Taxation of specified mineral mining

An officials' issues paper

October 2012

Prepared by the Policy Advice Division of Inland Revenue and the New Zealand Treasury

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Taxation of specified mineral mining – an officials' issues paper.
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CHAPTER 1

Introduction

1.1 Currently the Income Tax Act 2007 differentiates between specified minerals (which include gold, iron sand and silver) and other minerals (including oil, gas and coal).

1.2 The specified mineral mining tax rules effectively allow immediate deductions for expenditure that would normally be capitalised and depreciated over the useful life of the asset, and in certain circumstances allow expenditure to be deducted in anticipation of it being incurred.

1.3 The overall effect of the rules is that a miner's income tax liability can be deferred for significant periods of time. This is concessionary compared with the tax treatment of most other forms of investment.

1.4 This issues paper suggests repealing the current specified mineral mining tax regime and replacing it with rules that are more aligned with general tax principles. The paper seeks readers' views on the suggested rules and how the suggested rules might work in practice.

Purpose of the review

1.5 The purpose of the review is to align the tax rules that apply to specified mineral miners with general tax principles. This review was announced as part of the Government's Tax Policy Work Programme in March 2012.

1.6 Tax concessions are generally inconsistent with the Government's general broad-base, low-rate tax policy framework. Not only do concessions narrow the Government's tax base, they also tend to reduce capital productivity. In this case, they do so by subsidising investment in specified minerals, which encourages investment in this activity ahead of other investment which may have higher pre-tax rates of return.

1.7 The changes suggested in this paper are broadly consistent with the tax rules applying to most other business activities, and from a tax prospective, are intended to make investment decisions more efficient.

Summary of suggested new rules

1.8 The key changes discussed in this issues paper are:

- Continue to allow immediate tax deductions for prospecting and exploration expenditure. However, on the establishment of an operational mine, exploration expenditure on items used for the extraction of minerals will be clawed back and be deductible over the life of the mine.

- Tax deductions for development expenditure will be deferred and allowed over the life of the mine on a unit-of-production basis.
- Expenditure incurred in the extraction of minerals will be subject to ordinary capital/revenue tax rules.
- A tax deduction for restoration expenditure will be allowed in the year it is incurred. However, a tax deduction will be allowed for payments made to Inland Revenue in advance for expected restoration costs.
- So-called "revenue account treatment" will apply to land acquired for specified mineral mining. That is, sale proceeds will be taxable and the cost of acquiring and disposing of the land will be deductible.
- Tax deductions for expenditure on assets whose economic life is tied to the life of the mine (excluding expenditure incurred in the prospecting and exploration phases) will be spread over the life of the mine, on a unit-of-production basis. When these assets are sold or disposed of, the consideration will be taxable in the year of disposal, less the balance of the miner's costs associated with the asset.
- General tax depreciation rules will apply to expenditure on assets with a useful life independent of the life of the mine. Normal depreciation recovery rules will apply to the sale or disposal of these assets.

Points for submissions

- Are there any aspects of the mining process that are not covered adequately by the suggested new rules?
- Are there any aspects of the suggested new rules that will create unwarranted compliance costs?
- In relation to the suggested claw-back rule for exploration expenditure, what exploration expenditure is likely to be clawed back, and is the scope of the claw-back rule appropriate?
- Will the unit of production method for spreading deductions over the life of the mine result in undue compliance costs for certain mineral miners?
- When considering the unit of production method is there a more appropriate method of accounting for additional development expenditure or changes in mineral reserves?

Next steps

1.9 Submissions will be taken into account when officials report to the Government on recommended changes. Any resulting legislative changes are likely to be included in a future tax bill.

How to make a submission

1.10 Submissions should be addressed to:

Specified minerals tax review
C/- Deputy Commissioner Policy
Policy Advice Division
Inland Revenue Department
P O Box 2198
Wellington 6140

Alternatively, submissions can be made by e-mailing policy.webmaster@ird.govt.nz with "Specified minerals tax review" in the subject line.

1.11 The closing date for submissions is 7 December 2012.

1.12 Submissions should include a brief summary of major points and recommendations. They should also indicate whether the authors are happy to be contacted by officials to discuss the points raised, if required.

1.13 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their publication. The withholding of particular submissions on the grounds of privacy, or for any other reason will be determined in accordance with that Act. You should make it clear if you consider any part your submission should be withheld under the Official Information Act.

CHAPTER 2

Background

2.1 The Income Tax Act 2007 differentiates between specified minerals (which include gold, silver and iron sands) and other minerals (including oil, gas and coal). The current tax rules that apply to a specified mineral miner allow an immediate tax deduction for:

- prospecting, exploration and development expenditure, including expenditure on capital items like plant, machinery and production facilities; and
- an amount set aside (appropriated) for mining exploration or mining development, if it is to be applied for these purposes within the next two years. The amount that can be appropriated is limited to the company's net income for the year.

2.2 The current tax rules for specified mineral mining are therefore concessionary compared with most other sectors, including petroleum mining which also has a concessionary regime. This is because the current rules essentially allow an immediate deduction for capital expenditure and expenditure that has not yet been incurred. Under general tax principles, deductions for this expenditure should be deferred and allowed over the economic life of the asset that is being created (that is, a productive mine).

