SUBMISSION

STRATERRA™
NATURAL RESOURCES OF NEW ZEALAND

TO THE INLAND REVENUE DEPARTMENT AND THE TREASURY ON "TAXATION OF SPECIFIED MINERAL MINING – AN OFFICIALS' ISSUES PAPER" (OCTOBER 2012)

INTRODUCTION

1. The tax review is a prime opportunity to update and improve the tax regime applying to specified minerals. Straterra[1] welcomes the opportunity to participate in this review, on behalf of our industry-wide membership now standing at 54[2]. We do so in the interests of achieving benefits for the minerals sector, and for the New Zealand economy as a whole.

2. New Zealand needs to be clear about the role of the tax regime, and of the minerals industry and its significance for New Zealand, if we are to develop a competitive regime that delivers real benefits for the country. The context is international because the minerals sector is globally competitive. Capital is allocated based on competition for prospectivity, regulatory certainty, and cost competitiveness. The minerals tax regime needs to be such to as to encourage investment, provide certainty, and be simple to apply. It also needs to reflect, and be fit for purpose for the realities of modern mining, and associated capital raising requirements.

3. Straterra has prepared this submission in consultation with Chapman Tripp, Deloitte, Ernst & Young, Greenwood Roche Chisnall, PwC, Newmont Waihi Gold, and OceanaGold.

4. Straterra would welcome further engagement with officials as the tax review is progressed. Indeed, we believe that this will be necessary to improve our combined understanding of the purpose of the review and of our sector, in order to develop rational and reasonable amendments to the tax regime.

[1] Straterra represents more than 90% be value of New Zealand minerals production, exploration, scientific research, engineering, geo-technical and other services, and legal, accounting and other ancillary services.

[2] http://www.straterra.co.nz/uploads/files/straterra_members_list_1_december_2012.pdf

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INVESTMENT PARADIGM

5. The characterisation in the issues paper (2.6) of the investment paradigm governing minerals prospecting, exploration and mining is incorrect. As a consequence, the objective for the review of "more neutral tax treatment" (2.3) fails to reflect the reality of minerals activities (cf. chapter 3), and is the wrong objective.

6. Straterra first rebuts the investment paradigm as portrayed in the issues paper, and explains the reality of investment in minerals. We then provide additional information on the nature of prospecting, exploration and mining, to create a framework, based on the real world, for setting out our views and recommendations for a fit-for-purpose, fair and reasonable tax regime for specified minerals.

7. The issues paper asserts that "the current tax provisions for specified minerals may bias investment into the sector and away from other investments that offer a higher pre-tax rate of return" (2.6). This is a false and unsubstantiated assertion, as are the implications[3]. The issue is

[3] There is no evidence of over-investment in mining in New Zealand because of tax privileges, and no evidence that minerals investment is displaced from other, more profitable activities in New Zealand.

NOT: how should New Zealanders be enabled to invest wisely a dollar in New Zealand. The issue is: where in the world should globally-mobile sources of capital invest their *minerals dollar* - in New Zealand or elsewhere?

8. The crucial consideration is this. Investment in minerals in New Zealand stems largely from sources possessing a knowledge base in minerals prospecting, exploration and mining, who are at liberty to allocate that dedicated investment in minerals anywhere in the world. That is certainly the case for Newmont Waihi Gold, OceanaGold, Bathurst Resources, Chatham Rock Phosphate, Trans-Tasman Resources, L & M Group, Glass Earth Gold, Neptune Minerals, and Nautilus Minerals.

9. For an overseas investor, there are key criteria to consider when deciding whether to invest in minerals activities in New Zealand, *or* invest in minerals activities elsewhere. The criteria include: minerals prospectivity, access to land, and the regulatory regime, including the tax regime. New Zealand has no mortgage on prospectivity; we have limited access to land; and, on that basis, if the tax regime becomes relatively poorly attuned to the nature of global minerals activities and investment, New Zealand will not attract its "fair share" of investment in minerals.

10. To be specific, OceanaGold can choose how it allocates investment capital between its operations in New Zealand (Globe Progress and Macraes), and in the Philippines (Didipio). If New Zealand gets the tax regime for specified minerals wrong, OceanaGold will prioritise investment accordingly, and other companies like it may simply not come here in the first place, with a consequent decrease in current and future economic activity in New Zealand.

