

THE MINERALS RESOURCE RENT TAX IS DEAD, LONG LIVE RESOURCE RENT TAXES?

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The enactment of the Minerals Resource Rent Tax Repeal and Other Measures Act 2014 (Cth) finally heralded the demise of the Minerals Resource Rent Tax (MRRT). Accordingly, there is now space for a new debate about the legal design of a resource rent tax. While many factors led to the abolition of the MRRT, this paper focuses on two key matters that have been highlighted by post-MRRT developments: the political relevance of state ownership of resources and the interaction between the MRRT and the corporate income tax. The article examines how state ownership of resources and the impact of the corporate income tax affect the tax policy criteria of equity, efficiency, simplicity and sustainability. The goal is to examine how the legal design of resource rent taxes might be altered to take account of such real world constraints.

I INTRODUCTION

On 5 September 2014 the Coalition Government's third attempt to repeal the Minerals Resource Rent Tax (MRRT) was successful with the enactment of the *Minerals Resource Rent Tax Repeal and Other Measures Act 2014* (Cth) (MRRT Repeal Act). As its name suggests, the MRRT Repeal Act abolishes the MRRT, with effect from 1 July 2014. The rancorous process surrounding the precursor proposal to the MRRT, the Resource Super Profits Tax (RSPT) and the political acrimony over the deposal of then Prime Minister Kevin Rudd and the hasty negotiation of the MRRT did not provide a sound base for the MRRT. Its abolition marks the chance for a fresh start, but one that ought to be informed by lessons from the MRRT's short lifespan. This article aids that process by examining how the legal design of resource rent taxes might be altered to take account of several key real world constraints, being state resource ownership and the existence of company profits taxes. It does so from a law reform perspective, rather than as a matter of purely economic analysis.

A multitude of reasons, real and imagined, were cited in support of repealing the MRRT. They include:

- The historically low and unpredictable level of receipts.¹

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- Particular features of the MRRT such as starting base allowances, state royalty allowances and the need for transfer pricing methodologies which exacerbated the reduced revenue and the volatility.²
- The additional regulatory burden imposed on industry - in part due to the administrative mismatch with the company income tax by focussing on taxation at the project rather than entity level.³
- The increase in 'sovereign risk' associated with the introduction of the tax.⁴

In addition, the manner of interaction between state royalties, the company income tax and the MRRT was identified as a matter of concern in the Explanatory Memorandum relating to the MRRT Repeal Act.⁵

This article argues that it is necessary to be cognisant of these concerns if good tax design for a resources rent tax on non-renewable resources is to be achieved. In particular, the article focuses on the need to consider the role of resource taxes in the context of applicable company profits taxes (particularly, the corporate income tax (CIT)), as well as real world constraints such as state⁶ ownership of resources. Indeed, as Alannah MacTiernan acknowledged in Parliament:⁷

¹ See, eg, Commonwealth, *Parliamentary Debates*, House of Representatives, 26 June 2014, 77-8 (Bob Baldwin, Parliamentary Secretary to the Minister for Industry); Explanatory Memorandum to the Minerals Resource Rent Tax Repeal and Other Measures Bill 2014 (Cth) (MRRT Repeal EM) 50; Joe Hockey, Treasurer, Ian Macfarlane, Minister of Industry and Mathias Cormann, Minister of Finance, 'Repeal of the Minerals Resource Rent Tax' (Joint Media Release, 24 October 2013).

² MRRT Repeal EM 50-1; Senate Economics References Committee, Parliament of Australia, *Development and Operation of the Minerals Resource Rent Tax* (2013) 13 [2.3]-[2.5], 38-9 [2.119]-[2.126]; Henry Ergas and Alex Robson, 'Revenue Allocation Under the MRRT: Economic Aspects' (2012) 14(2) *Journal of Australian Taxation* 183, 186-7.

³ MRRT Repeal EM 49-50; Fortescue Metals Group Ltd, Submission to the Senate Economics References Committee, Parliament of Australia, *Inquiry into the Development and Operation of the Minerals Resource Rent Tax* (27 March 2013) 2. See also, Hockey, Macfarlane and Cormann, above n 1; Senate Economics Legislation Committee, Parliament of Australia, *Minerals Resource Rent Tax Repeal and Other Measures Bill 2013[Provisions]* (2013) 16-18, 35.

⁴ MRRT Repeal EM 48-9; Commonwealth, *Parliamentary Debates*, House of Representatives, 26 June 2014, 81 (Michael McCormack, Parliamentary Secretary to the Minister for Finance); Commonwealth, *Parliamentary Debates*, House of Representatives, 26 June 2014, 84-5 (Melissa Price); Hockey, Macfarlane and Cormann, above n 1. Despite assertions about increased industry confidence, it is far from clear how repeal of an existing measure, shortly after its introduction, helps to improve the perception of sovereign risk.

⁵ MRRT Repeal EM 13, 49-51.

⁶ References to 'states' include the Northern Territory and the Australian Capital Territory, unless the context otherwise requires.

⁷ Commonwealth, *Parliamentary Debates*, House of Representatives, 26 June 2014, 85-6 (Alannah MacTiernan).

There is no doubt that, when you look rationally at the taxation system and the best way to bring to account the value for the Australian community out of the resources industry, it is as the Henry tax review says. It says that we should replace the current royalties based system with a uniform, rent based tax, legislated for and administered by the Australian government. I agree with that. ... I guess my view is that I do not think that you can put this just on top of a royalties regime. I think that, if we are going to solve this problem, in the long term we need to work with the states and to come together with a composite and uniform system...

The significance of state resource ownership (hence state royalties) and the CIT to the design of a resource rent tax is highlighted in a different way in the modelling obtained by the Minerals Council of Australia that indicated that the combined effect of such royalties and the CIT on the Australian minerals industry, was potentially an overall tax rate in excess of 40%.⁸

To enable the subsequent investigation of good resource tax design, Part II outlines the form and functions of resource taxes. Part III identifies the role of the CIT, as well as identifying the key ways in which it interacts with resource taxes and hence the potential problems raised. Part IV discusses the problem of political constraints on resource tax design, which are grounded in the fact of significant ownership of most resources, other than offshore minerals and petroleum, at the state, rather than federal, level. This Part identifies reform proposals made by the GST Distribution Review Panel in relation to the MRRT and state royalties, in order to inform the critique in Part V by providing potential amendments to the form of a future MRRT (or PRRT).

Finally, Part V examines whether the alternatives for a resource tax that were proposed in the context of the MRRT (the RSPT, MRRT and extended Petroleum Resource Rent Tax (PRRT)) are well designed, when considered in light of interactions with the CIT and the political constraint of state resource ownership, by reference to:

- Efficiency, which concerns the economic cost of collecting a tax and is typically maximised if the effect of the tax measure on economic decisions is neutral.⁹
- Equity, comprising horizontal equity, which requires taxpayers in similar circumstances to be treated alike;¹⁰ and vertical equity, which

⁸ Minerals Council of Australia, Submission No 14 to Senate Economics Legislation Committee, Parliament of Australia, *Minerals Resource Rent Tax Repeal and Other Measures Bill 2013* [Provisions] (21 November 2013) 3-4.

⁹ Australia's Future Tax System Review Panel, *Australia's Future Tax System: Report to the Treasurer* (2009) Part One, 17.

¹⁰ Nicole Wilson-Rogers and Dale Pinto, 'Tax Reform: A Matter of Principle? An Integrated Framework for the Review of Australian Taxes' (2009) 7(1) *eJournal of Tax Research* 72, 77.

involves the imposition of tax according to taxpayers' ability to pay.¹¹

- Simplicity, which concerns the facility of administration and compliance.¹²
- Sustainability, involving an ability to satisfy ongoing revenue needs while delivering a 'durable' structure.¹³

Due to its focus on the relationship between the tax and transfer systems, the *Australia's Future Tax System Review* (Henry Review) criterion of 'policy consistency'¹⁴ has not been considered, although it is acknowledged that the interaction between resource rent taxes and state royalties or the CIT, may, in a broader sense, raise issues of policy consistency. For instance, the potential, discussed in Part V.D, for the horizontal fiscal equalisation mechanism of distribution of the GST to result in incentives for states to increase royalties at the expense of federal resource rent tax revenue.

II RESOURCE TAXES

Resource taxes have two key purposes.¹⁵ The first is to achieve a fair price for the community for providing access to its resources.¹⁶ The second is to raise revenue efficiently due to the fact that non-renewable resources form an

¹¹ *Ibid* 77.

¹² Chris Evans and Binh Tran-Nam, 'Managing Tax System Complexity: Building Bridges Through Pre-filled Tax Returns' (2010) 25 *Australian Tax Forum* 245, 249; Wilson-Rogers and Pinto, above n 10, 81.

¹³ Henry Review, above n 9, Part One, 17.

¹⁴ *Ibid*.

¹⁵ For further objectives of resource taxes, see, eg, Robin Broadway and Frank Flatters, 'The Taxation of Natural Resources: Principles and Policy Issues' (1993) *The World Bank Policy Research Department Working Papers*, 10-12, 43.

