

Deloitte Touche Tohmatsu
ABN 74 490 121 060

Woodside Plaza
Level 14
240 St Georges Terrace
Perth WA 6000
GPO Box A46
Perth WA 6837 Australia

Tel: +61 (0) 8 9365 7000
Fax: +61 (0) 8 9365 7001
www.deloitte.com.au

Mr Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
COLLINS STREET WEST VIC 8007

By email: standard@asb.gov.au

10 November 2011

Dear Kevin

Re: Accounting for the proposed Minerals Resources Rent Tax (MRRT) and Petroleum Resource Rent Tax (PRRT)

We are writing to the Australian Accounting Standards Board (AASB or the Board) in relation to the Board's ongoing deliberations on accounting for proposed Mineral Resource Rent Tax (MRRT) and extension of the Petroleum Resource Rent Tax (PRRT) (together referred to as 'MRRT/PRRT').

In summary:

- We believe that, due to Interpretation 1003, MRRT/PRRT should be accounted for as an income tax for entities required to comply with Australian Accounting Standards
- We believe that government imposts such as resource royalties and similar obligations are not always accounted for as income taxes under International Financial Reporting Standards (IFRSs) and accordingly, that the AASB should consider withdrawing Interpretation 1003
- There are a number of issues associated with accounting for MRRT/PRRT as an income tax, the most notable of which are the treatment of the 'market value uplift' (starting base allowance) and the characterisation and presentation of State Government royalties. We believe there may be more than one method of accounting for these matters.

More detailed information on each of the above topics is included in the Appendix.

Please feel free to contact me if you require further information.

Yours sincerely



Ross Jerrard
Partner, Energy & Resources Advisory Leader
Deloitte Touche Tohmatsu

Yours sincerely



Tim Richards
Partner, National Mining Leader
Deloitte Touche Tohmatsu

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/au/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

Liability limited by a scheme approved under Professional Standards Legislation.

Member of Deloitte Touche Tohmatsu Limited

APPENDIX

ACCOUNTING ISSUES ASSOCIATED WITH THE PROPOSED MINERAL RESOURCES RENT TAX (MRRT) AND PETROLEUM RESOURCE RENT TAX (PRRT)

Is MRRT/PRRT an income tax within the scope of AASB 112 *'Income Taxes'*?

Consequences of Interpretation 1003

It is difficult to argue that MRRT (and the proposed extension of the PRRT) are sufficiently different in substance to PRRT as it stood at the time Interpretation 1003 *Australian Petroleum Resource Rent Tax* was made. Accordingly, notwithstanding the AASB's observations in paragraph BC17 of the Basis for Conclusions on Interpretation 1003, we believe it would be difficult to argue that these taxes are not income taxes in light of the Interpretation.

We are also aware of a number of other government imposts which are now routinely accounted for as income taxes under Australian Accounting Standards as a result of Interpretation 1003, including:

- Northern Territory mineral royalties
- Western Australia Barrow Island resource rent royalty
- Tasmanian mineral resources royalties (in some cases as the tax is 'hybrid' in nature)
- Papua New Guinea additional profits tax
- East Timor additional profits tax
- United Kingdom petroleum revenue tax
- Production sharing arrangements with governments in many jurisdictions, based on individual assessment as each is unique.

However, as we brought to the Board's attention in our comment letters at the time the AASB originally considered the accounting for PRRT, we believe that Interpretation 1003 effectively represents the elimination of accounting policy options under Australian Accounting Standards that are available to entities that report under International Financial Reporting Standards (IFRS) as promulgated by the IASB. We believe that a number of entities reporting under IFRS do not treat PRRT and analogous imposts (such as those listed above) as income taxes that are accounted for under IAS 12 *Income Taxes*.

The AASB has previously decided that, in principle, all options that currently exist under IFRSs should be included in the Australian equivalents to IFRSs and additional Australian disclosures should be eliminated, other than those now considered particularly relevant in the Australian reporting environment¹.

