INCOME TAX AMENDMENT BILL 2013

DETAILED TECHNICAL EXPLANATION

The *Income Tax Amendment Bill*, 2013 (the **Bill**) provides for amendments to the *Income Tax Act* 1997 (the **ITA**). The primary purpose of the Bill is to include provisions in the ITA for the taxation of seabed mining activities. The Bill also makes some other technical amendments to the ITA, including by inserting provisions to prevent international tax avoidance (transfer pricing and thin capitalisation). In relation to seabed mining activities, the Bill: (i) modifies the application of the income tax regime as it applies to seabed mining activities; (ii) provides for the imposition of an additional profits tax on mining companies engaged in seabed mining; and (iii) makes other amendments to the ITA.

Clause 1: Title
This is the title clause of the Bill.

Clause 2: Commencement
This clause provides that the Bill, except *clause 22(2)* comes into force on 1 January 2014. *Clause 22* amends section 100 of the ITA, which relates to the imposition of withholding tax on certain income. *Subclause (2)* of that clause inserts a new provision into section 100 requiring withholding tax to be imposed at the amount of 30% if the income concerned is interest earned on an account with a bank and the taxpayer has not provided the bank with the taxpayer's RMD number. This amount is twice that normally imposed under current subsection (1). The deferred commencement date allows taxpayers time to inform their banks of their RMD numbers.

Clause 3: Principal Act amended
This clause provides that the Bill amends the Income Tax Act 1997.

Clause 4: Application
This clause provides that the Act applies to income years commencing on or after 1 January 2014. "Income year" is defined in section 2 of the ITA to mean the year in which a person derives income. The normal income year is the calendar year (see definition in section 2 definition of the ITA). However, by virtue of section 9 of the ITA, a taxpayer can, with the permission of the Collector, use the twelve months ending on the date of the annual balance of its accounts as its income year (referred to as a "substituted income year").

The most common situation for when a taxpayer may have a financial accounting period that is different from the calendar year (and that most likely to be so with multinational mining companies) is where the taxpayer is a Cook Islands subsidiary of a foreign company. For example, a multinational group (including its Cook Islands subsidiary) may use the period 1 April–31 March as its financial accounting period. In this case, the subsidiary may want to use that period also as its income year in the Cook Islands to avoid having to prepare separate financial accounts for tax purposes.

The effect of the amendment in this clause is that, for a person with a substituted income year, the amendments in the Bill will apply to the first substituted income year commencing after 1 January 2014. This means that, in the above example, the Bill when enacted will first apply to the Cooks Islands subsidiary from 1 April 2014.

Clause 5: Section 2 amended
This clause amends section 2 of the ITA, which provides for definitions of terms used in the Act.

Clause 5(1) deletes the existing definition of "minerals" and substitutes a new definition that cross refers to the definition of "mineral" in section 7 of the Seabed Minerals Act 2009 where "mineral" is defined as "any naturally occurring substance or naturally occurring mixture of substances, including in the form of coal, clay, evaporates, gravel, limestone, oil shale, sand, shale, rock and polymetallic nodules". The definition is particularly relevant to the definition of "natural resource amount" inserted by the Bill and the new source rules inserted into section 83(1).

Clause 5(2) inserts new definitions into section 2 of the ITA as explained below.

arm's length transaction

This term is relevant to the new transfer pricing rule inserted as new section 56A of the ITA by *clause 11* of the Bill.

An "arm's length transaction" is a transaction between independent persons dealing at arm's length with each other (i.e. a transaction between separate entities dealing wholly independently with each other). An arm's length transaction is one in which the market determines the price with the seller aiming to obtain the highest price possible and the purchaser aiming to pay the lowest price possible. In other words, the price is that freely negotiated in the open market.

Cook Islands

This term is relevant to a number of provisions inserted by the Bill that refer to the Cook Islands in a geographical sense, particularly the amendments to section 83 of the ITA providing rules for locating the source of income in the Cook Islands.

Now, when the ITA refers to the geographic area of the Cook Islands, it means the Cook Islands as defined in Article 1 of the Constitution of the Cook Islands and includes the territorial sea and exclusive economic zone of the Cook Islands as defined in sections 3 and 8 of the Territorial Sea and Exclusive Economic Zone Act 1977. This is particularly relevant to seabed mining activity and ensures that the new Part 8A inserted by *clause 24* applies to seabed mining in the territorial sea and exclusive economic zone of the Cook Islands.

entity

This term is relevant to the new definition of "underlying ownership" in section 2, the new source rule in section 83(1), the new anti-treaty shopping rule in section 86(6), the extended definition of "person" in new section 143A (applicable for the purposes of new Part), and the taxation of indirect transfers of titles in new section 143H.

"Entity" is defined to mean a government and a company, partnership, trust, or similar body or organisation. Company" is separately defined in section 2 of the ITA to mean a body corporate whether incorporated in the Cook Islands or elsewhere, but not including a local or public authority. "Partnership", "trust" and "body of persons" are not defined and, therefore, take their ordinary meaning.

A partnership is a contractual arrangement under which two or more persons carry on business for joint profit. A trust is an equitable obligation binding a person (the trustee) to deal with property (trust property) for the benefit of another person or persons (the beneficiary) or for some other object permitted by law (for example, a charitable object). A "body of persons" is a reference to an unincorporated association, which is currently included in the section 2 definition of "person".

The reference to "government" is intended as a reference to both the Cook Islands Government and foreign governments, and to all levels of government.

The definition includes a "similar body or association" (that is, a body or association similar to a company, partnership, trust or body of persons). This is intended to pick up, in particular, foreign-formed entities for which there is no legal equivalent under Cook Islands law, such as a Liechtenstein foundation, which is similar to a trust.

immovable property

This term is relevant to the new source rules in section 83(1) and the taxation of indirect transfers of titles in new section 143H.

"Immovable property" is defined to include a title, mining information, and prospecting information. "Title" is defined in section 2 of the ITA (as inserted by the Bill) to have the meaning in section 7 of the Seabed Minerals Act, namely a licence, permit or lease granted under that Act. Thus, the following are titles for the purposes of the ITA: an exploration licence, prospecting permit, retention lease and mining licence. A title should be within the ordinary meaning of immovable property, but has been expressly included for the avoidance of doubt.

"Mining information" is defined in section 2 of the ITA (as inserted by the Bill) to have the meaning in new section 143A, namely information associated with recovery operations. "Prospecting information" is defined in section 2 to have the meaning in new section 143A, namely information associated with prospecting or exploration operations, or operations associated with a retention lease. By virtue of new section 143A(2), "recovery operations", prospecting operations", "exploration operations" and "retention lease" have the meanings given in the Seabed Minerals Act. The inclusion of mining and prospecting information in the definition of "immovable property" extends the ordinary meaning of the term. Based on experience in other countries, the inclusion of mining and prospecting information is intended to counter any argument that the indirect disposal rule in new section 143H(1) does not apply because the interest in the entity derives its value not from a title but from information relating to the title.