¹⁶ Colin Barnett, Premier, 'Resource Super Profits Tax' (Media Statement, 4 May 2010); Ross Garnaut, 'The New Australian Resource Rent Tax' (Paper presented at the University of Melbourne Address, Melbourne, 20 May 2010) 6; Broadway and Flatters, above n 15, 11; John Freebairn and John Quiggin, 'Special Taxation of the Mining Industry' 2010 29(4) *Economic Papers* 384, 384; Henry Review, above n 9, Part Two, 219; John Freebairn, 'Overview of "Australia's Future Tax System"' in Chris Evans, Richard Krever and Peter Mellor, *Australia's Future Tax System: The Prospects After Henry* (Thomson Reuters, 2010) 11, 43; Jack Mintz, 'An Evaluation of the Business Tax Recommendations of the Henry Review and the Australian Government Response' in Chris Evans, Richard Krever and Peter Mellor, *Australia's Future Tax System: The Prospects After Henry* (Thomson Reuters, 2010) 161, 175; Craig Emerson and PJ Lloyd, 'Improving Mineral Taxation Policy in Australia' (1983) 59(3) *Economic Record* 232, 235; Kevin Rudd, Prime Minister and Wayne Swan, Treasurer, 'Stronger, Fairer, Simpler: A Tax Plan for Our Future' (Press Release, 2 May 2010) 1; Julia Gillard, Prime Minister, Wayne Swan, Treasurer and Deputy Prime Minister and Martin Ferguson, Minister for Resources and Energy, 'Breakthrough Agreement with Industry on Improvements to Resources Taxation' (Press Release, 2 July 2010) 1.

immobile base.¹⁷

The primary forms of resource taxes are:¹⁸

- An upfront cash bid for a tenement under a competitive auction.¹⁹
- ‘Specific’ royalties, imposed on the volume of mineral produced, or ‘ad valorem’ royalties based on the value of the product.²⁰
- Income or profits taxes, which use the same base as the CIT, but, for instance, impose a higher rate for resource companies, or a higher rate only for income years in which the quantum of income surpasses a threshold.²¹
- Economic rent taxes (ERT), which are intended to capture part of an economic rent, being the revenue obtained from resource extraction less the ‘sum of the supply prices of all capital, labour and other “sacrificial” inputs necessary to undertake the [mining]’.²² Economic rents can also be characterised as ‘above-normal profits’.²³ In other words, while an ERT is, in a sense, a profits tax,²⁴ it applies only to a limited range of profits. That is, only profits from resource projects

¹⁷ Garnaut, ‘The New Australian Resource Rent Tax’, above n 16, 6; Broadway and Flatters, above n 15, 11, 43; Freebairn, above n 16, 43.

¹⁸ See, eg, Garnaut, ‘The New Australian Resource Rent Tax’, above n 16, 6-8; Broadway and Flatters, above n 15, 1-6; Henry Review, above n 9, Part Two, 221-222; Emerson and Lloyd, above n 16, 236. See also, Diane Kraal and P W Senarath Yapa, ‘Resource Rent Taxes: The Politics of Legislation’ (2012) 27(3) *Australian Tax Forum* 485, 494-5.

¹⁹ Garnaut, ‘The New Australian Resource Rent Tax’, above n 16, 7; Freebairn and Quiggin, above n 16, 393; Broadway and Flatters, above n 15, 28.

²⁰ Henry Review, above n 9, Part Two, 221; Broadway and Flatters, above n 15, 33.

²¹ Ross Garnaut, ‘Principles and Practice of Resource Rent Taxation’ (2010) 43(4) *The Australian Economic Review* 347, 347, 349; Lindsay Hogan and Rebecca McCallum (ABARE Report Prepared for the Australia’s Future Tax System Review Panel, Australian Bureau of Agricultural and Resource Economics – Bureau of Rural Sciences, April 2010) 19.

²² Garnaut, ‘Principles and Practice of Resource Rent Taxation’, above n 21, 347, 349; Henry Review, above n 9, Part Two, 218. See also, Garnaut, ‘The New Australian Resource Rent Tax’, above n 16, 5-6; R Argyle, ‘Resource Rent Tax – The Commonwealth Proposals’ (1984) *Australian Mining and Petroleum Law Association Yearbook* 296, 297-298; Freebairn and Quiggin, above n 16, 385. Cf Albert Church, ‘Economic Rent, Economic Efficiency and the Distribution of Natural Resource Tax Burdens: Copper and Coal’ (1982) 22 *Natural Resources Journal* 559, 560.

²³ Henry Review, above n 9, Part Two, 218. See also, Ross Garnaut and Anthony Clunies Ross, ‘Uncertainty, Risk Aversion and the Taxing of Natural Resource Projects’ (1975) 85(338) *The Economic Journal* 272, 273.

²⁴ Garnaut and Clunies Ross, above n 23, 277; Rob Fraser, ‘The State of Resource Taxation in Australia: “An Inexcusable Folly for the Nation”?’ (1999) 43(3) *Australian Journal of Agricultural and Resource Economics* 259, 261. See also, Colin Barnett, Premier, ‘Henry Tax Review Statement’ (Multimedia Presentation, 2 May 2010).

and, theoretically, only those above the 'normal' rate of return.²⁵

The vast majority of state resource taxes constitute specific or ad valorem royalties.²⁶ State resource taxes are predominantly raised from iron ore and coal, with the vast bulk flowing to Western Australia, Queensland and New South Wales.²⁷ State mining royalty revenue amounted to around \$11.1 billion in 2011-12.²⁸ State resource tax receipts from oil and gas, while currently significantly lower, are not insignificant and are expected to increase as projects, particularly coal seam gas projects, mature.²⁹ Leaving the MRRT to one side, state royalties are the most prevalent form of resource taxes imposed in Australia.³⁰ However, at the Commonwealth level, an ERT in the form of the PRRT is imposed on offshore and onshore petroleum projects; as well as the crude oil excise, which is essentially a form of ad valorem royalty.³¹ PRRT revenue has averaged around \$1.5 billion between 2011-12 and 2013-14.³² The MRRT also applied as another ERT between 2012 and 2014, but as noted above, it has now been repealed.

Before critiquing resource rent tax design in Part V, it is necessary to briefly examine the background to the introduction of the MRRT, along with the broad scope and mechanics of the MRRT, the existing PRRT and the initially proposed RSPT. The Rudd/Gillard government first announced a broad resource rent tax on 2 May 2010, in the form of the RSPT,³³ following on from the Henry Review's recommendation for the adoption of a 'uniform resource rent tax imposed and administered' by the Commonwealth.³⁴ On 2 July 2010, the federal government announced that the RSPT proposal was to be replaced by the MRRT (to apply to iron ore and coal) and by the extension of

²⁵ Garnaut and Clunies Ross, above n 23, 277; Varis Vitols, 'Petroleum Taxation in Australia: The Resource Rent Tax Bills 1986' (1987-1988) 11 *Adelaide Law Review* 140, 173-174; Henry Review, above n 9, Part Two, 221.

²⁶ Some ERTs are also imposed. For instance, the Barrow Island royalty imposed by Western Australia; and certain Northern Territory resource taxes are profits-based taxes. See, eg, Henry Review, above n 9, Part Two, 226; Garnaut, 'Principles and Practice' above n 21, 349; Freebairn and Quiggin, above n 16, 384, 387; Nick Greiner, John Brumby and Bruce Carter, 'GST Distribution Review' (Second Interim Report, June 2012) 41.

²⁷ Greiner, Brumby and Carter, 'Second Interim Report', above n 26, 42.

²⁸ *Ibid.*

²⁹ See, eg, *ibid.* 43.

³⁰ Henry Review, above n 9, Part Two, 226; Freebairn and Quiggin, above n 16, 384.

³¹ See, eg, Greiner, Brumby and Carter, 'Second Interim Report', above n 26, 43-4; Garnaut, 'Principles and Practice' above n 21, 349. The Commonwealth also collects and passes on uranium royalties to the Northern Territory.

³² Commonwealth of Australia, *Budget Strategy and Outlook: Budget Paper No. 1 2013-2014* (2013) 5-24; Commonwealth of Australia, *Budget Strategy and Outlook: Budget Paper No. 1 2014-2015* (2014) 5-11.

³³ Rudd and Swan, above n 16, 1-2.

³⁴ Henry Review, above n 9, Part Two, 231.

the existing PRRT to all onshore as well as offshore petroleum projects, including coal seam methane projects and the North West Shelf.³⁵ The *Minerals Resource Rent Tax Act 2012* (Cth) (*MRRT Act*) (and associated legislation) was passed by the Federal Parliament on 19 March 2012 and commenced on 1 July 2012.³⁶

To delineate the scope of these taxes, the PRRT is an ERT applying to all offshore and onshore petroleum projects.³⁷ It is imposed at a 40% rate on annual net cash inflows relating to petroleum projects,³⁸ but doesn't result in refunds for annual negative cash flows. Rather net cash outflows are uplifted at various rates (which involve a risk free rate plus a premium)³⁹ and carried forward to be deducted in future years (or in limited circumstances transferred). A non-refundable credit is provided for state and federal resource taxes.⁴⁰

The transitional measures for existing projects to which the PRRT has been extended, make allowance for a deductible 'starting base' which, broadly, recognises the value or augmented cost of the project as at 1 May 2010 plus certain transition period expenditure.⁴¹ As a project based tax,⁴² the PRRT largely quarantines cash outflows (such as the credit for state royalties) to the relevant project, although there are some exceptions, such as limited transferability of exploration expenditure. In circumstances where a taxpayer has, or companies in a wholly owned group have, interests in multiple projects, if the taxpayer has excess exploration expenditure in relation to one project, they may, subject to strict eligibility requirements, be obliged to transfer that excess exploration expenditure to other projects (held by the taxpayer or another group company).⁴³

The MRRT was a similar style of rent tax,⁴⁴ but with a lower rate of 22.5% (30% as reduced by the 25% extraction allowance) and, in most cases, a single uplift rate (which was generally higher than those for the PRRT).⁴⁵ The MRRT

³⁵ Gillard, Swan and Ferguson, above n 16, 1.