2.3 The objective of this review is to create a more neutral tax treatment for specified mineral miners by aligning those activities with general tax principles.

2.4 This objective is consistent with the Government's Revenue Strategy outlined in Budget 2012, which states that:

> *The tax system should be as fair and efficient as possible in raising the revenue required to meet the Government's needs. The Government supports a broad-base, low-rate tax system that minimises economic distortions.*[1]

2.5 New Zealand's broad tax bases and relatively low tax rates make the tax system among the most coherent in the OECD. This promotes efficiency and fairness. Industry-specific tax concessions are inconsistent with a broad-base, low rate tax system.

2.6 Specifically, the current tax concessions for specified minerals may bias investment into the sector and away from other investments that offer higher pre-tax rates of return. When this happens, New Zealand's capital stock becomes less productive and economic performance could be adversely affected.

[1] Budget 2012, *Fiscal Strategy Report*, pg 17.

2.7 The Government also wishes to ensure that the Crown is receiving a fair financial return from the development of the nation's mineral resources. This return primarily comes from income tax and royalties.

2.8 Aligning the tax rules that apply to specified mineral miners with general tax principles should help ensure, from a tax perspective, that the Government receives a fair rate of return from the specified mineral mining sector and that investment decisions are made more efficiently.

CHAPTER 3

The mining process

3.1 The current tax rules and the suggested new rules are best understood with reference to the mining process, as different rules relate to each stage of the mining process. This chapter describes that process.

The Crown Minerals Act

3.2 The Crown Minerals Act 1991 sets the broad legislative policy for prospecting, exploration and mining of Crown-owned minerals in New Zealand. These include all naturally occurring gold, silver, coal, other metallic and non-metallic minerals, and aggregates.

3.3 The allocation of rights (permits) to prospect, explore or mine minerals that are owned by the Crown is carried out by the issuing of permits under the Act. The allocation of permits broadly mirrors the complete process of mining, from discovery of an ore body through to the extraction of the minerals.

The mining process

3.4 The process of mining, from discovery of an ore body through to the extraction of minerals and finally returning the land to its natural, usable or safe state comprises several distinct steps as described below:

The mining process

The prospecting phase

3.5 The prospecting phase involves the preliminary search for and the identification of an ore deposit. The techniques vary, but they typically have a low impact upon the land. Prospecting broadly involves identifying land likely to contain exploitable mineral deposits or occurrences. It includes aerial, geological, geochemical and geophysical surveys, and the taking of samples by hand or hand-held devices.

The exploration phase

3.6 The exploration phase involves more intensive methods to define the extent, location and value of the ore present. This leads to a quantitative estimate of the size and grade of any deposits identified. This estimate is used to conduct a pre-feasibility study to determine the preliminary view on whether any ore deposits within the permit area are economic to recover. This determines whether further investment in delineating the resource and engineering studies is warranted. It also identifies key risks and areas for further work.

3.7 If further investment is justified, a feasibility study is undertaken to evaluate the financial viability, the technical and financial risks, and the robustness of the project. This study includes mine planning to evaluate the economically recoverable portion of the deposit, including understanding the mineral chemistry and ore recoverability, marketability and expected returns on the ore concentrates, engineering concerns, milling and infrastructure costs, finance and equity requirements, and an analysis of the proposed mine from the initial excavation all the way through to reclamation.

The development and mining phase

3.8 Once the analysis determines the ore deposit is worth recovering, development begins to create access to the ore body. Progress towards mining operations involves acquiring a mining permit and other consents, and the construction of production, processing, storage and transport facilities. The mine buildings and processing plants are constructed and any necessary equipment obtained. Operation of the mine to recover the ore begins and continues as long as the company operating the mine finds it economical to do so.

The rehabilitation phase

3.9 Once all the ore that the mine can produce profitably is recovered, rehabilitation begins to make the land suitable for future use by others. Typically, good mine management will involve a rehabilitation programme that ensures, where practical, land rehabilitation is gradually undertaken over the life of the mine.

General points

3.10 It is important to note that entities involved in mining will typically abandon a project once there is enough information about a deposit to suggest that minerals are not economically recoverable.

3.11 Further, mineral exploration and development does not cease with a decision to mine. Exploration is often conducted to find ore deposits close to the primary deposit. This activity often uses information generated as a result of mining the deposit and is typically called “brown-fields exploration”.

CHAPTER 4

Current tax rules

4.1 The specified mineral tax rules provide tax concessions to miners of certain listed (“specified”) minerals. There are some 50 specified minerals, of which gold, silver and iron sands are the most commonly mined.

4.2 The main tax concessions for mineral mining are contained in subpart DU of the Income Tax Act 2007 and provide:

- immediate tax deductions for expenditure that would normally be capitalised and depreciated over the useful life of the mine. For example, a miner extracting specified minerals may claim immediate deductions for expenditure on land, plant or machinery, production facilities and preparing the site for mining operations; and
- tax deductions for amounts set aside (appropriated) for mining exploration or mining development that will be applied for these purposes within the next two years.