As the definition is inclusive, it will otherwise take its ordinary meaning, namely land and include any other interest or right within the ordinary meaning of immovable property, such as a lease, easement, or *profit-à-prendre*.

mining information

This term is relevant to the new definition of "immovable property" inserted into section 2 of the ITA by this clause.

"Mining information" is defined in section 2 to have the meaning in new section 143A, namely information associated with recovery operations. By virtue of new section 143A(2), "recovery operations" has the meaning in section 7 of the Seabed Minerals Act, namely "any activity that is directly related to the recovery of minerals including, but not limited to, mining and other operations to extract a mineral from its natural state on the seabed or from the subsoil of the Seabed of the Cook Islands".

natural resource amount

This term is relevant to new paragraphs in section 83(1) (which provide rules for determining whether a natural resource amount is derived from sources in the Cook Islands) and section 98 (which includes a natural resource amount as withholding income for the purposes of Part VII of the ITA).

There are two inclusions in the definition of "natural resource amount". Paragraph (a) includes an amount as consideration for the right to take minerals or a living or non-living resource from the land or sea (and includes any premium paid for the right). This would cover a natural resource royalty, such as a payment made for the right to enter land and remove natural resources if the amount of the payment is based on the quantum or value of the resource taken. Given that minerals are vested in the Crown on behalf of the Cook Islands people under section 5 of the Seabed Minerals Act, this inclusion will be relevant to other types of natural resources.

Paragraph (b) includes an amount that is calculated by reference to the quantum of minerals or living or non-living resources taken even though the recipient of the amount may have no rights to take those minerals or resources. An example of an amount covered by this paragraph is a private overriding royalty paid in relation to an exploration licence or prospecting permit. It can be difficult to put a value on an exploration right before a commercial discovery is made. If no commercial discovery is made, the exploration right will have little or no value. On the other hand, if a commercial discovery is made, the right may be very valuable. Because of the uncertainty about the value of an exploration right, a person holding the right may chose to dispose of it for a nominal cash consideration and a periodic amount (referred to as a "private overriding royalty") based on the gross revenues realised by the transferee from any commercial discovery. This allows the transferor to share in the value of the right if a commercial discovery is made..

For example, person A, who is the holder of an exploration licence, may transfer the licence to person B for $1 plus a 5% private overriding royalty. Under this arrangement, person B is obliged to pay person A 5% of the gross revenue realised from a commercial discovery relating to the exploration licence. While the amount is referred to as a "royalty" in the mining industry, it is not within the ordinary meaning of "royalty" as person A has no property right in relation to which the payment is made (in fact person A has transferred their property right to person B). Paragraph (b) treats a private overriding royalty as a natural resource amount as the amount paid to person B is calculated by reference to the quantum of minerals taken by person B. This means that if, in the above example, person B is a non-resident person, the private overriding royalty will have a source in the Cook Islands (see new amendments to section 83(1)) and be subject to withholding tax (under the amendments made to Part VII).

Another example of a natural resource amount under paragraph (b) of the definition is the case of a consulting geologist who may be engaged to provide advice as to where minerals

may be discovered. The geologist may agree to be paid a fee for services rendered and an additional amount as a "success fee" comprising periodic payments based on the quantum or value of minerals taken from the site indicated in the geologist's report. The periodic payments are within paragraph (b) of the definition of "natural resource amount" notwithstanding that the geologist has no rights in the resource taken. The services fee is not a natural resource amount as it is not calculated by reference to the quantum or value of minerals of taken. The services fee is included in assessable income as ordinary business income.

permanent establishment

This term is relevant to the new transfer pricing rule in new section 56A of the ITA and the withholding tax imposed under new section 143I of the ITA on fees paid by contractors to non-resident subcontractors. Withholding tax imposed under new section 143I does not apply if the services are rendered through a permanent establishment in the Cook Islands of a non-resident person.

The definition of "permanent establishment" follows closely the definition in tax treaties. It is intended that the existing learning on tax treaties is relevant to the interpretation of the definition, particularly the Commentary to the OECD Model Tax Convention on Income and Capital.

The basic notion of a permanent establishment is a fixed place of business through which the business of a person is carried on. There are three key requirements, namely there must be: (i) a place of business; (ii) the place of business must be fixed (that is, there is a degree of permanency); and (iii) a business activity must be carried on through the place of business (for example, it cannot just be a vacant office). The definition has five specific inclusions.

Paragraph (a) includes a place of management, branch, office (other than a liaison office), factory, warehouse, or workshop. These are largely illustrative of the types of places that can qualify as a permanent establishment under the general principle stated in the introductory words of the definition. Each inclusion is to be interpreted broadly. For example, "office" includes any office no matter what activity is conducted through the office. An exception is where the office is merely a "liaison office", which is an office that has representation of a person's business as its sole activity. This exception is necessary because the activities of a liaison office (being only representation) are too remote from the derivation of income for part of the income to be accurately allocated to the activity. To qualify for the exception, the liaison office must not engage in the negotiation of contracts of sale or supply. The negotiation of contracts is more than simply a liaison or representative function and goes to the core of a non-resident person's business.

Paragraph (b) includes a mine site, oil or gas well, quarry, or other place of exploration for, or extraction of, natural resources. Again, these are largely illustrative of the types of places that qualify as a permanent establishment under the general principle as stated in the introductory words of the definition as they would ordinarily constitute a fixed place of business. It is expressly provided that a boat or ship that provides a base for the exploration or extraction of natural resources is a permanent establishment. A specific reference to a "boat" or "ship" is included to avoid any argument that the boat or ship is not a permanent establishment as it is not a "fixed" place.

Paragraph (c) includes a building site, a construction, assembly or installation project, or supervisory activities (such as the services of a consulting engineer) connected with such site or project, but only if the site, project or activity continues for more than six months.

Paragraph (d) includes the furnishing of services through employees or other personnel if the services continue for the same or a connected project for a period or periods aggregating more than six months within any twelve-month period. The six-month period is tested over any twelve-month period and not by reference to the income year. The six-month period may be satisfied by aggregating two or more periods within any period of twelve months provided they relate to the same or a connected project. This will be particularly relevant to new section 143I.

Paragraph (e) specifies two situations where an agent is a permanent establishment of the principal. The first is when the agent has and habitually exercises an authority to conclude contracts on behalf of the principal. The reference to "authority to conclude contracts" is intended to be interpreted broadly and would include a case when the agent negotiates all the essential terms of a contract even though the contract may be formally signed by the principal.

The second is when the agent maintains a stock of goods or merchandise from which the agent regularly delivers goods or merchandise on behalf of the principal. The ability to make timely delivery of goods or merchandise is considered to be a central part of any sales activity.