³⁶ The *Petroleum Resource Rent Tax Assessment Amendment Act 2012* (Cth) also passed on 19 March 2012, with the majority of the changes commencing from 1 July 2012.

³⁷ Other than the Australia/East Timor Joint Petroleum Development Area.

³⁸ *Petroleum Resource Rent Tax Assessment Act 1987* (Cth), s 21. See also Peter Van Den Broek, 'Australia Prospects for Tax-Efficient Mineral Wealth' (1991) 3 *International Tax Review* 13, 15; Vitols, above n 25, 141.

³⁹ Henry Review, above n 9, Part Two, 243.

⁴⁰ *Petroleum Resource Rent Tax Assessment Act 1987* (Cth), s 35C.

⁴¹ *Petroleum Resource Rent Tax Assessment Act 1987* (Cth), s 35E and sch 2.

⁴² *Petroleum Resource Rent Tax Assessment Act 1987* (Cth), ss 21 and 22.

⁴³ *Petroleum Resource Rent Tax Assessment Act 1987* (Cth), ss 45A – 45D. See also G Cathro, 'Advanced PRRT' (Paper presented at the Taxation Institute of Australia National Resources Tax Conference, Perth, 14-15 October 2008) 7.

⁴⁴ Freebairn and Quiggin, above n 16, 393.

⁴⁵ *MRRT Act*, ch 3; *Minerals Resource Rent Tax (Imposition—General) Act 2012* (Cth), s 4; *Minerals Resource Rent Tax (Imposition—Customs) Act 2012* (Cth), s 4; *Minerals Resource Rent Tax (Imposition—Excise) Act 2012* (Cth), s 4.

applied, in broad terms, to iron ore and coal mining projects for miners with an annual group mining profit above the threshold of \$75 million.⁴⁶ There was no refund of excess deductions, for instance, if mining expenditure exceeded mining revenue in calculating mining profit.

State and federal resource royalties were creditable as grossed-up allowances against mining profit, but not refundable and only transferable in limited circumstances.⁴⁷ This was the result of a Policy Transition Group recommendation based on achieving certainty for industry and maintenance of Australia's 'international competitiveness'.⁴⁸ The gross-up was made using the MRRT rate, so that the MRRT liability was in fact reduced by the amount of the royalty. As noted, where there are excess royalty credits in a year, there was no refund, but instead they were uplifted at the long term bond rate plus 7 per cent and carried forward.⁴⁹ An allowance was also provided for a mining project's starting base, essentially a recognition of pre-MRRT investment in the upstream component of a mining project.⁵⁰ The extent and rate of uplift for the starting base depended on whether it was calculated according to book value or market value.

Like the PRRT, the MRRT was a project based tax,⁵¹ although there was a slightly greater provision for the transfer of losses between projects, with taxpayers being able to do so for projects of theirs involving the same commodity.⁵²

Accordingly, state royalties potentially applied in conjunction with the MRRT, to iron ore and coal projects and, with the PRRT, to oil and gas projects. It is the extension of the PRRT to onshore petroleum projects which has increased the significance and likelihood of overlap in the oil and gas sphere.

Other forms of ERTs include an 'allowance for corporate capital', such as the RSPT,⁵³ which can be viewed as a hybrid form of a PRRT style tax or 'Brown tax'.⁵⁴ The RSPT was proposed to be imposed at a set rate (40%)⁵⁵ on

⁴⁶ *MRRT Act*, divs 10, 15, 20, 45.

⁴⁷ *MRRT Act*, divs 60 and 65.

⁴⁸ Gillard, Swan and Ferguson, above n 16, 4; Commonwealth of Australia, Policy Transition Group, 'New Resource Taxation Arrangements' (Report, 2010), 55 (recommendation 39).

⁴⁹ *MRRT Act*, ch 3.

⁵⁰ *MRRT Act*, div 80.

⁵¹ *MRRT Act*, divs 10 and 15.

⁵² *MRRT Act*, divs 95 and 100.

⁵³ Freebairn and Quiggin, above n 16, 391-392.

⁵⁴ Emerson and Lloyd, above n 16, 234; Ross Garnaut and Craig Emerson, 'Mineral Leasing Policy: Competitive Bidding and the Resource Rent Tax Given Various Responses to Risk' (1984) 60(2) *Economic Record* 133, 140. A 'Brown tax' is imposed (or refunded) at a set percentage of net cash inflows (or outflows), so that refunds are potentially paid as costs are incurred: Henry Review, above n 9, Part Two, 221; Brian Parmenter, Amar Breckenridge and Stephen Gray, 'Economic Analysis of the Government's Recent Mining Tax Proposals' (2010) 29(3) *Economic Papers* 279, 281; Broadway and Flatters, above n 15, 10.

profits (with capital expenditure depreciated over time)⁵⁶ after providing an uplift for the delayed recognition of expenses based on the rate of return for a deemed loan to the government.⁵⁷ The tax rate percentage of net losses was to be refunded only once a project had failed.⁵⁸ The RSPT included a refundable credit for state royalties.⁵⁹

III PROBLEMS FROM CORPORATE INCOME TAX INTERACTIONS

The Australian corporate income tax can be characterised as having a number of purposes. First, it is an ‘investment tax’ applying at the business level to the ‘normal’ and ‘above normal’ returns to equity in companies.⁶⁰ For Australian resident shareholders it acts as an integrity support to the personal income tax, by effectively operating as a withholding tax on distributed profits and to some extent as an anti-deferral measure on retained profits.⁶¹ For foreign resident shareholders the CIT is generally a ‘final tax’.⁶²

Second, the CIT performs a ‘treasury transfer’ role in respect of foreign resident corporations in that if the home jurisdiction provides a tax credit for Australian CIT, to that extent, the CIT effectively transfers revenue from the home jurisdiction to Australia.⁶³ Third, the CIT can be viewed as a payment for infrastructure and services provided by the public to companies operating in Australia.⁶⁴ Finally, a significant purpose of the CIT is to raise general government revenue.⁶⁵

In terms of interactions between the CIT and resource taxes, as the above discussion demonstrates, there are some common purposes for resource taxes

⁵⁵ Commonwealth of Australia, *Tax Policy Statement: Stronger, Fairer, Simpler, A Tax Plan for Our Future* (2010) 21.

⁵⁶ Commonwealth of Australia, *The Resource Super Profits Tax: A Fair Return to the Nation* (2010) 24-25.

⁵⁷ Henry Review, above n 9, Part Two, 222, 245; *ibid* 26; Parmenter, Breckenridge and Gray, above n 54, 283; Freebairn and Quiggin, above n 16, 392.

⁵⁸ Commonwealth of Australia, *The Resource Super Profits Tax*, above n 56, v.

⁵⁹ Commonwealth of Australia, *Tax Policy Statement*, above n 55, 21.

⁶⁰ Henry Review, above n 9, Part Two, 150. See also Greg Smith, ‘The Henry Review and Taxing Business Income and Rents’ (2010) 43(4) *The Australian Economic Review* 422, 422; Mintz, above n 16, 162-163; Robert Cairns, ‘Reform of Exhaustible Resource Taxation’ (1985) 11(4) *Canadian Public Policy* 649, 649.

⁶¹ Henry Review, above n 9, Part Two, 150; Freebairn and Quiggin, above n 16, 386; Mintz, above n 16, 162-163; Broadway and Flatters, above n 15, 42.

⁶² Henry Review, above n 9, Part Two, 150.

⁶³ Mintz, above n 16, 163; Broadway and Flatters, above n 15, 42.

⁶⁴ Mintz, above n 16, 163.

⁶⁵ The 2014-2015 Budget estimates that the CIT will raise \$71.6 billion out of total Commonwealth revenue of \$360 billion for 2014-2015: Commonwealth of Australia, *Budget Strategy and Outlook: Budget Paper No. 1 2011-2012* (2011) 5-12. See also, Henry Review, above n 9, Part Two, 158-159.

and the CIT. Both seek to tax returns to equity from resource projects, with resource taxes intended to be focussed on the above normal returns.⁶⁶ In addition, both taxes aim to recoup part of the value provided by the public to support business activities, whether in the form of resources, or other services and infrastructure.

Inevitably, these taxes will interact and impact on the ability of the tax system to achieve their purposes in accordance with 'good' design principles. Even if there are no explicit interactions in the form of deductions or credits for one tax under the other,⁶⁷ the combination of the taxes will affect the combined statutory tax rate and the total tax burden, as well as the timing and consistency of revenue. In this context, it is worth noting that the Rudd/Gillard Government initially proposed a staged reduction in the company tax rate to 28% by 2014-2015.⁶⁸ This was not as deep a cut as the Henry Review recommendation to move to a CIT rate of 25%.⁶⁹ Following the replacement of the RSPT with the MRRT in 2010, the CIT cut was scaled back to a target rate of 29%.⁷⁰ Ultimately, the proposed reduction was withdrawn in the 2012-13 Budget.⁷¹

To the extent that deductions or credits are provided, this could affect the CIT's treasury transfer role, the CIT's interaction with the personal income tax and also the stability of the CIT's revenue raising function. These issues are explored further in Part V.