Accordingly, we believe that Interpretation 1003 (along with other Australian 'domestic' Interpretations) should be reassessed by the AASB for possible withdrawal. Such a withdrawal would deal with issues such as inconsistencies with the AASB's own objectives in relation to full convergence with IFRS and permit Australian entities to consider global practice in this area when setting their accounting policies. It would also serve to address misconceptions Australia is 'not fully compliant' with IFRSs, and set a leading example for other jurisdictions in Asia-Oceania and more broadly.

Accounting for MRRT/PRRT under IFRS

In our view, in the absence of Interpretation 1003, there may be many possible accounting treatments for MRRT/PRRT, some of which do not consider these imposts to be an income tax that is within the scope of AASB 112. Each of these alternate accounting policies has its own merits and arguably may be supportable under International Financial Reporting Standards (IFRSs).

¹ As documented in AASB 2007-4 *Amendments to Australian Accounting Standards arising from ED 151 and Other Amendments*.

These alternative treatments include accounting for MRRT/PRRT as:

- A provision under AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*, which may or may not include some measure of future expected MRRT/PRRT outflows (effectively as a constructive obligation) in the determining of the 'best estimate' of the expenditure required to settle the obligation
- An income tax under AASB 112, including full deferred tax accounting where appropriate
- By analogy to an income tax under AASB 112, including adopting deferred tax principles, but treating the amount recognised as a production cost and not as part of income tax expense
- An inventory cost under AASB 102 *Inventories*, recognising the total expected MRRT/PRRT cost into production costs on a units of production basis over the life of the operation
- A liability (accrual) under the *Framework*, only for amounts of MRRT/PRRT that are payable, i.e. recognising the legal obligation arising from production that has occurred only.

We do not necessarily support all of the above treatments, but as noted above, we believe that not all entities globally (applying IFRS) are accounting for PRRT and/or similar imposts as income taxes. The different treatments adopted in Australia for the (then) PRRT prior to the implementation of Interpretation 1003 is also testament to differing views on this matter. Accordingly, we believe it would be better for entities to be in the same position as their international counterparts and determine an appropriate accounting policy for MRRT/PRRT in light of their own assessment, global industry practice and other factors.

Issues arising in applying AASB 112 to MRRT/PRRT

In the event Interpretation 1003 is retained in its current form and MRRT/PRRT is to be accounted for as an income tax within the scope of AASB 112, a number of difficult interpretational issues arise. We set out below a discussion of a number of these issues.

Accounting for the 'market value' uplift

Entities will have the option on transition to the new regime to elect to adopt an initial tax value for MRRT/PRRT purposes based on the 'upstream' market value of each eligible operation, termed 'starting base assets'. This market value amount is then permitted to be amortised and used to reduce MRRT/PRRT taxable income by way of a 'starting base allowance'. Any starting base allowance not claimed in one period is eligible to be carried forward and is increased by 'augmentation', such that the ultimate allowance against MRRT/PRRT permitted over the life of a project can be substantially greater than the initial market value amount.

The market value approach is only available to projects in existence prior to the commencement of the new regime, i.e. new projects commenced after the commencement of MRRT/PRRT are not permitted to adopt starting base by reference to market value.

There are restrictions on transfer and use of the starting base allowance, which has the effect of 'quarantining' it to the particular project and also making it the most subordinated allowance/deduction, i.e. all other deductions and allowances are claimed first before any claim is made for the starting base allowance.

The effect of the election to adopt the market value approach is often to increase the total available deduction to be substantially in excess of recognised book values, particularly for long lived operations. In some cases, the effect of the market value uplift and augmentation can result in the entity expecting no payment of MRRT/PRRT at all over the remaining life of the project under reasonable revenue and cost assumptions.