In both cases, an agent is not a permanent establishment if the agent is of independent status (that is, its business is to act as agent for a number of customers and to act independently of each principal that it has as a client). An agent of independent status would include, for example, a share broker or a general import agent.

The main difference between this definition and the definition commonly found in tax treaties is that there is no general exception for preparatory or auxiliary activities, although there is an exception for a liaison office.

prospecting information

This term is relevant to the new definition of "immovable property. "Prospecting information" is as having the meaning in new section 143A, namely information associated with prospecting or exploration operations, or operations associated with a retention lease. By virtue of new section 143A(2), "prospecting operations", "exploration operations" and "retention lease" have the meanings given in the Seabed Minerals Act 2009.

Seabed Minerals Act

This term is relevant to the new definition of "title" in section 2 and the definitions in new section 143A and means the Seabed Minerals Act 2009 (Act No. 16 of 2009). The Act came into force on March 1, 2013 by an Order in Executive Council.

title

This term is relevant to the new definition of "immovable property" and new Part 8A. "Title" is defined to have the meaning given by section 7(1) of the Seabed Minerals Act, namely a licence, permit or lease granted under that Act. "Licence" is defined in section 7 of the

Seabed Minerals Act as an exploration or mining licence granted under that Act. An exploration licence is granted under section 106 of the Seabed Minerals Act and a mining licence under section 178 of that Act.

"Permit" is defined in section 7 of the Seabed Minerals Act as a prospecting permit granted under that Act. A prospecting permit is granted under section 84 of that Act.

While "lease" is not defined in section 7 of the Seabed Minerals Act, it is clearly a reference to a retention lease, which is defined in that section to mean a retention lease granted under that Act. A retention lease is granted under section 146 of that Act.

Thus, the following are titles for the purposes of the ITA: an exploration licence; prospecting permit; retention lease; and mining licence.

underlying ownership

The term is relevant to the new anti-treaty shopping rule in new section 86(6) and the taxation of indirect transfers of titles in new section 143H.

"Underlying ownership" is defined as an interest in an entity held directly, or indirectly through an interposed entity or entities, by an individual or a person not ultimately owned by an individual. In broad terms, the reference to the underlying ownership of an entity is a reference to the ultimate beneficial ownership of the entity determined by tracing through entities until it is not possible to trace any further. Thus, the underlying owner of an entity will be either an individual or an entity not ultimately owned by individuals (such as a government).

"Entity" is defined in section 2 to mean a government, and a company, partnership, trust, or similar body or organisation. An "interest" in an entity will depend on the entity. For example, for a company limited by shares, the interest in the company is the shares. It will also include an interest of a partner in a partnership and an interest of a beneficiary in a trust.

Clause 6: Section 11 amended
This clause amends the rule in section 11 of the ITA as to how the income of a husband and wife carrying on business together or deriving income jointly is treated for the purposes of the Act. Currently, this income is deemed to be all that of the husband's, unless a bone fide deed of partnership applies. The amendment removes this rule and instead requires the income to be apportioned according to the amount actually earned by each party, with a default power authorising the Collector to apportion the amounts at his or her discretion if the parties do not make an apportionment or the apportionment made by the parties is not appropriate.

Clause 7: Section 42 amended
This clause amends section 42(1)(p) of the ITA to remove the exemption relating to income derived as an old age pension under the Welfare Act 1989. As a result, this income will now be taxable income under the ITA.

Clause 8: Section 43 repealed
This clause repeals section 43 as the provision is spent and is no longer required.

Clause 9: Section 44 replaced
This clause replaces current section 44. It sets out the standard deduction to be applied when calculating the taxable income for any income year for all categories of natural persons (residents, non-residents, permanent arrivals, and permanent departures).

Clause 10: Section 46 amended
This clause amends section 46, which relates to what items are assessable income for the purposes of the ITA. The amendment ensures income derived from films is included as assessable income and is related to the amendment in *clause 15* that repeals current section 76 (and which provides a separate income assessment regime for the renting of films).

Clause 11: New section 56A inserted
This clause inserts new section 56A into the ITA, which provides rules to counter transfer pricing abuses.

New subsection (1) applies to a transaction that is not an arm's length transaction (as now defined in section 2). By virtue of this definition, new subsection (1) applies to any transaction that is not a transaction between independent persons dealing with each other at arm's length. In the case of non-arm's length transactions, new subsection (1) empowers the Collector to distribute, apportion, or allocate income, gain, deductions, or tax credits between the parties to the transaction as is necessary to reflect the tax position that would have been realised in an arm's length transaction.

Non-resident persons, in particular, may use transfer pricing as a means of reducing the level of taxable profits derived from the Cook Islands. For example, a non-resident parent company may supply goods or services to a Cook Islands subsidiary for a price that is greater than the price that would be expected in an arm's length transaction so as to reduce the taxable income of the Cook Islands subsidiary. For this reason, new subsection (2) provides that if a party to a transaction to which new subsection (1) applies is located in, and subject to tax in, the Cook Islands, and another party to the transaction is located outside the Cook Islands, any distribution, apportionment, or allocation of income, gain, deductions, or tax credits must be made in accordance with regulations made under the Act. These regulations will provide for transfer pricing adjustments based on internationally accepted norms as developed by the Organisation of Economic Co-operation and Development (**OECD**).

New subsection (3) provides that the allocation of income and deductions to a permanent establishment in the Cook Islands of a non-resident person or a permanent establishment outside the Cook Islands of a resident person must be made in accordance with regulations made under the Act. As explained above, a definition of "permanent establishment" has been inserted into section 2 for this purpose. As also explained above, the definition is consistent with that used in tax treaties. Again, these regulations will provide income and expense allocation rules based on internationally accepted norms developed by the OECD.

Multinational enterprises and foreign governments are well familiar with the OECD Guidelines on transfer pricing and it is important that adjustments are made that are consistent with OECD norms.

Clause 12: Section 57 amended
This clause amends section 57 of the ITA which provides that no deductions may be made for the purpose of calculating assessable income unless the deductions are expressly provided for

by the Act. *Clause 12* inserts two new subsections to require actual payment to the Collector of the tax deductions made under Parts VII or IX to be made before any allowable deduction for making the payments can be made by the person.

Clause 13: New section 71A inserted

This clause inserts new section 71A into the ITA, which provides rules to counter thin capitalisation abuses.