4.3 The overall effect of the specified mineral tax rules is that a miner’s income tax liability can be deferred for significant periods of time. This chapter discusses the main aspects of the existing tax rules that apply to miners of the 50 specified minerals.

Meaning of “specified mineral”

4.4 The list of 50 specified minerals is contained in section CU 28 of the Income Tax Act. The list includes gold, silver, iron sands, phosphate and platinum group elements.

Prospecting and exploration expenditure

4.5 Prospecting and exploration expenditure is deductible as it is incurred, as provided by section DU 1. Exploration expenditure includes prospecting expenditure and refers to expenditure a mining company incurs in exploring or searching in New Zealand for a specified mineral. Section CU 24 defines exploration expenditure and includes amounts incurred on:

a. acquiring mining prospecting information:

b. acquiring a mining or prospecting right:

c. geological mapping and geophysical surveys:

d. systematic searches for areas containing specified minerals:

e. searching by drilling in areas containing specified minerals:

f. searching for ore containing a specified mineral within or in the vicinity of an ore body by crosscuts, drilling, drives, rises, shafts or winzes.

Development and rehabilitation expenditure

4.6 Mining development expenditure is deductible as it is incurred, as provided in section DU 1. Mining development expenditure is expenditure that a company incurs in its mining or associated operations and includes expenditure on restoring the mining site. Section CU 23 defines development expenditure and includes amounts incurred on:

a. acquiring land for mining operations:

b. preparing the site for mining operations:

c. restoring the site during or after mining operations:

d. any of the following for mining operations:

   i. buildings, mineshafts, platforms, tunnels, wells, or other improvements:
   ii. plant or machinery, including vehicles:
   iii. production equipment or facilities:
   iv. storage facilities:

e. vessels or aircraft for use wholly or mainly in mining operations:

f. providing, or contributing to the cost of providing, communication equipment, fuel, light, power, or water for the site of mining operations:

g. buildings or facilities that—

   i. are situated at, or adjacent to, the site of any mining operations; and
   ii. are for use in the education, housing, or welfare of, or the supply of meals to, its employees in or connected with mining operations or in the education, housing, or welfare of, or the supply of meals to, the employees' dependants.

h. Providing, or contributing to the cost of providing, communication equipment, fuel, light, power, or water for the buildings or facilities described in paragraph (g).

Appropriated amounts

4.7 A mining company is also allowed a tax deduction in advance for amounts appropriated for use as mining exploration expenditure or mining development expenditure. The amount of the deduction is based upon the amount of expenditure the company will, or considers likely to, incur in the following two years. The amount appropriated cannot exceed the amount of net income in the year the appropriation is made, as provided in section DU 4.

4.8 Appropriated amounts for mining development or mining exploration expenditure, when a deduction has been taken in the year that it was appropriated, is treated as income from mining in the following income year, as provided in section CU 9.

Loans

4.9 A New Zealand company that holds shares in a "mining company" may claim a deduction for amounts written off in relation to loans made to the mining company for funding its exploring, searching or mining activities. The deduction allowed is for the principal (but not interest) written off.

4.10 The amount of the deduction is up to the lesser of 50 percent of the net income of the holding company for the tax year the deduction is claimed, or the holding company's proportionate share of the operating company's total outgoings on exploration and development, reduced by any similar deduction allowed in a previous tax year (as provided by section DU 12).

4.11 Under section CU 17, a holding company of a mining company that has been allowed a deduction for an amount it has written off on a loan made to the mining company must, to the extent of the deduction, include as income:

- any repayment of that debt made by the mining company (whether the repayment is made to the holding company or to any other person);
- any amount derived from the disposal of shares (or an interest in shares) in the mining company that is in excess of the amount paid up in cash on the shares by the holding company; and
- any net income that would have been derived by the mining company in a later tax year in accordance with section CU 19.

4.12 The income is allocated to the income year in which the mining company repays the amount or, in the last two cases, is treated as repaying the amount.

Sale of shares

4.13 The assessment of income from the sale of shares in a mining company that would ordinarily be taxable because the shares were acquired with the intention of resale or the person was in the business of share dealing may be deferred.

4.14 The deferral applies when the income is reinvested for mining purposes (as defined in section CU 29). The period of deferral can be up to six income years following the year that the shares are sold.

4.15 If any part of the above consideration is used for non-mining purposes, or the six-year period lapses, the amount is income in the year that it is used for non-mining purposes, or at the end of the six-year period (whichever is the earlier). However, if the above consideration is lent to a mining company, the principal repaid is income unless the repayment is further invested for mining purposes within six income years of receipt.

4.16 Deferral can also apply if the shares were sold to a mining company in return for shares in that company.

4.17 If the mining company is liquidated, any shares held are deemed to be sold to the company. All distributions on the liquidation are deemed to be consideration for the sale of shares, and any resultant profit is income.

Losses and grouping

4.18 Under section DU 7 a mining company may deduct a net loss from one class of income (mining income) against another class of income (income from other sources). This is subject to the qualification that any mining income deducted from the non-mining income should be reduced by one-third. For example, every $100 of mining loss is worth only $66.66 when making the deduction from non-mining income.