11. Regardless, there are compelling economic arguments to have more investment in the minerals sector in New Zealand. They are that: most of the capital comes from overseas, while most of the economic activity occurs in New Zealand (including payments of income tax and PAYE); no activities are displaced, creating a net gain to the economy; the Government's policies are aimed at economic growth (Business Growth Agenda); and there are the social benefits of a more stable and skilled work force, mineral investment is typically regionally focused, often in areas that are desperate for investment, and more productive communities.

12. New Zealand needs tax rules that encourage more investment in the minerals sector, rather than less investment, while providing a reasonable financial return to the Crown (cf. 2.7 and 2.8). That will entail designing a tax regime that is attuned to the nature of minerals prospecting, exploration and mining, and investment in this industry. That can be done without adversely affecting any other sector in New Zealand. On that basis, there is no argument for "more neutral

tax treatment" – it is an illogical proposition – because the minerals sector is very different from almost every other sector. Moreover, it is a sector that, on multiple other fronts, the Government is encouraging. We turn now to the specific nature of our sector.

THE NATURE OF MINERALS AND MINING

13. As stated, the minerals prospecting, exploration and mining sector is very different from almost every other in the New Zealand economy, or, indeed, in any economy. Following are relevant considerations, to add to the context provided in chapter 3 of the issues paper:

- Prospecting/exploration, and mining, are distinctly different activities, and are in many circumstances very different businesses, operating on different business drivers, and models;
- Exploration is a form of high-risk, scientific research & development, the precursor stage to mine development, if a mine is developed;
- The generation and assessment of exploration data, in terms of studying the feasibility and practicability of minerals development, falls logically within the R & D phase;
- Changes of ownership or JV arrangements are frequent within the minerals sector – as opposed to the petroleum sector – especially when moving from exploration to development, as a means of raising capital for development, and because exploration and mining skill sets are very different;
- The boundary between the prospecting and exploration phase (the feasibility phase), and the development and mining phase is usually clearly drawn for any project because of the attending paper trail, in terms of business planning and decisions made, prior to mine development;
- Even when the same company moves from exploration to development, the capital-raising process can cause substantial shifts in shareholder structure;
- Consequently, it is usual in the global mining industry to have certainty in being able to retain deductions for prospecting and exploration expenditure into the development phase;
- This is justifiable because the value of shares in a business going into the development phase will reflect the value of information obtained during the prospecting and exploration phases

(a non-physical asset with intellectual property rights attached to it), which in turn depends to a significant degree on the amount spent to acquire that information;

- Large minerals developers will often hold a number of permits relating to the same operation, and/or a number of operations, and will wish to manage those permits as a single business or in an integrated way;

- The expected Life of Mine (LOM) is constantly changing; and mining companies identify resources and reserves to meet opposing drivers – business certainty and minimising and deferring capital spend. This tension, along with the many variables resource companies deal with such as commodity prices, technology, costs, exchange rates, means that a project with a LOM of 7 years can still be operating after, say, 20 years, having still a LOM of 7 years. This is typical of mining, but no project is the same;

- During the LOM costs incurred can vary greatly year by year: e.g., overburden can be removed in one year, at significant cost, to expose ore for many years; similarly, tailings dams and other earthworks may be built, and extended intermittently;

- During the LOM equipment will wear out and be replaced or upgraded; e.g., the only constant in a processing plant by the end of the mine's life may be the shell of the building;

- Mining entails a range of activities producing a benefit for a period of time not considered adequately in the issues paper, including: earthworks, embankments, tailings dams, and other civil engineering infrastructure or works; buildings; and improvements to land;

- The minerals industry is materially different to the offshore petroleum industry, notably: income earned during minerals mining will typically increase over time as investment in plant and efficiency occurs, cf. an oil or gas well where a rush of income is earned at the beginning and this stream then tails off; equipment used at one mine is poorly transferable to another mine, cf. floating oil and gas rigs; and exploration and mining are often carried out by different businesses or ownership structures, cf. petroleum companies; and

- A mining company may have assets in more than one jurisdiction, and more than one asset in the same jurisdiction, all of which are managed as a portfolio.

14. In conclusion: "more neutral tax treatment" is an irrelevant objective in this setting, as is the assertion that "industry-specific tax concessions are inconsistent with a broad, low-rate tax system" (2.5).

SUMMARY/CONCLUSIONS

15. Straterra contends that the issues paper's objective for the tax review is inappropriate, because it is based on false premises. The investment paradigm for minerals is very different from that portrayed in the issues paper. In addition, there is much to the nature of mining that has not been considered.

