently above the average of total industries in Australia.

Analysis by Professor Sinclair Davidson of RMIT has shown that over the decade to 2009-10 (the last year for which official data is available), the average effective company tax rate for mining (net corporate tax as a percentage of taxable income) has remained above the average plus one standard deviation of all industries (Figure 6).^{vii}

Figure 6: Average effective tax rates for all industries and mining



Source: ATO Taxation Statistics (various issues). Calculations by Davidson (2012).

Professor Davidson has also undertaken an analysis of official tax expenditure and industry assistance data. Such analysis is directly relevant to any consideration of policy change where the objective is to provide for a more “neutral” framework where resources are allocated more efficiently.

The OECD defines tax expenditures as allowances, exemptions, rate relief, tax deferral and credits. Tax expenditures are created when the actual tax system deviates from an “ideal” tax system to the benefit of a narrow group of taxpayers. As Professor Davidson notes, the difficulty is in establishing the ideal tax system – especially in defining the ideal tax base. In theory, it is possible to define economic income, but in practice the tax system does not define the tax base as being economic income. As the OECD itself concedes, “definitions of exactly what constitutes a ‘benchmark’ tax system – used to identify tax expenditures as deviations from the benchmark – are controversial”.^{viii}

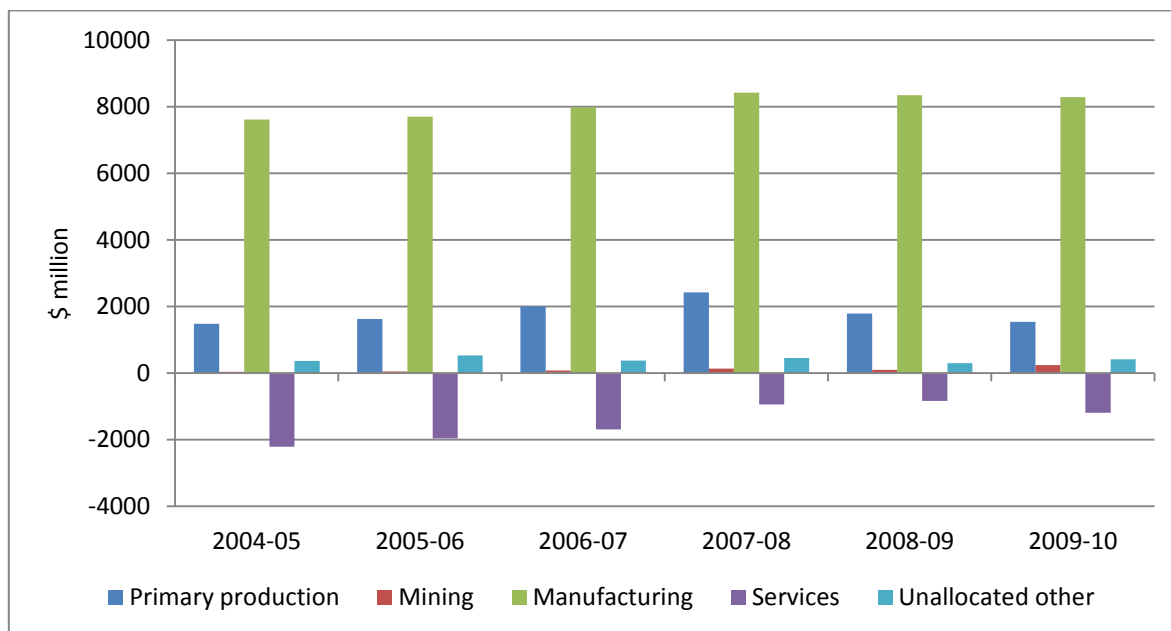
Examining Treasury's *Tax Expenditure Statement* for 2011, Professor Davidson notes that the broad category of "Mining, Manufacturing and Construction" generates *negative* tax expenditure of \$1.75 billion. In other words, deviations from the "idealised" tax system as defined by the Tax Expenditure Statement actually generate additional revenues to the Commonwealth, not a loss of revenue. That increase in revenue is driven primarily by levying customs duty on imported equipment.

The Productivity Commission also provides official data on effective rates of industry assistance in its annual *Trade and Assistance Review*. As Professor Davidson notes, this is a much broader exercise than estimating tax expenditure with industry assistance defined as "... any act that, directly or indirectly, assists a person to carry on a business or activity, or confers a pecuniary benefit on, or results in a pecuniary benefit to, a person in respect of carrying on a business or activity". The Productivity Commission attempts to value the sum of government assistance given to industry via "tariffs, budgetary outlays, taxation concessions, regulatory restrictions on competition and other measures".^{ix}

Again, this sort of economy-wide analysis is relevant to any exercise where the stated objective is to provide for a more "neutral" policy framework when it comes to commercial decision-making and resource allocation. In its most recent industry assistance report, the Productivity Commission reports \$242 million of net government assistance to mining in 2009-10. The vast bulk of what the Productivity Commission records as government assistance to mining (approximately 90%) is in fact general R&D assistance – in other words, an economy-wide program.

Figure 7 shows a comparison of estimates of net assistance to all industries. The single largest beneficiary of government assistance is manufacturing, while services appears to be a net "loser" – that is due to negative tariff assistance. Of sectors that receive some net assistance, the mining sector is the smallest beneficiary. Treasury has concluded on this basis that "the effective rate of assistance provided to the mining sector was negligible".^x

Figure 7: Net government assistance by broad industry grouping, 2004-05 to 2009-10



Source: Productivity Commission (2011: 90)

1.3 TAX POLICY, PROJECT ECONOMICS AND AUSTRALIA'S SOVEREIGN RISK REPUTATION

Policy settings, particularly the taxation system, are crucial to attracting the investment needed to develop Australia's minerals resources. As the (outgoing) Productivity Commission Chairman Gary Banks has observed:

No country's taxation system is an island. Relative expected returns across resource-prospective countries will be the main determinant of international investment and thus domestic activity in the long term.^{xi}

Minerals resources companies make multi-decade investment decisions based on risk-weighted, after-tax returns. It is common for mining companies to rank mining taxation regimes across the world and project-specific reassessments of a country's fiscal regime are always undertaken when evaluating potential investment opportunities. This sensitivity can be attributed to the particular (and often unique) characteristics of minerals resource projects. These characteristics include:

- The exploration phases preceding start-up and production are lengthy and costly, and there is no income during these phases
- The development of a mine is very capital intensive and requires specialist equipment and skills
- A mining project typically has a long life and therefore may be subjected to changes in the political regime or domestic circumstances
- Prices take larger cyclical swings than in most other economic sectors
- The scale of operations can be very large, with high replacement and incremental investment to maintain production
- Mining activities generally get more costly as a project matures because the resource becomes less accessible
- Mine closure and reclamation incur large costs after income has ceased.

Securing the benefits of Australia's comparative advantage in mineral resources requires stable and globally competitive tax arrangements that encourage investment. Australia's taxes on minerals are already high compared with our major competitors. Moreover, there is no shortage of opportunity for the strategic deployment of capital in an industry that is increasingly globally integrated and where competitor nations are gearing up to secure future investment and resource supply opportunities.

For example, coal is mined commercially in more than 50 countries, with Australia accounting for less than 9% of global black coal production. Australia faces stiff competition for market share from a range of other low-cost producers in Indonesia (thermal), Columbia (thermal), South Africa (thermal), Mozambique (metallurgical and thermal), Mongolia (metallurgical and thermal) and India (thermal), as well as interior provinces of China (metallurgical and thermal). High grade iron ore resources remaining in Western Australia are eclipsed by those in the Carajas region in Brazil and there are substantial high-grade resources in other countries. According to one study, Brazil, Guinea in West Africa and also India combined have more than enough resources to take all of the future growth in demand.

Foreign direct investment has supported the expansion of the Australian minerals industry and accounts for an estimated 70% of total funds raised by the industry in recent years. Australian projects need to maintain internationally competitive risk-return profiles and increasing globalisation and industry consolidation has meant that investment responds to project and market opportunities wherever they arise. Policies that drive Australian projects up the global cost curve, result in the destruction of value or otherwise increase sovereign risk impede investment and result in lost national income.

As the Minister for Resources and Energy Martin Ferguson has pointed out repeatedly:

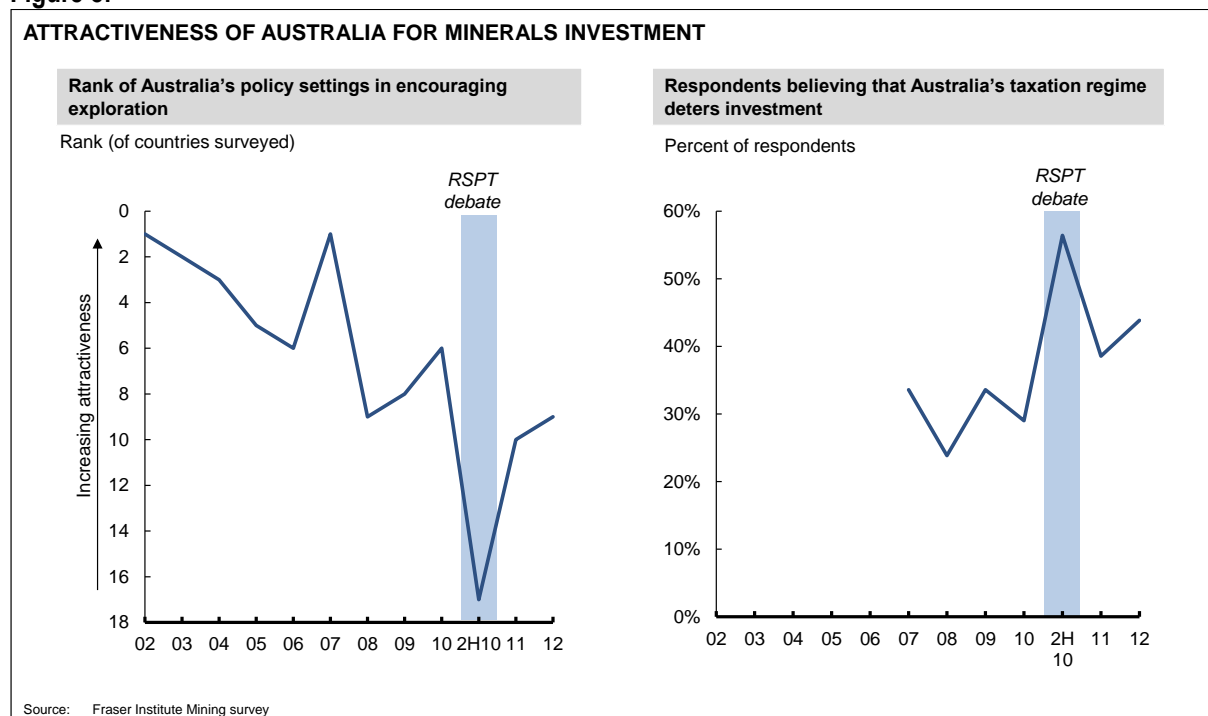
We cannot underestimate the importance of sound government policy in attracting investment and facilitating economic growth. Investment capital is footloose, and Australia is competing globally to attract this capital and investment.^{xii}

The investment economics of projects are assessed based on the overall tax burden such that it is the combination of all business tax rates and measures (not just the corporate rate or any other single tax measure) that is used to assess project viability. As well as the overall burden of taxation, the stability and predictability of fiscal regimes is a critical factor influencing commercial decision-making.

Any “trade-off” between the corporate tax rate and other tax arrangements (such as those applying to depreciation or exploration expenditure) may have disproportionate effects on cash flows and the investment economics of projects. In part, this reflects the particular challenges of the minerals industry noted above. The diversity of taxation measures employed by government, and their complex interaction, further complicates any assessment of alternative tax structures.

Australia’s reputation as a stable and attractive minerals investment destination has deteriorated over recent years. This can be seen most clearly in the ranking of Australia in the wake of the Resource Super Profits Tax (RSPT) proposal, based on the annual survey of mining companies conducted by the Fraser Institute in Canada. Prior to the RSPT debate, investors consistently ranked Australian mining policies as amongst the most attractive in the world. The RSPT debate, however, put Australia’s reputation at risk. Australia’s policy attractiveness fell from 6th to 17th among mining peers, below Zambia, Ghana, and Peru.

Figure 8:



Although ultimately settled, the RSPT debate left a legacy in terms of policy uncertainty and sovereign risk perception. As reported in the Fraser Institute’s 2011-12 Survey of Mining Companies, Australian States and Territories now rank down in the middle of the pack based on tax regime attractiveness to investment – between 30th and 61st of the 93 nations and provinces examined.^{xiii} Further increases in the overall tax burden on Australia’s minerals industry would make Australian projects less attractive than alternatives in other countries. Far from guaranteeing future growth and investment in Australia, the outcome would be less growth, less investment and (ultimately) less taxation revenue.

2. BUSINESS TAX WORKING GROUP: GENERAL OBSERVATIONS

2.1 MINERALS INDUSTRY TAX REFORM PRINCIPLES

The Minerals Council of Australia has been a consistent and long-standing advocate of improving the efficiency, fairness and simplicity of the tax system so as to enhance economic growth and Australia's reputation as an attractive investment destination for highly mobile global capital. The MCA participated actively in the Australian Government's Tax Forum in October 2011 which led in turn to the establishment of the Business Tax Working Group. In its Statement of Priorities to the Tax Forum, the MCA stressed the opportunity the Forum presented to recast the national policy conversation based on the following long-term, strategic policy objectives:

- Ensuring fiscal sustainability, but with a stronger emphasis on disciplined, higher quality spending decisions (rather than ever higher taxation revenues)
- Lifting the nation's productivity performance, with a greater focus on reforms that facilitate the flow of factors of production (capital and labour) to where they are used most productively
- Maintaining Australia's international competitiveness, recognising that global capital is increasingly mobile
- Addressing persistent imbalances in Commonwealth-State financial relations in a way that more closely reflects the spending responsibilities of each level of government and that provides incentive for further economic reform.

In the event, the BTWG was assigned a much more limited task. The Australian Government has asked the BTWG to focus its attention on how a cut in the company tax rate might be funded from within the business tax system or business expenditure programs. While some attention has been given to the possibility of moving to a business expenditure tax system – in particular, the Allowance for Corporate Equity (ACE) model – the main longer term focus has been on reducing the corporate tax rate, especially in light of the Prime Minister's explicit statement at the June 2012 Economic Forum.

As it has in approaching previous taxation reviews and inquiries in Australia, the industry has considered the BTWG process through a lens of tax reform principles. The principles that have guided industry consideration are as follows:

1. Tax reform needs to be **comprehensive** and take a "big picture" view in order to deliver **demonstrable** economic benefits to Australia and clear improvements in the efficiency, equity and simplicity of the tax system.
2. Tax reform proposals should **enhance Australia's international competitiveness and encourage investment**, taking account of globalisation, structural changes in the world economy and increased mobility of capital internationally.
3. Tax reform proposals should be **prospective** to ensure appropriate **stability and predictability** in tax arrangements and so as avoid creating perceptions of sovereign risk.
4. A **broad tax base with a uniform tax structure** has potential benefits in terms of efficiency, equity and simplicity, though there are likely to be economically justified departures from this principle. Taxation instruments should not favour or disadvantage particular industries, firms or business structures over others.
5. Tax reform proposals should **reduce tax complexity and minimise administrative and compliance burdens**.
6. To be successful, tax reform should involve **extensive consultation** (especially where proposals result in higher effective tax rates on specific industries).

These are high-level principles and it is noted that the BTWG has itself set down a set of business tax reform principles, some of which mirror closely those outlined above. It is recognised further, as noted in the MCA

submission to the Australia's Future Tax System Review, that tax principles can conflict; hence there is a need for judgements that balance different principles.

2.2 BTWG TERMS OF REFERENCE AND CONTEXT

The industry supports the broad policy position taken by the BTWG that: "Australia should have an ambition to reduce its company tax rate over the medium term and that achieving a materially lower rate is a worthwhile reform objective". Other things equal, a lower corporate tax rate would increase Australia's ability to attract investment capital with flow-on benefits in terms of higher productivity and wages and hence higher living standards for Australians.

In reality, however, the industry considers that the BTWG's narrow focus and Terms of Reference constrain markedly the scope for this process to deliver clear and meaningful net benefits to the Australian economy.