Thin capitalisation practices are commonly used by multinational enterprises to limit source country taxation. Thin capitalisation involves taking advantage of the different tax treatment between dividends and interest. If a multinational enterprise finances a Cook Islands subsidiary with equity (i.e. shares), the return is dividends, which are paid after company tax is paid. In other words, dividends are not a deductible expense. Thus, a Cook Islands subsidiary will pay corporate tax at the rate of 20% on its taxable income. If it pays a dividend to the foreign parent company out of its after tax profits, the dividend is subject to withholding tax at the rate of 15%. This gives an effective Cook Islands tax rate on an equity investment of 32%.[1] This can be compared with a debt investment, which gives rise to interest, which is a deductible business expense. Because of the tax deduction, no corporate tax is paid on the profits of the Cook Islands subsidiary that are used to pay the interest to the parent company. The interest is subject to withholding tax at the rate of 15%, which means that the effective rate of tax on a debt investment is 15% (less than half the effective rate on an equity investment). This provides a strong incentive for multinational enterprises to finance their Cook Islands operations through the excessive use of debt. The purpose of new section 71A is to counter such practices.

New subsection (1) provides that a foreign-controlled resident company that has a debt-to-equity ratio in excess of 1.5:1 at any time during an income year is disallowed a deduction for the interest paid by the company during the year on the excess debt. The subsection applies only to a "foreign-controlled resident company", which is defined in new subsection (3) as a resident company in which 50% or more of the shares in the company are held, directly or indirectly, by a non-resident person either alone or together with an associate or associates. "Associate" is defined in subsection (4) to refer to a relationship that exists between persons when one person acts in accordance with the wishes of another or it is reasonable to expect that they will so act. This is an objective test to be determined having regard to all the circumstances. If one person is an associate of another person under the definition, it is expressly provided that both persons are treated as associates of each other. The following are examples of persons that would ordinarily be regarded as associates: husband and wife, parent and child, partners in a partnership, beneficiary and trustee, and controlling shareholders and the company they control.

It is expressly provided that the section does not apply if the foreign-controlled resident company is a bank (which is defined in section 2 as a person licensed to carry on banking business in or from the Cook Islands under the Banking Act 2003). This is because a bank's business involves dealing in money and, therefore, it is usual for a bank to have significant levels of debt.

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[1] Assuming a $100 of taxable income and 20% corporate tax rate, the after tax profits are $80. If all the after tax profits are repatriated as a dividend, the withholding tax is $12 ($80 x 15%). Thus, the total Cook Islands tax is $32 ($20 + $12). This gives an effective tax rate of 32%.

For the purposes of calculating the debt-to-equity ratio of a foreign-controlled resident company for a tax year, the amount of debt (defined in new subsection (3)) is the greatest amount, at any time during the income year, of the debt obligations of the company on which interest is payable as determined according to the current International Financial Reporting Standards. Only interest-bearing debt is taken into account in calculating the level of debt. "Debt obligation" is defined in new subsection (3) to mean an obligation to make a repayment of money to another person, including obligations arising under promissory notes, bills of exchange, and bonds, but does not including accounts payable or a repayment on money on which no interest is payable. The amount of equity (defined in new subsection (3)) is the greatest amount, at any time during an income year, of the equity of the company as determined according to International Financial Reporting Standards. It is expressly provided that equity includes debt obligations on which no interest is payable.

New subsection (2) provides an exception to new subsection (1) if, at all times during the income year, the amount of debt of the company does not exceed the arm's length amount of debt (as defined in new subsection (3)).

Clause 14: Section 75 replaced
This clause replaces current section 75 of the ITA, which provides for the taxation of non-resident owners (and charterers) of aircraft and ships for their carriage of merchandise, goods, livestock, mail, and passengers outside of the Cook Islands.

New section 75 retains the status quo in relation to ships, and deems 5% of the gross amount paid or payable for the carriage to be taxable income of the owner. The position with respect to aircraft is amended by new subsection (2) so that the amount for the carriage must be included in the total income derived by the owner unless an Order in Council made under new subsection (5) exempts or varies the application of new subsection (2) in relation to an owner.

Clause 15: Heading before section 76 and section 76 repealed
This clause repeals the heading before section 76 and section 76 of the ITA to remove the special regime applying to the assessment of film renters for income tax.

Clause 16: Section 82 amended
This clause amends section 82(1) of the ITA, which sets out when a natural person is deemed to be a resident of the Cook Islands. The amendment, by way of replacement of the subsection, adds a second limb to the test by requiring a person to be personally present in the Cook Islands for more than 183 days over a 12-month period. This requirement is commonly known as the "183-day rule".

Clause 17: Section 83 amended
This clause amends section 83 of the ITA, which provides rules for determining whether income is derived from geographic sources in the Cook Islands. Section 83 of the ITA is primarily relevant to section 80 of the ITA, which states the jurisdictional limits on the income tax imposed under section 39 of the ITA. In broad terms, under section 80 of the ITA, a resident person is liable for tax on worldwide income and a non-resident person is liable for tax only on income derived from the Cook Islands. The charge to tax in relation to direct and indirect disposal of mining rights and information is in new sections 143F and 143H.

The clause amends section 83(1) by inserting five new source rules –

(1) New section 83(1)(la) provides that an amount derived on disposal of a mineral extracted in the Cook Islands is deemed to be derived from the Cook Islands. This rule is necessary because the extracted resource is likely to be transferred offshore for processing before being sold. The intention is that, regardless of where the contract of sale is made, the sale proceeds will have a Cook Islands source if they relate to minerals extracted in the Cook Islands. Current section 83(1) is expressed to be subject to section 84, which provides for apportionment when part of an economic activity occurs in the Cook Islands and part occurs outside the Cook Islands. The Bill amends section 84 so that it explicitly applies to mining. This means that, if the extraction occurs in the Cook Islands and the processing occurs outside the Cook Islands, the sale proceeds have to be apportioned on any reasonable basis between those two locations.

(2) New section 83(1)(lb) provides that a natural resource amount is derived from the Cook Islands if it relates to the taking of minerals or a living or non-living resource from the Cook Islands. As discussed above, the main example of a natural resource amount is a private overriding royalty. The Bill amends the definition of "withholding income" in section 98 to include a natural resource amount derived from the Cook Islands. A natural resource amount derived from the Cook Islands is subject to withholding tax under section 100 at the rate of 15%. In the context of seabed mining, this means that the mineral is extracted in the Cook Islands, including in the territorial sea or exclusive economic zone of the Cook Islands (see new definition of "Cook Islands" inserted by *clause 5*).

(3) New section 83(1)(lc)(i) provides that an amount derived on disposal of immovable property in the Cook Islands, or an interest in immovable property in the Cook Islands, is derived from the Cook Islands. The reference to "amount" is intended to cover whatever is taxable – the gross proceeds of disposal or the gain arising on disposal. This means, for example, that a gain arising on disposal of an exploration licence over an area in the territorial sea or exclusive economic zone of the Cook Islands is derived from the Cook Islands. An example of the disposal of an "interest" in immovable property is the disposal of a percentage interest in an exploration licence (such as a 25% interest in the licence).