IV THE POLITICAL CONSTRAINT OF STATE RESOURCE OWNERSHIP

Apart from offshore minerals and petroleum, minerals and petroleum are typically owned by the states.⁷² Unsurprisingly, states wish to retain control of resource taxation, despite exhortations for them to adopt a unified approach to collection and allocation.⁷³ This is partly because states are primarily responsible to their own constituents,⁷⁴ as well as the immobility of non-

⁶⁶ Cairns, above n 60, 649.

⁶⁷ See, eg, Henry Review, above n 9, Part Two, 231.

⁶⁸ Commonwealth of Australia, *Tax Policy Statement*, above n 55, 3-4. The government subsequently asked the Business Tax Working Group to recommend tax amendments that would fund a company tax rate reduction, but the Business Tax Working Group was unable to agree on the changes that would fund the cut.

⁶⁹ Henry Review, above n 9, Part Two, 166. Note that the Henry Review proposed that an adjustment mechanism be included in the ERT rate in order to take account of future CIT reductions (beyond the 25% rate), so as to maintain the same overall (CIT plus ERT) rate on resource rents: at 235.

⁷⁰ Gillard, Swan and Ferguson, above n 16.

⁷¹ Commonwealth of Australia, *Budget Measures: Budget Paper No. 2 2012-2013* (2012) 22.

⁷² Garnaut, 'The New Australian Resource Rent Tax', above n 16, 5.

⁷³ Emerson and Lloyd, above n 16, 242; Neil Warren, 'The Henry Review, State Taxation and the Federation' (2010) 43(4) *The Australian Economic Review* 409, 415.

⁷⁴ Church, above n 22, 565-566.

renewable resources.⁷⁵ The need for state revenue, or state controlled revenue, is also paramount, albeit that the capacity to generate resource royalties may impact on the share of GST revenue distributed to a state.⁷⁶ Moreover, in the on-shore context, states, in conjunction with local government, have the chief remit for regulating resource exploration, development and extraction, as well as the provision of supporting public infrastructure, such as roads, ports, and residential services. Hence, as emphasised by the Chamber of Minerals & Energy of Western Australia, '[t]he State has primary responsibility for resources project approvals and the provision of non-privately owned infrastructure which enable development of mining opportunities'.⁷⁷

Further, the efficiency benefits from state tax reform (such as the replacement of royalties with an ERT) are likely to flow primarily to the Commonwealth,⁷⁸ meaning that allocation is intrinsically linked to reform of the collection method. In addition, a further portion of efficiency gains may be shared with other states due to the application of 'horizontal fiscal equalisation' principles by the Commonwealth Grants Commission in recommending the distribution of GST revenue,⁷⁹ a point consistently emphasised in Western Australia.⁸⁰

Accordingly, good tax design must be judged in light of state taxes applying to resource projects as well as the CIT.⁸¹ In the context of a federation, this may favour a mix of individually less efficient taxes over one theoretically efficient (but impracticable) tax.⁸² In particular, the key issue under an ERT is the crediting of state royalties in the event of royalty increases.⁸³ Accordingly it is instructive to look at royalty raises since the introduction of the MRRT. A summary of announced State royalty increases between the announcement of the MRRT and October 2012 is contained in the GST Distribution Review

⁷⁵ Ibid 566.

⁷⁶ Nick Greiner, John Brumby and Bruce Carter, 'GST Distribution Review' (Final Report, October 2012) 105.

⁷⁷ Chamber of Minerals & Energy of Western Australia, Submission to Treasury (Cth), *MRRT and Related Measures Repeal* (31 October 2013) 2.

⁷⁸ Neil Warren, 'The Future of State Taxes Post Henry' (Paper presented at the Taxation Institute of Australia Tenth Annual States' Taxation Conference, Brisbane, 29 July 2010) 45.

⁷⁹ Ibid 6, 46-48; Garnaut, 'The New Australian Resource Rent Tax', above n 16, 17.

⁸⁰ Sarah-Jane Tasker, 'States Dig in Against Canberra's Mining Tax', *The Australian* (online), 23 January 2010 <<http://www.theaustralian.com.au/business/states-dig-in-against-canberras-mining-tax>>; Colin Barnett, Premier, 'Premier Welcomes Review of GST Arrangements' (Media Statement, 30 March 2011). See also Barnett, 'Henry Tax Review Statement' above n 24: any shift of control over resource taxation to the Commonwealth under the RSPT would be a 'disaster' for Western Australia.

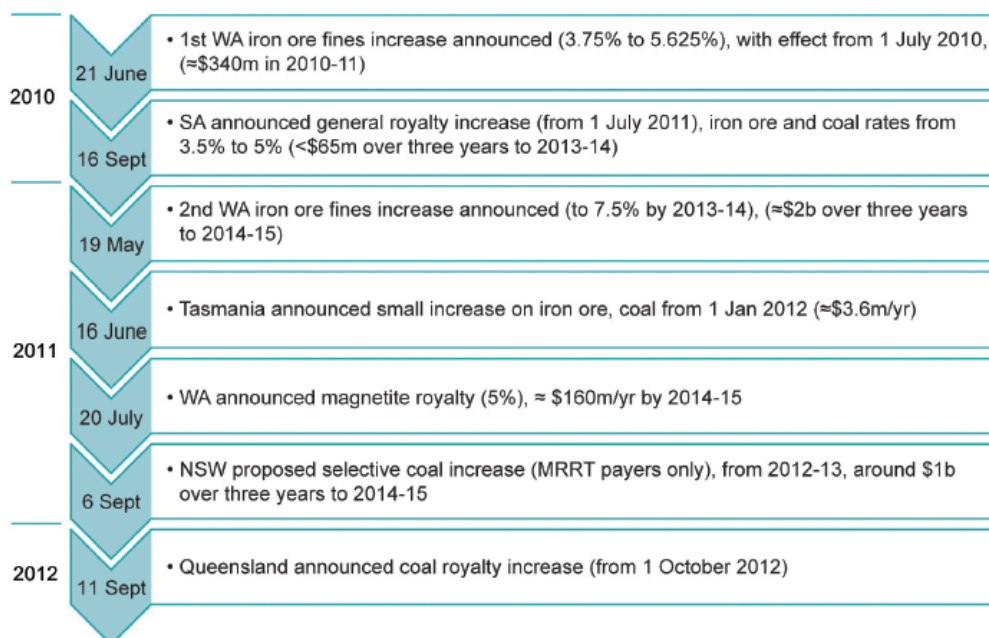
⁸¹ Church, above n 22, 565.

⁸² Cairns, above n 60, 655-656.

⁸³ The Western Australian Premier, Colin Barnett indicated an intention to raise iron ore royalty rates a mere eight days after the RSPT announcement: Peter Kerr, 'Barnett Digs in Over Plan to Raise Miners' Royalties' *The West Australian* (Perth) 10 May 2010, 4.

Panel's *Final Report*:⁸⁴

Figure 8.3 Announced increases to State royalties on MRRT commodities since 2 May 2010



As demonstrated by the diagram, each of the key mining jurisdictions of Western Australia, Queensland and New South Wales (where almost all iron ore and coal production takes place)⁸⁵ announced royalty increases.

As concluded by the GST Distribution Review Panel:

[t]here should now no longer be any doubt that the Commonwealth's decision to fully credit State royalties under the MRRT and PRRT (without reaching any agreement with the States regarding their royalty regimes) has created an incentive for States to increase these royalties'.⁸⁶

The increased state royalty take has had a detrimental revenue and political impact at the federal level.⁸⁷ Indeed, it appears that the disquiet at the Commonwealth level was so great that then Treasurer Swan threatened to 'implement' unspecified 'measures to protect MRRT revenue from recently

⁸⁴ Greiner, Brumby and Carter, 'Final Report', above n 76,125. Note that Western Australia is currently undertaking a royalty review: Department of Mines and Petroleum (WA), *Royalties* (accessed 19 December 2014) <<http://www.dmp.wa.gov.au/11857.aspx>>

⁸⁵ Greiner, Brumby and Carter, 'Final Report', above n 76, 107.

⁸⁶ *Ibid* 123.

⁸⁷ See, eg, Commonwealth, *Parliamentary Debates*, House of Representatives, 26 June 2014, 79 (Anthony Albanese).

announced or future royalty increases'.⁸⁸ The efficiency impact is explored further in Part V.A below.

The GST Distribution Review Panel suggested several alternatives to deal with the state royalty/Commonwealth ERT overlap problem, all of which could be characterised as 'hybrid' models in that they retain a role for state royalties alongside a Commonwealth ERT.⁸⁹ The political constraints discussed in this Part were key reasons for such a hybrid model.⁹⁰ The potential hybrid models involved:

- A set ERT credit based on a 'uniformly' applicable 'notional royalty rate' rather than on actual state royalty rates.⁹¹
- Retaining state royalties, but at reduced, or possibly capped, rates, with a correspondingly greater role for a Commonwealth ERT, although this model would rely on Commonwealth transfers to the states to make up for the lost royalty revenue.⁹²
- Reducing the impact on an ERT of recognising state royalties by providing recognition in a less valuable form. For instance, by giving only a deduction, not a credit, for royalty payments or by removing the ability to uplift the value of unused royalty credits.⁹³

V IMPACT OF STATE RESOURCE OWNERSHIP AND COMPANY INCOME TAX INTERACTION ON TAX POLICY FACTORS

This part examines the impact of state resource ownership and the interaction with company income tax on a tax policy analysis of resource rent taxes.