4.19 However, under section CU 13 any income derived by a non-resident mining operator from outside of the mining venture is separately assessed without regard to any income or expenditure incurred on the mining venture.

4.20 Special rules apply to the consolidation of mineral mining operations to ensure that:

- under section FM 31(2) a mineral mining company may only form a consolidated group with other wholly owned mineral mining companies; and
- losses incurred by a mineral mining company are ring-fenced to the mining company and to the relevant mining permit area, when shareholder continuity has been breached, or the company is not wholly owned. Under section IA 7 any losses from a permit area may be offset against the net income in the year of claim from the permit area.

Integrity measures

4.21 Given the generous deduction rules for specified mineral mining expenditure, the rules deem income from mining to arise in a number of situations.

4.22 Under section CU 3 the rules treat income from mining to be derived when an asset is transferred and an amount has previously been allowed as a deduction as mining development or mining exploration expenditure for that asset. Transfers include:

- an asset used to derive income from mining is used to derive income other than income from mining. The amount of income from mining is an amount equal to the market value of the asset on the first day the asset is used to derive income not from mining); and
- an asset used to derive income from mining, including mining prospecting information or a mining or prospecting right, is sold or disposed of. The amount derived from the disposal is treated as income from mining (there are various rules to assist with quantifying the amount – for example, when a mining asset is sold to an associated person it is treated as having been sold for market value).

4.23 Income from mining also includes compensation received for the loss, damage, or destruction of mining assets. When the asset is not restored or replaced, the insurance proceeds are treated as income from mining in the year received. When an asset is restored or replaced, only the excess of insurance plus scrap proceeds over restoration or replacement costs are included within income from mining. Under section CU 4 any costs of replacement or restoration that exceed insurance and scrap proceeds may be deducted in the year incurred.

CHAPTER 5

Economic framework for the suggested new rules

5.1 As discussed in chapter two, the Government's objective is to, where possible, have a tax system that raises revenue in a fair and efficient manner. This is achieved by adopting a broad-base, low-rate tax policy framework that minimises economic distortions.

5.2 The suggested new rules governing the specified mineral mining are intended to reflect these objectives. This chapter outlines the economic policy behind the suggested new rules.

Economic background

5.3 For taxes to be neutral and therefore not distort investment decisions, expenditure incurred in acquiring future economic benefits should be amortised over the expected period of the future benefits. This principle applies equally to situations when expenditure is intended to produce future economic benefits but fails to do so.

5.4 A simple example demonstrates this principle in Table 1. Assume that there is an asset that is expected to produce a stream of income over five years and then expire. In years one to five it is estimated that the asset will produce the following series of cashflows: $300, $280, $260, $240 and $220.

Table 1:
Marginal project, world without tax and no uncertainty

World without tax	
Investment	$ 1,000
Discount rate	10%
Year	**Cashflow**
1	$ 300
2	$ 280
3	$ 260
4	$ 240
5	$ 220
Sum of cashflows	$ 1,300
Net present value of cashflows	$ 1,000
Initial investment	-$ 1,000
Difference	**$ -**

5.5 In a world without taxes and assuming a risk-free discount rate of 10 percent (10 percent is used to keep things simple), an investor would be indifferent between buying, for $1,000, the series of cashflows or placing $1,000 in the bank. The project can therefore be described as marginal.

5.6 For taxes to neither encourage nor discourage this investment, the $1,000 should be deductible over this five-year period. Moreover, the amount of the tax deduction in each year should mirror the asset's expected decline in value. When the tax rules do this, an investor is still indifferent between buying for $1,000 the series of after-tax cashflows or placing $1,000 in the bank.

5.7 Table two demonstrates that when the tax rules allow a deduction for an asset's actual decline in value, the project remains marginal despite the introduction of taxes. While the example is for a riskless investment, this analysis applies equally to risky investments.

Table 2:
Marginal project, world with tax (deductions spread) and no uncertainty

World with taxes (deductions spread)				
Investment	$ 1,000			
Post-tax discount rate	7%			
Tax rate	30%			
Year	**Cashflow (1)**	**Depreciation (2)**	**Tax (1-2)*30%**	**Post-tax cashflow**
1	$ 300	$ 200	$ 30	$ 270
2	$ 280	$ 200	$ 24	$ 256
3	$ 260	$ 200	$ 18	$ 242
4	$ 240	$ 200	$ 12	$ 228
5	$ 220	$ 200	$ 6	$ 214
		Sum of cashflows		$ 1,210
		Net present value of cashflows		$ 1,000
		Initial investment		-$ 1,000
		Difference		**$ -**

5.8 In a world with a 30 percent tax rate, the post-tax discount rate is seven percent (.10 x (1 – .3), and the total amount of tax paid is $90. Allowing a tax deduction for the asset's actual decline in value, in this case $200 per year, means that this project remains the marginal project in a world with taxes.

5.9 This can be contrasted with a scenario where an immediate deduction is allowed when the investment is made. This is illustrated in table three.