There are a number of possible ways in which the starting base allowance can be characterised for accounting purposes, each is discussed in turn below. We are however of the view that most companies would choose to treat the starting base allowance as a tax holiday (view 2 below) given the choice, as it is the most pragmatic and best reflects the commercial reality.

View 1: Adjustment to the tax base

Under this view, the starting base allowance is treated as the tax base of associate upstream assets, applying the definition of “tax base” and the related guidance in paragraphs 5 and 7 of AASB 112. Accordingly, a deferred tax asset arises (as the carrying amount is lower than the tax base) and is recognised to the extent it is probable that it will be used to reduce MRRT/PRRT otherwise payable in the future, in accordance with the requirements of paragraph 24 of AASB 112.

The starting base allowance is determined on application of the new regime and therefore, none of the exemptions in paragraph 24 of AASB 112 will apply, as the imposition of MRRT/PRRT arises after the initial recognition of the associated assets. In accordance with the requirements of Interpretation 125 *Income Taxes – Changes in the Tax Status of an Entity or its Shareholders*, the recognition of the deferred tax asset is included in profit or loss for the period, unless the deferred tax consequences relate to amounts recognised in equity or other comprehensive income (which is unlikely in this case, with the possible exception of any revalued property, plant and equipment)².

Under this view, the effects of augmentation are not anticipated (as they relate to the passage of time and future inflation) and accordingly, a deferred tax asset is only recognised to an uppermost amount of the amount of the starting base allowance available at the reporting date.

Under View 1:

- The entity recognises a deferred tax asset at the inception of the new regime, with an often substantial credit in the profit or loss
- The entity must determine the amount of the starting base allowance considered ‘probable’ at each reporting date, requiring long-term forecasting of relevant revenues, costs and other factors (including other allowances permitted), which can be onerous and is subjective, with small changes in forecast variables potentially impacting the amount of deferred tax asset recognised
- Each year as the starting base allowance is utilised for MRRT/PRRT purposes, the entity effectively recognises an income tax expense (reflecting the ‘reversal’ of the deferred tax asset).

View 2: Tax holiday

Under this view, the election to utilise the market value approach is considered akin to the Federal Government providing the entity with a tax holiday for an amount of tax equal to the initial starting base ascribed to the asset. In other words, the effect of the starting base allowance of (say) \$1million is equivalent to the government exempting the first \$1million of taxable income from the MRRT/PRRT. This approach is also supported by the fact the starting base allowance can only be utilised against the project from which it arose, unlike many other allowances which can be transferred.

There is limited guidance on how to account for ‘tax holidays’ under Australian Accounting Standards, however a common method is to use a zero tax rate for the relevant tax holiday period(s). This has the effect of not recognising any deferred tax amounts during the tax holiday period, but would recognise deferred taxes where they were expected to reverse outside the tax holiday period.

Under this view, the effects of augmentation are not anticipated. However, future augmentation would be considered to ‘extend’ the tax holiday period and so would indirectly impact the recognition of deferred tax assets expected to arise outside the tax holiday period (i.e. when the entity expects to pay MRRT/PRRT).

Under View 2:

- The entity treats the starting base allowance as equivalent to a tax holiday and does not recognise a deferred tax asset for the amount of the starting base allowance, eliminating the ‘up front’ gain from applying a new tax for the first time

² In the event Interpretation 125 is considered not to apply to the imposition of MRRT/PRRT, paragraph 65 of AASB 112 results in an equivalent outcome.

- The complexity and subjectivity surrounding the forecasting of future relevant revenues, costs and other factors is reduced over View 1, as it would only apply to allowances and other temporary differences expected to reverse once the entity actually starts being subject to MRRT/PRRT (once the starting base allowance is utilised)
- Entities that expect not to pay any MRRT/PRRT over the remaining life of the project would not recognise any current or deferred tax amounts, consistent with the commercial outcome.