A *Efficiency*

Assuming an open economy, the taxation of immobile rents (such as resource rents) should not affect investment decisions.⁹⁴ Of course, very high taxation of economic rents increases the risk that inaccuracies in determining the rent and reduced returns from efficiency-improving investments may result in

⁸⁸ Greiner, Brumby and Carter, 'Final Report', above n 76, 123, quoting Phillip Coorey, 'Swan Warns States Not To Gouge Royalties', *Sydney Morning Herald* (online) 21 August 2012 <<http://www.smh.com.au/opinion/political-news/swan-warns-states-not-to-gouge-royalties-20120821-24kql.html#ixzz28DSyxe53>>.

⁸⁹ Greiner, Brumby and Carter, 'Final Report', above n 76, 128-34.

⁹⁰ Ibid 128-9.

⁹¹ Ibid 130, 132 (this model could be implemented as both a Commonwealth unilateral amendment, or as part of an agreed sharing of risks and revenue).

⁹² Ibid 131; Greiner, Brumby and Carter, 'Second Interim Report', above n 26, 74-5.

⁹³ Greiner, Brumby and Carter, 'Final Report', above n 76, 131.

⁹⁴ Henry Review, above n 9, Part Two, 154; Evans and Krever, above n 19, 308; Freebairn and Quiggin, above n 16, 387.

distortions.⁹⁵ This means the joint effect of the CIT and an ERT must be evaluated.⁹⁶

Further, because the CIT taxes the 'normal' rate of return as well as economic rents, it is not neutral in its effect on resource extraction decisions.⁹⁷ In contrast, a resource rent tax can, theoretically, realise neutrality. However, as discussed below, this is unlikely to be fully achieved in practice.⁹⁸ Additionally, as the CIT applies to a broader range of activities than resource projects, there is a tension between attracting elastic capital and labour (which respond to a far greater degree to the CIT rate) and under-taxing inelastic capital and labour (such as the rents from resource projects).⁹⁹

Accordingly, if resource tax reform enabled access to revenue without significantly reducing efficiency, it is arguable that reform design should be coupled with a reduction in the CIT rate to achieve increased productivity (in part through attracting greater levels of capital to Australia).¹⁰⁰ For this reason the Henry Review recommended reducing the CIT rate to 25%,¹⁰¹ although as noted in Part III, no CIT rate reduction has been realised, despite the introduction of the MRRT.

How well do the proposed or implemented ERT approaches fit this paradigm? While the RSPT was close to a pure rent tax, it was not truly neutral as:¹⁰²

- Mining companies discounted the value of refundable losses primarily because the Government would likely be called on to honour its refund guarantee during economic downturns.¹⁰³
- In practice, the cost of raising 40% of the capital for projects was likely

⁹⁵ Freebairn and Quiggin, above n 16, 390; Freebairn, above n 16, 45-46.

⁹⁶ Mintz, above n 16, 162, 176; Garnaut, 'Principles and Practice', above n 21, 353; Garnaut, 'The New Australian Resource Rent Tax', above n 16, 13.

⁹⁷ Henry Review, above n 9, Part Two, 222.

⁹⁸ See below nn 103 - 106 and accompanying text.

⁹⁹ See, eg, Ibid Part Two, 166, 228.

¹⁰⁰ Freebairn and Quiggin, above n 16, 390; Greg Smith, above n 60, 423-424; Ibid Part Two, 151-152.

¹⁰¹ Henry Review, above n 9, Part Two, 166.

¹⁰² Also, if investors in resource projects are 'capital constrained' investors may select between projects that provide the return on capital plus more or less of the economic rents: Parmenter, Breckenridge and Gray, above n 54, 280; Freebairn and Quiggin, above n 16, 389; Paul Garvey and Luke Forrestal, 'Changes Jeopardise Investment' *Australian Financial Review* (Melbourne) 3 May 2010, 43. Cf Diderik Lund, 'Neutrality of the Resource Super Profits Tax' (2011) 44(3) *Australian Economic Review* 233.

¹⁰³ Parmenter, Breckenridge and Gray, above n 54, 285; Freebairn and Quiggin, above n 16, 393; Garnaut, 'Principles and Practice', above n 21, 351; Ergas and Robson, above n 2, 184. In addition, the guarantee would not have been as liquid as an actual government bond, the rate would change over time and the 'payment date' would be uncertain: Parmenter, Breckenridge and Gray, above n 54, 285.

to be above the government bond rate given transaction costs and imperfect competition.¹⁰⁴

- States retained the ability to increase royalties for which there would potentially be no increased matching credit under the RSPT, enabling the states to increase royalties and re-introduce a distortion.¹⁰⁵
- Implementation would almost certainly involve inaccuracies in measuring the economic rent. Particularly in ascertaining the cost of expenses, such as intangibles, in fully recognising costs such as exploration costs and in appropriately allocating costs (such as management time) to upstream or downstream operations.¹⁰⁶ This would mean that the RSPT would also have captured non-resource rents.

More fundamentally, because the RSPT was deductible for CIT purposes¹⁰⁷ rather than the CIT being treated as a project cost for RSPT purposes, the RSPT would not have been neutral even if the issues above had been addressed or minimised. A number of commentators have suggested that to ensure an ERT does not increase any existing CIT distortions, the CIT cost should be recognised under the resource tax (rather than vice versa) in the form of a credit.¹⁰⁸

For instance, adopting an RSPT example used by the government of the day, involving capital expenditure of \$100, depreciated \$60 in year one and \$40 in year two, assuming the same depreciation rate for CIT purposes,¹⁰⁹ a cost of capital equal to the long term government bond rate and altering the revenue

¹⁰⁴ Garnaut, 'Principles and Practice', above n 21, 351; Parmenter, Breckenridge and Gray, above n 54, 279; Henry Ergas, Mark Harrison and Jonathan Pincus, 'Some Economics of Mining Taxation' (2010) 29(4) *Economic Papers* 369, 374; Ben Smith, 'Charging for Non-Renewable Resource Depletion, or Slimming the Goose: Less *Foie Gras* but More Golden Eggs?' in Chris Evans, Richard Krever and Peter Mellor, *Australia's Future Tax System: The Prospects After Henry* (Thomson Reuters, 2010) 365, 375; Garnaut, 'The New Australian Resource Rent Tax', above n 16, 14. A number of resource companies highlighted the likely difficulty in raising funding under a proposed RSPT: Louise Dodson et al, 'Resources Row Escalates as PM, Forrest Trade Blows' *Australian Financial Review* (Melbourne) 7 May 2010, 14.

¹⁰⁵ Ben Smith, above n 104, 384-385; Garnaut, 'The New Australian Resource Rent Tax', above n 16, 17; John Kehoe, 'Swan Denies Investment Will be Stifled' *Australian Financial Review* (Melbourne) 4 May 2010, 16.

¹⁰⁶ Freebairn and Quiggin, above n 16, 388. See also Ergas, Harrison and Pincus, above n 104, 371, 379; Cairns, above n 60, 653-654. See also, Ben Smith, above n 104, 373.

¹⁰⁷ Commonwealth of Australia, *The Resource Super Profits Tax*, above n 56, v.

¹⁰⁸ Mintz, above n 16, 176; Broadway and Flatters, above n 15, 16. See also Garnaut and Clunies Ross, above n 23, 278, 282-283.

¹⁰⁹ While this may not be the case due to accelerated depreciation in some circumstances, the capital allowance arrangements for RSPT purposes were generally intended to be aligned with those for income tax: Commonwealth of Australia, *The Resource Super Profits Tax*, above n 56, 31.

generated to \$106 in year two to make the project marginal, results in the following:¹¹⁰

Description	Year 1	Year 2
Revenue	0	106
less expenses (including depreciation)	60	40
less RSPT Allowance (6% applied to RSPT capital base)	0	6
less carried forward losses	0	60
Net RSPT profit	-60	0
Taxable RSPT profit	0	0
RSPT Tax (40%)	0	0
Assessable income	0	106
less allowable deductions (including depreciation)	60	40
less carried forward losses	0	60
Taxable income	0	6
CIT (28%)	0	1.68
Total tax		1.68

Compare the outcome with a refundable credit for RSPT purposes (in a similar fashion as for state royalties), assuming the project is closed at the end of year two:

Description	Year 1	Year 2
Revenue	0	106
less expenses (including depreciation)	60	40
less RSPT Allowance (6% applied to RSPT capital base)	0	6

¹¹⁰ See Box 4.4: Ibid 27.

less carried forward losses	0	60
Net RSPT profit	-60	0
Taxable RSPT profit	0	0
RSPT Tax (40%)	0	0
Refundable RSPT credit for CIT		1.68
Assessable income	0	106
less allowable deductions (including depreciation)	60	40
less carried forward losses	0	60
Taxable income	0	6
CIT (28%)	0	1.68
Total tax		0

In the absence of a credit, the combined effect of the CIT and RSPT would discourage marginal projects.

However, the concern about a refundable CIT credit is that it would remove the effect of the CIT in some circumstances, thereby undermining the purposes of the CIT.¹¹¹ A credit would also need to be quarantined to entities whose only activities concerned resource projects.¹¹² More fundamentally, adopting an economy-wide perspective in which the CIT still applies to other industries, a full credit is unlikely to be appropriate as it would remove neutrality between mining and those other industries.¹¹³ Therefore, the best that can be achieved is to improve efficiency by reducing the CIT while imposing an ERT to make up lost revenue. The RSPT was tied to only a relatively modest and staged reduction in the CIT rate to 28%.¹¹⁴ The combined statutory tax rate of 56.8% would have been higher than that recommended by the Henry Review (55%), raising the risk of disincentives.¹¹⁵

The MRRT and extended PRRT lie further from neutrality than the RSPT.