Table 3:
Marginal project, world with tax (immediate deduction) and no uncertainty

World with taxes (immediate deductions)				
Investment	$ 1,000			
Post-tax discount rate	7%			
Tax rate	30%			
Year	**Cashflow**	**Immediate deduction**	**Tax**	**Post-tax cashflow**
0	$ -	$ 1,000	-$ 300	$ -
1	$ 300	$ -	-$ 210	$ 300
2	$ 280	$ -	-$ 126	$ 280
3	$ 260	$ -	-$ 48	$ 260
4	$ 240	$ -	$ 24	$ 216
5	$ 220	$ -	$ 66	$ 154
		Sum of cashflows		$ 1,210
		Net present value of cashflows		$ 1,012
		Initial investment		-$ 1,000
		Difference		**$ 12**

5.10 Although the investor pays the same amount of tax ($90) an immediate tax deduction means that the investor's tax liability is deferred (until year four), as the first three years the investor has a tax loss. As a result, the post-tax cashflows are greater in the first few years, which in turn results in the cash flows having a higher net present value ($1,012). In this scenario, taxes are no longer neutral and the investor is incentivised to take up the series of cash flows instead of placing the $1,000 in the bank.

Fair return

5.11 As well as making the tax rules applying to specified mineral mining neutral, the Government is also concerned to ensure that New Zealand obtains an adequate return from the exploitation of its mineral reserves.

5.12 The current specified mining tax rules enable mining companies to defer the payment of income tax. This has a direct cost to the Crown. Assuming that the Government's cost of capital is five percent, allowing mining companies to defer a $100 million tax liability for three years would cost the Crown approximately $15 million over the three years.

CHAPTER 6

More neutral tax rules

6.1 This chapter outlines the suggested new tax rules for specified mineral miners. It suggests that the existing specified mineral mining rules be replaced with rules that reflect the economic principles discussed in the previous chapter, while being broadly consistent with the taxation of other industries.

Overview of the suggested new rules

6.2 The following table summarises the suggested new rules for specified mineral miners:

Item	Suggested tax treatment
Prospecting expenditure	Allow a tax deduction in the year the expenditure is incurred.
Exploration expenditure	Allow a tax deduction in the year the expenditure is incurred. However, on the establishment of an operational mine, exploration expenditure on items used for the extraction of minerals is clawed back and is deductible over the life of the mine.
Development expenditure	Defer tax deductions and allow these over the life of the mine, on a unit-of-production basis.
Mining expenditure	Expenditure incurred in the extraction of minerals is subject to ordinary capital/revenue tax rules.
Rehabilitation expenditure	Allow a tax deduction in the year the expenditure is incurred. However, a tax deduction would be allowed earlier for payments made to Inland Revenue in advance for expected restoration costs.
Expenditure on land	Apply so-called "revenue account treatment" to land acquired in the prospecting, exploration and development phases. That is, sale proceeds would be taxable and the cost of acquiring and disposing of the land would be deductible.
Assets with a life tied to the life of the mine	Tax deductions for expenditure on assets whose economic life is tied to the life of the mine (excluding expenditure incurred in the prospecting and exploration phases) would be spread over the life of the mine, on a unit-of-production basis. When such assets are sold or disposed of, the consideration would be taxable in the year of disposal, less the balance of the miner's costs associated with the asset.
Assets with a life independent of the mine	Apply general tax depreciation rules to expenditure on assets with a useful life independent of the life of the mine. Normal depreciation recovery rules would apply to the sale or disposal of such assets. During the development phase depreciation deductions would be capitalised and amortised over the life of the mine on a unit-of-production basis.

6.3 Prospecting expenditure is generally incurred to identify and provide an initial view about the mining potential of mineral deposits within an area covered by a prospecting permit.

6.4 Under a strict framework, tax deductions for prospecting expenditure would be deferred and allowed as a deduction over the economic life of the mine. However, adopting this treatment would be inconsistent with the tax treatment of early-stage expenditure in other industries. For example, the existing petroleum mining rules allow immediate deductions for prospecting expenditure.

6.5 For this reason, the suggestion is to allow prospecting expenditure to remain deductible in the year it is incurred.

6.6 Prospecting expenditure would be limited to expenditure directly incurred on acquiring prospecting permits and information, labour, materials, services, administrative overheads and other expenses in prospecting for specified minerals. Prospecting expenditure would not include the costs of land.

Exploration expenditure

6.7 Exploration expenditure is generally incurred to determine whether the minerals identified in the prospecting phase can be profitably recovered.

6.8 As discussed in the previous chapter, for tax to be neutral, expenditure incurred on acquiring something that will provide future economic benefits should be amortised over the expected period of future benefits. However, like prospecting expenditure, adopting this treatment for exploration expenditure would appear harsh when compared with the tax treatment of similar expenditure in other industries. For example, the existing petroleum mining tax rules allow immediate tax deductions for exploration expenditure.

6.9 Therefore, the suggestion is to allow exploration expenditure to remain deductible in the year that it is incurred.

6.10 Exploration expenditure would be limited to expenditure incurred on acquiring exploration permits and information, labour, materials, services, administrative overheads, and other expenses on exploration and feasibility studies. Exploration expenditure would not include the costs of land.