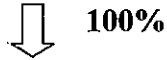
(4) New section 83(1)(lc)(ii) provides that a gain derived on disposal of an interest in an entity is derived from the Cook Islands if the interest derives 20% or more of its value, directly or indirectly, from immovable property in the Cook Islands. Again, the reference to "amount" is intended to cover whatever is taxable – the gross proceeds of disposal or the gain arising on disposal.

The purpose of this rule is to protect the integrity of the rule in new section 83(1)(lc)(i) by preventing avoidance of that rule through an indirect disposal of immovable property. An interest in an entity (such as shares in a company) derives its value from the assets held by the entity. Thus, if the principal asset of an entity is a mining title, the value of the interest in the entity will equate to the value of the title. This means that, instead of the entity that holds a title making a gain by selling its interest in the title, an equivalent gain could be made by the owners of the entity selling their interest in the entity. Indeed, it is a common form of tax planning for non-

residents to invest through a multi-tier non-resident entity structure so as to facilitate possible tax-free exit from the investment. This is illustrated by the following example –

Example 1

Non-resident Company (NRC)



Contractor Company

Cook Islands immovable property (including a mining title)

In this example, instead of Contractor Company selling its interest in a mining title, NRC could make an equivalent gain by selling the shares in Contractor Company. In the absence of new section 83(1)(lc)(ii), the gain made by NRC is unlikely to be derived from the Cook Islands as NRC has no business operations in the Cook Islands and the contract of transfer is likely to be entered into outside the Cook Islands.

New section 83(1)(lc)(ii) provides that a gain is derived from the Cook Islands if it is derived from the disposal of an interest in an entity, if the interest derives 20% or more of its value, directly or indirectly, from immovable property in the Cook Islands. Example 1 illustrates the case when a gain relates to an interest in an entity that derives 20% or more of its value directly from immovable property in the Cook Islands. Example 2 below illustrates the case when a gain relates to an interest in an entity that derives 20% or more of its value indirectly from immovable property in the Cook Islands.

Example 2

Non-resident company 1 ("NR1")

Non-resident company 2 ("NR2")

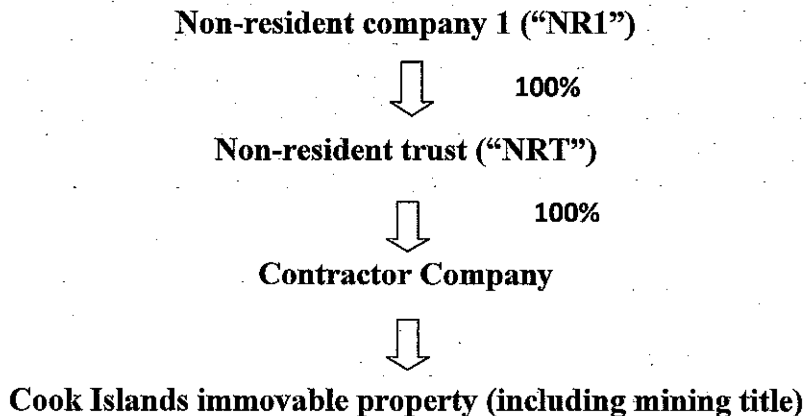
Contractor Company

Cook Islands immovable property (including mining title)

In this example, the value of the shares held by NR1 in NR2 is derived directly from the value of the shares held by NR2 in Contractor Company. As the value of the shares held by NR2 in Contractor Company is derived directly from the value of the immovable property of Contractor Company, the value of the shares held by NR1 in NR2 is derived indirectly from the immovable property of Contractor Company. The reference to the value being derived indirectly is intended to apply down an unlimited number of tiers of non-resident entities.

If new section 83(1)(lc)(ii) were limited to the disposal of shares in a company, then it could be avoided by interposing a non-corporate entity, such as a limited partnership or trust. For this reason, section 83(1)(lc)(ii) applies to the disposal of an interest in an entity. "Entity" is now defined broadly in section 2 (see amendment made by *clause 5(2)*). While it will include partnerships and trusts, the definition is also broad enough to cover foreign-formed entities for which there is no legal equivalent under Cook Islands law, such as a Liechtenstein foundation, which is similar to a trust. This is illustrated below:

Example 3



In this example, as the value of the shares held by NRT in Contractor Company is derived directly from the value of the immovable property of Contractor Company, the value of the interest held by NR1 in NRT is derived indirectly from the immovable property of Contractor Company.

The reference in new section 80(1)(lc)(ii) is to the value of the interest. The term "value" is used rather than cost, which means that the determination of the threshold is based on the market value of the immovable property.

(5) New section 83(1)(lc)(iii) provides that an amount included in assessable income under new sections 143D(5) or (6), 143F(1), (2)(a) or (4), or 143G(3) is derived from the Cook Islands. In the case of new sections 143D(5) or (6), and 143F(1), (2)(a) or (4), the amount included in assessable income is, in effect, a reimbursement of deductions, so should, as a matter of general principle, have a Cook islands source, but a specific rule has been included for the avoidance of doubt. Generally, new section 143G(3) will be covered by new section 83(1)(lc)(i) (as the cash amount is

consideration for disposal of an interest in immovable property), but there may be cases when there is no transfer of the interest as the work commitments are not competed, so a separate inclusion rule has been added to ensure such amount has a Cook Islands source.

Clause 18: Section 84 amended

This clause amends section 84 of the ITA, which provides for the apportionment of the source of income when business activities are conducted partly in the Cook Islands and partly outside the Cook Islands.

One situation when the section currently explicitly applies is when "successive steps of production or manufacture" occur in different countries. The section has been amended to also explicitly apply when successive steps of extraction and processing of minerals occur in different countries (as will likely be the case with seabed mining). In particular, a contractor may extract minerals in the Cook Islands and process them outside the Cook Islands. In this case, the gross proceeds of sale of the minerals must be apportioned between Cook Islands as the country of extraction and the country of processing on any reasonable basis as determined by the Collector. That part apportioned to extraction is treated as having been derived in the Cook Islands.

Clause 19: Section 86 amended

This section amends section 86 of the ITA, which provides for the entering into of a double tax agreement (**DTA**) between the Cook Islands and another country (referred to as the "contracting state"). The amendment inserts new subsections (6) and (7).

In broad terms, the effect of a DTA may be to modify the application of the Cook Islands income tax law as it applies to income derived in the Cook Islands by a resident of the contracting state. For example, under a DTA, the Cook Islands will be able to tax the business profits of a person who is a resident of the contracting state only if that person has a permanent establishment in the Cook Islands to which the profits are attributable. Similarly, a DTA may provide for a lower withholding tax rate applicable to dividends, interest and royalties derived in the Cook Islands by a resident of the contracting state. These DTA benefits may encourage residents of countries with which the Cook Islands does not have a DTA to invest in the Cook Islands through an entity established in a country with which the Cook Islands does have a DTA so as to take advantage of the exemption from, or reduction in, Cook Islands tax provided for in the DTA. This practice is known as "treaty shopping".