¹¹¹ Broadway and Flatters, above n 15, 16.

¹¹² Garnaut and Clunies Ross, above n 23, 279.

¹¹³ See, eg, Ben Smith, above n 104, 377-378; Emerson and Lloyd, above n 16, 242.

¹¹⁴ Commonwealth of Australia, *Tax Policy Statement*, above n 55, 23-24. Based on the 2 May 2010 RSPT projections, this amounted to approximately a third of the RSPT revenue: Rudd and Swan, above n 16, 1.

¹¹⁵ The combined statutory tax rate of the CIT and RSPT was a key concern of the Minerals Council of Australia: Garvey and Forrester, above n 102, 43.

The lack of a refund may cause some marginal projects not to be pursued.¹¹⁶ Further, these ERTs adopt arbitrary uplift rates for the cost of capital which do not reflect the individual entity and project risk premium.¹¹⁷ This results in a 'subsidy' to projects with a lower risk premium¹¹⁸ and a higher tax on riskier projects,¹¹⁹ which is likely to benefit larger, diversified, mining companies with mature projects.¹²⁰ The ability to offset a market value starting base against MRRT receipts also provides a significantly lower rate in the early years to the larger miners with mature projects.¹²¹

Similar issues apply as for the RSPT in measuring economic rents, although for the MRRT, a 25% extraction allowance is provided as an arbitrary measure of intangible costs.¹²² In addition, it has been suggested that a key source of inaccuracy in measurement is the transfer pricing method used by the MRRT to separate upstream from downstream operations.¹²³ Further, the MRRT will apply to only iron ore and coal, not the majority of minerals,¹²⁴ creating distortions for investment decisions between different mining operations.

However, a fundamental flaw of the MRRT and extended PRRT is their manner of dealing with state royalties. Despite the fact that state royalties, even if increased after the introduction of the MRRT and extension of the PRRT, receive a full credit and an uplift, as royalty payments are not refundable the inefficiencies associated with royalties are retained for marginal projects.¹²⁵ Indeed, as argued by the GST Distribution Review Panel the increases in state royalties identified above, in conjunction with reduced (since mid 2010) commodity prices¹²⁶ amplify these inefficiencies.¹²⁷ It is on this basis that the GST Distribution Review Panel recommended a 'cooperative approach' involving lower levels of state royalties, in combination with a resource rent tax

¹¹⁶ Garnaut and Emerson, above n 54, 140; Henry Review, above n 9, Part Two, 229.

¹¹⁷ Freebairn and Quiggin, above n 16, 393. See also Garnaut, 'Principles and Practice', above n 21, 350.

¹¹⁸ Which may encourage over-investment: Rob Fraser, 'On the Neutrality of the Resource Rent Tax' (1993) 69(1) *Economic Record* 56, 56; Ben Smith, above n 104, 387.

¹¹⁹ Freebairn and Quiggin, above n 16, 393; Ergas, Harrison and Pincus, above n 104, 378-379.

¹²⁰ Ergas, Harrison and Pincus, above n 104, 379-380; Ben Smith, above n 104, 387; Henry Ergas and Jonathan Pincus, Submission to the Senate Economics References Committee, Parliament of Australia, *Inquiry into the Development and Operation of the Minerals Resource Rent Tax* (2013) 2-3.

¹²¹ See, eg, Document tabled before Senate Economics Legislation Committee, Parliament of Australia, Canberra, 27 November 2013, 1-2 (Association of Mining and Exploration Companies).

¹²² Gillard, Swan and Ferguson, above n 16, 3.

¹²³ Ergas and Robson, above n 2.

¹²⁴ *Ibid* 1.

¹²⁵ Ergas, Harrison and Pincus, above n 104, 378-379. See also Mintz, above n 16, 176-177.

¹²⁶ IndexMundi, *Commodity Prices* (May 2014) < <http://www.indexmundi.com/commodities/>>.

¹²⁷ Greiner, Brumby and Carter, 'Final Report', above n 76, 123.

(such as the MRRT or extended PRRT) and the return of a portion of the resource rent tax receipts to states as agreed recompense for reducing their royalties.¹²⁸

Even if the position (ie the existence of federal resource rent taxes alongside state royalties) is compared with the pre-MRRT and pre-extended PRRT situation of ‘inefficient’ state royalties applying to iron ore, coal and petroleum projects, the comparison does not fare well on the grounds of efficiency. Given the incentives for states to increase royalty rates on profitable projects to divert resource rent tax revenue to themselves, and the demonstrated history of escalating royalties, conceptualising the MRRT as a “top-up” tax on the most highly profitable projects, while leaving the amount paid by less profitable projects unchanged’, as described in the GST Distribution Review Panel’s, *Second Interim Report*, is inaccurate.¹²⁹ In practice, state royalty increases meant that the introduction of the MRRT potentially increased the level of tax for the least profitable projects as well, except to the extent that state royalties were selectively increased for more profitable projects.¹³⁰

Even amending the MRRT and PRRT to fix the credit for state royalties in some way would still retain or introduce distortions, first due to the lack of refundability, as discussed above and, second, by affecting investment and production choices that would result in the application of the above-ERT state royalty.¹³¹ Indeed, any ‘hybrid’ system that leaves both state royalties and an ERT in place will ensure that distortions remain.

In addition, when combined with the CIT, the MRRT and extended PRRT, like the RSPT, potentially result in further distortions because MRRT and extended PRRT payments are deductible for CIT purposes,¹³² rather than the other way around. In addition, the structures of the MRRT and extended PRRT involve faster recognition of capital expenses than the RSPT. However, for many types of capital expenditure, the CIT base provides for deductions over time,¹³³ which means that later payments under an MRRT or PRRT result in later CIT deductions and hence accelerated timing of CIT taxation.¹³⁴

The MRRT and extended PRRT were introduced without any reduction in

¹²⁸ Ibid 123-4.

¹²⁹ Greiner, Brumby and Carter, ‘Second Interim Report’, above n 26, 54. It is not suggested that the GST Distribution Review Panel were unaware of the political incentives for and practice of state royalty increases.

¹³⁰ For instance, New South Wales’ targeted coal royalty increase for miners with mining projects subject to MRRT: *Mining Amendment (Coal Royalty) Regulation 2012* (NSW).

¹³¹ As to the second ground, see, eg, Greiner, Brumby and Carter, ‘Second Interim Report’, above n 26, 69.

¹³² *Income Tax Assessment Act 1997* (Cth), ss 40-750, 40-751.

¹³³ Henry Review, above n 9, Part Two, 241; Emerson and Lloyd, above n 16, 240.

¹³⁴ Ben Smith, above n 104, 378.

the CIT, potentially providing lower efficiency gains than the 25% rate recommended by the Report. The combined statutory tax rate, would be 58% for the extended PRRT and (taking account of the 25% extraction allowance) 45.75% for the MRRT, the latter being significantly lower than that recommended under the Henry Review, potentially amounting to an undercharging.

The interaction between the CIT and an ERT can also result in other distortions which should be considered in designing an ERT. For instance, a deduction under the CIT for ERT payments (as existed for the MRRT and exists for the PRRT)¹³⁵ may impact on the ability of foreign investors to claim credits for Australian tax in their home jurisdictions, which may distort investment decisions.¹³⁶ While many of Australia's double tax treaties provide for crediting of the CIT and existing PRRT,¹³⁷ these provisions may not apply for the MRRT or, possibly, even the extended PRRT¹³⁸ and the Federal Government had therefore previously announced that it would negotiate with other jurisdictions to enable crediting of the MRRT.¹³⁹ The recent Swiss treaty now refers to 'resource rent taxes' as an example of Australian taxes and in relation to which crediting may occur,¹⁴⁰ although this is certainly not true for all treaties negotiated in light of the MRRT introduction and PRRT extension.¹⁴¹ Similarly, if ERT payments are a deduction from the CIT, this would reduce the CIT paid and the amount of franking credits generated, potentially resulting in a disincentive for investment by domestic shareholders

¹³⁵ *Income Tax Assessment Act 1997* (Cth), ss 40-750, 40-751.

¹³⁶ Broadway and Flatters, above n 15, 5-6; Garnaut and Clunies Ross, above n 23, 283.

¹³⁷ See, eg, *Convention Between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, 6 August 1982, [1983] ATS 16 (entered into force 31 October 1983), as amended by the *Protocol Amending the Convention Between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, 27 September 2001, [2003] ATS 14 (entered into force 12 May 2003), Articles 1(b), 22(1).

¹³⁸ See, eg, *Convention Between Australia and the Republic of Chile for the Avoidance of Double Taxation with Respect to Taxes on Income and Fringe Benefits and the Prevention of Fiscal Evasion*, 10 March 2010, [2013] ATS 7 (entered into force 8 February 2013), Articles 2(1)(a) and 23(2).

¹³⁹ Swan and Ferguson, above n 81; Commonwealth of Australia, Policy Transition Group, above n 48, 81 (recommendation 60). This was also a concern for the RSPT: John Kehoe, 'No Franking Credits for Super Profits Imposé' *Australian Financial Review* (Melbourne) 4 May 2010, 17.

¹⁴⁰ See, eg, *Convention Between Australia and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income, with Protocol*, 30 July 2013, [2014] ATS 33 (entered into force 14 October 2014), Articles 2(3) and 22(2).

