TAXATION OF MINING COMPANIES IN NEW ZEALAND.

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The development of a mineral industry is of great importance to New Zealand's economy. One of the ways in which it is encouraged is by special taxation provisions and incentives.

Mining operations have three factors which require special treatment:-

(a) the high cost of mineral exploration and exploitation;
(b) the speculative nature of mining including prospecting;
(c) the depletion of the minerals.

In New Zealand, a fourth factor is the need to attract overseas capital and know-how.

The first factor is met by permitting a mining company to write off all classes of expenditure, whether capital or revenue, over the life of the mine (Section 91). This is a usual sort of provision and applies also to the timber and flax industries.

However, New Zealand's tax legislation has some unusual features applicable to a mining company which mines for specified minerals of importance, or for petroleum. Such a company is not taxed on the basis of profits made, but on the basis of dividends paid to shareholders. As a result, the company's taxable income is reduced by at least $33\frac{1}{3}$ % and can be reduced by a much greater percentage if the company retains earnings to carry out prospecting and development activities.

These allowances are of great benefit once a mining company has begun to make profits.

Provisions also exist to encourage investment in mining companies before they have reached the profit-making stage. Shareholders are entitled to a deduction of up to $33\frac{1}{3}$ % in respect of payments for the allotment or meeting of calls on shares in companies mining the specified minerals or petroleum. Companies may write off loans, up to a certain limit, which they have made to mining exploration companies in which they hold shares.

Foreign companies may derive the benefit of the incentives by forming New Zealand subsidiaries. In addition there are provisions aimed at making New Zealand's tax no more onerous than the tax payable in the home country.

In the above ways, the tax legislation seeks to meet the special requirements of the mining industry.

An unexpected problem has arisen with respect to ability of profits or gains received on the sale of shares in a mining company. This has been met by a new provision which exempts such profits or gains from taxation so long as they are being used for mining purposes.

The legislation will now be discussed in more detail.

Companies engaged in mining for certain minerals (Section 152 Companies):

(a) that its sole or principal source of income is the business of mining in New Zealand any one or more of certain specified minerals, or

(b) that its undertaking is in New Zealand and comprises solely or principally the carrying on in New Zealand of exploring searching for or mining any one or more of the said minerals or the carrying on of any development work relating to such exploring searching or mining.

Clause (a) above relates, then, to companies which are engaged in actual mining operations, whereas Clause (b) relates to companies which are engaged in prospecting or development work. Clause (b) was inserted by Section 20 of the 1969 Amendment (No. 2) to the Act, and it is subject to the rider set out in the Amendment (inserted as subsection 1A of Section 152), namely that a company shall not be eligible if its prospecting or development activities are performed as a service to any other person for reward, unless the Commissioner is satisfied that the main purpose of the undertaking is to provide that service for a reward which is solely or principally related to and dependent upon the production of any one or more of the said minerals or the participation by that Company in any profits from the production of any one or more of the said minerals. The purpose of this rider is to exclude companies which provide a prospecting or development service for other companies

without assuming part of the risk of the mining venture.

The specified minerals are as follows:-

(a) Antimony, asbestos, barite, bentonite, bituminous shale, chromite, copper, dolomite, feldspar, gold, halloysite, kaolin, lead, magnesite, manganese, mercury, mica, molybdenite, nickel, perlite, phosphate, platinum group, pyrite, silver, sulphur, talc, tin, titanium, titanomagnetite, tungsten, uranium, wollastonite, zinc, or zircon; or

(b) Any other mineral which is declared in the Gazette by the Minister of Finance to be a qualifying mineral. Factors to be taken into account by the Minister are the importance of the mineral in the industrial development of New Zealand, or as a means of reducing the quantity of industrial minerals or industrial rock required to be imported into New Zealand, or as an item of export from New Zealand.

If a mining company meets the above requirements, then its taxable income is a notional one based on the amount of dividends paid to shareholders. The taxable income is one half of the dividends paid to shareholders during the year until total dividends paid since the company began exceed twice the amount of the paid-up capital of the company. From then on it is the full amount of the dividends paid to shareholders during the year.

To find the company's paid-up capital, contributions of property or other assets are taken into account at a true value. Bonus shares and other forms of capital issues which do not require payment of fully adequate consideration are excluded.

The effect of taxation under Section 152 may be seen from the following examples. The tax is calculated at maximum rates.