The effect of new subsection (6) is that, if an entity (particularly a company) cannot satisfy the underlying ownership requirement specified in the subsection, the entity cannot take advantage of any exemption, exclusion, or reduction in the rate of tax in a DTA. For example, a subcontractor to which new section 143I(1) applies may incorporate a subsidiary in a country with which the Cook Islands has a DTA through which the services are provided so as to obtain the benefit of the business profits article in that DTA to exclude the liability under new section 143I(1). Similarly, an entity may be established in a DTA country to take advantage of a lower rate of tax under the articles of the DTA relating to dividends, interest, or royalties. If the resident of the contracting state does not satisfy the underlying ownership requirement in subsection (6), the entity cannot take advantage of these benefits.

An entity satisfies the underlying ownership requirement if 50% or more of the underlying ownership of the entity is held by an individual or individuals who are resident of the

contracting state. In other words, the underlying ownership (as now defined in section 2 by an amendment made to that section by *clause 5(2)*) of the entity must also be located in the contracting state. In broad terms, the underlying ownership of an entity is a reference to the ultimate beneficial ownership of the entity determined by tracing through entities until it is not possible to trace any further.

New subsection (7) provides that new subsection (6) does not apply if the resident of the contracting state is a public company listed on the stock exchange of that state. This recognises the difficulty of tracing the ultimate beneficial ownership of a publicly listed company.

Clause 20: Heading to Part VII amended
This section amends the heading of Part VII of the ITA to include a reference to "natural resource amounts".

Clause 21: Section 98 amended
This clause amends section 98 of the ITA, which defines terms for the purposes of Part VII, which relates to withholding tax on dividends, interest and royalties. The amendment now limits interest within the meaning of the definition to interest derived from the Cook Islands and paid to a non-resident while also including natural resource amounts derived from the Cook Islands and paid to a non-resident.

Clause 22: Section 100 amended
This clause amends section 100 of the ITA, which imposes a withholding tax of 15% on persons who derive withholding income, by adding new subsections (4) and (5). New subsection (4) provides that withholding tax paid under the section is the final tax in respect of the income concerned. New subsection (5) sets the rate of the tax at 30% if the withholding income is interest earned on a bank account where the account holder has not provided the bank with the holder's RMD number. As noted previously, this amendment comes into force as from 1 January 2015.

Clause 23: Section 105 repealed
This clause repeals section 105 of the ITA as the contents of the section are now incorporated into section 100 by way of the amendments made to that section by *clause 22* above.

Clause 24: New Part 8A inserted
This clause inserts new Part 8A into the ITA, which provides special rules for the taxation of seabed mining operations.

The application of new Part 8A is explained below.

New section 143A: Part 8A Interpretation

This section provides for the definition of terms used in new Part 8A. New subsection (1) provides for specific definitions of terms and new subsection (2) provides a rule of interpretation to the effect that any term that is not defined in the ITA but which is defined in the Seabed Minerals Act has its meaning in that latter Act (unless the contrary intention appears). This ensures that there is consistency in the meaning of terms used in both Acts.
The terms defined in subsection (1) are explained as follows:

Commencement date

This term is relevant to the computation of the cash balance of a contractor under new section 143K. "Commencement date" is defined by reference to a contractor. It means the start of the first income year of the contractor to which new Part 8A applies.

Commencement of commercial production

This term is relevant to new section 143C(3), which provides that the depreciation of development expenditure (also defined in new section 143A(1)) incurred prior to commercial production starts from the date of commencement of commercial production.

"Commencement of commercial production" is defined to mean the first day of the first period of 30 consecutive days during which the average level of production on the 25 highest production days in the 30-day period reaches a production level as determined by the Collector acting on the advice of the Seabed Minerals Commissioner. Computing the average over 25 days rather than the full 30-day period allows for the possibility of any exceptional or temporary production difficulties affecting operations in the early period of production.

Contractor

This term is central to the operation of new Part 8A as the provisions in the Part apply to contractors.

"Contractor" is defined to mean a person who has been issued with a title. "Person" has the meaning in section 2 extended by the definition in new section 143A(1) to include an "entity" (as defined in section 2). Thus, "person" will include an individual, body of persons, company, partnership, trust, and any similar body or association, and a government. While the definition of person is broad, it would be expected that a contractor would normally be a company. "Title" is newly defined in section 2 by an amendment made by *clause 5* to have the meaning given in the Seabed Minerals Act.

Section 7 of the Seabed Minerals Act defines "title" to mean a licence, permit or lease granted under that Act. "Licence" is defined in section 7 of that Act as an exploration or mining licence granted under that Act. "Permit" is defined in section 7 of the Seabed Minerals Act as a prospecting permit granted under that Act. While "lease" is not defined in section 7 of the Seabed Minerals Act, it is clearly a reference to a retention lease, which is granted under section 146 of that Act.

Accordingly, taking account of the definition of "title" in the Seabed Minerals Act, the following persons are contractors for the purposes of new Part 8A of the ITA:

(1) A person granted an exploration licence under section 106 of the Seabed Minerals Act.

(2) A person granted a mining licence under section 178 of the Seabed Minerals Act.

(3) A person granted a prospecting permit under section 84 of the Seabed Minerals Act.

(4) A person granted a retention lease under section 146 of the Seabed Minerals Act.

Development expenditure

This term is relevant to new section 143C(2) and (3) (which provide for the depreciation of development expenditure) and new section 143K (which provides for the computation of the cash balance of a contractor).

"Development expenditure" means capital expenditure incurred in undertaking recovery operations authorised under a mining licence granted under the Seabed Minerals Act. "Recovery operations" is not a defined term in the ITA and, therefore, by virtue of new subsection (2), has the meaning given by section 7 of the Seabed Minerals Act, namely "any activity that is directly related to the recovery of minerals including, but not limited to, mining and other operations to extract a mineral from its natural state on the seabed or from the subsoil of the Seabed of the Cook Islands". In broad terms, recovery operations occur after the search for minerals has ceased and a mining licence has been issued.

Development expenditure is confined to capital expenditure. Generally, expenditure is capital in nature if it has a useful life of more than one year. The normal rules on deductibility in section 58 of the ITA apply to expenditure of a revenue nature incurred in undertaking recovery operations (i.e. operating expenditure). It is also confined to capital expenditure that is authorised under the mining licence.

The definition expressly includes expenditure incurred on the following:

(1) The acquisition of an interest in a title, but not including an interest in a prospecting permit, exploration license, or retention lease that is acquired (i) from the Government or (ii) under a farm-out agreement (separately defined), as these are treated as exploration expenditure. Expenditure incurred in acquiring an interest in a title in any other circumstances is development expenditure. This is the case regardless of when the expenditure is incurred. In particular, it will include expenditure incurred to acquire the interest before recovery operations commence. The cost of acquiring a title is treated as development expenditure regardless of whether the acquisition is by way a grant of the title under the Seabed Minerals Act or by transfer from another person.