¹⁴¹ See, eg, *Protocol Amending the Agreement Between the Government of Australia and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, 16 December 2011, [2013] ATS 22 (entered into force 2 April 2013).

– particularly if foreign tax credits are negotiated for MRRT and extended PRRT payments.¹⁴²

B *Equity*

In considering the equity impact of resource tax reform, it is relevant to note that the total tax collected from mining should increase,¹⁴³ even if the increase has been small in practice. In contrast, the level of CIT, if the rate is eventually reduced as recommended by the Henry Review, should decrease from what it would otherwise be. The tax burden is therefore likely to be increased for iron ore, coal and on-shore petroleum resource companies, which should depress share prices,¹⁴⁴ as well as being passed on to some extent, in the longer term, to labour.¹⁴⁵ Accordingly, through superannuation fund holdings and labour force participation, the tax burden is likely to fall on a significant cross-section of Australians,¹⁴⁶ as well as on substantial numbers of foreign residents, given large foreign holdings in some of the bigger resource companies, such as BHP Billiton, Rio Tinto and Glencore.¹⁴⁷ However, as noted above, at least for the MRRT, the size of that tax burden was relatively small during the relatively short life of the MRRT.

Further, in terms of distributional effects, it is worth noting that relatively little of the resource rent tax burden is likely to be shifted to purchasers, given the relatively immobile nature of resource rents.¹⁴⁸ In comparison, relatively more of the tax burden of the CIT or state royalties, in the form of higher prices, would be expected to be passed on to resource purchasers. Therefore, greater reliance on an ERT, coupled with a reduction in the CIT or in state royalties might be anticipated to reduce the tax ultimately borne by (predominantly foreign) buyers and increase the tax borne by (largely Australian) labour and (a mix of Australian and foreign) shareholders.

Looking solely at the impact of a resource rent tax, it could be argued that

¹⁴² John Kehoe ‘RSPT Opens Door to Foreign Ownership’ *Australian Financial Review* (Melbourne) 7 May 2010.

¹⁴³ Commonwealth of Australia, *Tax Policy Statement*, above n 55, 4; Commonwealth of Australia, *Budget Strategy and Outlook: Budget Paper No. 1 2011-2012* (2011) 5-28 – 5-29; Freebairn, above n 16, 48.

¹⁴⁴ Freebairn and Quiggin, above n 16, 390; Ergas, Harrison and Pincus, above n 104, 376; Broadway and Flatters, above n 15, 11; Ben Smith, above n 104, 386. Including due to the indirect impact of reduced cash-flow on resource companies’ ability to raise finance: see, eg, Fortescue Metals Group Ltd, above n 3, 2.

¹⁴⁵ Greg Smith, above n 60, 423; Freebairn, above n 16, 20.

¹⁴⁶ Ben Smith, above n 104, 380-381.

¹⁴⁷ See, eg, The Australia Institute, Submission No 15 to Senate Economics Legislation Committee, Parliament of Australia, *Minerals Resource Rent Tax Repeal and Other Measures Bill 2013* [Provisions] (November 2013) 3.

¹⁴⁸ For the general principles, see, eg, Treasury (Cth), ‘Architecture of Australia’s Tax and Transfer System’ (Paper, August 2008) 171-3.

shareholders in resource companies are likely to be disadvantaged relative to shareholders in other companies, in breach of horizontal equity. The impact on vertical equity is harder to determine, as the tax burden will be borne by both shareholders (who might typically be expected to be persons with greater ability to pay tax, hence consistent with vertical equity)¹⁴⁹ and workers (this might be expected to be inconsistent with vertical equity).

If an ERT was introduced in conjunction with a CIT rate reduction, the impact on larger shareholders is likely to be ameliorated by a corresponding increase in the share price of non-resource companies, potentially breaching vertical equity requirements to a degree.¹⁵⁰ An increase in non-resource company share prices might also exacerbate horizontal equity concerns, unless such shareholders had index-based holdings, which would likely be common for superannuation fund holdings. None of the RSPT, MRRT and extended PRRT proposals as initially raised or implemented involved the application of all extra resource revenue to reduce the CIT rate.¹⁵¹ Indeed, as identified above, no CIT rate reduction was ever implemented in conjunction with the MRRT and extended PRRT. Accordingly, these ERTs are likely to have a redistributive effect in combination with the CIT, which might be expected to support vertical equity to a degree,¹⁵² if it can be assumed that the extra government revenue will flow to socio-economically disadvantaged persons to a larger degree than would otherwise have been the case for the captured portion of the resource rents. To the extent a modest CIT reduction was implemented, it would be expected to increase wages from an economy-wide perspective, with most of the benefits flowing to workers, rather than shareholders such that this should also support vertical equity,¹⁵³ although this would be counterbalanced by the impact on resource sector wages of an ERT. Welfare improvements would also be counterbalanced by the potential reduction in tax borne by foreign residents as customers of resource companies.

The political constraints discussed in Part IV also render horizontal equity harder to achieve if inconsistent increases in state royalties result in different overall tax burdens depending on the location of activities, although shareholders or indirect interest holders will not necessarily be distributed by geographic location in a corresponding way to the mining or petroleum entities that are subject to inconsistent rates.

¹⁴⁹ Shares are held disproportionately by those with higher wealth: Neil Warren, *Tax: Facts, Fiction and Reform* (Sydney, 2004) 245.

¹⁵⁰ See, eg, Freebairn and Quiggin, above n 16, 390.

¹⁵¹ Commonwealth of Australia, *Tax Policy Statement*, above n 55, 4; Gillard, Swan and Ferguson, above n 16, 1.

¹⁵² See, eg, Greg Smith, above n 60, 426-427.

¹⁵³ For the distributional impact of changes to the company income tax, see, eg, Liangyue Cao et al, 'Understanding the Economy-wide Efficiency and Incidence of Major Australian Taxes' (Treasury Working Paper 2015-01, Treasury (Cth), April 2015) 53.

C *Simplicity*

As discussed in Part III, both the CIT and ERTs are profit taxes. Accordingly, adopting the CIT base and concepts, to the extent possible, should aid administration and compliance.¹⁵⁴ For instance, this was proposed for capital depreciation rates under the RSPT.¹⁵⁵ However, the MRRT had a significant administrative mismatch with the CIT, due to the MRRT's focus on taxation at the project rather than entity level, which was raised in inquiry submissions as a cause of compliance costs.¹⁵⁶

Aligning the CIT concept of exploration with that for PRRT purposes has also been suggested,¹⁵⁷ although not implemented.¹⁵⁸ However, if income tax concepts are used, care will be needed to ensure that income tax concessions do not flow through for resource tax purposes also – eg immediately deductible exploration expenditure.¹⁵⁹

Further, greater simplicity would be achieved if arrangements between the states and Commonwealth over sharing of risks and revenue were finalised before the introduction of a replacement ERT.¹⁶⁰ In particular, if there were one central, uniform, administration and collection mechanism and not two layers of collection with a corresponding credit, as is the case for the RSPT, the MRRT and extended PRRT.¹⁶¹ Such an approach could involve the payment of notional royalty amounts to the states by the Commonwealth.¹⁶² Alternative arrangements, like the 'hybrid' models discussed above, which involve retaining state royalties, at reduced rates, in conjunction with a federal ERT would likely result in similar levels of compliance and administration costs as existed for the MRRT plus state royalty regimes.¹⁶³

¹⁵⁴ See, eg, Henry Review, above n 9, Part Two, 225; Garnaut, 'Principles and Practice', above n 21, 350.

¹⁵⁵ Commonwealth of Australia, *The Resource Super Profits Tax*, above n 56, 31.

¹⁵⁶ MRRT Repeal EM 49-50; Fortescue Metals Group Ltd, , above n 3, 2.

¹⁵⁷ Commonwealth of Australia, Policy Transition Group, above n 48, 105.

¹⁵⁸ As to the differences between 'exploration' for income tax and PRRT purposes, see, eg, ATO, *Petroleum Resource Rent Tax: What Does 'Involved In or In Connection With Exploration for Petroleum' Mean?*, TR 2014/9, 17 December 2014, 5 [13], 25 [124]-[127], 27 [133]-[134].

¹⁵⁹ *Income Tax Assessment Act 1997* (Cth), s 40-730. See, eg, Henry Review, above n 9, Part Two, 235. The recent amendments which curtail the ability to claim an immediate deduction for the cost of acquiring a mining right or mining information only tangentially address this issue.

¹⁶⁰ See, eg, Freebairn and Quiggin, above n 16, 395.

¹⁶¹ Fraser, 'The State of Resource Taxation in Australia: "An Inexcusable Folly for the Nation"?', above n 24, 260; Garnaut, 'The New Australian Resource Rent Tax', above n 16, 17.

¹⁶² See, eg, Greiner, Brumby and Carter, 'Second Interim Report', above n 26, 73.

¹⁶³ See, eg, Greiner, Brumby and Carter, 'Second Interim Report', above n 26, 74; Henry Review, above n 9, Part Two, 240.

D *Sustainability*

There are three key sustainability reasons why an ERT should be designed in light of the CIT and state royalties. First, as noted in Part V.B, an ERT is likely to increase Commonwealth revenue whereas a reduction in the CIT would reduce it. If any reform is intended to at least be revenue neutral (if not raise further revenue), as seems likely given the current state of the federal budget, the degree to which the CIT rate can be reduced will be limited by the revenue raised by the ERT.