Company A is a Section 152 company which has not paid out dividends of twice the amount of its paid up capital,

Company B is a Section 152 company which has paid out dividends of twice the amount of its paid up capital, and

Company C is an ordinary trading company which is not eligible for taxation under Section 152.

Example 1: All of the companies earn a profit of $100.00 the total amount of which, less tax, they decide to distribute as a dividend.

	Company A	Company B	Company C
Profit	$100.00	$100.00	$100.00
Taxable Income	$ 40.00	$ 66.66	$100.00
Tax	$ 20.00	$ 33.33	$ 50.00
Dividend	$ 80.00	$ 66.66	$ 50.00

Example 2: All of the companies earn a profit of $100.00 and decide to put $20.00 in reserves, and distribute the balance less tax, as a dividend:

	Company A	Company B	Company C
Profit	$100.00	$100.00	$100.00
Taxable income	$32.00	$ 53,32	$100.00
Reserve	$20.00	$ 20.00	$ 20.00
Tax	$16.00	$ 26.66	$ 50.00
Dividend	$64.00	$ 53.32	$ 30.00

These examples show that Section 152 contains allowances of considerable value for the risk and depletion factors inherent in any mining venture.

The risk factor is allowed for by providing a very low rate of tax until the company has distributed profits which exceed twice the company's paid up capital, and thereafter an effective deduction of one-third of the company's profits (that is, assuming the company pays out its total profits as in Example 1 above). A tax advantage clearly flows from the company having a large paid-up capital. Accordingly, investment in the company by way of share subscription rather than loan advances may be preferable.

The depletion factor is allowed for by permitting the company to retain profits tax free to be used for further exploration or development work (as in Example 2 above).

Three further taxation features should be noted:-

(a) Mining companies eligible under Section 152 (here-

inafter referred to as "Section 152 companies") are exempt from the proprietary company provisions. (Section 152 (2)). In addition if Company A is a Section 152 company and is a shareholder of Company B which is another Section 152 company, and dividends paid by Company A consist of dividends received by Company A from Company B, then Company A receives as credit the amount of tax paid by Company B on the amount of its dividends included in Company A's dividends. (Section 152 (3)). In this way double taxation is avoided.

(b) Section 152 companies are not liable to excess retention tax. But Section 152A of the Act imposes some limitations on their freedom to retain profits. If in any income year a Section 152 company earns profits, and does not pay them to its shareholders as dividends within the succeeding five income years, then the Commissioner may deem the company, as at the last day of the first income year, to have paid out of such profits such a dividend as the Commissioner considers reasonable, and the company shall be taxed under Section 152 accordingly. (If the company does in fact subsequently pay a dividend which represents any amount already deemed to be a dividend, then double tax is not payable). However, the Commissioner cannot treat retained profits as deemed dividends, if the retained profits are being held or used by the company for certain purposes, including expenditure on furthering prospecting, development, or mining operations relating to the specified minerals.

(c) A current point of controversy is whether a company ceases to be a Section 152 company when it commences smelting or other working distribution or transportation of mineral products. The problem is, when does the undertaking of the company cease to be one of mining and become one of manufacturing? At this stage it can only be said that it may be necessary to form a separate smelting or distribution company if the actual mining operations are to retain their tax concessions. This would of course mean that the smelting or distribution company would not be entitled to the concessions. It is hoped that this point can be satisfactorily resolved with the Commissioner.

Petroleum Mining Companies (Section 153 Companies):

Under Section 153 of the Act, taxable income of companies which mine or explore for petroleum or carry on development work in respect thereof (other than service companies) is based on the amount of dividends paid to shareholders. The basis of assessment is similar, then, to that of Section 152 companies, but with the following important differences:-

(a) To be eligible, the petroleum mining company must be a New Zealand company.

(b) The taxable income is, subject to (c) below, the amount of dividends paid to shareholders, and not half the amount until the dividends paid exceed twice the paid-up capital of the company.

(c) Tax is not payable at all, until the aggregate amount of dividends paid exceeds the aggregate amount of the company's "irrecoverable expenditure". The term "irrecoverable expenditure" means the amount spent by the company in development work reduced by the selling value of assets (excluding petroleum under the ground) resulting from that expenditure. Thus in any income year, the taxable income of a Section 153 company cannot be more than the amount by which the total dividends to date exceed the total irrecoverable expenditure plus the total taxable income to date.