The binding constraint on the process (revenue-neutral within the business tax system) means that there is no prospect of a lower overall corporate tax burden from the process; by definition, some firms and sectors will face a higher tax burden. At the same time, it is well established that Australia relies more heavily on corporate taxes than most other advanced economies, with the percentage of total tax revenues collected from corporate tax more than double the OECD average. With no prospect of a lower overall corporate tax burden, the essentially marginal nature of any **potential** gains has been highlighted by a number of economic and tax advisory bodies.

Commenting on the possible gains from the BTWG process, the Productivity Commission has stated that:

... in assessing the impact of tax reform, consideration also needs to be given to the corresponding changes that accompany the reform (be they changes in government expenditure, revenue raised from other taxes or changes in a government's fiscal position). The overall impacts will depend on the impacts from the tax reform relative to the impacts from the accompanying changes...

The possible gains from the business tax reforms being considered (by the BTWG) will depend on the nature of the changes made to these business taxes and the offsetting changes to other business taxes to ensure revenue neutrality. That is, the gains from reforming these business taxes need to be weighed up against the effects of the offsetting changes. For example, the net effect on economic efficiency will depend on the changes in the deadweight loss arising from each tax change. The net effects of such change are likely to be relatively modest, unless the changes have a material effect on the production and investment decisions of business.^{xiv}

Mr Richard Highfield, a senior tax adviser at the OECD, has observed that:

This is not a reduction in the overall tax burden, this is really just a bit of tinkering to lower the marginal rate. I think because this exercise is largely intended to be tax neutral, then it clearly can't be as attractive as a set of proposals that over time reflect a change in the tax mix.^{xv}

Related to this overarching concern about the limited scope for meaningful reform, the minerals industry considers there are multiple limitations surrounding the BTWG process:

1. The efficiency of government expenditure in Australia is deemed off limits. The minerals industry recognises the competing demands on government and the ongoing need to finance public services in a sustainable way. At the same time, the industry considers that piecemeal reform in isolation from the potential for improved government expenditure limits considerably the scope for long-term, productivity enhancing tax reform initiatives.

2. There is no scope for the BTWG to consider changes to the tax mix in Australia through targeting the most inefficient taxes. A number of taxes in Australia are both costly and hamper economic growth, especially in an economy undergoing significant structural adjustment. The imposed constraint of revenue neutrality within the business tax regime limits any comprehensive consideration of a reform with demonstrable benefits to the Australian economy.
3. The basis on which some measures have been identified as “overly generous” or “distortions” from a neutral business tax system is unclear. While recognising that the discussion paper released by the BTWG in August 2012 is not a “position paper”, it does include a number of statements which appear to pre-empt an open and transparent consideration of the evidence.
4. The basis on which certain proposals are **not** considered departures from a neutral business tax system is unclear. While arrangements bearing on capital intensive industries such as mining appear to have attracted intense scrutiny, other areas appear to have escaped similar examination. For example, various concessional arrangements related to the banking and finance industry, including those geared to making Australia a “low-tax” financial hub, are not examined.^{xvi}
5. The ultimate decision-making criteria of the BTWG are unclear. While presented as an evidence-based, transparent examination of the business tax regime, in practice the exercise appears more about finding sufficient savings with minimal backlash to fund a corporate tax rate reduction. The principles that will ultimately guide any BTWG recommendations to government remain uncertain.
6. There is no settled view on the costing of various options. In some cases, this reflects a lack of transparency relating to assumptions used by Treasury. In the case of possible changes to thin capitalisation rules, Treasury has effectively “outsourced” the costings process to business groups which itself has underlined the inadequacy of the BTWG process. The tight timetable for the exercise has only added to disquiet within the business community about the rigour of the process.

A further concern of the industry, as noted earlier, is the degree to which the BTWG’s mandate has been framed very deliberately around a conceptual framework – the “patchwork economy” – which fails to offer a sound basis for tax reform. This is problematic both from an empirical and policy perspective.

The composition of the economy is constantly changing and there is nothing unusual about sectoral or regional growth disparities. According to the Australian Bureau of Statistics (ABS), in a typical year Australia’s economy sees around 300,000 firms entering and exiting and roughly half a million workers changing industries.^{xvii} There are always sectors that are expanding and contracting as demand and supply conditions change and prices adjust. Moreover, research has shown that economic growth in Australia has rarely, if ever, been uniform between sectors or regions.^{xviii}

It is a sign of a well-functioning, flexible economy that capital and labour are allowed to flow to where they are used most productively. Non-uniform rates of expansion and contraction are desirable and in fact necessary for economic progress and are part and parcel of the process of economic growth and sustained improvements in living standards.

Accordingly, the notion that economic policy – especially business tax arrangements – should be geared towards ameliorating a patchwork economy runs counter to the market-based reform policies that have helped Australia achieve two decades of continuous economic growth. These policies have sought to lift economic growth and productivity by facilitating the movement of capital and labour towards activities where they can yield the biggest payoff.

2.3 RISKS FROM A PIECEMEAL REFORM APPROACH

In summary, the industry considers the BTWG process, as constituted, to be characterised by critical flaws when measured against criteria for genuine tax reform – strong principles, compelling empirical evidence and good process.

Particular concerns relate to:

- The narrow Terms of Reference set for the BTWG which constrain markedly the scope for meaningful taxation reform
- The risk that piecemeal change (under the guise of addressing the “patchwork economy”) will actually worsen the fiscal regime in Australia, decreasing international competitiveness and adding to sovereign risk at a time when future minerals industry investment is highly uncertain
- The absence of a compelling case for changing those provisions identified as base broadening options
- The unbalanced nature of the list of savings options under consideration which seemingly impact disproportionately on capital intensive industries, in particular the resources sector.

In light of these concerns, the minerals industry does not support a “package trade-off” to deliver a (marginal) reduction in the company tax rate.

There is a non-trivial risk that the BTWG process will leave the business tax system more complex than it found it and Australia further away from a growth-oriented policy framework geared towards the efficient allocation of resources. The OECD has correctly identified this type of risk in noting that:

... if piecemeal reforms are undertaken for the sake of reform and without any strategic vision to guide them, politicians might not understand or take into account the long-term implications of these measures, such as potentially negative impact on future tax revenues or the possibility that tax complexity might breed further tax complexity. This entails the risk of making the tax system more complex without tackling the underlying economic problems and tax issues in the most efficient way.^{xix}

The minerals industry considers this accurately describes the risk presented by the BTWG process. **There can be no presumption that any recommendations from this process would yield a net benefit to the Australian economy.**

3. BASE BROADENING OPTIONS: KEY ISSUES

3.1 EXPLORATION

3.1.1 The backbone of the mining industry

Broadly defined, mineral exploration is the collection of information necessary to identify mineral deposits and evaluate whether they have real economic value. Exploration is clearly necessary to ensure continuing production in the minerals industry. In the words of the Argus-Ferguson Policy Transition Group (PTG) report on Minerals and Petroleum Exploration, released in December 2010:

A strong resource exploration sector is the backbone of the resource industry in Australia, ensuring continued future access to high quality deposits. The amount of investment in exploration affects the ability of Australia's resources to sustain strong growth and expand its contribution to national economic growth over the medium to long term.^{xx}

Minerals exploration is intrinsically high-risk. The exploration process is lengthy, expensive, often conducted in remote and inhospitable environments and scientifically complex. Using international data, the Colorado School of Mines concludes that it takes 500-1,000 grassroots exploration projects to identify 100 targets for advanced exploration which lead in turn to 10 development projects, one of which becomes a profitable mine.^{xxi} In short, exploration typically has a very high failure rate and rarely leads to creation of continuing asset value.

Exploration is also vulnerable to the highly cyclical nature of the minerals industry. In a 'boom', heightened competition makes mineral rights, labour and equipment expensive to source. When the cycle turns, finance is more difficult to secure both internally and externally.^{xxii}

Funds invested in exploration are substantial and increase significantly at each stage. In the initial 'grassroots' phase, a company assesses existing information, acquires minerals rights, commences community engagement and conducts regional geological, geochemical and geophysical examinations. In the subsequent 'detailed target evaluation' phase costs are likely to be higher based on activities such as closer-scale drilling and geological and metallurgical analysis to construct a three-dimensional model of the deposit and begin evaluating the viability of its extraction. In the third stage, a company prepares a feasibility study, including mineral reserve estimates, undertakes mine and plant designs, environmental management plans, detailed cost estimates and full technical and financial assessments – all targeted towards evaluation and assessment of economic viability. These assessments are the basis for an investment decision about whether the project under evaluation is sufficiently viable economically to proceed to development. The cost of this stage is often very significant. In total, an exploration process of this sort typically takes between five and 15 years.^{xxiii}

As the PTG report concluded in its report to the Australian Government:

To sustain the contribution of Australia's mineral and petroleum resources to national economic performance in the longer term, additional high quality resources need to be discovered and developed. Industry and government should be strategic in their approach to the continued development of Australia's resource sector, establishing policies that are conducive to exploration and will allow for the development of the next generation of Australia's resources.^{xxiv}

In December 2011, the Standing Council on Energy and Resources, comprising State and Federal Energy and Resources Ministers, commissioned further work on an options to improve Australia's global position for attracting exploration investment. The resultant April 2012 paper noted correctly that: "Policies that are ignorant of the realities of exploration risk will cripple the industry and drive away investment".^{xxv}

Taxation treatment is a crucial influence on exploration expenditure decisions. As the Colorado School of Mines has observed: "Both the rate and form of taxation affect the relative attractiveness of different countries or sub-

national regions for investment in mineral exploration and development... Exploration is footloose in that explorers can redirect their activities to regions or countries with more favourable tax regimes.”^{xxvi}

The immediate deductibility of exploration expenditure acknowledges that:

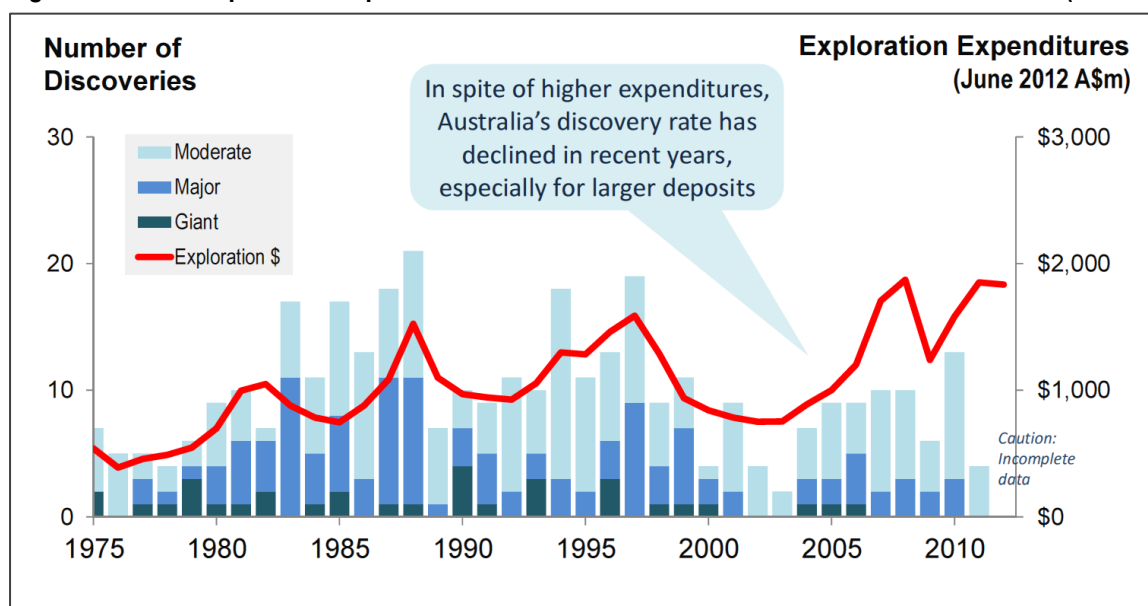
- Such expenditure is an ongoing, necessary and ordinary business expense of a minerals company
- There are high levels of risk associated with exploration
- There is a need to encourage discovery of new deposits (where exploration has both public good and positive externality attributes)
- Typically, there will not be a successful mine resulting from most exploration expenditures and
- A competitive fiscal regime is a policy imperative for future mineral resource development.

Importantly, immediate deductibility of exploration expenditure has been supported by various inquiries and policy advisory bodies – including the Industries Assistance Commission and the Industry Commission, the precursors to the Productivity Commission – as the least distorting tax treatment in terms of the efficient allocation of resources in the economy.

3.1.2 Australia’s Recent Performance

Australia’s competitive position as an exploration jurisdiction has been described as “like the ‘curate’s egg’, good in parts”. Australia possesses a strong mineral endowment, but discovery is “becoming harder and more costly”^{xxvii}. This is consistent with the view expressed by the chief of Geoscience Australia’s Energy and Minerals Division that: “While Australia’s resource stocks are healthy overall, the country’s position as a premier minerals producer is dependent on continuing investment in exploration to locate high quality resources and to upgrade known deposits to make them competitive on the world market”. There have been “very few world class discoveries in Australia over the last two decades and the inventory has been sustained largely through delineation of additional resources in known fields”.^{xxviii} The PTG process found similarly that most of Australia’s major discoveries were made more than 20 years ago and “there has been a decline in the success rates and in the average size and quality of deposits discovered”.^{xxix}

Figure 9: Exploration expenditure and mineral discoveries for non-bulk commodities (1996-2012)



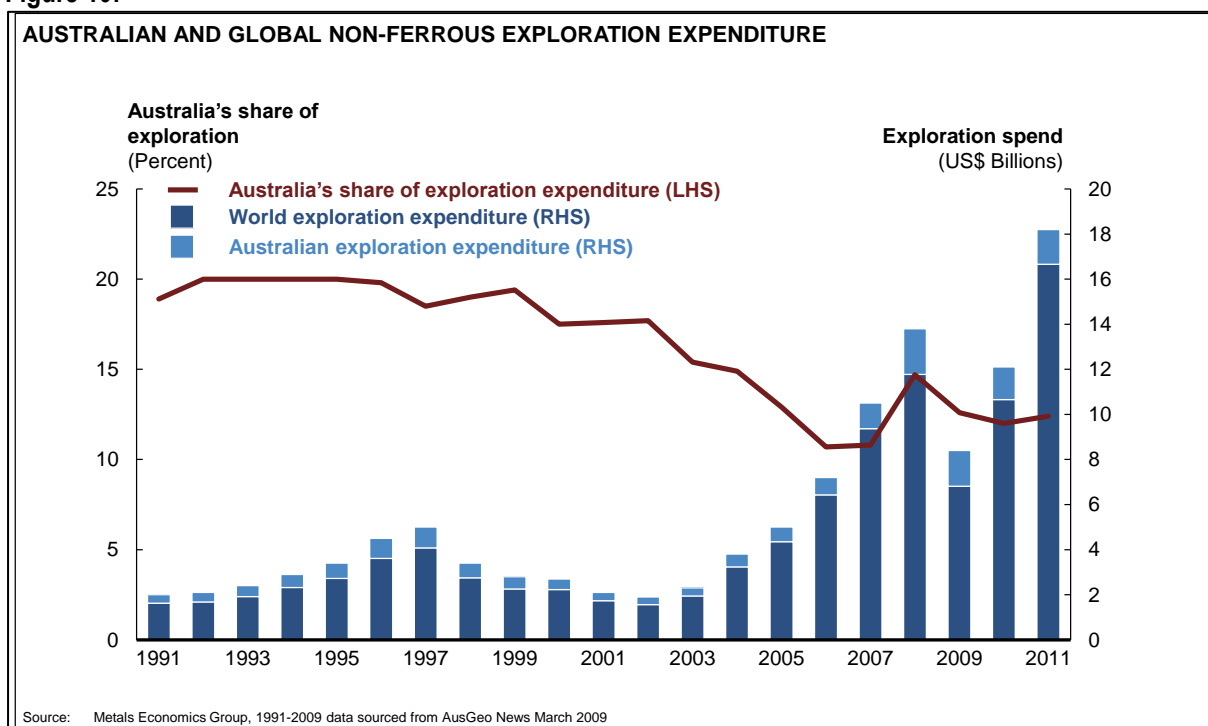
Sources: ABS and MinEx Consulting. Discoveries and expenditures exclude bulk minerals (coal, iron ore and bauxite), includes uranium.