Claw-back rule

6.11 It is also suggested that on the establishment of an operational mine, exploration expenditure on items used for the extraction of minerals would be clawed back and allowed as a deduction over the life of the mine.

6.12 The suggested claw-back rule is consistent with the tax treatment of petroleum mining, where expenditure on an exploration well is clawed back if that well is then used to extract resources.

6.13 The claw-back rule is also intended to buttress the division between the "exploration" and "development" phases. That is, the claw-back rule will reduce the incentive to reclassify development expenditure as exploration expenditure in order to receive immediate deductions, as those deductions will be clawed back.

6.14 Similar to the claw-back rule in the petroleum tax regime, the claw-back of previous deductions would be achieved by treating an amount of income as arising in the first year of commercial production. The amount of income treated in this way would be equal to the amount of expenditure that has been previously claimed on items in the exploration phase that are subsequently used in the extraction process. A deduction would then be allowed for that amount over the life of the mine on a unit-of-production basis.

Example

An immediate deduction would be allowed for the costs associated with establishing an access road initially used in the exploration phase. However, if that road is later used in the mineral extraction phase, the cost associated with establishing the road would be treated as income in the first year of commercial production. That same amount would be an allowable deduction and allocated over the life of the mine.

Development expenditure

6.15 Once a profitable mineral resource is found, development of a mine begins. Expenditure on developing a site for mining operations includes the costs of acquiring the mining permits, resource consents, and establishing mine infrastructure, including processing and transportation infrastructure.

6.16 Under general tax principles, expenditure that is incurred to produce a capital asset should not be immediately deductible. Rather, the costs should be capitalised and written off over the economic life of the asset. Similarly, when a miner spends money developing a mineral resource, that expenditure should be seen as part of the cost of producing a productive mine.

6.17 Therefore, it is suggested that these costs should be deducted over the life of the mine, on a unit-of-production basis.

Life of the mine

6.18 The "life of the mine" is based on the estimated reserves of minerals in the permit area at the beginning of the year. The deductions for the development expenditure would be then aligned with the amount of minerals extracted during the year.

6.19 The suggested method of allocating deductions over the estimated reserves is heavily influenced by the International Reporting Template (IRT) work of the Committee for Mineral Reserves International Reporting Standards (CRIRCSO). The IRT is a document that draws on the best of the CRIRSCO-style reporting standards, the JORC Code (Australasia), SAMREC Code (South Africa), Reporting Code (UK / Western Europe), CIM Guidelines (Canada), SME Guide (USA) and Certification Code (Chile). These reporting standards are recognised and adopted world-wide for market-related reporting and financial investment.

6.20 The IRT sets out a framework for classifying tonnage and grade estimates of mineral deposits according to levels of geological confidence and degree of technical and economic evaluation. Having reviewed this work, we consider that the most appropriate estimate for amortising the development costs of a mining permit is on the basis of "proven" plus "probable" mineral reserves.

6.21 A proven mineral reserve represents the highest confidence category of reserve estimates. A probable mineral reserve has a lower level of confidence, but is of sufficient quality for the deposit to be developed. Together, these estimates represent the economically recoverable part of the mine.

6.22 This estimate also provides allowances for diluting materials, and the losses which may occur when the material is mined. This includes the consideration of, and modification by, realistically assumed mining, metallurgical, economic, marketing, legal, environmental, social and governmental factors.

6.23 Deductions for development expenditure under the depletion method would be computed according to the following basic formula:

Allowable deduction = expenditure x proportion of extracted minerals

- **expenditure:** The amount of development expenditure, less the expected residual value, reduced by the total deductions allowed in previous tax years; and
- **proportion of extracted minerals:** The proportion that the current production in that year bears to the estimated total recoverable reserves remaining at the beginning of the year.

6.24 From time to time, over the life of a field, additional development expenditure may be required to maintain production or bring new reserves into production. It is suggested that miners account for additional development expenditure in the income year directly following the year in which the expenditure was incurred.

6.25 A similar approach is suggested to deal with changes in reserves. That is, changes in reserves will be counted in the year directly following the year the reserve's estimate is adjusted. Estimates of reserves may change over the life of the mine. This may be due to external reasons, like a natural disaster, or to changes in the expected price of the mineral. It may also occur because of matters relating to the specific field, such as original reserve estimates being less than previously estimated.

6.26 While there is an element of approximation in both these suggested treatments, they have the benefit of being relatively straightforward.

Mining expenditure

6.27 It is suggested that expenditure incurred in the extraction of the minerals be subject to ordinary capital/revenue tax rules.

6.28 This means that expenditure on revenue items will be immediately deductible, and expenditure on capital assets will either be deductible over the life of the asset or over the life of the mine.

6.29 Whether the cost of the asset is deductible over the life of the asset or the life of the mine depends on whether the asset's life is independent or tied to the life of the mine. This concept is discussed in paragraphs 6.36 to 6.44.

6.30 This suggested rule is intended to align the specified mineral mining tax rules with ordinary tax principles.

Cost of land

6.31 Under the suggested new rules, land acquired directly for prospecting, exploration or mining development would be treated as "revenue account property". This means the sale proceeds would be taxable and the cost of acquiring and disposing of the land would be deductible in the year of sale.