The Section 153 concessions are not available to a company which carries on refining, distribution or transportation of petroleum or any other business not incidental to mining for petroleum. If a Section 153 company should commence such activities, then in the year of commencement it would be liable to income tax as if all the receipts theretofore derived by the company, reduced by the sum of its irrecoverable expenditure and aggregate taxable income in former years, were taxable income. Thus the risk and depletion allowances would be lost, and the company would be no better off than if it had always been taxed under Section 91.

The excess retention tax provisions of the Act do not apply to Section 153 companies, but Section 152A (discussed when dealing with Section 152 companies) does apply. Part Vl B of the Act, relating to bonus issue tax, does not apply

to a Section 153 Company.

Companies holding Shares in Exploration Companies (Section 153A):

Section 153A provides tax concessions for companies (referred to as "holding companies") which hold shares in companies mining or prospecting for minerals or petroleum (referred to as "exploration companies"). A company need hold only one share in an exploration company to be a holding company for the purposes of the section. An exploration company is a New Zealand company engaged in exploring or searching for or mining in New Zealand any of the minerals specified in Section 152 or petroleum.

The section enables a holding company which makes loans to an exploration company to claim a deduction for any of such loans which it writes off, but the deduction is limited by the amount of the holding company's own taxable income, and by the amount which the exploration company has in fact spent on development work in New Zealand in relation to prospecting or mining for any of the specified minerals or for petroleum (referred to as "development expenditure").

In more detail, the limit of the holding company's deduction in any year is the smaller of:-

(a) Half its own taxable income for the year, or

(b) The total amount for all years of the development expenditure of the exploration company, reduced by the total of all amounts allowed to the holding company as deductions under the section in any earlier year or years;
PROVIDED that where an exploration company has more than one holding company, then the limit of each holding company, under this paragraph (b) is a "prescribed proportion" of the total amount of the development expenditure of the exploration company, the amount equivalent to such proportion to be reduced by previous deductions under the section as aforesaid. The "prescribed proportion" is the proportion which the holding company's total loans (less repayments) bears to the total loans (less repayments) made by all the holding companies.

Where the exploration company repays or is deemed to have repaid a loan which a holding company has written off and claimed a deduction for, then the Commissioner may amend any assessment made on the holding company. The amendment may be made at any time, notwithstanding the 4 year limitation for amendments imposed by Section 24.

A holding company is deemed to have been repaid in two situations:-

(a) Where the holding company disposes of shares in the exploration company in consideration of an amount in excess of the amoun paid up on such shares, then the amount of the excess is deemed to be a repayment in part of a written off loan.

(b) Where it appears to the Commissioner that the exploration company would have derived assessable income if it had not received the tax concessions available to it under the Act, then the Commissioner has a discretion to deem the prescribed proportion of such assessable income as a repayment in part of the holding company's written off loan.

The effect of Section 153A is to enable a holding company to loan half its profits to an exploration company and to claim such loans as a deduction if the exploration company is unsuccessful. The section, then, provides a further allowance for the 'risk' factor of mining ventures.

Concessions to Shareholders:

Under Section 129c a shareholder of a mining company (i.e. a Section 152 or 153 company) may deduct one third of the amount paid by him in respect of his shares in the company, provided that the payment is used for and is necessary for the purposes of the company. If the payment is not used by the company for its purposes within a reasonable time, then the Commissioner may disallow the deduction and alter the shareholder's assessment.

It will be noted that the deduction only applies to payments made to the mining company, whether on allotment or payment of calls, and is not applicable to the purchase of shares from a third party. Another feature of the

Section is that no time limit is specified within which the company must use the payment for its purposes, thereby giving the Commissioner a very wide discretion. A final point is that if the company does not use the payment for its purposes within what the Commissioner regards as a reasonable time, it is the shareholder who is penalized directly, and not the company.

Under Section 129BB a similar deduction of one-third may be claimed by a shareholder making payments to a "mining holding company" (i. e. a company which in the opinion of the Commissioner is engaged exclusively or principally in the holding of shares in, or the making of loans to, any mining company). In this case, the one-third deduction only applies to such part of the payment as is:-

(a) used by the mining holding company for the purpose of subscribing for, or paying calls on shares in a mining company, or paying calls on shares in a mining company, or making loans to a mining company for the purpose of enabling the mining company to carry on in New Zealand prospecting or mining of the specified minerals or petroleum or development work in respect thereof; and

(b) used by the mining company for its purposes within a reasonable time.

Section 88D provides that the deductions allowed under Sections 129C or 129BB are to be taken into account in calculating the profit or loss made on the sale or other disposition of shares in a mining or mining holding company.