Whereas in the 1980s and 1990s more than 10 significant deposits were found **each year** on average, only 43 significant deposits were found over the decade between 2000 and 2010. Excluding bulk commodities, Australia's discovery rate has roughly halved over the decade despite increased exploration expenditures.^{xxx}

Analysis by MinEx Consulting has found that in the last decade Australia made fewer discoveries, found a declining share of global discoveries (including among "mature" mining jurisdictions) and paid substantially more for them. The cost of each "giant discovery" was twice that of comparable discoveries elsewhere.^{xxx}

Mining regions in developing nations are also becoming more competitive as a destination for exploration investment. Of the 121 countries documented by the Metals Economics Group (MEG), nations commonly perceived to be "high risk" accounted for 15% of total exploration expenditure in 2010 and 23% in 2011. MEG figures for 2011 global non-ferrous exploration expenditure put Australia's share of exploration expenditure at 13 per cent – below Latin America (25%), Canada (18%), and Africa (15%).^{xxxii} On this measure, Australia lost 8 percentage points as a share of global exploration in the 15 years to 2011.

Figure 10:

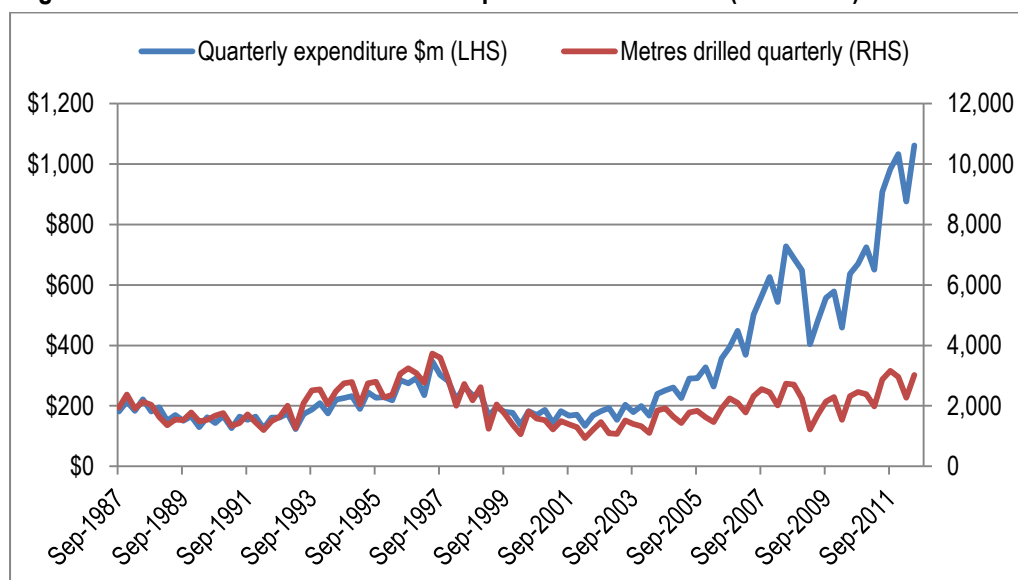


An increasing number of Australian explorers are investing overseas. It is estimated that half of locally sourced exploration funds are now spent offshore notably in developing nations with increasingly stable Governments, attractive mining and taxation policies and where the early-mover advantage still exists. It has been reported for example, that there are now 325 Australian based companies operating about 850 projects (including 45 operating mines) worth around \$40 billion in of the 54 African countries.^{xxxiii}

The Fraser Institute in Canada identifies 93 national and sub-national exploration jurisdictions in its annual survey assessing the impact of public policy decisions on minerals investment. There are exploration projects vying for finance on every continent except Antarctica. Australia's attractiveness based on the survey's mining taxation criterion deteriorated between 2009 and 2012 for all States (the Northern Territory being the only jurisdiction to record an improvement). In the overall ratings, no Australian state ranks in the top ten. Queensland, Tasmania and New South Wales fall outside the top 20, while Victoria is ranked 44th among relevant jurisdictions.^{xxxiv}

As noted previously, while nominal exploration expenditure has risen in light of higher mineral commodity prices, this has not translated into a commensurate increase in the more significant indicator of exploration activity – namely, the number of metres drilled. A September 2012 report by the Centre for Exploration Targeting at the University of Western Australia attributes the lower drilling “efficiency” to a range of factors including: a significant real escalation of costs; the higher unit costs from having to drill more deeply; a real escalation in non-drilling exploration costs; and possible regulatory or other impediments.^{xxxv}

Figure 11: Total mineral exploration in Australia (1987-2012)

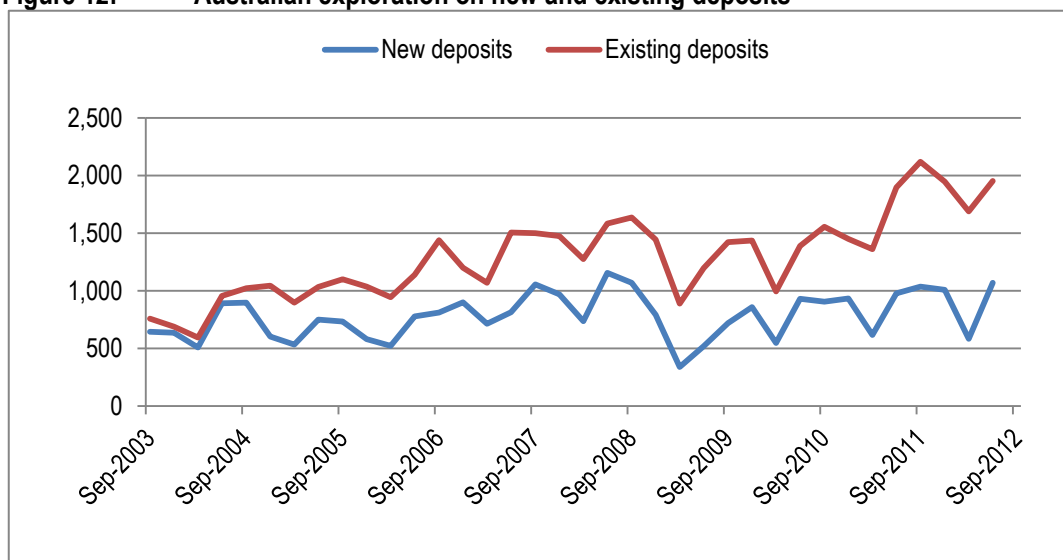


Source: ABS

A greater focus on exploring existing “brownfield” rather than new “greenfield” deposits is one consequence of the increasing cost of exploration. Brownfield exploration involves searching more deeply or laterally for mineralisation related to a known deposit. Greenfield exploration investigates outside areas of known deposits.^{xxxvi} As shown in Figure 12, the number of metres drilled on greenfield and brownfield sites were broadly similar roughly a decade ago. Since then, a gap has opened (and widened) between metres drilled on new and existing deposits. The effort on brownfields sites is now approximately double that on greenfields sites.

While brownfields exploration has the potential to add to the life of an existing mining project, the University of Western Australia report concluded that: “The gradual shift of funding from greenfield to brownfield exploration, while understandable in terms of short-term profitability, is worrying as in the long-run it will affect the metal contribution to the national resource inventory and with it the sustainability of the Australian mining industry.”^{xxxvii}

Figure 12: Australian exploration on new and existing deposits



Source: ABS

3.1.3 Policy Consideration of Exploration Expenditure

Since 1947, Australia’s income tax laws have (correctly) recognised exploration as a “normal business expense” of the mining industry – a necessary business cost critical to a mining company’s ongoing operation. The Treasurer’s Second Reading Speech on the Income Tax Assessment Act of 1947 stated that:

The Explanatory Memorandum to the Income Tax Assessment Act 1947 defined exploration broadly to include:

...geological mapping, geophysical surveys, systematic search for mineralised areas and detailed search by drilling or other means for ore deposits within those areas. It will also embrace the search for ore within or in the vicinity of an ore-body by drives, shafts, cross-cuts, winzes, rises and drilling, not being normal development.^{xxxviii}

The taxation treatment of exploration nonetheless has been the subject of inquiry and analysis in a variety of processes over subsequent decades. By way of illustration, the following is by no means exhaustive:

- In 1975, the Asprey Committee Taxation Review concluded that all exploration and prospecting expenditure should be immediately deductible against income derived from any source. This conclusion was based on the Committee’s view that the expenditure is a normal operating expense of a mining enterprise and should be treated as such.
- In 1976, the Industries Assistance Commission endorsed immediate deductibility for exploration expenditure and the view that expenditure on exploration represents a “necessary and continuing operating expense of a mining company and should be treated consistently whether successful or not”:

Since expenditure on both exploration and R and D represents a necessary operating expense, the criterion of neutrality requires that the manner in which it is allowed as a deduction for tax purposes should be similar in both cases.^{xxxix}

- In 1991, the Industry Commission’s *Review of Mining and Minerals Processing in Australia* concluded: “Although immediate deductibility of exploration expenditures may involve an element of assistance, this ‘concession’ is the least distorting tax treatment in terms of the efficient allocation of resources in the economy”. It recommended further that:

The definition of eligible exploration expenditure in Section 122J of the Income Tax Assessment Act 1936 be broadened beyond the existing 'on tenement' definition to include all properly attributable exploration expenditure, including modern approaches such as remote sensing and 'desktop' research. Expenditures on feasibility studies which are essentially exploration related also be deductible^{xi}

- The *Review of Business Taxation* chaired by Mr John Ralph AO similarly recommended retention of immediate deductibility of exploration expenses:

Expenditure on exploration and prospecting will continue to be immediately deductible under the Review's proposals. The strict logic of the generalised approach would suggest that expenditure on unsuccessful exploration and prospecting would be immediately deductible, while successful expenditure would be written off over the life of the resulting asset. However, in many cases there may be significant delays before it is known whether the activity has been successful or before a mine is established. It is largely on the grounds of practicality that the current treatment is proposed to be retained.^{xii}

- The *Australia's Future Tax System Review* chaired by Dr Ken Henry determined that exploration expenditure was "favourably treated" under the income tax regime, while concluding that the treatment of tax losses "disadvantaged exploration relative to other investments" and created a "tax bias" against junior explorers who do not have income against which tax losses can be deducted which put them a "competitive disadvantage" and "may discourage investment". Over a long period of time, the Australian minerals industry has drawn attention to this structural asymmetry in the tax system and advocated a measure similar to the "Flow-through-Shares" provision in Canadian tax legislation. The Henry Review instead recommended that:

If earlier access to tax benefits from exploration expenses (relative to other expenses) is to be provided, it should take the form of a refundable tax offset at the company level for exploration expenses incurred by Australian small listed exploration companies, with the offset set at the company income tax rate.^{xiii}

- Though originally announced together with the RSPT in May 2010, this proposal was reconsidered in the context of new resource taxation arrangements announced in July 2010. Subsequently, the PTG process was charged with further examining fiscal incentives for exploration. The PTG report of December 2010 concluded that the existing regime of immediate deductibility acknowledges "the high-risk nature of exploration and the economic benefits that result from it".^{xiiii}
- The Australian Government accepted the PTG's recommendations in their entirety in March 2011.

In summary, immediate deductibility of exploration expenditure has received close scrutiny through a range of official processes over the years, including very recently. The dominant view has supported immediate deductibility of exploration expenditure on grounds of efficiency, practicality, spill-over benefits and international competitiveness. This has provided an important measure of certainty and stability to what is, intrinsically, a very high risk economic activity.

3.1.4 Business Tax Working Group Consideration of Exploration

The BTWG identifies five options that would remove or otherwise limit immediate deductibility of expenditure on exploration and prospecting. The five options are as follows:

- B.7 – Remove or reduce the "first use" exploration deduction for capital assets (such as exploration declines for underground mines, drill rigs etc.) – with the asset being written off over five years
- B.8 – Remove or reduce the "first use" exploration deduction for "intangibles" (i.e. exploration tenements and leases) – with the asset being written off over five years

- B.9 – Deduction for non-depreciating exploration expenditure (i.e. general expenditure on transport, materials, labour and expenditure costs to be written off over five years or over its effective life)
- B.10 – Removal of immediate deduction for exploration expenditure by large companies – five year write-off would only apply to companies with a turnover of more than \$500 million
- B.11 – Exclude feasibility studies from exploration expenditures (i.e. remove feasibility studies from the definition of exploration expenditure)

The Discussion Paper states that “it is a matter of judgement” whether these measures provide “**an optimal level of support**” (emphasis added) citing a number of criticisms:

- They are poorly targeted (particularly the “first use” test)
- They may be misapplied (for example, when an exploration right (“tenement”) changes hands immediately before being converted into a mining tenement)
- They may not benefit junior miners (who do not have income against which expenses can be deducted).

The BTWG also acknowledges that:

- The immediate deductibility for exploration is a “long-standing feature of the income tax system” intended to encourage mineral exploration, in recognition of potential spill-over benefits
- The “net present value of these deductions would be reduced”
- The reduction or removal of exploration deductions “**would be expected to increase marginal effective tax rates for explorers** (emphasis added), reducing the scale of exploration in Australia and encouraging some investors to transfer activities overseas”
- There are real complexities in ensuring tax depreciation reflects the economic life of an asset
- There are cases where departures from uniform tax treatment may be justified in economic, social or environmental grounds.

3.1.5 Minerals Industry Response

KEY POINTS:

- **Conceptually and from a business perspective, general exploration expenditure is analogous with other normal operating expenses that are immediately deductible, such as those geared towards market research or marketing (e.g. advertising). Mineral exploration is “exploring for business”.**
- **Immediate deductibility of exploration expenditure has been supported by a number of official processes over the years, including the Policy Transition Group which reported to the Australian Government in December 2010. Both the Industry Commission (the forerunner to the Productivity Commission) and the Ralph Review concluded that it provides the least distorting and most practical way to treat exploration expenses.**
- **The insertion in taxation law of arbitrary limits (e.g. deductible over five years), thresholds (e.g. companies with a turnover of more than \$500 million) and/or the singling out of aspects of the exploration continuum (e.g. feasibility studies) run directly counter to sound tax principles of efficiency, fairness and simplicity.**
- **The industry would be keen to participate in a detailed and considered process to examine what measures would provide “an optimal level of support” for exploration in Australia. However, the BTWG does not offer such a process. The industry strongly recommends no change to the immediate deductibility exploration expenditure (on grounds of efficiency, practicality, spill-over**

benefits and international competitiveness) noting that, as the BTWG concedes, the likely result would be to “increase marginal effective tax rates for explorers”.

Conceptually, general exploration expenditure is analogous with other normal operating expenses that are immediately deductible and geared towards market research and/or marketing (such as advertising). Within the context of a highly competitive, high-risk industry, the “exploration for business” by mineral resource companies should not be treated differently.

General exploration expenditure should qualify for a basic deduction under the general deduction provisions in ITAA97 s 8-1 which allow deduction for expenditure incurred in producing assessable income, provided the expenditure is not of a capital, private or domestic nature and also provided that the expenditure is not specifically prevented from being deductible another (specific) provision within ITAA97 or ITAA36. The existence of a specific provision (ITAA97 s 40-730) which provides for expenditure on exploration as deductible outright in the year in which it is incurred should not cloud the issue.

S 40-730 replaced ITAA97 Div 330 subdiv A, which had in turn replaced ITAA1936 s 122-J. ITAA1936 s 122-J was introduced in 1947 to better clarify what was otherwise considered uncertain at the time. It was accepted that exploration expenditure incurred by an established mining company was deductible as a basic deduction under the general deduction provisions, as expenditure incurred in replenishing ore reserves that were being consumed in the course of mining. However, uncertainty surrounded whether start-up exploration companies could claim exploration expenditure as a basic deduction under the general deduction provisions when they did not have an existing history to prove this was their business.

The introduction of ITAA1936 s 122-J in 1947 was to clarify this uncertainty in relation to exploration expenditure by operations that were not already engaged in mining. It was not introduced to provide a concessionary deduction – the deduction was already available under the general deduction provisions.

Further support for the proposition that exploration is deductible under the general deduction provisions is found in the case *Commissioner of Taxation v Ampol Exploration Limited* 1986 FCA 414 (27 November 1986). The judgment made the point that exploration expenditure could be deductible under either the specific provision or under the general deduction provision, which at that time was ITAA36 s 51(1).

Correspondingly, general exploration expenditure should not be viewed as capital expenditure creating a long-term asset. Most exploration expenditure does not create long-term assets because, as outlined above, most exploration expenditure does not result in discovery. Similarly, exploration cannot be deducted over life of mine (LOM) because – by definition – it occurs before there is a mine and in most instances a mine never eventuates.