(2) The acquisition of information relating to mining operations (as separately defined), but not including prospecting information acquired (i) from the Government or (ii) under a farm-out agreement (separately defined, as these are treated as exploration expenditure. Expenditure incurred in acquiring information relating to mining operations in any other circumstances is development expenditure. This is the case regardless of when the expenditure is incurred. In particular, it will include expenditure incurred to acquire the information before recovery operations commence.

The definition expressly excludes expenditure incurred in acquiring plant, machinery, equipment, or other property depreciated under the ITA. This would cover, for example, expenditure incurred in the acquisition of a ship. Such expenditure is not development expenditure and the normal depreciation rules apply to the cost of acquiring the ship. Consequently, development expenditure is confined to intangible expenditure (including in the acquisition of a mining licence and mining information).

Environmental fund

This term is relevant to new section 143D, which provides for the tax treatment of amounts contributed to, and payments out of, an environmental fund.

"Environmental fund" is defined to mean a fund or account required to be established under Chapter 8 of the Seabed Minerals Act in relation to a title to provide for the future payment of remedial work to the title area and is managed jointly by the contractor and the Seabed Minerals Authority. The remedial work may relate to rectifying environmental damage or to rehabilitating the title area on completion of all mining operations.

Exploration expenditure

This term is relevant to new section 143C(1) (which allows an outright deduction for exploration expenditure incurred by a contractor).

"Exploration expenditure" means expenditure incurred in undertaking operations authorised under a prospecting permit, exploration licence, or retention lease.

An exploration licence is granted under section 106 of the Seabed Minerals Act. The holder of an exploration licence has an exclusive right to undertake exploration and prospecting operations in the block(s) covered by the licence. A prospecting permit is granted under section 84 of the Seabed Minerals Act. The holder of a prospecting permit has a non-exclusive right to undertake prospecting operations in the block(s) covered by the permit. A retention lease is granted under section 146 of the Seabed Minerals Act. A retention lease is issued when the lessee has identified and evaluated a mineral deposit in a location but recovery is not commercially viable in the short term but may be viable in the longer term. The lessee is permitted to explore for minerals and recover minerals on an appraisal basis in the lease area but cannot undertake commercial mining activities.

Under section 7 of the Seabed Minerals Act, "prospecting operations" is defined as "operations associated with the search for minerals on the seabed of the Cook Islands including estimation of the composition, sizes, and distribution of minerals and their economic values, without any exclusive rights". Similarly, under section 7 of the Seabed Minerals Act, "exploration operations" is defined as "operations associated with the search for minerals in a title area with exclusive rights, and includes operations involving the analysis of minerals and mineral deposits, the testing of collecting systems and equipment, processing facilities and transportation systems, and the carrying out of studies on environmental, technical, economic, commercial and other factors necessary to be undertaken prior to the commencement of recovery operations".

Exploration expenditure is confined to expenditure that is authorised under a prospecting permit, an exploration licence or a retention lease.

The definition expressly includes expenditures incurred on the following:

(1) The acquisition of an interest in a prospecting permit, an exploration licence or a retention lease granted under the Seabed Minerals Act, but only if the interest is acquired (i) from the Government or (ii) under a farm-out agreement (separately

defined). An interest in a prospecting permit, exploration licence or retention lease will usually be acquired from the Government on the initial signing of the permit, licence or lease. In broad terms, a farm-out agreement is entered into when a contractor wants to spread the risk of exploration. It involves a person agreeing to undertake some or all of the contractor's work commitments under a title in return for an interest in the title. The cost of other transfers of an interest in a prospecting permit, exploration licence, or retention lease are not treated as exploration expenditure as there is likely to be less uncertainty about the value of the interest than when the interest is acquired from the Government or under a farm-out agreement. In other words, such transfers are likely to involve access to known mineral resources and, therefore, the cost of the interest is properly treated as development expenditure.

(2) The acquisition of prospecting information, but the acquisition is limited to information acquired (i) from the Government or (ii) under a farm-out agreement (separately defined). "Prospecting information" is information associated with prospecting or exploration operations, or operations associated with a retention lease. Information acquired in other circumstances is likely to relate to known resources and, therefore, the cost of the information is properly treated as development expenditure.

The definition expressly excludes expenditure incurred in acquiring plant, machinery, equipment, or other property depreciated under the Act. This would exclude, for example, expenditure incurred in the acquisition of a ship from being exploration expenditure. As such expenditure is not exploration expenditure, the normal depreciation rules apply to the cost of acquiring the ship. This means, in effect, that exploration expenditure is confined to intangible expenditure (including in the acquisition of rights and information).

Farm-out agreement

This term is relevant to the definition of "exploration expenditure".

"Farm-out agreement" is defined to mean an agreement to which new section 143G applies. In broad terms, a farm-out agreement is an agreement for the transfer of an interest in a title when the consideration for the transfer includes the transferee undertaking the transferor's work commitments under the title.

Mining information

This term is relevant to new section 143F (which in part applies to the disposal of mining information).

"Mining information" is defined as information associated with recovery operations. As "recovery operations" is an undefined term in the ITA, by virtue of new subsection (2), it has the meaning in section 7 of the Seabed Minerals Act, namely "any activity that is directly related to the recovery of minerals including, but not limited to, mining and other operations to extract a mineral from its natural state on the seabed or from the subsoil of the Seabed of the Cook Islands".

Mining operations

This term is relevant to the new section 143A definition of "subcontractor", new section 143D (environmental funds), and new section 143E (ring fencing of mining operations in calculating taxable income).

"Mining operations" is defined to mean prospecting, exploration, or recovery operations, or operations undertaken under a retention lease. The terms "prospecting operations", "exploration operations", "recovery operations", and "retention lease" are undefined in the ITA and, therefore, by virtue of new subsection (2), they have their meaning in the Seabed Minerals Act.

"Prospecting operations" is defined in section 7 of the Seabed Minerals Act to mean "operations associated with the search for minerals on the seabed of the Cook Islands including estimation of the composition, sizes, and distribution of minerals and their economic values, without any exclusive rights".

"Exploration operations" is defined in section 7 of the Seabed Minerals Act to mean "operations associated with the search for minerals in a title area with exclusive rights, and includes operations involving the analysis of minerals and mineral deposits, the testing of collecting systems and equipment, processing facilities and transportation systems, and the carrying out of studies on environmental, technical, economic, commercial and other factors necessary to be undertaken prior to the commencement of recovery operations".

"Recovery operations" is defined in section 7 of the Seabed Minerals Act to mean "any activity that is directly related to the recovery of minerals including, but not limited to, mining and other operations to extract a mineral from its natural state on the seabed or from the subsoil of the Seabed of the Cook Islands".