Convertible notes are not 'shares' for the purposes of these Sections.

Foreign Companies and Experts:

In order to derive the benefit of Section 153 a foreign company interested in prospecting for or mining petroleum must form a New Zealand subsidiary to carry out the operations. It would probably do the same in the case of mining any of the minerals specified in Section 152, since to qualify under that Section a company's principal source of income or principal undertaking must be in New Zealand.

Other Sections of the Act endeavour to encourage overseas capital and know-how by reducing New Zealand taxation to or near to the amount of taxation that would be payable in the home country if the capital or know-how were employed

Section 78B provides a rebate for a "non-resident investment company" of such part of the New Zealand tax on interest and dividends derived from "development investments" as is in excess of the tax that would be payable on such income in its country of residence.

A non-resident investment company is defined in Section 2A. Briefly, it is a company which is not incorporated or does not have its head office in New Zealand, and which:-

(a) derives no income from New Zealand except interest; or

(b) has 50% of its total New Zealand assets in "development investments". These are investments by way of loans or shareholding in undertakings declared to be development projects by Order in Council.

Section 78F extends the general principle to the total taxable income of a non-resident company which, through a branch office, is carrying on an industrial undertaking declared by Order in Council to be a special development project for the purposes of the Section. Ther Governor - General is empowered to make such a declaration where he is satisfied that the undertaking is of major importance in the development of New Zealand. To qualify the undertaking must comprise the purchase, processing, marketing and disposal of a mineral and primary metal produced from it. If a company qualifies, then it is entitled to a rebate of the amount by which the New Zealand tax on its income exceeds the lesser of:-

(a) $42\frac{1}{2}$% of its taxable income in New Zealand, or

(b) the tax that would be payable on such income in its country of residence plus $7\frac{1}{2}$% of such income.

Taxation of the company on such a basis may not exceed fifteen years. After the expiry of such period, the company may for a further period of ten years be entitled to a rebate of such tax as is in excess of the tax it would pay if it were a company resident in New Zealand.

Section 78K provides a rebate of tax to visiting experts in respect of approved services on a particular project for a period of not more than two years. The rebate is, roughly, the excess of New Zealand tax over 35% in respect of the

of the services qualifying for the rebate.

Section 78C provides a rebate of 5% of so much of the taxable income of a non-resident investment company as consists of interest from development interests.

Section 78E provides a rebate for non-resident companies paying dividends to shareholders resident in New Zealand.

Section 203 S (2) (f) exempts Section 152 and 153 companies from payment of non-resident withholding tax. This exemption is of little benefit, since a Section 152 company will usually be a New Zealand resident company, and a Section 153 company must be a New Zealand company. A more sensible exemption, and perhaps the one that was in fact intended, would be an exemption of overseas shareholders in Section 152 and 153 companies from payment of non-resident withholding tax on dividends and interest paid by such companies.

Section 203 S (2) (g) provides an exemption from non-resident withholding tax in respect of interest derived by a non-resident investment company from development interests.

"Capital" gain

The mining industry encounters a peculiar problem with respect to taxability for gains normally regarded as of a capital nature. An example is now given.

If Company A is not a Section 152 company, is interested in mining and makes a significant discovery, then it will probably form a separate subsidiary to explore and mine the mineral. It will do this for normal business reasons, and also, if the mineral is a Section 152 mineral, for the purpose o obtaining the tax concessions provided by that Section. Company A may form several subsidiaries to develop its various mineral prospects. If Company A decides that further prospecting or a commercial mining operation is justified, it may well find that it does not have the necessary capital or know-how to undertake the work required. One answer to this problem is to obtain the services of a large and experienced mining company, probably an overseas company. The large company, Company B, may then under-

take the work required in exchange for acquiring a proprietary interest in the mining venture. This is commonly referred to, from the point of Company A, as a "farm-out agreement." Company A may receive a money payment from Company B, or it may sell some of its shares in its subsidiary or float a public company in order to raise sufficient finance to pay its way in the mining venture.

A problem now arises as to the taxability in the hands of Company A of the money payment from Company B, or the money received for the sale of the shares in the subsidiary. The problem may become more difficult for Company A if there is a history of farm-out agreements, and sales of shares in subsidiaries to other companies.