The economic consequences of an investment decision related to exploration needs to be capable of being determined before the investment is made – i.e. the net present value of the expenditure by reference to its tax treatment. The success or otherwise of the exploration is not known at the time of the expenditure and therefore if depreciation was intended to be over Life of Mine (LOM), the deduction profile and thus economic consequences of the expenditure could not be determined at the time the expenditure is incurred. This was the practical reality recognised by the Ralph Review.

Conceptually, the Ralph Review concluded that expenditure on acquiring information should be treated according to the benefit obtained from that information. Hence, on “strict logic” expenditure on unsuccessful exploration would be immediately deductible, while successful expenditure would be written off over the life of the resulting asset. However, Ralph went on to note that there may be “significant delays before it is known whether the activity has been successful or before a mine is established. It is largely on the grounds of practicality that the current treatment is proposed to be retained.”

Arbitrary and artificial limits to the deduction of exploration expenditure have no sound basis in tax policy principles (efficiency, equity, simplicity). The insertion of arbitrary five year depreciation periods or turnover thresholds in the tax law by definition runs the risk of distorting efficient commercial decision-making and

of adding unnecessary complexity to both compliance and administration. In particular, the turnover threshold would discriminate against those companies likely to be best placed to undertake the largest and highest risk exploration programs that are necessary to secure the long-term future of the Australian resources industry.

Similarly, the singling out of aspects of the exploration continuum for exclusion from the current taxation regime misunderstands the exploration process:

- B.8: denial of immediate deduction for “first use” intangibles – This provision arose as part of the process of moving to Uniform Capital Allowances as opposed to a specific policy decision aimed at encouraging specific investments or behaviours. It recognises that due to the significant sums expended, minerals companies undertake very little exploration without securing the mineral title and the legal and commercial rights to any potential discovery.^{xiv} In this sense, the intangible asset is clearly a business expense analogous to the purchase of a patent by a biotech company.
- B.11: exclusion of feasibility studies – The MCA Tax Committee is aware that the ATO is looking at this as part of an overall review the definition of exploration and prospecting as applicable under the Petroleum Resource Rent Tax, the MRRT and the Income Tax Assessment Act, but the law is clear and longstanding in accepting feasibility studies as an integral element within the exploration process and a necessary and normal business expense:
 - ATO ruling TR 98/23 states: Expenditure incurred on feasibility studies to evaluate the economic feasibility of mining minerals or quarry materials once they have been discovered, is expenditure within the meaning of “exploration or prospecting” in section 330-20.
 - Section 330-15 (1) (c) includes within the definition of “exploration or prospecting”: feasibility studies to evaluate the economic feasibility of mining minerals or quarry materials once they have been discovered.
 - The “Explanations” to TR 98/23 state: The 1997 Act has introduced an open-ended inclusive definition of exploration or prospecting rather than the closed definition contained in the general mining and quarrying provisions of the previous law. The new definition represents a more flexible approach, as the meaning of “exploration or prospecting” is no longer exhaustively defined but now has the ability to take in, over time, comparable activities that evolve from technological and other changes.... This reference was inserted to recognise the Commissioner's practice of allowing expenditure on certain feasibility studies as expenditure on exploration or prospecting as outlined in Taxation Ruling IT2642 at paragraphs 25 to 27... In determining the economic viability of a project, it is necessary to weigh the market for the resource that is to be won and the price obtainable for it against all the costs that will be incurred in winning and marketing the commodity.”^{xlv}

It may be the case, as noted in the BTWG Discussion Paper, that existing arrangements do not provide an “optimal level of support” to exploration in Australia. A considered approach may determine that the level of support should be higher. If the BTWG process were constituted as a process geared to examining what measures would deliver an optimal level of support to exploration in Australia, the industry would be a keen and proactive participant. However, this is not the case.

Based on the BTWG’s narrow mandate and approach, including the extent to which the vast bulk of industry-related measures (whether in terms of direct budget assistance or tax expenditures) are not being considered, the industry would contend that any reference to what may or may not be “optimal” from a resource allocation perspective is largely irrelevant in this case. Unlike other measures beyond the BTWG’s consideration (e.g. “co-investment” payments to sections of manufacturing or tax incentives geared to Australia as a regional financial centre), immediate deductibility of exploration expenditure has the benefit of supporting growth of a sector in which Australia has a demonstrable comparative advantage.

3.2 TAX DEPRECIATION – DIMINISHING VALUE METHOD

KEY POINTS:

- Australia’s move in 2006-07 to a Diminishing Value (DV) rate of 200% for claiming depreciation on assets (replacing a DV rate of 150%) was based on the same policy objectives articulated by the BTWG – namely, to bring the rate of depreciation for tax purposes more closely into line with economic depreciation and to encourage investment.
- No evidence has been presented to substantiate a view that a 200% rate is a concession or distortion such that moving back to 150% would achieve closer alignment with economic depreciation or otherwise improve Australia’s international competitiveness. What is clear is that capital intensive industries (such as mining) would be adversely affected, both in absolute terms and relative to other industries.
- Analysis for the MCA by KPMG concludes that the 200% rate “does not necessarily provide Australian taxpayers with an advantage relative to taxpayers in other countries sampled”. Among the countries sampled, the United States, Japan and Indonesia feature a 200% rate for diminishing value calculations. Importantly, the KPMG analysis also concludes that a number of countries which are key competitors with the Australian minerals sector (including Canada, Chile, Indonesia and South Africa) “have some accelerated depreciation arrangements for the mining sector”. While direct comparisons are difficult due to different depreciation methodologies and effective lives, across a sample of representative assets, KPMG found that the depreciation allowed over the first five years of an asset’s life was consistently higher in countries such as Canada, Chile, Indonesia and South Africa when compared with Australia.
- On international competitiveness grounds alone, the industry considers that no case has been made for reducing the DV rate.

3.2.1 Current Tax Treatment

Currently, taxpayers can claim depreciation using either the “straight line” (Prime Cost) or DV methods. The total depreciation over time is the same for both. Under the straight line method the asset is written off in equal instalments over the asset’s effective life. The DV method recognises that an asset’s decline in value may be greatest in the first year, diminishing in each subsequent year.

The DV method is intended to approximate the actual decline in value of an asset and the true cost to taxpayers of the asset as an input cost. The rate at which DV is set does not change the effective life over which the assets are depreciated or the total dollar amount written off over the asset’s effective life (assuming the asset is “scrapped” at the end). However, a higher DV rate increases depreciation deductions in the early years thereby increasing their net present value and reducing a business’s financial cost of holding the asset.^{xlvi}

3.2.2 Earlier Policy Consideration

In the context of a general move towards reducing accelerated depreciation provisions within the business tax system, the Ralph Review in 1999 recommended (Rec. 8.8): “That taxpayers be given the option of writing off depreciable assets on the basis of prime cost or diminishing value”.^{xlvii} The Review did not recommend a DV rate.

With the introduction of the new Uniform Capital Allowance (UCA) provisions from 1 July 2001, the DV rate was set at 150%. In the Federal Budget of 2006-07, the rate was increased to 200%. This was presented at the time as building on the reforms recommended by the Ralph Review with the 200% rate seen as preferable for a number of reasons, including:

- The 150% DV rate did not fully reflect the true change in value of many depreciating assets.

- A 200% rate more accurately aligns depreciation deductions for tax purposes with the actual decline in the economic value of assets.
- The increase to 200% would ensure that Australian businesses have the right incentive to undertake investment in new plant and equipment necessary for them to keep pace with new technology and to remain competitive.
- The higher rate would strengthen prospects for economic and employment growth through capital deepening and improved resource allocation.
- It would bring Australia more into line with other comparable countries, enhancing the international competitiveness of Australian business.
- It would improve resource allocation by providing a more neutral arrangement across depreciating assets.^{xlviii}

Particularly relevant in this context was benchmarking analysis conducted for the Australian Government in *International Comparisons of Australia's Taxes*. The report delivered to the Australian Government found that of 10 OECD comparator countries, Australia had the equal lowest present value of depreciation allowances for an eight-year asset. Several of the comparator countries had a diminishing value rate of 200%. The 2006-07 Budget decision was welcomed by business groups at the time as ensuring "that tax depreciation rates more closely align with economic depreciation".^{xlix}

3.2.3 Business Tax Working Group's Consideration

Reducing the DV rate from 200% to 150% is one of 14 savings options relating to capital allowances and exploration advanced by the BTWG. The policy rationale advanced is that the "benchmark for the neutral treatment of capital expenditure is that tax depreciation should align as closely as possible with economic depreciation".

The BTWG paper acknowledges that this was the "stated purpose" of the Australian Government moving to a DV rate of 200% in 2006-07. It goes on to reference academic studies as supporting DV rates of between 150 and 200%, while noting that such studies are "decades old"; reference is also made to views expressed by New Zealand regulators to the effect that these studies are "necessarily limited because of a lack of reliable, representative data" and "difficult, expensive and complex" to undertake.

The Discussion Paper states further that depreciation rates in OECD countries have become "less generous over the past two decades". Beyond this, the BTWG does not offer empirical or benchmarking analysis of its own, merely stating that it is "difficult to accurately measure economic depreciation".

3.2.4 Minerals Industry Response

The industry supports the policy proposition that tax depreciation should encourage investment and, in general, align as closely as possible with economic depreciation. The industry considers this benchmark is better met by the current DV rate of 200%, compared with a rate of 150%. As noted above, this was precisely the standard on which the earlier decision to move to a DV rate of 200% was based. The then Treasurer's 2006-07 Budget states: "To ensure that depreciation rates are competitive in a world of rapidly advancing technology, the diminishing value rate has been increased to 200 per cent." The decision was taken in order "to better align depreciation deductions with the actual rate at which assets decline in value".

No evidence has been presented by the BTWG to substantiate a view that a 200% rate is a concession or distortion such that moving back to 150% would achieve closer alignment with economic depreciation. Indeed, given quite general assumptions about rates of technological change it is likely the opposite is true. Nor is it likely that Australia's international competitiveness and attractiveness as an investment destination would be improved by reducing the DV rate. In fact, benchmarking by KPMG on a representative sample of assets suggests that depreciation allowed over the first five years of an asset's life was consistently higher in Canada, Chile, Indonesia and South Africa, compared with Australia.

What is clear is that such a move would impact most adversely on capital intensive industries (such as mining) which invest large sums of capital in long-lived assets under conditions of volatility and high risk. In the current, more difficult environment facing the mineral resources sector, any movement from the current 200% rate could impact adversely on Australia's capacity to attract investment in new projects that are already considered relatively marginal.

A reduction in the DV rate from 200% to 150% will have a material impact on the resources industry project pipeline. This can be illustrated, using an example of a greenfield thermal coal project, located in the Hunter Valley region, in NSW. Similar to many of the mines in the area, the plan for the project is to mine the coal by open cut, with the coal washed in a two stage wash plant to produce export coal. Capital required to develop the operation is significant, and includes items such as Heavy Equipment (i.e. Draglines), Mobile Equipment, Light Vehicles, Mine Service Equipment and Coal handling and Wash plant infrastructure. Modelling shows that applying the reduced DV rate will result in a 29% reduction in the NPV of this project, which will most certainly damage the prospects of its future development.

More generally, there is no evidence to suggest that Australia's depreciation regime is "generous" by international standards. Analysis for the MCA by KPMG (see Appendix 1) concludes that the 200% rate "does not necessarily provide Australian taxpayers with an advantage relative to taxpayers in other countries sampled". Among the countries sampled, the United States, Japan and Indonesia feature a 200% rate for diminishing value calculations. Japan and the United States were Australia's second and third largest trading partners in two-way goods and services in 2011.ⁱ

Moreover, a number of countries which are key competitors with the Australian minerals sector (including Canada, Chile, Indonesia and South Africa) "have some accelerated depreciation arrangements for the mining sector". Indonesia (which as noted above has the same 200% DV rate as Australia) has emerged in recent years as a major competitor to Australia in the production of minerals, most notably thermal coal. Indonesia is now the world's largest thermal coal exporter – Australia is ranked second.ⁱⁱ

On international competitiveness grounds alone, the industry considers that no case has been made for reducing the DV rate. Reducing the DV rate from 200% to 150% would reduce the net present value of depreciation deductions increasing the financial cost of holding an asset and making investment significantly less attractive. The industry understands BTWG members have been advised of specific projects which will not proceed if this policy change occurs.

3.3 THIN CAPITALISATION AND INTEREST DEDUCTIBILITY

KEY POINTS:

- The statement included in the BTWG Discussion Paper that Australia's thin cap rules are "overly generous" is not supported by any empirical evidence. Work for the MCA by KPMG suggests a much more complex picture. The BTWG paper glosses over the fact that current Australian rules apply to *all* debt, as distinct from arrangements in many countries where rules apply solely to *related-party* debt.
- Integrity concerns should be addressed within the current legislative framework. Tightening Australia's thin cap rules without further detailed consideration of Australia's relative position internationally could adversely affect our ability to attract capital and is likely to pose sovereign risk problems.
- Alternative proposals such as capping interest deductibility to EBITDA also appear problematic, especially for cyclical industries such as mining.
- The inability of Treasury to cost proposals relating to thin cap underlines concerns about the nature of the BTWG process and further cautions against precipitate change to existing arrangements.

3.3.1 Current Tax Treatment

The purpose of thin cap rules is to prevent both foreign and Australian based multinational companies profit-shifting offshore. They seek to prevent companies allocating an excessive share of their global debt to their Australian operations in order to inflate income tax deductions for interest expenses, reduce taxable income and minimise tax payments.

Thin cap rules limit the income tax deductions a company may claim by disallowing deductions when the company's debt exceeds certain thresholds.ⁱⁱⁱ The limit commonly applied to test thin cap is a company's debt-to-equity ratio. The ratio allowed under Australian tax law since 2001 is 3:1 meaning that for every \$3 of debt, the company is funded by \$1 of equity. Unlike most other nations, in Australia the ratio applies to both related party and third-party debt.

3.3.2 Earlier Policy Consideration

The current regime is based on recommendations of the earlier Ralph Review of Business Taxation. It found that the existing thin cap regime was not "fully effective at preventing an excessive allocation of debt to the Australian operations of multinationals"ⁱⁱⁱ Although it had a tighter 2:1 debt-to-equity ratio (also called the safe harbour gearing level), the ratio only applied to foreign-related-party debt and foreign debt covered by a formal guarantee, not total debt.

To overcome this problem, the Review recommended that the rules be "strengthened" and extended to focus on the entire organisation, including where the entity is a branch or subsidiary. It was also recommended that the rules be extended to Australian multinational investors.^{iv}

The Review argued that these changes would bring Australia more into line with countries such as New Zealand and the United Kingdom; introduce greater "investment neutrality" between branches and subsidiaries; and balance the competing objectives of revenue protection and allowing for wide variations in commercial arrangements.

Consequently, Recommendation 22.3 of the Review's final report stated: "Recognising that total debt is being included in the rules, and having regard to the treatment provided in other countries, the Review recommends a ratio of 3:1 be adopted."^{lv} In its supporting statement, the Review stated:

Careful judgment is required in setting the safe harbour gearing level. A low safe harbour ratio would place greater restrictions on gearing levels while a higher level would give taxpayers greater freedom to choose their own funding structure, but with potential detrimental effects to Australian revenue. Providing comparable treatment to other countries is also important.^{lvi}

The Federal Government adopted the Ralph Review's recommendations with changes to thin cap rules enacted in 2001 geared to ensuring that Australia received "a fairer share of tax paid by multinational enterprises", but also that "Australian businesses are not hindered from expanding overseas and that Australia becomes a more attractive investment destination".^{lvii}

3.3.3 Business Tax Working Group's Consideration

The BTWG identifies five options for tightening Australia's thin cap regime or otherwise restricting interest deductibility for business taxpayers. The first three options (A.1 to A.3) focus specifically on the thin cap regime, with a central scenario based on reducing the safe harbour maximum debt limit for general entities from a debt equity ratio of 3:1 to a 1.5:1 ratio. Two options (A.4 and A.5) propose more fundamental change by limiting the scope of all firms (domestic and foreign) to claim interest deductions, the features of which are "unresolved".

The BTWG acknowledges that thin cap rules "must strike the right balance between revenue protection, on the one hand, and allowing firms to structure their finances as they see fit, on the other" but argues that Australia's rules "could be seen as overly generous". No evidence is offered in support of this statement.

The BTWG refers to "flaws" with particular rules, citing in this context the arm's length test and associated administrative difficulties and "integrity concerns". The BTWG makes the observation that current rules provide multinationals with a potential tax advantage over their Australian market competitors, because they are more highly geared than purely domestic firms or firms that rely on truly independent financing arrangements, but notes elsewhere that "the marginal investor in Australia is likely to be a foreign investor that does not have access to imputation credits".