Second, the overall level of risk assumed by the Government under the combined CIT and ERT is relevant. As rent taxes typically shift a proportion of project risk to government (although there would be no risk of a cash refund under the MRRT and extended PRRT, as opposed to the RSPT)¹⁶⁴ and involve greater revenue volatility, there may be a limit to how far it is appropriate to trade off the CIT (or state ad valorem royalties) for an ERT.¹⁶⁵ Treasury's summary of the extensive revisions to estimates of MRRT revenue between the initial MRRT announcement in July 2010 and the 2013 Pre-election Economic and Fiscal Outlook, provides a practical example of the multi-billion dollar scale of this volatility.¹⁶⁶

Finally, interactions between an ERT, the CIT and state royalties may impact on the durability of the tax system and an ERT should be designed to account for this. For instance, a properly designed rent tax could potentially enable further CIT rate changes without a reduction in the combined statutory rate for resource rents.¹⁶⁷ The potential effects on imputation credits and foreign tax credits discussed in Part V.A are also relevant to durability. Further, until an agreement is negotiated with the states, their continuing ability to cannibalise the Commonwealth's ERT revenue by increasing state royalties may generate instability. Indeed, as discussed in Part IV, the royalty increases thus far created considerable political anguish at the federal level and were a factor, at least for later budget amendments, reducing the amount of revenue

¹⁶⁴ Parmenter, Breckenridge and Gray, above n 54, 281; Freebairn and Quiggin, above n 16, 386.

¹⁶⁵ See, eg, Henry Review, above n 9, Part Two, 233; Ben Smith, above n 104, 373; Fraser, "The State of Resource Taxation in Australia: "An Inexcusable Folly for the Nation"?", above n 24, 269; Freebairn and Quiggin, above n 16, 389; Broadway and Flatters, above n 15, 23-24. The MRRT Repeal EM cites the comparative volatility of resource rent taxes at 50.

¹⁶⁶ Treasury (Cth), Submission No 23 to Senate Economics Legislation Committee, Parliament of Australia, *Minerals Resource Rent Tax Repeal and Other Measures Bill 2013[Provisions]* (27 November 2013) 12. It has also been suggested that a portion (perhaps a significant one) of the revisions was due to failure to understand certain design features of the MRRT, such as the starting base allowance and transfer pricing principles: Senate Economics References Committee, Parliament of Australia, *Development and Operation of the Minerals Resource Rent Tax* (2013) 16-17 [2.21]-[2.22], 38-9 [2.119]-[2.126]; Evidence to Senate Economics References Committee, Parliament of Australia, Melbourne, 29 April 2013, 7 (Ross Garnaut).

¹⁶⁷ Henry Review, above n 9, Part Two, 235.

expected.¹⁶⁸

In addition, the mechanics of the horizontal fiscal equalisation process by which the GST is allocated between states also means that a failure to increase royalties in response to another state's increase (for instance coal royalties in Queensland and New South Wales) could lead to a reduced share of GST, creating volatility for those states.¹⁶⁹ Accordingly, if an ERT creates political cover for states to increase royalties (as the MRRT did), this could also have negative sustainability effects at the state level.

Considered at a whole of government level, sustainability may also favour retaining a mix of resource rent taxation and royalty taxation for several reasons. As discussed in relation to the CIT and ERT mix, a combination of taxes may provide a more predictable revenue stream as a whole for the state and federal governments.¹⁷⁰ Further, retaining a proportion of royalties would also enable maintaining current arrangements to some degree, which, by reducing transition costs – be they political, psychological or economic,¹⁷¹ may bolster support for the resource taxation structure. Further, permitting flexibility in setting resource taxation at the local level of the states, at least to some degree, may help maintain the sustainability of the overall structure as it would provide states with another tool to respond to local issues. Permitting some decision-making control over resource taxation at the state level, provided it is done in a transparent manner, may ensure that a measure of accountability¹⁷² remains with the states, supporting overall system integrity for similar reasons as discussed for flexibility above.

VI CONCLUSION

The removal of the MRRT means that there is now a relatively clean slate to debate the design of Australian resource rent tax legislation. Moreover, the forthcoming white papers on tax and reform of the federation present an opportunity to imagine a new approach. The essential point made in this paper is that a reimagined resources ERT will be enhanced by considering its

¹⁶⁸ See, eg, Senate Economics References Committee, Parliament of Australia, *Development and Operation of the Minerals Resource Rent Tax* (2013) 16-17 [2.22], quoting Dr Martin Parkinson. See also, Evidence to Senate Economics References Committee, Parliament of Australia, Melbourne, 29 April 2013, 2-3, 7 (Ross Garnaut); Diane Kraal, 'A Grounded Theory Approach to the Minerals Resource Rent Tax' (2013) 28(4) *Australian Tax Forum* 841, 856-7.

¹⁶⁹ Greiner, Brumby and Carter, 'Final Report', above n 76, 126-7.

¹⁷⁰ As recommended by the GST Distribution Review Panel: *ibid* 131. For the importance of sustainability to the states, see references to state submissions in the *Second Interim Report*: Greiner, Brumby and Carter, 'Second Interim Report', above n 26, 46-7.

¹⁷¹ See, eg, Greiner, Brumby and Carter, 'Final Report', above n 76, 131.

¹⁷² As to linking state accountability to the 'independence' and 'visibility' of state royalties, see the reference to New South Wales' submission to the GST Distribution Review Panel: Greiner, Brumby and Carter, 'Second Interim Report', above n 26, 68.

combined effect with the CIT, as well as the limits imposed by the likely continued existence of state royalties. Indeed, the historical evidence of no change (since MRRT introduction) to the CIT rate and furious increases in royalty rates, informs the application of tax policy criteria.

In applying the tax policy criteria efficiency, equity, simplicity and sustainability, the following key points can be made. Efficiency gains can potentially be made in a revenue neutral manner by imposing a resources ERT and reducing the CIT due to the extra revenue obtained (with minimal efficiency loss) from the ERT, while ensuring that the combined statutory rate is appropriate. Careful consideration would need to be provided to the crediting of ERT and CIT payments for the purposes of each tax, including the impact on franking credits and foreign tax credits. However, it is noteworthy that the Rudd/Gillard Government's original RSPT proposal was never twinned with a CIT rate reduction for the full projected amount that would be raised by the RSPT and indeed no CIT rate reduction ever eventuated, even once the MRRT was introduced. Therefore, it seems there may well be political and practical (see the sustainability discussion below) difficulties in coupling a resources ERT to a reduced CIT.

Replacing or partially replacing (eg by means of a hybrid arrangement) state royalties with a resources ERT would also permit an improvement in efficiency, although the MRRT experience demonstrates that unless coordinated federal and state action is taken, an ERT plus increased state royalties may actually decrease efficiency.

In terms of equity, a resources rent tax is likely, at least in the short term, to result in a redistribution of income from higher income taxpayers to lower income taxpayers, consistently with the principles of vertical equity. However, this may be ameliorated in the longer term as some of the cost is passed on to workers or shifted from foreign residents to Australian residents. Shareholders in resource companies are likely to be disadvantaged relative to shareholders in other companies, in breach of horizontal equity, unless it is possible to assume that such shareholders hold indexed portfolios. The vertical re-distributional effect is also likely to be supported by any reduction in the CIT, although the impact on horizontal equity is likely to be exacerbated. Inconsistent state taxation may hamper horizontal equity, although the link is less clear.

As for simplicity, consistent bases and concepts, should where possible, be applied between the CIT and the resources ERT to aid administration and compliance. In addition, completely replacing state royalty regimes with one central, uniform administration and collection mechanism would improve simplicity, whereas adoption of a state royalty/federal ERT hybrid would potentially result in increased administration and compliance costs relative to existing state royalty regimes.

For sustainability, attention should be paid to the acceptable overall level of

revenue and revenue risk, as well as the effect of interactions on tax system durability. In particular, the demonstrated volatility of the MRRT highlights the degree of revenue risk that an ERT can transfer to the government. State royalties and the CIT (to a lesser extent) do not involve the same degree of risk. The variability of resource ERT receipts also suggests caution in the degree to which projected ERT revenue is traded off for reduced state royalties or a lower CIT rate.

Weighing these competing considerations, there is clearly a strong efficiency argument for reintroducing a resources ERT, coupled with a reduction in the CIT rate, provided the factors causing distortions which were inherent in the design of the MRRT are eliminated.¹⁷³ Adopting one of the GST Distribution Review Panel's hybrid solutions to the state royalty overlap problem is a means of at least limiting or reducing the distortions caused by state royalties, while meeting the pragmatic realities of resource ownership by the states. This approach would, of course, mean that administrative complexity is retained for the overlap between state resource taxes and a federal ERT. Greater opportunity remains, however, to align administrative concepts between the CIT and federal resource rent taxes.

Imposing a resources ERT in conjunction with a CIT rate reduction would have mixed equity effects, some of which may balance out, although it poses an initial horizontal equity risk. Finally, a mix of taxes, involving a resources rent tax, a moderate reduction in the CIT and reduced or limited state royalties, should ensure greater revenue (than in the absence of a resources ERT) over the long term, raised with less damage to efficiency, and with a level of residual stability, as most state royalties are not linked to profits. Accordingly, it should result in a boost to sustainability. In addition, ensuring the continued existence of state royalties should also make the states more amenable to the existence of a federal ERT, which again should increase its chances of success and its durability.

¹⁷³ For instance, the uncapped crediting of state royalties and generous starting base allowances.