16. At issue is that minerals sector investment, generally, is sourced from overseas markets and investors that are dedicated to minerals investment anywhere in the world – resource sector investment is globally mobile. It is New Zealand Government policy to attract that investment into New Zealand. It is not a question of allocating an investment dollar within New Zealand.

17. As minerals activities move from prospecting, to exploration (including mining feasibility), to mining, the level of investment increases greatly, against a progressive reduction in risk of an unsuccessful outcome. Changes in company ownership structure are common in moving from exploration to development, as necessary for raising capital, and developing a mine.

18. Deductions related to prospecting, exploration, and other mining feasibility expenditure need to be immediate, offsettable against other permits, as well as deferrable, including in the event of loss of continuity of ownership. All mining-related capital expenditure on assets, including purchase-sale of land, should be eligible for straight-line depreciation over seven years, or a shorter period for, e.g., mobile plant.

19. Environmental restoration work during the mining phase should be treated as operational expenditure. Post-closure environmental restoration is already addressed under other legislation, i.e., via the posting of bonds, and financial provision made for that in company accounts.

20. We consider that the proposed claw back of deductions for particular types of prospecting and exploration expenditure is unnecessary, and contrary to the way in which ordinary tax rules apply to other activities. This expenditure is incurred to establish the feasibility or otherwise of establishing a mine, and occurs prior to the decision to develop the mine. The extent that any physical or intangible assets that may be created during the exploration phase are applicable to developing a mine are incidental to the purpose for which they were created, namely, to confirm the feasibility of the project. There is no guarantee this expenditure will have any ongoing value when it is incurred.

RECOMMENDATIONS

21. Straterra recommends the Department of Inland Revenue and the Treasury to adopt the following recommendations in their entirety, as a balanced package, and as necessary to ensure a fair, reasonable, workable and coherent tax regime for specified minerals:

   a) Agree to restate the **objective of the tax review** in the following terms: “a tax regime for specified minerals that encourages and enables investment in prospecting, exploration and minerals development, while providing a reasonable financial return to the Crown, consistent with other Government objectives for the specified minerals sector”;

   b) Note Straterra’s support for **immediate deductions for prospecting and exploration expenditure**, as consistent with general tax principles for feasibility expenditure;

   c) Consistent with Rec. (b), agree to provide for **retention of deductions** for prospecting and exploration, if needed, into the development phase, including with loss of shareholder continuity, as per the tax rules for R & D expenditure, in the event of new equity investment being required to move into the development phase;

   d) In relation to Rec. (c), agree to remove the **ring-fencing** of deductions to individual permits, because many businesses will hold a number of permits, and will seek to manage all permits as a single business or in an integrated way;

   e) Note Straterra’s support for the **boundary between exploration and development** being placed between the two sets of activities in the following way: the first does not earn income from the direct physical production of minerals, while the second activity earns income of that form, a line that is clearly drawn in company business planning and decisions made prior to mine development;

   f) Agree to reject the proposal for the Crown to **claw back** deductions for prospecting and exploration expenditure, in particular circumstances, as unnecessary, and contrary to the treatment for other sectors;

   g) Agree to provide for straight-line depreciation over seven years for **all capital expenditure on assets related to development**, for administrative complexity and workability (cf. the tax rules for the petroleum sector);

   h) Notwithstanding, Rec. (g), agree to provide for **shorter depreciation schedules** for assets with a shorter life than seven years, e.g., mobile plant, with the default being seven years;

i) Agree to include within the ambit of Rec. (g), **all capital expenditure on assets related to development**, including: earthworks, embankments, and other civil engineering infrastructure or works; tailings dams, and waste impoundments; and improvements to land;

j) Agree to treat **environmental restoration work during the mining phase** as operational expenditure;

k) Agree to include within the ambit of Recs. (g) and (i), expenditure in relation to the acquisition and sale of **land**, being an asset that is partly consumed during development, e.g., some land may be converted into a tailings dam or waste impoundment, and/or a lake or wetland;

l) Agree to include within the ambit of Recs. (g) and (i), provisions for **post-mining environmental restoration** work when the obligation to incur the expenditure is accrued in the financial statements, because the value of this work is well known, and guaranteed in advance (in the form of a bond or bonds posted under other legislation); and

m) Note Straterra's support for the proposal to remove eligibility for deductions for **appropriated amounts** for planned expenditure, as inconsistent with general tax principles, *subject to* a transitional regime being developed to allow existing investments to manage cashflows, and *subject to* all other Recs. being upheld, for coherence of the tax regime.