6.32 Where land is disposed of for consideration below the costs of the asset, a loss on disposal would be allowed.

6.33 This treatment reflects the fact that mining generally decreases the value of land. This is because land values may reflect the unexploited minerals contained in the land. As minerals are extracted, the value of the land decreases, representing a cost of the mine. Therefore, miners should be able to claim a deduction for the decline in value.

6.34 Conversely, any realised gains should also be taxable. Otherwise, the tax base would be subsidising the mining industry by allowing deductions for realised losses while not taxing realised gains.

6.35 Furthermore, if mining land were not taxable on sale or disposal, a specified mineral miner may in certain situations be able to extract the value of economically recoverable resources without tax, by selling the land rather than mining and selling the resources.

Assets with a life independent of the mine

6.36 Under the suggested new rules, the cost of assets with useful lives independent of the life of the mine would be amortised over the assets estimated useful life, in accordance with the current depreciation rules. This includes the costs of assets attained during the prospecting, exploration, development, mining phases and rehabilitation phases.

6.37 This would include assets that have a different lifespan to that of the mine. Examples include assets that could be reasonably expected to be moved to other operations, such as motor vehicles or on-site office equipment. These assets are likely to have a useful life less than the mine. Other assets – for example, a tailings dam, may have a useful life beyond the life of the mine.

6.38 Depreciation deductions on these assets incurred during the development phase, and before the mine becomes operational, should be capitalised and deductible over the life of the mine. This treatment is appropriate for these expenses as they represent the cost of producing a capital asset (the operational mine). Once the mine becomes operational, the capitalised depreciation deductions have a nexus with the income-earning process and are allowable over the life of the mine.

6.39 Furthermore, it is suggested that normal depreciation recovery rules would apply to the disposal of assets that have a life independent of the mine. For example, disposal of an asset for more than its adjusted tax value creates depreciation recovery income. Conversely, if the calculation of depreciation recovery income reveals a loss, a further deduction for that loss will be allowed.

Assets tied to the life of the mine

6.40 It is suggested that the cost of assets that is commercially inseparable from the mineral deposits be amortised over the life of the mine (excluding expenditure that creates assets with a life tied to the mine in the prospecting and exploration phase, as it is suggested an immediate deduction would be allowed). Such assets might include items that are not readily movable (for example roads, buildings and utilities) or assets that are so specialised that there is no other economic use for them other than to extract minerals from a particular mine.

6.41 There are a number of ways of allocating the costs of assets that are commercially inseparable from the mineral deposits within the mining permit area. Such costs could be allocated over the life of the mining permit, including renewals, or over the geological mineral resource estimates for the mining permit area. Our preference is for the latter, because this method is most likely to better reflect the pattern of consumption of the assets' future economic benefits.

6.42 Further, it is suggested that the proceeds from the sale or disposal of such assets be taxable, less the balance of the miner's costs associated with the asset in the year of disposal. If assets are disposed of for consideration below the costs of the asset, a loss on disposal would be allowed.

6.43 The rationale for the suggested change is similar to the rationale behind the suggested treatment of mining land on revenue account. That is, the value of the asset (similar to land) will generally be tied to the value of the mine and, as minerals are extracted, the value of the asset will generally decrease. Therefore, miners should be able to claim a deduction as the asset declines in value.

6.44 The suggested new rule also reduces the incentive to extract the value of economically recoverable resources without tax by selling the asset rather than mining and selling the resources.

Mine reclamation and monitoring expenditure

6.45 Typically, mining companies are required to restore, or at least make safe, land and land improvements once mining activities have ceased. These obligations often extend to requirements to monitor and remedy any post-mining environmental risks and hazards.

6.46 It is suggested that deductions be allowed for mining reclamation and monitoring expenditure in the year this expenditure is incurred. These costs are incurred in producing taxable income from the mining activities and therefore should be deductible in the year that they are incurred.

6.47 However, given these costs are often incurred after the mining activity ceases to earn income, it is suggested to allow deductions for payments made to Inland Revenue for expected mining reclamation and monitoring expenditure. The payments would be based on amounts that the miner has made a provision for in their financial accounts.

6.48 These payments will be held on account for the mining company and will be able to be drawn down on when these liabilities fall due. The rules would broadly follow the current environmental restoration account rules in subpart EK of the Income Tax Act 2007.

CHAPTER 7

Other matters

Income from mining

7.1 A mining company is currently required to separate its mining income from other income. Expenditures and losses also have to be categorised into amounts relating to mining exploration or development (or income from mining) and amounts that relate to other income.

7.2 A mining company may deduct a net loss from one class of income from the other class of income. This is subject to the qualification that any mining income deducted from the non-mining income should be reduced by one-third (for example, every $100 of mining loss is worth only $66.66 when making the deduction from non-mining income).

7.3 Repealing the rules is suggested for classes of income and the deduction reduction rule for future expenditure incurred by mining companies.

Mining loans

7.4 Currently, a New Zealand company that holds shares in a mining company may claim a deduction for amounts written off in respect of loans, excluding interest, made to the mining company to fund its exploring, searching or mining activities. Should this amount be recovered, the Commissioner of Inland Revenue has the power, at any time, to reopen the assessments on the holding company and disallow the deductions.