View 3: Government grant accounting

Under this view, the market value uplift is treated as a government grant in accordance with AASB 120 *Accounting for Government Grants and Disclosure of Government Assistance*. Under this view, the starting base allowance is considered akin to assistance provided to eligible entities to ameliorate (at least partially) the effects of a new government impost, being the MRRT or PRRT³. Alternatively, the starting base allowance can be considered a form of ‘super deduction’ over and above the amount paid⁴.

The uplift in tax value afforded under the MRRT/PRRT can be differentiated from other situations such as:

- Tax consolidation (where entities also often receive an uplift in tax values), as the uplift under tax consolidation is linked to the amount paid for an entity joining a tax-consolidated group (i.e. an actual amount paid), whereas the amount of the starting base allowance is linked to the market value of the assets at the date of inception of the tax (i.e. bears no relationship to the amount paid for the assets and does not represent an outflow made by the entity)
- Taxation of Financial Arrangements (TOFA), as the effect of TOFA is to affect the *timing* of the recognition of gains and loss for taxation purposes, rather than changing the *amount* of the gain/loss recognised (as is the effect with both the starting base allowance and augmentation under MRRT/PRRT).

As the starting base allowance arises from the entity’s assets at the inception of the MRRT/PRRT regime, it is argued that the better treatment under AASB 120 is to treat the amount as a grant related to assets. Accordingly, the starting base allowance is recognised on a systematic basis over the periods in which the starting base allowance is utilised to effectively reduce the MRRT/PRRT that would otherwise be payable⁵.

Under View 3:

- The entity recognises a deferred tax asset in the same way as View 1, but also recognises the benefit received from the starting base allowance for an equal amount as a government grant
- The government grant component is deferred and recognised in accordance with the requirements of AASB 120
- The outcome is similar in treatment to View 2, although it shows an income tax amount in each period, either offset partially or fully through a government grant income ‘above the line’.

³ As the starting base allowance is treated wholly within the MRRT/PRRT regime, is it outside the scope of AASB 120 by virtue of paragraph 2(b) of that Standard. This view also relies on the starting base allowance being considered an “investment tax credit” for the purposes of AASB 112, thereby being excluded from the scope of AASB 112 by virtue of paragraph 4. Accordingly, under this view, the entity applies AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* to determine the appropriate accounting policy for the starting base allowance, and chooses to account for it as a government grant by analogy to AASB 120. Equally, the entity could choose to apply AASB 112 by analogy, which would produce an outcome similar to View 1. It is also noted that the AASB is currently considering the analogous situation of accounting for free carbon permits under Australia’s carbon reduction scheme.

⁴ This is similar in concept to research and development allowances where the super deduction is sometimes treated as a government grant, although there is often considered to be an accounting policy choice for similar reasons as explained in footnote 3.

⁵ Because the benefit of the government grant can only be used to reduce future PRRT/MRRT payable, it could also be argued that the government grant is not recognised until such time as future taxable amounts arise under the PRRT/MRRT. This would have the effect of not recognising any amount up front, but rather recognising an offsetting income amount in each year an MRRT expense is recognised.

Accounting for royalties

Under the MRRT/PRRT, entities are effectively permitted to claim an offset for royalties paid to State Governments over the resources concerned. This is designed to avoid double-taxation. Royalties paid are claimed as a form of allowance for MRRT/PRRT purposes and are deducted before the starting base allowance. Any royalties not utilised in one period are subject to augmentation and carried forward to future periods.

There are a number of views as to how this aspect of the MRRT/PRRT should be treated, these are outlined below⁶. We are however of the view that the most pragmatic method is to treat the royalties as an operating cost as explained under view 1 below.

View 1: Operating cost

Under this view, the imposition of the royalty obligation is considered to be separate and distinct from the MRRT/PRRT, on the basis that the imposts are levied by different levels of government. Accordingly, any royalties paid are accounted for in accordance with the entity's existing accounting policy. As most of these royalties are levied on sales revenue (or a derivation of it), they are usually treated as operating costs, and included in inventory costing to the extent relevant.