DISCUSSION

Provision for immediate deductions for prospecting and exploration expenditure

22. Immediate deductions for prospecting and exploration expenditure are proposed in the issues paper (6.3 – 6.10), in the year in which expenditure is incurred, and that is supported. The deductions could be realised during that time if the owner is able to offset against income being earned in the year expenditure is incurred. That is often not the case for exploration companies, and not always for mining companies who also carry out exploration work. The ability to retain such deductions is essential if these immediate deductions are to have any value.

Retention of deductions for prospecting and exploration expenditure

23. Flowing on from para. 22, the ability for minerals interests to retain deductions for prospecting and exploration expenditure is fundamental, otherwise these deductions may have no value,

and the inability to place a value on them would be a hurdle to the prospecting-exploration-mine feasibility-mining sequence, posing an unreasonable disincentive to investment.

24. The general tax principle is noted that deductions should stay with the owner, not the asset. We advise against holding fast to this principle in the case of specified minerals.

25. At issue under the proposed new rules is that losses made in the first phase of a project (prospecting/exploration) may not be eligible to be deferred to a later stage (mining), if there is a loss of continuity in the ownership structure of the company. (This can also be a problem for infrastructure projects, e.g., private-public partnerships, where ownership structure can change.)

26. While there is benefit to industry in providing for deductions for exploration (6.9) in the year expenditure is incurred if the explorer's business model is to sell the exploration *asset* to a mining company, or if the explorer is otherwise earning revenue, the usual practice is to sell the exploration *company*, in which case a loss of continuity will occur, and the value of deductions obtained will disappear.

27. Accommodation needs to be made for the scenarios presented to avoid unnecessarily discouraging investment. In New Zealand, some types of businesses incur upfront R & D expenditure in making discoveries, and will earn income off only successful discoveries. The IRD's solution[4] was to provide the option of deferring deductions during the R & D phase against future income, and claim those deductions when income is made, to accommodate a significant change in ownership of the business or assets. The same treatment should apply to the minerals industry, for parity, and to be reasonable.

Remove ring-fencing

28. Under current rules, deductions are ring-fenced to the permit. A miner cannot offset losses under one permit against income being earned under another permit, unlike other industries in New Zealand, e.g., farms. Many companies operating in the New Zealand industry have multiple permits; and what is economically and operationally speaking a single mining operation may span several different permits. The deductions regime should be framed accordingly.

29. The need for ring fencing is unwarranted (cf. 7.17 and 7.18), and should be removed for parity of treatment with other sectors of the economy, and as unnecessary for achieving our proposed objective for the tax regime.

[4] http://www.ird.govt.nz/technical-tax/legislation/2006/2006-3/2006-3-allocation-of-rd-tax-developments/

Boundary between exploration and development

30. The special nature of the prospecting-exploration-feasibility study-mining sequence is partly recognised in the proposed tax regime – provision for deductions should be immediate for non-income earning expenditure.

31. In the issues paper, a line is drawn between exploration (including feasibility), and development and mining (3.7, 3.8), a line that is clearly drawn in company business planning and decisions made prior to mine development.

Remove claw back of deductions for prospecting and exploration expenditure

32. Under 6.11-6.14, it is proposed that the Crown should be able to claw back deductions for expenditure on prospecting and exploration for items that are then used in the development phase. Straterra does not support this proposal, as discussed in para. 20 of this submission, and considers that it is contrary to general tax principles for other sectors.

33. We also disagree with the view expressed in the 6.13 of the issues paper: "The claw-back rule is also intended to buttress the division between the exploration and development phases … reduce the incentive to reclassify development expenditure as exploration expenditure". This is unnecessary for the reasons given in paras. 30 and 31 of this submission.

Straight-line, 7-year depreciation of all development capital expenditure on assets

33. The suggested amortisation of deductions for development expenditure in relation to assets over the life of the mine is generally reasonable as a tax principle (5.3, 6.15 – 6.17).

34. There is detail to be considered in how to implement this objective (6.18 – 6.26), in light of the nature of mining, i.e., constantly-changing projections for life of mine, the absence for smaller operators of estimates of reserves, the case-by-case nature of mining, and the need to ensure that all reasonable expenses to do with mining are eligible for deductions.

35. For example, a tailings dam is not a life-of-mine asset, properly speaking, because a major part of the expenditure occurs before mine development, before income is earned, and because it lives on after the mine has closed. Nor is it independent of the mine, as such. The need for post-closure management, e.g., capping, pumping of water, water treatment, monitoring may be necessary for a considerable period post mine closure, all of which relates to the dam's previous function, rather than any other function. It would be useful to depreciate that expenditure over a fixed period – we suggest seven years – because this is the income-generating period of its life.