7.5 Repeal of these rules is suggested for future loans and allow the general provisions for bad debt and bad debt recoveries to apply.

Appropriation of income

7.6 A specified mining company is currently allowed a deduction for an amount of income appropriated towards mining exploration or development expenditure. The deduction is allowed in the year that the appropriation is made. This rule is concessionary compared with the general deduction rules.

7.7 It is suggested that the current appropriation rule be repealed.

Insurance proceeds for mining assets

7.8 The current rules treat compensation received for the loss, damage or destruction of mining assets as income to the miner.

7.9 It is suggested this rule be repealed and that the normal tax treatment of insurance receipts apply. Therefore, if the compensation is for the loss of trading profits the payment is generally taxable. If the compensation relates to the damage to an asset, the compensation is generally a non-assessable capital receipt.

Farm-out arrangements

7.10 A farm-out arrangement is a contractual agreement where a mineral rights owner or lessee (the vendor) assigns a working interest to another party (the purchaser) who will become responsible for specific exploration, development or production activities.

7.11 It is suggested that the consideration received by the vendor, less any costs that the vendor has not already claimed and losses carried forward, would be taxable in the year of sale.

7.12 Further, the purchaser would capitalise the purchase price and deduct it over the life of the mine on a unit-of-production basis. However, if the purchase was made during the prospecting and exploration phase, it is suggested that the purchaser would be able to claim an immediate deduction for the purchase cost.

7.13 Any expenditure subsequently incurred by the parties to the farm-out arrangement would be treated according to the suggestions outlined in this paper (ensuring that the vendor and the purchaser do not both claim for the same expenditure). For example, development expenditure incurred by the purchaser would be capitalised and allocated over the life of the mine.

Grouping and losses

7.14 Mining companies seek ore deposits with characteristics that enable its profitable extraction and processing. Often the subsequent analysis of mineral deposits identified during the prospecting phase determines that the identified ore deposit is not worth recovering. In theory, the costs of unsuccessful projects should be offset against the next successful project. After all, mining businesses expect to be compensated for costs incurred in the unsuccessful prospects by the successful mines.

7.15 Currently, special rules apply to the consolidation of mineral mining operations to ensure that a mineral mining company may only form a consolidated group with other wholly owned mineral mining companies. These rules are likely to have been put in place because of the concessions that applied to specified mineral mining.

7.16 Provided most of the current concessions for specified mineral mining are repealed, we see no policy reason why normal grouping rules should not apply to entities involved with specified mineral mining.

7.17 In addition, under the current rules, losses incurred by a mineral mining company are ring-fenced to the mining company and to the relevant mining permit area when shareholder continuity has been breached. That is, losses can only be used to offset income derived from the permit area.

7.18 With the suggested changes to the specified mining rules, it seems unnecessary to keep the current loss ring-fencing rules for losses incurred under the new rules. Instead, the normal shareholder continuity rules should apply.

Resident and non-resident mining operators

7.19 The current rules apply differently depending on the way the business activity is structured and whether the business is a resident or a non-resident taxpayer.

7.20 It is suggested that most of these distinctions be removed (resident and non-resident mining operators). However, the rule that deals with mining assets transferred under a relationship property agreement should be retained. In these cases, the asset will be deemed to transfer at book value and the transferee is assessed on any profit made on the subsequent disposal of the mining asset. This occurs as if the mining asset was sold by the transferor.

Timing of changes

7.21 Reforms improving efficiency should be implemented as quickly as possible, since their deferral would also defer the economic benefits of the reform. Transitional measures may be justified on efficiency grounds to effect a smooth reallocation of resources. Such measures can also be justified on equity grounds when the loss suffered would otherwise be substantial, or when individuals cannot readily adjust their circumstances to minimise the impacts of the policy change. Any transitional measures must, however, achieve a significant reduction in inequities at an acceptable cost in terms of deferral or reduction of the efficiency gains.

7.22 There appears to be no strong efficiency or equity arguments for a gradual phase-out of the concessions or for other transitional measures. Further, it would not be appropriate to grandparent mining operations that exist at the time the new rules are introduced. Expenditure incurred before the new rules would have received the benefits of immediate deductions and, in this sense, there is nothing to grandparent. Expenditure on new assets associated with existing mines should be subject to the suggested new rules as this promotes more efficient investment decisions.

7.23 Royalties, on the other hand, can be regarded as a contract between the Government and miners. Therefore, grandparenting current royalty treatment for mining investment can be justified.

7.24 Accordingly, it is suggested that the changes suggested in this paper apply from the beginning of the 2014–15 income year. This provides a short period of time for mining companies to gear-up for the new rules.

7.25 However, tax losses created under the current concessionary regime should continue to be subject to the current (more restricted) grouping and loss rules. The loss rules are intended to balance the more concessionary specified mineral mining rules. Therefore, for consistency, and to avoid revenue risks, losses created under the current rules should be subject to the more restrictive grouping and loss rules.

7.26 New losses created under the new rules would be subject to ordinary tax grouping and loss rules.