The BTWG does not offer estimates of the potential Budget savings from adopting any of the Discussion Paper's proposals except to state that they are "likely to be significant".

3.3.4 Minerals Industry Response

The industry does not accept the premise that the Australian thin cap regime is "overly generous". This conclusion is highly simplistic and glosses over the fact that current Australian rules apply to *all* debt, as distinct from arrangements in a number of other countries where rules apply solely to *related-party* debt. Analysis conducted for the MCA by KPMG (see Appendix 2) has found no convincing evidence that Australia's thin cap regime is "overly generous". KPMG notes:

The Australian approach of including both related party and third party debt is a less common approach to thin capitalisation, with the majority of countries analysed having rules that apply solely to related party debt.

The industry notes that the claim of excessive generosity is not substantiated in the Discussion Paper beyond the observation that Belgium, Canada, Finland and Sweden have recently announced proposals to tighten their thin cap rules. Information on the detail or context of these countries' new regimes is not provided. KPMG did not analyse all these countries in its work for the MCA but did look specifically at Canada, reporting that its lower debt-to-equity ratio applies only to narrower related-party debt. Therefore it is Australia's thin cap regime that

better aligns with the BTWG policy ideal of an internationally competitive “broad base, low rate” approach to tax reform.

In further contradiction of this principle, tightening Australia’s thin cap rules will impede Australian competitiveness in attracting foreign investment. As has been noted elsewhere in this submission, the tax treatment of investment strongly influences the ability of Australia (and capital intensive industries in particular) to attract foreign capital. Tightening Australia’s thin cap rules, especially within the context of other recent tax changes, will necessarily add to international concerns about the cost and sovereign risk of doing business in Australia. The industry further notes the BTWG’s own observation that as multinationals can choose where to locate their production they are “more sensitive to the tax rates which apply to them than a purely domestic firm”.

Changing the debt-equity rules would have a negative retrospective impact on projects and companies financed under the current rules. Tightening existing rules without appropriate grandfathering could compromise principles of international competitiveness and retrospectivity; on the other hand, detailed transitional rules would necessarily add complexity. The industry notes that when the current thin cap regime was legislated, companies could elect to apply the former rules for a period of three years for interests issued before the date on which the exposure draft legislation was released.^{lviii}

The industry submits that “flaws” or “integrity concerns” held by the ATO should be addressed directly within the existing legislative framework and its administrative procedures, rather than adding to the complexity of the tax system by implementing a new regime that may have economic consequences beyond the specific problems identified.

In the time available, the industry has not been able to fully assess the implications of the proposal to cap interest deductibility to EBITDA. However preliminary analysis suggests that this proposal would unfairly and adversely impact on cyclical industries such as mining. As the BTWG states, this option proposes a “more fundamental change” to the tax treatment of interest deductions and “further detail on how these options would apply in practice and possible effects on business are needed”. The BTWG also does not offer any analysis as to how options A.4 and/or A.5 might operate in an Australian context which in light of the very short time frame over which the BTWG consultation is undertaken, effectively undermines the opportunity for any true consultation on these proposals.

The industry makes no comment on proposals relating to the financial services sector except to highlight the persistent and legitimate concern of the resources sector that the savings options identified by the BTWG appear to impact disproportionately on the resources sector.

The industry considers that Treasury’s inability to calculate credible costings on any of the five thin cap options is a further sign of a process that is inadequate and an important caution against changing existing arrangements without due consideration.

3.4 R&D TAX INCENTIVE

KEY POINTS

- Proposed options for changing the R&D Tax Incentive are ad hoc and offer no clear economic benefits. Further resort to provisions such as arbitrary turnover thresholds would add additional complexity to a regime that has only recently become law.
- The industry considers that any piecemeal change in this area would only heighten concerns of international investors regarding the stability and predictability of Australia's taxation arrangements.

3.4.1 Earlier Policy Consideration

The R&D Tax Incentive is designed to encourage industry to conduct R&D activity that might not otherwise occur because the benefit of the knowledge gained is likely to spill-over to the wider economy. The incentive which took effect from 1 July 2011 provides:

- A 45% refundable R&D tax offset available to companies with an aggregate annual turnover of less than \$20 million
- A 40% non-refundable offset available to companies with an aggregate annual turnover of \$20 million or greater (with any unused offset amounts capable of being carried forward).

The incentive is available to corporations that are Australian residents, foreign corporations that are resident of a country with which Australia has a double tax agreement and carry on business through a permanent establishment in Australia.

3.4.2 Business Tax Working Group's Consideration

The BTWG identifies four options for more narrowly targeting access to the R&D Tax Incentive:

- C.1 – Abolish the 40% non-refundable tax offset for companies with a turnover of more than \$20 million
- C.2 – Impose a turnover threshold (\$10 billion/\$20 billion) above which the 40% offset could not be claimed
- C.3 – Impose a \$100 million cap on annual claims under the 40% non-refundable offset
- C.4 – Cut the rate of the non-refundable tax offset from 40% to 37.5%

Referring to these options, the BTWG concedes that:

... the reforms could, depending on transitional arrangements, affect the returns of long-term projects that were modelled on the basis of the pre-existing regime. As a result, some companies may relocate their R&D to countries that offer better incentives.

3.4.3 Minerals Industry Response

The minerals industry, along with other business groups, engaged in an extensive process of consultation on the new R&D tax credit which began with the work of the Cutler Review in 2008 and was only completed in the second half of 2011. This involved consideration of a consultation paper; two exposure drafts of the legislation and a final bill which was subject to further consultation. As tax experts in the area have noted, most companies are still to make their first claims under the new system. Hence, there is no data to assess the impact of the current arrangements.

To tinker further with the current regime on no basis other than to raise revenue is poor policy and even poorer processes. The proposed options for changing the R&D Tax Incentive are ad hoc and offer no clear economic benefits.

As an example, further resort to provisions such as arbitrary turnover thresholds would add more complexity to a regime that has only recently become law. The industry considers that any piecemeal change in this area would only heighten concerns of international investors regarding the stability and predictability of Australia's taxation arrangements.

4. COSTINGS ISSUES

Credible and transparent costings are essential to providing business stakeholders with confidence in the quality and integrity of a tax reform process, especially one that has been set a very narrow framework for making recommendations based on revenue neutrality. The onus falls squarely on advocates of change to existing taxation arrangements to deliver the highest standard of costings.

Along with other business stakeholders, the minerals industry has drawn attention to weaknesses in the costings element of the BTWG process. Specific concerns include the following:

- Following criticism of earlier costings on thin cap changes, the BTWG has withdrawn published estimates relating to option A.1. While described as “under review”, in effect the costing process has been “outsourced” to business groups. That the results are still unknown at a point when companies and industry groups are being asked to comment on the acceptability or otherwise of specific options underlines a process that is both rushed and lacking in transparency. While the costings of Options A.2 and A.3 are also reliant on this “review”, the BTWG states further that it “does not have sufficient information” to “reliably estimate” the potential savings of Options A.4 and A.5. Given what are likely to be very substantial sums of revenue, and the earlier industry conclusion that the case for changing the thin cap rules has not been made empirically, additional time must be taken to ensure business has confidence in the costings process.
- In relation to removing the effective life caps (Options B.1 – B.6), the costings acknowledge but do not include provision for critical transition measures.
- A number of the assumptions bearing on the deductibility of exploration and related costings are either not transparent or questionable from an industry perspective. For example:
 - The assumption that the proportion of deductions utilised by companies with a turnover greater than \$500 million is 58% is questionable. That would mean 42% of deductions for companies in this category are not utilised at all, either as immediate deductions or carry forward losses. Further, whilst it is recognised that junior explorers can encounter difficulties in obtaining tax recognition for some exploration expenditure, the industry would need more information before accepting that the proportion of deductions utilised by smaller companies is only 8%.
 - More generally, the costings attributed to each category of exploration and prospecting fall short of industry expectations. The ATO’s Taxation Statistics for the 2009-10 year (Table 9) indicate that the resources sector claimed approximately \$12 billion of capital expenditure in that year. The costings for exploration in the BTWG report bear no resemblance to these statistics.
 - The industry notes the difficulty in formulating an accurate costing for general exploration expenditure in light of the fact that the majority of this expenditure is an ordinary, ongoing business expense deductible as an operating expense. Tax return disclosures do not facilitate analysis of different types of operating expenses for any industry sector.
 - The BTWG itself acknowledges in relation to Option B.11 that “tax return data is not sufficiently disaggregated to allow Treasury or the ATO to identify what proportion of expenditure currently deducted under section 40-370 relates to feasibility studies”. The inability to isolate these expenditures is inherently due to the fact that they are either ordinary business expenditures deductible as operating costs, or an unsegregated component of exploration expenditure being part of the exploration continuum of determining economic viability.

The inadequacies on costings issues alone are such that it is difficult for the industry to view the BTWG process as holding out the prospect of potential benefits to the Australian economy, much less the Australian minerals industry.

5. ALLOWANCE FOR CORPORATE EQUITY (ACE)

5.1 INTRODUCTION

Recent years have seen increased attention both within academic literature and among policy makers on the potential scope for and benefits of moving towards an ACE system of business taxation. The principle feature of an ACE is that it allows a specific deduction for equity finance with the view to removing tax on the “normal” return to a firm’s investment. Consequently, tax is only payable on “above normal” or “super” returns, theoretically removing the disincentive to invest in riskier or more marginal projects. As such, the ACE shares characteristics with a “rent tax”.

The Australia’s Future Tax System Review considered possible benefits from a business level expenditure tax such as an ACE whereby it would:

... reduce source-based taxes on the normal return to investment in Australia, provide greater neutrality between debt and equity and reduce tax biases across different investments, improving the stability and productivity of domestic business and investment. It may also provide opportunities for wide-ranging simplification of the company income tax system. Such a system would provide a more effective mechanism for company and personal tax integration in a world of increased capital mobility.^{lix}

On the other hand, the Review noted that there was little international precedent for the ACE and early introduction by Australia could involve “considerable risks”:

... the practical implications from a tax administration and compliance perspective are unknown. There may also be opportunities for tax arbitrage if Australia is one of only a few countries using such a system.^{lix}

The Review concluded that an ACE was “worthy of further consideration and public debate” but did not recommend its immediate adoption.

5.2 BTWG WORK PROGRAM AND CONSIDERATION

Following the Federal Government’s October 2011 Tax Forum, consideration of the ACE proposal was included as part of the BTWG Terms of Reference as part of a “longer term” focus on reform options “by reducing the corporate tax rate further or moving to a business expenditure tax system, particularly an allowance for corporate equity”.

However, an indication of the Government’s thinking became clearer in June 2012, with the Prime Minister indicating clearly that the BTWG should focus on consideration of a corporate tax rate reduction:

From today I want to see achieving this company tax rate reduction as the absolute top priority of the Business Tax Working Group. I want it to be the focus, and I want it to be the outcome. I want it dealt with before the other business tax issues in the Working Group’s in-tray are dealt with.^{lix}

As outlined in the August discussion paper, the BTWG undertook its consideration through an examination of the economic literature, consultation with overseas academics and an examination of how an ACE would operate in the Australian tax system. The BTWG concluded that, while an ACE has “some theoretical attractions, there are a significant number of practical issues that the Working Group has confronted in its consideration of an ACE”. These include:

- Full implementation of an ACE may not be possible while maintaining revenue neutrality and the Working Group would not advocate increasing the corporate tax rate to fund the implementation of an ACE.

- Based on limited international experience, introduction of an ACE in Australia would involve “considerable implementation risks”.
- A number of key design issues present obstacles to achieving the theoretical attractions of an ACE.
- The potential benefits of an ACE may not justify the costs of additional administrative complexity, especially in transition.
- Company tax collections would likely be more sensitive to economic cycles under an ACE.

On this basis, the BTWG concluded that “an ACE should not be pursued in the short-to-medium term but may be worthy of further consideration and public debate in the longer term”. It noted further that: “Given the uncertainty being faced by business from developments in the global economy, now is not the time to introduce significant uncertainty in the business tax system”.

5.3 THE MINERALS INDUSTRY RESPONSE

- **The industry considers that the risks of Australia moving towards an ACE significantly outweigh any theoretical benefits. This is in line with the conclusion of the BTWG.**
- **Work by KPMG examining the international experience with ACE has confirmed the difficult design issues, practical complexities and questionable effectiveness of an ACE regime.**

A central theme of this submission relates to the need for tax reform proposals to be carefully examined, especially proposals that would impact disproportionately on industries (such as mining) which are highly capital-intensive, heavily reliant on foreign investment, characterised by long-lived assets and highly sensitive from a sovereign risk perspective to chopping and changing taxation arrangements.

Against this backdrop, there are simply too many unanswered questions – how it would be structured, key design features, transitional arrangements, near and longer term economic impacts – for the industry to conclude other than that the risks of moving towards an ACE significantly outweigh any perceived theoretical benefits, including in relation to new investment.

As the BTWG has itself noted, a range of conceptual and practical hurdles need to be overcome in implementing an ACE in a form that accords broadly with the economic rationale of eliminating the tax on the normal return to investment and only tax above normal returns, and removing biases in financing decisions. These include:

1. **Choosing a “reasonable” rate of return or ACE rate** – Under an ACE, only projects with a sufficiently high rate of return are taxed. Setting a reasonable rate of return is a key part of an ACE design because of its associated impacts on companies and industries. While some academic literature suggests using the risk free nominal interest rate (approximated by the rate on government bonds), other work points to reasons why the rate should be higher or differentiated. Companies in different industries face different operating environments – characterised by different risk levels, exit/entry requirements, demand behaviours and intensities of competition.
2. **Achieving genuine neutrality between financing options** – The choice of the ACE rate is one factor that has implications for the degree to which, in practice, firms may be indifferent between debt and equity financing.
3. **Determining the equity base** – Again, a range of practical complexities need to be considered. Some have been identified by Cooper including: the classification of different types of equity and complications in relation to a company’s equity post a merger or acquisition. If the treatment of debt and equity varies between host and home nations, distortions are likely to remain and the theorised benefits of neutrality are unlikely to be realised.^{lxii}
4. **Administrative costs and complexity** – At least in the near term, as the BTWG notes, introduction of an ACE “would itself introduce further complexity” into the business tax system.

5. **Transition issues** – Whether the allowance relates solely to new equity or existing equity as well (with the latter clearly having more significant revenue implications) is one of a number of important transition issues. Where the allowance applies only to new equity, new rules may be required given incentives for “rebirthing” – that is, where forms of existing equity are refashioned as new equity.
6. **Revenue implications** – Implementing an ACE, other things equal, would narrow the tax base and lead to lower government revenue collections, at least in the short term. Thus, if overall business tax revenue is to remain unchanged, an increase in the headline company tax rate or other increases in effective tax rates may be required. In addition, it is widely recognised that company tax collections would be more sensitive to economic cycles under an ACE.

International experience has tended to underline both the conceptual and practical design challenges with ACE-type systems, while also raising questions about whether postulated benefits (especially in terms of new investment) have accrued in practice. Analysis for the MCA by KPMG reinforces the case for policy caution on ACE. Based on the international cases examined (Croatia, Italy, Austria, Belgium and Brazil) KPMG concludes that “an ACE system in practice does not tend to line up with the ACE system in theory” and “there are many difficulties around successful implementation”.

Key findings from this work include the following:

- A number of countries that have chosen to do so have only implemented partial ACE systems (for example, Italy and Austria), demonstrating that it is difficult to introduce all of the theoretical design features of an ACE.
- International experience has also highlighted the practical difficulties in setting the “reasonable” rate of return or otherwise updating an ACE deduction to account for changes in the economic environment. Klemm found in this context that the Italian ACE system was subject to frequent revisions over its period of operation. Based on the experience of Brazil, it was concluded that volatile economic conditions meant that the rates applied in the ACE calculation often did not align with interest rates on debt.^{lxiii}
- Having been introduced, ACE systems have been subsequently abolished (for example, Croatia, Italy) and in some cases replaced by a system with a reduced headline company tax rate.
- In assessing the foreign investment consequences of the ACE in Austria, Belgium, Brazil, Croatia and Italy over relevant years, KPMG could not find evidence of a positive effect. In practice, any effect, whether positive or negative, would likely have been masked by wider economic events, including the global financial crisis.