Certainly, the future life of the asset, which could be hundreds of years, is an inappropriate period for depreciation.

36. As a separate issue, tunnels in one part of a mine may be collapsed or filled for health & safety reasons, and as part of the mine plan, and, therefore, depreciated to zero, while mining continues in a different part of the footprint. In this case, the asset is neither “tied to the life of the mine” nor is “independent” of the mine (cf. 6.29, 6.36 – 6.44). Deductions of this sort could be immediate, rather than amortised over seven years.

37. The foregoing illustrates that there is much detail to be considered under this heading, which warrants further engagement with officials.

38. Perhaps, the most tractable approach would be to provide for a default straight-line depreciation of all mining-related capital expenditure on assets over seven years, cf. the tax rules for petroleum. In Australian States, for comparison, this depreciation is carried out over eight years.

39. In the case of some capital expenditure, the amortisation should occur over a shorter time period, e.g., haul trucks and other mobile plant which have a life of less than seven years. As is the case for other industries, a table of depreciation rates could be constructed for this type of asset, with the default being seven years.

Land

39. It is proposed the purchase and sale of land will be treated on a revenue-account basis (6.31 – 6.35). The expectation is that land will lose value after it is mined – ostensibly because the minerals are removed - and rehabilitated. In reality, miners typically buy at greater than market value and sell at market value, which more reflects the value of property rights to the land than the mineral wealth lying beneath it. This is chiefly because a land owner is usually not in the position of choosing between mining the deposit on their own, and selling or leasing the land to a mining company – both because of title to minerals, and expertise.

40. Generally speaking, losses would be incurred in land transactions, which will be deductible, however, at the end of the project when income is not being earned. This is highly undesirable from a business perspective because the deduction will not always have a value.

41. As an additional consideration, once mining is completed not all land is available for re-use, e.g., land covered in tailings dams, waste impoundments, lakes, wetlands, roads, and that also leads to reduced value of land. Land is, therefore, partly consumed during the mining process.

42. For the above reasons, we suggest treating land the same as every other mining-related expenditure. The expected net loss on the land could be amortised over seven years.

Environmental restoration

43. Rehabilitation expenditure (6.45 – 6.48) is to "broadly"[5] follow the environmental restoration accounting rules[6], introduced in 2005 (incidentally, for Comalco, now Rio Tinto Alcan). The concept is the company sets aside funds for rehabilitation, with deductions factored in, while earning income, lodged with the IRD, to be used when restoration occurs, on application to IRD. Our understanding is that this provision is rarely if ever used.

44. It is often the case, when geology and mining practices and conditions allow, that rehabilitation work starts during mining, and is carried out in tandem with mining operations, and afterwards. For example, as an opencast mining operation progresses across the permit areas, overburden is replaced and re-vegetation occurs. That rehabilitation and re-vegetation work is intricately tied in with the mining, and should be treated as operational expenditure.

45. As a general tax principle, development expenditure incurred under legislation other than the Income Tax Act, e.g., to meet the conditions of resource consents, archaeological and heritage authorities, access arrangements and concessions, and permits to move wildlife, is already provided for and is already deductible, as it should be.

46. To elaborate, very good knowledge is available on how much this work will cost because of the environmental bond or bonds that are required to satisfy consent providers such as councils, and the Department of Conservation. Indeed, because of the existence of the bond, setting aside appropriations for the IRD would be paying twice for the same work. This is totally unnecessary, and undesirable. The most straight-forward course is to allow a deduction for the expenditure as it is accrued for accounting purposes, recognising that the associated legal obligations (matched by the bonding requirements) mean that the expenditure will be incurred, which is the safeguard for society.

Appropriated amounts

47. The tax regime should be reasonable to both the minerals sector and the Crown (cf. 2.7, 2.8). We agree that the current rules providing for deductions against planned expenditure are overly

[5] The term "broadly" will need to be defined.
[6] IRD new rules for business environmental expenditure 2005 http://www.ird.govt.nz/business-income-tax/expenses/environmental/

concessionary (2.1, 4.7). The proposed loss of this tax privilege is not surprising. We support the proposal, *subject to:*

- The adoption of Straterra's other recommendations for a fair, reasonable, workable and coherent tax regime; *and*

- Suitable transition provisions.