Under this view:

- The entity continues to treat royalties as an operating cost ('above the line') and includes the amount in inventory costing
- The calculation of MRRT/PRRT adjusts for the impacts of the royalty in the same way as any other expense
- The effective income tax rate will depend upon the level of royalties paid, and so will vary from operation to operation and from State to State.

View 2: Prepayment of tax

Under this view, the payment of royalties is considered to represent a 'prepayment' of MRRT/PRRT and so is treated wholly within the scope of AASB 112.

Accordingly:

- The payment of royalties is considered a current tax amount, and is recognised as a current tax asset to the extent it is expected to be recovered (this may require discounting in some cases where the recoverability period is long⁷)
- The effect of royalties are wholly treated as being part of income tax expense and are not taken into account in inventory costing.

View 3: Reflect the entity's particular circumstances

Under this view, one of either View 1 or View 2 is adopted, depending upon the entity's circumstances and the overall expected profile of resource rent type imposts imposed:

- Where an entity is expected to pay no or little MRRT/PRRT over the life of the project, View 1 above is adopted on the basis the total amount of royalty and MRRT/PRRT paid is not calculated by reference to a measure of "taxable profit", but instead is more closely linked to (adjusted) sales revenue

⁶ In addition to the views outlined, the effective 'rebate' of royalties may also be considered to give rise to a form of government grant (because the Federal Government is effectively providing a rebate of taxes paid to a State) or (potentially) a 'receivable'. These alternate options have not been considered in detail in this document.

⁷ This is consistent with the (then) International Financial Reporting Interpretation Committee's (IFRIC) view in its agenda rejection statement in June 2004 regarding whether an entity should discount current taxes payable under IFRSs when an agreement with the taxing agency has been reached to permit the entity to pay such taxes over a period greater than twelve months.

- Where the entity expects to pay MRRT/PRRT, then the total payment of royalties and MRRT/PRRT together may produce a total resource rent payment which *is* measured by reference to a measure of 'taxable profit', and accordingly View 2 above would be adopted for such operations.

In some cases, this may mean that two different projects held by the one entity may be treated differently depending on each operation's total expected resource rent profile.

Other issues

The issues discussed above are the most significant issues facing entities at this stage of the implementation of MRRT/PRRT. However, there are a number of other issues that also arise and which may be expected to become more significant in due course as the enabling legislation is finalised and affected entities develop their own accounting policies and approaches to accounting for MRRT/PRRT.

These include:

- The timing of substantive enactment of the enabling legislation, particularly if the legislation passes the House of Representatives, but not the Senate, prior to December 2011 but there is an apparent intention by a majority of the parties in the Senate for passage of the legislation. Whilst this seems straightforward in terms of the application of Interpretation 1039 in these circumstances (suggesting substantive enactment may have occurred), the finely balanced nature of the Federal Parliament and the behaviour of political parties in recent times may not necessarily indicate that 'substantive enactment' has occurred
- The measurement of deferred tax assets insofar as whether a (net) deferred tax asset arising under MRRT/PRRT should itself be tax-effected for normal income tax purposes. The 'tax-effecting' of a net deferred tax asset in these circumstances (including for the starting base allowance) effectively relies on an argument that future income tax payments will be higher because of the lack of a deductible amount for MRRT/PRRT. The alternate argument would argue that the 'recovery' of the deferred tax asset has no future income tax consequence and accordingly, that there is no deferred tax amount (a deferred tax liability) to recognise⁸
- The treatment of augmentation, as to whether it should be recognised as a 'permanent difference', or treated as a form of 'super deduction', leading to questions of possible 'government grant' accounting.

⁸ As an alternative to the recognition of a separate deferred tax liability, some entities use a 'tax-effected' rate for the recognition of the base MRRT/PRRT deferred tax amount. This produces the same outcome as the approach outlined.