ACE: INTERNATIONAL EXPERIENCE

Croatia introduced its ACE-like scheme in 1994 as part of reforms to a controlled, socialist economy. The so-called Protective Interest (PI) scheme provided an allowance equal to a rate of 5% (adjusted for inflation) of the book value of equity as defined on the balance sheet. Profits were taxed at 35%. Losses could be carried forward for up to five years. The PI was abolished after six years as part of package of measures to stimulate investment and employment, including a cut in the corporate income tax rate from 35% to 20%.

Italy introduced an ACE-style Dual Income Tax (DIT) scheme in 1997 as part of reforms to simplify the business tax system. Unlike a traditional ACE, it taxed “normal” profits (at 19%) as well as “above normal” profits (at 37%, later reduced to 36%). A further modification was that the deduction allowance applied only to new equity, not all equity. The nominal rate was initially 7% then set at 6%. Studies concluded that the system favoured larger, more profitable companies and it was repealed in 2004 as part of a tax reform package on the basis that it was distorting company financing decisions.

Austria introduced the ACE-like Notional Interest system in 2000. Like the Italian version, it taxed both “normal” and “supernormal” profits at rates of 25% and 34%, respectively. The return on equity was calculated as the average return of government bonds plus a 0.8 percentage point premium. It applied only to equity issued after the ACE’s introduction. It was abolished in 2004 on evidence that Austria lost foreign investment to countries with lower headline corporate tax rates. Tax professionals also found the Austrian ACE to be cumbersome and to impose high administrative costs.

Brazil has had an ACE model in place since 1996. Called Remuneration of Equity, it was introduced to address a debt-equity bias, together with a cut in the corporate tax rate from 47.7% to 30.7%. It is calculated as the interest rate on long-term loans multiplied by the book value of equity. Unlike the Italian and Austrian schemes, “normal” profits are not taxed – “above normal” profits are taxed at the corporate rate of 30.7%. However, unlike a traditional ACE, a deduction is not granted to retained notional normal returns on equity. Studies have noted the difficulties in administering the scheme in a volatile, high-inflation economy and reported that, in practice, the bias in favour of debt equity has remained.

Belgium has also retained its ACE. Called the Notional Interest Deduction or Risk Capital Deduction, it was introduced in 2006 as a means to attract foreign investment and strengthen companies’ equity base. The Belgian ACE is calculated by multiplying the average interest rate on 10-year government bonds by a company’s adjusted equity. The “adjustments” are integrity rules to prevent “double dipping” and artificial inflation of the equity base. The Belgian Government continues to promote the ACE as an attractive feature for foreign investors. However, some studies have found the scheme to be expensive (reducing revenue by an estimated 10% in 2008) and difficult to administer.

APPENDIX 1: KPMG ANALYSIS - DEPRECIATION



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Depreciation Review

Minerals Council of
Australia

September 2012

Disclaimer

Inherent Limitations

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No warranty of completeness, accuracy or reliability is given in relation to the statements and representations made by, and the information and documentation provided by, the Minerals Council of Australia consulted as part of the process.

KPMG is under no obligation in any circumstance to update this report, in either oral or written form, for events occurring after the report has been issued in final form.

The findings in this report have been formed on the above basis.

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1. Introduction

The Business Tax Working Group (“BTWG”) released a discussion paper on 13 August 2012 which canvassed a series of options to fund a reduction in the corporate tax rate.

The BTWG options included changes to the depreciation rules, including reducing the diminishing value rate from 200 per cent to 150 per cent, and changing the rules for mining exploration deductions.

KPMG has been engaged by the Minerals Council of Australia (“MCA”) to examine the tax arrangements in several nominated countries with respect to the method for calculating the decline in value of depreciating assets, specifically the methods available to taxpayers and the rules.

2. General depreciation regimes

Australian taxpayers are entitled to deductions for the decline in value of depreciating assets, referred to in this paper as ‘depreciation deductions’.

Australia provides taxpayers with the choice of using the prime cost (‘straight-line’) and diminishing value (‘diminishing balance’) methods to determine depreciation deductions. The choice is available on an asset-by-asset basis, other than for a limited class of intangible assets (for which the straight-line method must be applied).

The choice of depreciation methods is only available in three of the other countries surveyed, namely Japan, Korea and Indonesia. The United States, the United Kingdom and Canada were the only countries to prescribe the diminishing value method.

General Depreciation

COUNTRY	TAX RATE	DEPREC BASIS	P&E	BLDGS	DMV for DB
Australia	30.0%	individual assets`	SL or DB	SL	200%
United States	40.0%	individual assets	DB	SL	200%*
China	25.0%	asset classes	SL	SL	
Japan	38.0%	asset classes	SL or DB	SL	200%
Germany	29.5%	individual assets	SL	SL	
Brazil	34.0%	individual assets	SL	SL	
United Kingdom	26.0%	asset classes	DB	n/a	

COUNTRY	TAX RATE	DEPREC BASIS	P&E	BLDGS	DMV for DB
Canada	26.0%	asset classes	DB	DB	
Korea	24.2%	individual assets	SL or DB	SL or DB	
Indonesia	25.0%	asset classes	SL or DB	SL	200%
South Africa	34.6%	individual assets	SL	SL	
Chile	18.5%	individual assets	SL	SL	
Equatorial Guinea	35.0%	individual assets	SL	SL	

* Also reduced rates and capped amounts

Among the countries analysed Australia, the United States, Japan and Indonesia feature a 200% rate for diminishing value calculations. The United States also has reduced rates for some asset classes (e.g. farm equipment) and in some cases dollar capped amounts (e.g. motor vehicles).

We did not identify a direct correlation between the depreciation methods available and the relative economic development, the corporate tax rate or the extent to which the economy has a significant natural resources sector.

Australian taxpayers calculate depreciation deductions by reference to the effective lives of the depreciating assets, which are determined using either the Commissioner's determination of effective lives, self-assessed effective lives or, in limited cases, statutorily provided 'capped lives.'

While a similar approach to determining effective lives is used in Germany, taxpayers in most other countries are required to apply statutory depreciation rates.

There are many examples within the countries studied where the rates used to calculate depreciation do not align with the effective lives of those assets as determined by the Australian Commissioner of Taxation.

An example is Canada, which enables taxpayers to claim 'cost of capital allowances' by reference to the rate given to the class of assets, rather than to the effective lives of the assets. The rates for the classes range from 4% to 100%, and can result in the cost of assets being deducted over a significantly shorter period than the effective lives of those assets. For example, Class 43 includes machinery and equipment used for the manufacturing and processing of goods in Canada, and uses a 30% rate.

A further example is the United Kingdom, which applies a standard rate for pooled assets of 18% and a special rate for certain longer life assets of 8%.

Most of the countries analysed allow some form of accelerated depreciation and this typically matches the particular characteristics of their economies. Countries with significant natural resources sectors, including Canada, Chile, Indonesia and South Africa, have some accelerated depreciation arrangements

for the mining sector. Special arrangements for the mining sector are less transparent in the case of Equatorial Guinea, as they are based on project incentives negotiated with the government.

The departure from the use of actual effective lives and the adoption of incentives makes it very difficult to compare depreciation regimes between countries.

Further, we cannot conclude from our review that the availability of the diminishing value method or a 200% uplift within the diminishing value method provides a comparatively generous taxation outcome for Australian taxpayers.

To illustrate this point, we have undertaken depreciation deductions for a sample of assets, including agricultural equipment (a combine harvester), industrial equipment (a printing press), a motor vehicle and a computer, and calculated the total tax deductions available within the first four years for those assets. The assumptions used and the outcomes of the calculations are included in Part 5.

It is important to stress that this is a very small sample and may not be reflective of the relative benefits of depreciation deductions available to Australian taxpayers.

Nevertheless, the results as set out in Part 5 of this report indicate that the 200% uplift within the diminishing value method does not necessarily provide Australian taxpayers with an advantage relative to taxpayers in the other countries sampled.

3. General depreciation regime description

The following tables provide further descriptions of the depreciation regimes in the countries analysed.

3.1 Australia

Method	Buildings/ Immovables	Plant, Machinery and equipment	Effective life/Rate	Other comments
<p>Uniform Capital Allowances (“UCA”) regime contained in Div 40 ITAA97.</p> <p>A taxpayer is entitled to a deduction for the decline in value of a depreciating asset that it holds in an income year. A depreciating asset is defined as an asset that has a limited effective life and can reasonably be expected to decline in value over the time it is used.</p> <p>Land, items of trading stock, most intangible assets and certain depreciating assets used in R&D activities are excluded from the UCA.</p> <p>The cost of the depreciating asset generally includes (a) the cost to start holding the asset and (b) any additional costs to the taxpayer to bring the asset to its current condition and location.</p> <p>Depreciation for assets is assessed on an asset-by-asset basis.</p>	<p>Straight line¹ (Capital works deductions).</p>	<p>Straight line; or Diminishing balance.²</p>	<p>Taxpayers can elect to apply the statutory effective lives published by the Commissioner of Taxation or to self-assess the effective life of the asset provided it is appropriate and reasonable.</p> <p>200% uplift for the diminishing balance method.</p>	<p>Project pools</p> <p>Certain expenditure, which is not part of the cost of a depreciating asset but which relates to a project, may be pooled and deducted, using the diminishing balance method, over the life of the project to which it relates (e.g. costs of feasibility studies, costs in seeking to obtain a right to intellectual property, etc) once the project commences operation.</p> <p><u>Mining capital expenditure incurred in carrying on mining operations that may be pooled includes costs:</u></p> <ul style="list-style-type: none"> • to prepare a site for such operations; • on buildings or other improvements necessary for the carrying on by the taxpayer of mining operations; and • to provide water, light or power for use on the mining site. <p>Statutory caps</p> <p>Certain caps have been introduced for the effective lives of certain depreciating assets used in specified industries, including, for example, the oil, gas and petroleum refining industries.</p>

¹ Referred to as ‘prime cost method’ under Australian uniform capital allowances regime.

² Referred to as “diminishing value method” under Australian uniform capital allowances regime.

3.2 United States

Method	Buildings / Immovables	Plant, machinery and equipment	Effective life/Rate	Other comments
Modified accelerated cost recovery system ("MACRS) – post 1986 - Includes straight line and diminishing balance methods.	Straight line.	Diminishing balance.	Effective lives of the asset (referred to as 'applicable recovery period') summarised in Revenue Procedures. 200% uplift for the diminishing balance method.	MACRS is based on both the Internal Revenue Code legislation and Revenue Procedures published by the IRS.

3.3 China

Method	Buildings / Immovables	Plant, machinery and equipment	Effective life/Rate	Other comments
Depreciable assets are grouped into classes with a prescribed minimum depreciation period.	Straight line.	Straight line.	Minimum effective lives are prescribed.	Special rules may apply to special assets such as natural resources. Fixed assets exposed to severe corrosion or constant vibration through the years may be depreciated over a shorter period (not less than 60% of the prescribed minimum depreciation period).

3.4 Japan

Method	Buildings / Immovables	Plant, machinery and equipment	Effective life/Rate	Other comments
Depreciable assets are grouped into classes and taxpayers can generally choose to apply either straight line or diminishing balance method for computing depreciation for each class of asset.	Straight line.	<p>Straight line; or Diminishing balance.</p> <p>Taxpayer may elect method for each class of asset.</p> <p>Where taxpayer fails to elect, the diminishing balance method is applied at the statutory depreciation method.</p>	Computed in accordance with the statutory useful lives provided in the Ministry of Finance Ordinance.	<p>Minor assets</p> <p>Minor assets with acquisition cost less than JPY100,000 or which are used up within 1 year can be expensed in the same year.</p> <p>Assets with acquisition cost greater than JPY100,000 but less than JPY200,000 can be depreciated over 3 years.</p> <p>Accelerated depreciation or tax incentives</p> <p>Special depreciation by means of either increased first year depreciation or accelerated depreciation is available for companies filing blue-form tax returns in relation to certain fixed assets as specified under the law.</p> <p>Instead of the special depreciation, companies can select tax credit incentives for certain fixed assets as specified under the law.</p>

3.5 Germany

Method	Buildings / Immovables	Plant, machinery and equipment	Effective life/Rate	Other comments
<p>Assets depreciated on an individual basis (i.e. depreciation is calculated separately for each asset).</p> <p>There are limited options to switch the method applied to an asset once choice is made.</p>	<p>Straight line.</p> <p>The applicable rate depends on the type of building and the year of construction (varies between 33 – 50 years).</p>	<p>Straight line;</p> <p>or</p> <p>Production method (provided the taxpayer can document the performance on an annual basis);</p>	<p>The depreciation period determined by the taxpayer based on the estimated effective life of the asset.</p> <p>The Federal Ministry of Finance issues annual non binding recommendations for depreciation periods for the most common moveable assets.</p>	<p>Legal and economic ownership</p> <p>German tax law distinguishes between legal and economic ownership. For tax purposes, assets are generally attributed to the economic owner. This becomes relevant especially in case of leasing arrangements. For determining the economic ownership for tax purposes certain criteria are set forth by the German tax authorities.</p>

3.6 Brazil

Method	Buildings / Immovables	Plant, machinery and equipment	Effective life/Rate	Other comments
<p>Depreciation is assessed on an asset-by-asset basis.</p> <p>Generally the depreciation rate will be determined by the effective life of the asset (i.e. the period of economic use of the asset in production of the taxpayer's income).</p>	Straight line.	Straight line.	Effective lives published by tax administration authority. The current applicable rates were last updated in 1999.	<p>Accelerated depreciation</p> <ol style="list-style-type: none"> 1. Accelerated accounting depreciation granted where accelerated decrease of the value of goods caused by a more intensive operation regime also deductible for tax. Calculated based on number of hours of daily operation. 2. Accelerated depreciation also granted for R&D and specific industries or activities in the public interest. <p>Pre-operating expenses</p> <p>Pre-operating expenses may be depreciated over a minimum period of 5 years.</p>

3.7 United Kingdom

Method	Buildings / Immovables	Plant, machinery and equipment	Effective life/Rate	Other comments
<p>Different methods are adopted to compute depreciation (referred to as 'capital allowances') of an asset, depending on the nature of the asset, being:</p> <ul style="list-style-type: none"> • Straight line; or • Diminishing balance (referred to as 'Written down allowance' ("WDA")). <p>Depreciable assets are generally grouped into classes and pooled for capital allowances purposes.</p>	<p>N/A - no WDA permitted for buildings.</p> <p>However integral features (e.g. insulation, heating, etc) may qualify in special rate pool with an 8% WDA.</p>	<p>Diminishing balance.</p> <p>WDAs 18% for main pool assets (PM&E, etc).</p> <p>WDAs 8% for special rate pool assets (e.g. integral features, long life assets, certain cars).</p>	<p>The written down allowance rate prescribed under separate legislation (the <i>Capital Allowances Act 2001</i>).</p>	<p>First year allowance</p> <p>New capital expenditure on eligible assets (e.g. energy efficient items) may qualify for a 100% first year allowance.</p> <p>Mining and extractive industries</p> <p><u>Separate WDAs applied for mineral extraction, certain mineral assets and assured tenancies.</u></p> <p>Annual Investment Allowance</p> <p>Some groups/companies may be eligible for the Annual Investment Allowance - immediate deduction for \$25,000 of new capital expenditure on eligible assets (excludes cars and first year allowance assets).</p>

3.8 Canada

Method	Buildings / Immovables	Plant, machinery and equipment	Effective life/Rate	Other comments
<p>Capital Cost Allowance regime.</p> <p>Depreciable property is subdivided into various “classes” depending on the particular type of asset acquired, the year of acquisition, etc.</p> <p>Taxpayers can claim an annual deduction – a capital cost allowance (“CCA”) - in respect of each class of depreciable property owned at the end of the income year.</p>	Diminishing balance.	Diminishing balance.	A taxpayer is entitled to claim any amount of CCA from nil to the maximum permitted for the class (e.g. a taxpayer can claim nil CCA in a year the taxpayer is in a tax loss position).	<p><u>Accelerated CCA is permitted on capital acquisition on Class 41 assets – (i.e. mining assets).</u></p> <p>However some buildings, machinery and equipment may qualify for an accelerated CCA rate of up to 100%. Broadly, this accelerated CCA is available on capital acquisitions made before the commencement of commercial production or for the purposes of a major expansion.</p>

3.9 Korea

Method	Buildings / Immovables	Plant, machinery and equipment	Effective life/Rate	Other comments
<p>Taxpayers can choose the depreciation method to be applied (provided it is reported to the tax office before lodgement of the income tax return). Method elected by taxpayer is to be consistently applied (little scope for change).</p> <p>Where no election is made (i.e. not reported to the tax office) the default method applies.</p>	<p>Straight line; or Diminishing balance (default method).</p>	<p>Straight line; or Diminishing balance (default method).</p>	<p>Statutory rates for depreciation.</p>	<p><u>Service output method allowed for fixed assets of the mining business and mining rights.</u></p>

3.10 Indonesia

Method	Buildings / Immovables	Plant, machinery and equipment	Effective life/Rate	Other comments
<p>All depreciable property is divided into 4 groups according to its useful economic life. Broadly, the 4 groups are:</p> <ol style="list-style-type: none"> 1. Furniture and office equipment; 2. Trucks, buses, plant and equipment; 3. Equipment for general mining (not oil and natural gas), heavy equipment; and 4. Construction for heavy machinery. 	Straight line.	<p>Straight line; or Diminishing balance. Class 3 assets are depreciated at a diminishing balance rate of 12.5% and a straight line rate of 6.25%.</p>	Effective life specified for each group of assets.	<p><u>Expenditure for acquiring mining (other than oil and gas) rights may be depreciated using the production unit method at a maximum of 20% per year.</u></p> <p>Intangible assets may be depreciated using the production unit method.</p>

3.11 South Africa

Method	Buildings/ Immovables	Plant, machinery and equipment	Effective life/Rate	Other comments
South African statutory tax regime is very specific with regards to depreciation allowance ('wear and tear allowance') on assets. The method applicable to each asset is very much dependant on the industry in which asset is used and the use/purpose of the asset.	Straight line.	Straight line.	Depreciation rates are either prescribed in the tax legislation or acceptable rates are published in Interpretation Notes by the Commissioner.	<p>There are various tax incentives with regards to assets used in a research and development process. Furthermore, specific allowances are provided for assets used in, <i>inter alia</i> –</p> <ul style="list-style-type: none"> • the production of renewable energy; • <u>assets used in the mining industry</u>; • farming; • aircraft; and • ships.