The Commissioner might argue under Section 88(1) (a) that Company A was in the business of exploiting mineral interests in one way or another, and that the gain derived from the sale of shares in a subsidiary or the sale of a mineral right, was not a capital gain at all, but ordinary income from its business. In the alternative, the Commissioner might argue that Section 88 (1) (c) was applicable: that Company A was in the business of selling mineral rights or shares in mineral companies, or that the shares or rights were acquired by Company A for the purposes of resale, or that the profits were derived from the carrying on or carrying out of an undertaking or scheme entered into or devised for the purpose of making a profit.

Company A might argue that the subsidiary was originally formed, or the mineral rights originally acquired, for the purpose of exploiting the minerals and not for the purpose of later selling part of the shares or mineral rights; that the sale of shares or rights was only made because Company A did not have sufficient finance to futher the mineral operation and that the sale was necessary if Company A was to obtain sufficient funds to maintain at least a partial interest in the mineral operation; in short, that Company A was in the business of mining, not the business of selling shares or mining rights, and that any gain which was realised by the sale of the shares or rights was gain of a capital nature, and one that did not come within Section 88 (1) (c).

There appears to be no authoritiative case law on this problem.

It should be noted that the problem will seldom arise in the case of Section 152 or 153 companies, since they are taxed on the basis of dividends paid. The problem could, however, arise if a Section 152 company asserted that a payment to its shareholders was not taxable as a dividend because it represented the realisation of a capital assest - Section 4 (3).

The problem has not been resolved, but a complex new section was enacted last year which safeguards the company against tax liability so long as the profit derived is re-invested in mining activities. The new section is Section 152B.

Profit or Gain from Sale of Mining Shares. (Section 152B)

Section 152B only applies to profit or gain which is taxable under Section 88(1) (a) and (c) of the Act. It is still open to the taxpayer to assert that the profit or gain from the sale of mining shares is a capital gain outside those Sections and accordingly not taxable at all.

If, however, a taxpayer company derives profit or gain from the sale or other disposition of shares in a mining company or a mining holding company which would normally be taxable, then such profit or gain shall not be included in the assessable income of the company in that income year to the extent that the Commissioner is satisfied that the consideration received from that sale or other disposition is used, or is to be used, within the prescribed period (6 years from the end of the income year) for mining purposes.

"Mining purposes" means:-

(a) Subscribing for, or paying calls on, shares in any mining holding company or any mining company; or

(b) Making loans to a mining company for the purpose of enabling the mining company to carry on in New Zealand exploration or mining or development work in respect thereof; or

(c) Making loans to a mining holding company, where the loans are to be used to finance exploration or mining to be carried out by a mining company in New Zealand.

or to finance development work in relation to such exploration or mining.

The Section also applies where the taxpayer company sells the shares to a mining holding company or to a mining company in consideration of shares in such mining holding company or mining company.

The profit or gain which is excluded from the assessable income of the taxpayer company under the provision of the section, is referred to as "reinvestment profit." If any part of the reinvestment profit is not used for mining purposes, then it shall be taxed by the Commissioner. So long as the reinvestment profit continues to be used by the taxpayer company for mining purposes it will not be taxable, but so soon as the reinvestment profit ceases to be so used, tax is payable.

The section contains involved provisions as to calculation of the reinvestment profit, the cost of a mining share, and the consequences of winding up.

Conclusion.

The Taxation Review Committee (Ross Committee) considered that a Section 152 or 153 company had too much power over its tax liability, since the liability was based on the decision to pay a dividend. This criticism has been met by Section 152A of the Act which enables the Commissioner to deem the company to have paid a dividend, if the company has not been using its income for certain purposes.

The Ross Committee also thought that Section 152 and 153 companies should be taxed on a uniform basis whereunder all costs of exploration, development, normal outgoings and running expenses would be accumulated; the company would not be liable for tax until such time as its gross revenue from sales exceeds the accumulated costs to date; and the taxable income would be chargeable with income tax at a rate equal to two-thirds of the rate applicable to ordinary companies.

Such a basis of assessment would produce results very similar to those of the present legislation, and would remove the somewhat arbitrary element of tax being based on a

decision to pay a dividend (subject to Section 152A).

The suggested basis would also be capable of application to individuals and partnerships, and in this regard it should be noted that the Minerals Committee of the National Development Conference recommended that the tax incentives granted to mining companies and investors in mining companies should be extended to individuals and partnerships who prospect or mine.

No doubt further improvements are possible, especially in the encouragement of overseas capital and know-how, but New Zealand's tax legislation has gone a long way towards providing the allowances and incentives required to encourage our mining industry.

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