3.12 Chile

Method	Buildings / Immovables	Plant, machinery and equipment	Effective life/Rate	Other comments
Assets depreciated on an individual basis (i.e. depreciation is calculated separately for each asset).	Straight line.	Straight line.	<p>Rates fixed by tax administration in accordance with useful life of asset.</p> <p><i><u>Depreciation rates for assets used in mining extractive industry will depend on the depreciation method elected by the taxpayer (straight line or accelerated (see next column).</u></i></p>	<p>Accelerated depreciation</p> <p>Taxpayer can choose to reduce the useful life of the asset to 1/3 of the pre-determined rate only where normal useful life of asset exceeds 3 years.</p> <p>The following rates/effective lives would be applied (straight line depreciation):</p> <ul style="list-style-type: none"> • 9 years for machinery and equipment; • 5 years for installation in mines and mineral recipient plants; • 10 years for tailing dams; and • 20 years for tunnels. <p>Therefore, applying accelerated depreciation, the useful life of the above assets would be 3, 1, 3 and 6 years respectively.</p>

3.13 Equatorial Guinea

Method	Buildings / Immovables	Plant, machinery and equipment	Effective life/Rate	Other comments
Taxpayer may elect to use a rate based on the useful life of the asset, but may not choose a rate which exceeds the prescribed maximum statutory limits.	Straight line. Permanent structures are depreciated at the rate of 5% (over 20 years) while temporary or removable buildings are depreciated at 20% (over 5 years).	Straight line. The rates set out in the Tax Code vary depending on the type of plant machinery and equipment.	The rates vary depending on the type of asset.	<u><i>The Equatorial Guinean Government is known to often sign mutually beneficial Establishment Agreements with foreign mining companies in order to encourage investments. These agreements sometimes contain special incentives that are peculiar to each company or project.</i></u>

4. Mining specific depreciation

Countries in which the resources sector plays a key role in the economy tend to have more generous arrangements for the depreciation of key mining related assets such as line haul trucks, drilling equipment, mine plant and equipment and mine tenements.

Mining specific depreciation

Country	Trucks	Drill Equip	Process P&E	Tenements	Effect Accel
Australia	10	10	25	mine life	Y
United States	7	7	39	15	Y
China	10	10	20	mine life	
Japan	4	6	12	mine life	Y
Germany	8 – 10	8 – 15	8 – 15	mine life	
Brazil	4	10	25	25	Y
United Kingdom	5.5	5.5	5.5	10	Y
Canada	4	4	4	< 3.3	Y
Korea	5	10	40	20	Y
Indonesia	8	16	10	n/a	Y
South Africa	1	1	1	10	Y
Chile	3 (9)	3 (9)	2 (5)	n/a	Y
Equatorial Guinea	3	5	20	n/a	Y

South Africa has the most generous regime for the depreciation of mining equipment, allowing for a 100% immediate deduction of plant and equipment, line haul trucks and drilling equipment, subject to there being sufficient mining income.

Canada also provides relatively generous depreciation outcomes, with a 25% capital cost allowance (four year effective life) for plant and equipment, line haul trucks and drilling equipment, with certain other mine assets being subject to a 100% capital cost allowance.

Brazil allows for faster rates of depreciation for the intensive operation of assets, for example equipment that operates on a 24 hour basis would be depreciated faster than equipment that is only operated during daylight hours.

While having similar effective lives to several other countries for line haul trucks and drilling equipment, Chile allows for the depreciation of mine plant and

equipment over 5 years. However, Chile also allows taxpayers to elect for accelerated depreciation for certain assets at triple the rate applying to the effective life of the assets.

The most common approach to the depreciation of mine tenements across the countries analysed is the life of mine, however South Africa allows for depreciation over 10 years and Canada may allow a rate of up to 30% (effectively up to 3.3 years).

	Assets grouped into classes for the purposes of depreciation?	D/B ³ method available	DMV uplift	Effective life				Broadly consistent with actual useful life mining assets	Depreciation rules/rates currently applied a subject of law/rate change in past 3 years	Other comments
				Haul truck	Drilling equipment	Mine processing plant	Mining tenements			
Australia	Asset-by-asset basis.	Yes	200%	10 years	10 years	25 years	Life of the mine	Yes	No	
United States	Asset-by-asset basis.	Yes	Generally 200% but method varies depending on asset type.	5 years	7 years	39 years	Dependent on whether tenement represents: a) economic interest in mineral = recovered through depletion; or b) right to mine = depreciate over 15 years straight line.	Yes	No	

³ Diminishing Balance.

China	Grouped by asset type.	No	N/A	10 years	10 years	20 years	Life of the mine.	Yes	No	Fixed assets exposed to severe corrosion or constant vibration through the years may be depreciated over a shorter period (not less than 60% of the prescribed minimum depreciation period).
Japan	Asset-by-asset basis.	Yes	200%	4-5 years	6 years	6 years	Prescribed by the relevant tax office based on the volume of mining, etc.	No	Yes D/B step-up rate for assets (not just mining) acquired after April 1, 2012 has been changed from 250% to 200%.	The statutory method is 'unit of production method', although taxpayers can elect to use diminishing balance.
Germany	Generally asset-by-asset basis. Exceptions for certain industries where grouped by asset type.	No	N/A	8-10 years	8-15 years	8-15 years	Life of the mine.	Yes	No	Average effective life based on (non-binding) depreciation guidelines issued by the German tax authorities.

Brazil	Asset-by-asset basis.	No	N/A	4 years or term of concession	10 years or term of concession	25 years or term of concession	25 years or term of concession	Yes	No	Brazil grants accelerated depreciation methods in certain circumstances.
United Kingdom	Grouped by asset type.	Yes	No	18%*	18%*	18%* if main pool. 8%* if long life asset.	10%	No	No	*Written down allowance rates applied (rather than useful life).
Canada	Grouped by asset type.	Yes	No	25% CCA rate (100% accelerated CCA rate for certain assets)			Discretionary (up to 30% per year).	No	No	
Korea	Asset-by-asset basis.	Yes	Depends on S/L effective rate	5 years	10 years	40 years ⁴	20 years; or Depreciated by service output method.	Yes	No	Taxpayer can adjust effective life of the asset by ± 25%.
Indonesia	Grouped broadly by economic useful life.	Yes	200%	8 years	16 years	20 years	N/A			

⁴ Re steel framed reinforced concrete construction.

South Africa	All mining assets grouped as mining capital expenditure.	No	N/A	100% in year one subject to there being sufficient mining income.			(a) 10 years i.e. 10% per annum on straight-line basis. (b) N/A	No	No	The specific allowances for mining assets in South Africa are mainly as a result of the mining industry in SA being very capital intensive. Different incentives are available for gold mining.
Chile	Asset-by-asset basis	No	N/A	9 years	9 years	5 years	Non-depreciable. Cost forms part of the cost of extracted mineral bade on a depletion system	No	No	Accelerated depreciated may apply whereby the normal useful life is reduced to one third. Accelerated depreciation only available for imported assets acquired new or used and for locally purchased new assets.
Equatorial Guinea	Grouped by asset type	No	N/A	Rates depend on the useful life of the asset, but may not exceed the prescribed maximum statutory limits.				Yes	No	
				3 years	5 years	20 years	N/A			

5. General depreciation comparison

As discussed in Part 2 above, we have undertaken depreciation deductions for a sample of assets to compare the depreciation deductions available under various tax regimes. The assets included in our sample are:

- agricultural equipment – a combine harvester (\$500,000 cost)
- industrial equipment – a printing press (\$100,000 cost)
- general – a motor vehicle (\$30,000 cost); and
- office equipment – a computer (\$2,000 cost)

In completing these calculations we have assumed:

- the assets were acquired on the first day of the income year; and
- no incentives or investment allowances were available.

The total depreciation deductions below represent the sum of the tax deductions available for the four years after acquisition. The deductions are disclosed in nominal terms.

COMBINE HARVESTER	Method	EL	Total depreciation deductions
Chile	SL	3	\$500,000
Equatorial Guinea	SL	4	\$400,000
Korea	SL	5	\$400,000
Canada	DB	3.3*	\$379,950
Japan	DB	7	\$369,846
Indonesia	DB	8	\$341,797
South Africa	SL	6	\$333,333
United States	DB 150%	7	\$309,441
United Kingdom	DB	5.5*	\$273,939
Australia	DB	12	\$258,873
Brazil	SL	10	\$200,000
China	SL	10	\$200,000
Germany	SL	10	\$200,000

PRINTING MACHINE	Method	EL	Total depreciation deductions
Equatorial Guinea	SL	3	\$100,000
Japan	DB	5	\$87,040
Korea	SL	5	\$80,000
Chile	SL	5	\$80,000
United States	DB	7	\$73,969
Canada	DB	4*	\$68,359
Indonesia	DB	8	\$68,359
South Africa	SL	6	\$66,667

United Kingdom	DB	5.5*	\$54,788
Germany	SL	8	\$50,000
Australia	DB	15	\$43,583
Brazil	SL	10	\$40,000
China	SL	10	\$40,000

PASSENGER MOTOR VEHICLE	Method	EL	Total depreciation deductions
Chile	SL	2	\$50,000
China	SL	4	\$50,000
Equatorial Guinea	SL	4	\$50,000
Japan	DB	4	\$46,875
Indonesia	DB	4	\$46,875
Brazil	SL	5	\$40,000
Korea	SL	5	\$40,000
South Africa	SL	5	\$40,000
Canada	DB	3.3*	\$37,995
Australia	DB	8	\$34,180
Germany	SL	6	\$33,333
United Kingdom	DB	5.5*	\$27,394
United States	DB	cap	\$20,685

PERSONAL COMPUTER	Method	EL	Total depreciation deductions
Chile	SL	2	\$2,000
China	SL	3	\$2,000
Equatorial Guinea	SL	4	\$2,000
Germany	SL	3	\$2,000
Korea	SL	1	\$2,000
* South Africa	SL	3	\$2,000
Canada	DB	1.8*	\$1,918
Australia	DB	4	\$1,875
Indonesia	DB	4	\$1,875
Japan	DB	4	\$1,875
United States	DB	5	\$1,741
Brazil	SL	5	\$1,600
United Kingdom	DB	5.5*	\$1,096

* Canada and the United Kingdom use percentage rates which have been recalculated as effective life years.

APPENDIX 2: KPMG ANALYSIS – THIN CAPITALISATION



cutting through complexity™

Thin Capitalisation

Minerals Council of
Australia

July 2012

Disclaimer

Inherent Limitations

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The findings in this report have been formed on the above basis.

Third Party Reliance

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Introduction

KPMG was engaged by the Minerals Council of Australia (“MCA”) to examine the thin capitalisation rules in thirteen nominated countries, including commentary on any recent or current proposals for changes to those rules and possible drivers for those changes.

The project aims to inform the MCA about comparative thin capitalisation regimes in the context of possible proposals by the Australian Government to amend the existing thin capitalisation rules, in particular the existing debt-equity ratio of 3:1.

We have not addressed in this paper another approach being considered by the Business Tax Working Group, an Allowance for Corporate Equity regime, which in theory should provide a more neutral tax outcome for debt and equity.

Summary

The approach to the tax treatment of thin capitalisation varies considerably between countries. The most common approach to thin capitalisation rules among the countries analysed is a formula-based approach, with an emphasis on safe harbours for defined debt-equity ratios and thresholds. Germany is unique amongst the countries reviewed as it applies a formula approach, but links debt deductions within an income year to a proportion of EBITDA.

Other methods of tax treatment of thin capitalisation include the United States ‘facts and circumstances’ approach with the revenue agency providing guidance about the circumstances that they would consider acceptable.

Thin capitalisation rules may also be integrated with the transfer pricing regime (United Kingdom, Indonesia and South Africa) with requirements for arm’s length transactions between domestic and foreign businesses. While the transfer pricing approach may potentially provide greater flexibility to borrowers, in the absence of clearly defined debt-equity ‘safe harbours’ they may also create some uncertainty and have the potential to foster conflicting views between taxpayers and revenue agencies.

A key distinction between thin capitalisation regimes is how the rules apply to third party debt. The Australian approach of including both related party and third party debt is a less common approach to thin capitalisation, with the majority of the countries analysed having rules that apply solely to related party debt.

Country	Tax rate	Debt	Formula	Other method
Australia	30.0%	all	3:1	
United States	40.0%	all		facts & circumstances, with cap
China	25.0%	related	2:1	
Japan	38.0%	related	3:1	
Germany	29.5%	all	30% EBITDA cap	
Brazil	34.0%	related	2:1	
United Kingdom	26.0%	related		arm's length
Canada	26.0%	related	1.5:1	
Korea	24.2%	related	3:1	
Indonesia	25.0%	related		arm's length
South Africa	34.6%	related		arm's length
Chile	18.5%	related	3:1	
Equatorial Guinea	35.0%	related	1:1	
Mozambique	32.0%	related	2:1	

Different approaches to thin capitalisation do not appear to be related to variations in corporate tax rates. The US and Japan have relatively high corporate tax rates, with the US applying a facts and circumstances approach while Japan applies a debt-equity formula. In the lower corporate tax rate countries, Korea applies a debt-equity formula, while the UK uses the transfer pricing arm's length approach.

Similarly, the comparative levels of economic development do not appear to be factors that will influence the tax treatment of thin capitalisation; for example the United Kingdom and Indonesia have similar approaches based on transfer pricing arm's length principles, while both Canada and Mozambique apply debt-equity formulas.

There does not appear to be a relationship between the tax treatment of thin capitalisation and countries that have significant natural resources sectors including Brazil, Canada, Indonesia, South Africa, Chile, Equatorial Guinea and Mozambique. Among these countries there are debt-equity and transfer pricing arm's length approaches.

The regulatory trend, to the extent that it is identifiable in the group of countries analysed, appears to be towards a tightening rather than a relaxation of thin capitalisation rules. Specific examples include Canada, which is reducing its thin capitalisation debt-equity safe harbour from 2:1 to 1.5:1, and South Africa, which is replacing a 3:1 debt-equity safe harbour with an arm's length test. Some of the countries analysed have recently made amendments to thin capitalisation rules but these have generally been relatively minor in nature, such as the carry-forward provisions in Germany or the expanded debt definition in Chile.

Thin capitalisation regimes

There is a range of different approaches adopted by different countries that are designed to limit tax deductions for thinly capitalised businesses. The countries analysed below after Australia have been ordered based on International Monetary Fund estimates of the size of their respective economies.

Australia

- **General rules:** Australian thin capitalisation rules limit tax deductions for debt used to fund the local operations of foreign businesses investing into the country and local businesses investing overseas. A debt deduction is an expense incurred by a business in connection with a debt interest, such as an interest payment or a loan fee for which the business would otherwise be entitled to claim a deduction. Interest incurred on debt is generally an allowable deduction, to the extent that the amount of debt does not exceed one of the prescribed safe harbours. The safe harbour is a 3:1 debt-equity ratio. Alternatively, if the taxpayer does not fall within the safe harbour debt amount, it may rely on an arm's length test or worldwide gearing test.
- **Application:** Rules apply to all debt, whether borrowed from a related party or otherwise.
- **Debt definition:** The definition of debt includes all interest bearing debt.
- **Equity definition:** The assets of the company, net of non-interest bearing liabilities.
- **Date of last change:** 2001.
- **Proposed changes:** none identified.

United States

- **General rules:** The US applies a 'facts and circumstances' approach in determining whether a corporation is thinly capitalised. The US does not have debt-equity ratios that can be used as a safe harbour to ensure debt treatment, however it is believed that US tax authorities would generally respect a ratio of 3:1 or less on debt instruments that do not have equity features.
- **Application:** Rules apply to all debt, whether borrowed from a related party or otherwise, with stricter rules for related party debt as outlined below.

Debt definition: debt is generally computed based on the highest amount owed at any time during the financial year, including trade debts. Debt has a broad definition, including related party and non-related party debt. Factors cited in the statute include for defining debt include:

- whether the instrument contains a written unconditional promise to pay on demand or on a specified date a sum certain in money, in return for adequate consideration, and to pay a fixed rate of interest;
- whether the instrument is subordinate to or has a preference over indebtedness of the corporation;
- the debt to equity ratio of the corporation;

- whether the instrument is convertible into stock of the corporation; and
- the relationship between the holding of the instrument and the stock of the corporation, i.e. whether or not such holdings are proportional.

In addition, US tax law contains provisions which can apply to limit the deductibility of interest (even if the underlying instrument is characterised as debt for US tax purposes). For example, to the extent debt to equity ratios exceed 1.5 to 1; US tax law generally limits related party interest deductions to not more than 50% of earnings (note that there is a specific US tax definition for earnings for this purpose). Additionally, interest expenses owed to a related foreign party is often required to be paid in order to be deducted (thereby matching the US tax deduction with US interest withholding tax in many cases).

- **Equity definition:** generally adopts the accounting balance for share capital.
- **Date of last change:** 1992 Amendment to Internal Revenue Code.
- **Proposed changes:** none identified.

China

- **General rules:** China's thin capitalisation rules only apply to related party debt and equity. Where related party debt exceeds the prescribed standards it cannot be deducted. Standard debt- equity ratios are:
 - 2:1 for non-financial services enterprises
 - 5:1 for financial services enterprises

Non-deductible interest cannot be carried forward and will be generally be characterised as dividends and subject to income tax when paid directly or indirectly to overseas related parties.

- **Application:** Related party debt.
- **Debt definition:** debt is calculated as the sum of the monthly average associated debt amount. For these purposes, debt includes only amounts from foreign related parties.
- **Equity definition:** adopts the accounting balance for share capital.
- **Date of last change:** 2009.
- **Proposed changes:** none identified.

Japan

- **General rules:** A Japan resident corporation may deduct interest on debts owed to specified non-residents only to the extent that it does not exceed a 3:1 ratio. The ratio applied is so-called "foreign controlling shareholder debt to equity ratio" that is, debt of the Japanese borrower owed to the foreign controlling shareholders compared with the equity of the Japanese borrowing company multiplied by the percentage of shareholding, direct or indirect, of foreign controlling shareholders in the Japanese company at the end of the fiscal year. However, as a safe harbour rule, even if the ratio exceeds 3:1, where the total debt-equity ratio of the Japan resident

corporation does not exceed 3:1, the thin capitalisation rules may not apply. If the ratio is exceeded, the interest on the excess debts is non-deductible for Japanese corporate tax. As an alternative to the 3:1 figure, a company may use the debt-equity figure of a comparable Japanese company if a higher ratio is available.

- **Application:** Related party debt.
- **Debt definition:** debt is characterised as the average amount owed at any time during the financial year, including trade debts. For these purposes, debt includes amounts from foreign related parties and certain third party debts may also be subject to the thin capitalisation rules.
- **Equity definition:** The average balance of the net of total assets less total liabilities. If the net is less than the total of paid-in capital and capital surplus, the latter is treated as 'net equity' for the purpose of this rule.
- **Date of last change:** The last change was in 2006 amendment to expand the scope of "debt" and "interest" under Japan's thin capitalisation rules. Main additional items are as follows:
 - a loan guaranteed by a foreign controlling shareholder, interest on such loan, and guarantee fees paid to the foreign controlling shareholder (excluding interest and guarantee fees subject to Japanese corporation tax); and
 - a loan mortgaged with bonds borrowed from a foreign controlling shareholder, interest on such loan and bond lending fees paid to the foreign controlling shareholder (excluding interest and bond lending fees subject to Japanese corporation tax).
- **Proposed changes:** none identified.

Germany

- **General rules:** There is a general limitation on the deductibility of interest expenses. Interest expenses which exceed the threshold of €3 million may only be deducted up to a limit of 30% of EBITDA. There is an additional escape clause for group entities which focuses on the group's equity ratio. Non-deductible interest expenses can be carried forward indefinitely, however, the carry-forward is subject to the loss-carry-forward limitation rules (change of control). In addition, the interest carry-forward is considered in future years when determining whether the interest threshold is exceeded. From 2010 an EBITDA carry-forward applies. Unused EBITDA, i.e. interest expenses lower than 30% of the EBITDA in a tax year, must be carried forward for a maximum period of 5 years.
- **Application:** Rules apply to all debt, whether borrowed from a related party or otherwise.
- **Debt definition:** Interest expenses are defined as all interest on capital that has reduced taxable income.
- **Equity definition:** Based on financial statements prepared under IFRS.
- **Date of last change:** 1 January 2010 carry forward provisions for unused interest expenses.

- **Proposed changes:** none identified.

Brazil

- **General rules:** interest paid or credited by a Brazilian source to related entities, residing or domiciled abroad, will be deductible within the fiscal year for purposes of calculating corporate income taxes if they cumulatively meet the following requirements:
 - (a) for related parties with equity participation in the Brazilian company, the debt funding, verified on the date of the accrual of the interest, shall not exceed two times the amount of equity participation of the related foreign party in the net equity of the Brazilian company;
 - (b) for related parties with no equity participation in the Brazilian company, the debt funding, verified on the date of the accrual of the interest, shall not exceed two times the amount of the net equity of the Brazilian company;
 - (c) in any of the two cases above, under (a) or (b), the sum of the debt funding, verified on the date of the accrual of the interest, shall not exceed two times the amount of the combined equity participation of every related entity of the group in the net equity of the Brazilian party.

The excess portion of the interest expenses exceeding these ratios will not be tax deductible.

A further limitation is that the interest paid by a Brazilian company to a foreign creditor (related or not) in a low-tax jurisdiction shall not exceed 30% of the equity of the Brazilian borrower. Brazilian thin capitalisation rules also apply to cross-border loans when a related party (or a party located in a low tax jurisdiction or under a privileged tax regime, related or not) acts as guarantor, consigner or intervening party of the debt contract.

- **Application:** Related party debt.
- **Debt definition:** Debt is characterised as the highest amount owed at any time during the financial year, including trade debts. For these purposes, debt includes only amounts from foreign related parties. Debt may be held with related parties (2:1 ratio) or parties (related or not) located in low tax jurisdictions or under a privileged tax regime (0.3:1 ratio).
- **Equity definition:** Adopts the accounting balance for share capital. New accounting rules were introduced in late 2007 (Law 11,638) as an effort towards the adoption of the international accounting standards. In view of that, Brazilian government issued a Provisional Measure in late 2008 imposing that the accounting rules in force before Law 11,638 should remain applicable for tax purposes (which was called Transitory Tax Regime – TTR). There is some debate on whether taxpayers should observe the accounting rules introduced by Law 11,638 or not for thin capitalisation calculation purposes.
- **Date of last change:** 2011 (by the issuance of Law 12,249/10 and Federal Revenue's Normative Instruction 1154/11).
- **Proposed changes:** none identified.

United Kingdom

- **General rules:** Thin capitalisation rules are integrated in the transfer pricing rules. While no ratio is prescribed, however based on previous revenue agency guidance, companies with an interest cover of 3:1 or less are generally considered thinly capitalised.
- **Application:** Related party debt.
- **Debt definition:** n/a.
- **Equity definition:** n/a.
- **Date of last change:** 2004.
- **Proposed changes:** none identified.

Canada

- **General rules:** limits the deductibility of interest on loans to Canadian resident corporations from substantial non-resident shareholders or non-arm's length persons on loan amounts that exceed a 2:1 statutory determination of equity capital comprising retained earnings, and shareholder capital and surplus invested or contributed by substantial shareholders. Denied interest would be treated as a dividend and subject to withholding tax.
- **Application:** Related party debt.
- **Debt definition:** the average of the greatest total debt amount in each month owing to specified non-residents.
- **Equity definition:** the retained earnings (deficit not included) of the corporation at the beginning of the year plus the average of contributed surplus at the beginning of each month contributed by specified non-resident shareholders and the average paid-up capital at the beginning of each month on shares owned by specified non-resident shareholders.
- **Date of last change:** 1971 set debt-equity ratio of 2:1.
- **Proposed changes:** 2012 Budget contained a measure to reduce the debt-equity ratio to 1.5:1 and to extend the rules to cover partnerships, trusts and branches of non-resident corporations.

Korea

- **General rules:** Debt-equity ratio limits for a Korean company borrows from its controlling overseas shareholders are 3:1 for non-financial services companies and 6:1 for financial services companies. Interest payable on the excess portion of the borrowing is re-characterised as dividends and is not deductible in calculating taxable income.
- **Application:** Related party debt.
- **Debt definition:** debt is characterised as the highest amount owed at any time during the financial year, including trade debts. For these purposes, debt includes only amounts from foreign related parties and any third party debt arrangements that are guaranteed by the foreign controlling company.

Note that interest directly paid to foreign controlling company in this connection is reclassified as a dividend subject to dividend withholding tax whereas third party interest payment are not considered dividends (no withholding tax). It is considered 'excessive' when the accumulated amount of the concerned debt (amount of debt multiplied by number of days) is greater than three times the accumulated equity contributed by the foreign controlling company (amount of equity as defined below by the number of days).

- **Equity definition:** adopts the accounting balance for share capital. Equity for thin-cap purposes shall be calculated as follows: (a) the ratio of share ownership multiplied by (b) the greater of (i) the paid-in capital or (ii) net assets as of the end of the fiscal year.
- **Date of last change:** 2 February 2012.
- **Proposed changes:** none identified.

Indonesia

- **General rules:** There are no specific provisions on thin capitalisation, however the revenue authorities have the authority to re-characterise debt as equity if the parties to the transaction have a 'special relationship' (i.e. not dealing at arm's length).
- **Application:** Related party debt.
- **Debt definition:** n/a.
- **Equity definition:** n/a.
- **Date of last change:** 2010 formal regulations on transfer pricing.
- **Proposed changes:** none identified.

South Africa

- **General rules:** Thin capitalisation is covered under the transfer pricing rules. Revenue Service Practice Note 2 published in 1996 regards any debt-equity ratio exceeding 3:1 as breaching the arm's length standard, although it is possible to approach the Revenue Service to justify a debt-equity ratio that exceeds this safe harbour.
- Interest is also regarded as excessive and not deductible if in the case of Rand-denominated loans it exceeds the weighted average of the South African prime rate plus 2 per cent or in the case of foreign currency denominated loans it exceeds the weighted average of the interbank loan rate plus 2 per cent.
- An amount which has been adjusted or disallowed in respect of the thin capitalisation rules is treated as a dividend.
- **Application:** Related party debt.
- **Debt definition:** The weighted average of the financial assistance in existence during the relevant year of assessment and includes interest-bearing financial assistance only. Where no significant variation occurred

in the level of financial assistance during the year of assessment, the amount of financial assistance as it exists at the end of the relevant year of assessment may be used. Trade credit which is interest-bearing must be included in the amount of financial assistance.

- **Equity definition:** In determining the amount of fixed capital of the resident or recipient, the following items are to be taken into account on a pro rata basis in accordance with the investors' interest in the South African entity:
 - share capital;
 - share premium;
 - accumulated profits of a capital and revenue nature; and
 - permanent owners' capital (excluding any financial assistance) in circumstances where there is no share capital.
- **Date of last change:** 1996.
- **Proposed changes:** The Revenue Service will issue a new Practice Note in 2012 that will deal with thin capitalisation and transfer pricing.
- With effect from years of assessment commencing on or after 1 April 2012, the Revenue Service is to adopt a new arm's-length test for the purposes of thin capitalisation. This means that the current 3:1 debt to equity ratio safe harbour will fall away and will be replaced with the arm's-length test. In terms of the new regime, the test, with regard to foreign loan funding, will be based on the level of finance the borrower could have secured under the same terms and conditions had the borrower (the local company) and the lender (the foreign company) been independent parties dealing at arm's length, and, whether as a result of the transaction, a tax benefit is derived by the parties to the transaction. The intent is to limit the deductible interest incurred in a transaction between independent parties dealing at arm's length. Furthermore, the new test does not make reference to the value of the financial assistance being excessive in relation to the fixed capital.

Chile

- **General rules:** Chilean Law 19,738 introduced a thin capitalisation rule under which outbound, related-party interest payments that otherwise qualify for a reduced 4% withholding tax will be subject to an additional 31% corporate rate if paid on indebtedness incurred in a year in which the debtor was in an "excessive indebtedness" position. For these purposes, "excess indebtedness" refers to indebtedness exceeding three times the taxpayer's equity, as defined for tax purposes. The excess-indebtedness test must be applied only on 31 December of the year in which a new amount of foreign related-party indebtedness is incurred.
- **Application:** Related party debt.
- **Debt definition:** The definition of debt for this purpose only includes debt with foreign related parties which are also eligible for the 4% withholding tax rate. Therefore, not all related party debt should be considered. Trade debts should be included only if they meet these conditions, which would typically be the case of vendor financing for the import of goods purchased

from a related party. Also, accrued and unpaid interest balances should be added to the computation of total debt.

- **Equity definition:** The equity definition corresponds to the net equity determined for tax purposes, which is typically the accounting net equity with adjustments to conform to tax rules. Also very specific and detailed adjustments for purposes of thin capitalisation rules have to be made for determining the total equity amount.
- **Date of last change:** 2001.
- **Proposed changes:** Chilean Congress is considering a tax reform package proposed by the Government at the beginning of May 2012. The reforms include certain changes to thin capitalisation rules. The most relevant include an expansion of the definition of related parties to include all debt secured either in kind or personally (e.g. corporate guarantee) by a third person. The reform also proposes changing the time at which the ratio is measured. Under current law the measurement is done for each new borrowing in the year the borrowing is obtained and is thereafter fixed for the entire life of the loan. The proposed change considers doing the measurement on a monthly basis, therefore the debt position of a specific borrower could vary from the time in which the borrowing is obtained to the time in which interest is paid.

Equatorial Guinea

- **General rules:** The deduction of interest paid on shareholders loans is subject to certain conditions described below.

Interest paid to partners or shareholders on funds provided by them to the company, under the following conditions:

- the interest is deductible up to the maximum interest rate (i.e. the lending rate of Equatorial Guinean commercial banks at the time the interest payments were due), and
 - for shareholders having a control over the company, the amount of the loan may not exceed the amount of the share capital (which implies a 1:1 ratio for related parties).
- **Application:** Related party debt.
 - **Debt definition:** n/a.
 - **Equity definition:** Share capital.
 - **Date of last change:** None identified.
 - **Proposed changes:** None identified.

Mozambique

- **General rules:** Generally indebtedness is considered excessive when the amount of the debt is more than twice the value of the concerned holding in the equity capital of the liable person. Thin capitalisation rules are applied when the debt/equity ratio exceeds 2:1.
- **Application:** Related party debt.
- **Debt definition:** debt is characterised as the highest amount owed at any time during the financial year, including trade debts. For these purposes, debt includes only amounts from foreign related parties.
- **Equity definition:** adopts the accounting balance for share capital.
- **Date of last change:** None identified.
- **Proposed changes:** None identified.

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