The definition also includes activities undertaken under a retention lease. A retention lease is granted under section 146 of the Seabed Minerals Act. A retention lease is issued when the lessee has identified and evaluated a mineral deposit in a location but recovery is not commercially viable in the short term but may be viable in the long term. The lessee is permitted to explore for minerals and recover minerals on an appraisal basis in the lease area but cannot undertake commercial mining activities.

Person

This term is relevant to the definitions of "contractor" and "subcontractor". A contractor is defined to mean a person issued with a title and a subcontractor is a person supplying services to a contractor in respect of mining operations. It is important, particularly in the case of a subcontractor, that "person" has a broad meaning.

"Person" is defined to have the meaning in section 2 of the ITA and to include an entity. "Entity" is newly defined in section 2 to mean a government, and a company, partnership, trust, or similar body or association. "Person" is defined in section 2 to include "a company, a corporation sole, and also a body of persons, whether incorporated or not, and a local or public authority". The definition in section 2 is inclusive so "person" otherwise has its meaning under the Acts Interpretation Act 1924, namely "person includes a corporation sole, and also a body of persons, whether corporate or unincorporated". It would appear that there

is nothing in the definition of "person" in the Acts Interpretation Act that is not included in the definition of "person" in section 2 of the ITA.

The definition in section 2 of the ITA (and the Acts Interpretation Act) will include an individual and any other entity that has separate legal status under general law.

It is uncertain, though, whether the section 2 definition includes a partnership or trust. This will be important, particularly, in determining whether the reference to a subcontractor in new Part 8A covers a provider of services who is a partnership or trust (although, it may not be common for services to be provided through a trust). It may be that the reference to "body of person" is broad enough to cover a partnership (but not trust), although it is more likely that "body of persons" refers to a less formal relationship than a partnership.

To ensure that the reference to "person" in new Part 8A covers a broad range of entities (including partnerships and trusts), an extended definition of "person" has been inserted providing that "person" includes an entity as defined in section 2. Thus, person will include an individual, body of persons, government, company, partnership, trust, and any similar body or association.

Prospecting information

This term is relevant to new sections 143F (which applies in part to the disposal of prospecting information).

"Prospecting information" is defined to mean information associated with prospecting or exploration operations, or operations associated with a retention lease. As "prospecting operations", "exploration operations" and "retention lease" are undefined terms in the ITA, by virtue of new subsection (2), they have their meaning in the Seabed Minerals Act.

Seabed Minerals Authority

This term is relevant to new section 143D, which provides for a deduction for the cost of remedial work to mine sites, including for contributions by a contractor to an environmental fund established to finance remedial work. The Seabed Minerals Authority is the Cook Islands Seabed Minerals Authority established under section 16 of the Seabed Minerals Act.

Seabed Minerals Commissioner

This term is relevant to the definition of "commencement of commercial production. The Seabed Minerals Commissioner is the Seabed Minerals Commissioner appointed under section 24 of the Seabed Minerals Act.

Subcontractor

This term is primarily relevant to new section 143I, which provides for the imposition of withholding tax on service fees paid by a contractor to a subcontractor.

A "subcontractor" is a person supplying services to a contractor in respect of mining operations undertaken by the contractor. "Person" has the meaning in section 2 extended by the definition in new section 143A(1) to include an "entity" (as defined in section 2). Thus,

"person" will include an individual, body of persons, government, company, partnership, trust, , and any similar body or association. As many subcontractors will be non-resident, it is important that the definition of "person" is broad to cover the range of possible entities (including foreign government bodies) that may supply services to a contractor.

"Mining operations" is separately defined in new section 143A to mean prospecting, exploration or recovery operations, or operations under a retention lease.

It is expressly provided that a person supplying services to a contractor as an employee is not a subcontractor. The normal wage withholding rules apply to employment income paid to an employee of a contractor.

A subcontractor may be a resident person, a non-resident person with a Cook Islands permanent establishment, or a non-resident person without a Cook Islands permanent establishment. Withholding tax is imposed under new section 143I only on service fees paid to a non-resident that does not have a permanent establishment in the Cook Islands.

143B. Taxation of Contractors and Subcontractors

This section sets out the basic principles of taxation of contractors and subcontractors (as defined in new section 143A).

New subsection (1) provides that a contractor and a subcontractor are subject to tax in accordance with the ITA but subject to the modifications in new Part 8A. This means that a contractor and subcontractor are subject to the normal operation of the ITA as modified by new Part 8A. Thus, all the provisions of the ITA (including those dealing with procedural matters) apply to contractors and subcontractors except to the extent to which new Part 8A modifies the application of those provisions.

New subsection (2) expressly provides that, if there is any inconsistency between new Part 8A and the other provisions of the ITA, new Part 8A applies.

New subsection (3) specifies the rate of corporate tax applicable to a contractor. For a resident contractor, the corporate rate is 20% and, for a non-resident contractor, the corporate rate is 28%. The residence of a company is determined under section 82(2) of the ITA. This provision is included for fiscal stability purposes. The intention is that fiscal stability applies for the benefit of both the contractor and the Government. The rate of corporate tax remains at 20% (resident companies) or 28% (non-resident companies) regardless of whether the general corporate rate is increased (stability for the contractor) or reduced (stability for the Government). In the absence of this subsection, an increase in the general corporate tax rate will increase the Government's take from mining operations and a decrease in the corporate tax rate will increase the contractor's take. Thus, the purpose of new subsection (3) is to ensure that a change in the corporate tax rate does not automatically apply to contractors thereby (inadvertently) altering the relative takes of the Government and contractor from mining operations. New subsection (3) must be specifically amended for any change to the corporate tax rate to apply to a contractor.

143C. Exploration and Development Expenditure

This section provides for the deductibility of exploration and development expenditure.

New subsection (1) provides that a contractor is allowed a deduction for exploration expenditure incurred by the contractor in relation to a title area in the income year in which the expenditure is incurred. This means that exploration expenditure is deducted outright. "Exploration expenditure" is defined in new section 143A. In broad terms, exploration expenditure is intangible expenditure incurred during the prospecting and exploration phases in a mining project. The definition expressly includes expenditure incurred in acquiring a prospecting permit, exploration licence, or retention lease, and prospecting information. By virtue of new section 143A(2), in the context of exploration expenditure, "title area" means any of the following:

(1) An area constituted by a block or blocks in respect of which a prospecting permit is in force ("permit area).

(2) An area constituted by a block or blocks covered by an exploration licence ("licence area").

(3) An area constituted by a block or blocks covered by a retention lease ("lease area").

New section 143F provides for the taxation of any cost recapture and gain made on disposal of a permit, licence, lease, or information.

New subsection (2) provides that a contractor is allowed a depreciation deduction under the ITA on a straight-line basis for development expenditure incurred in relation to a title area on the basis that the useful life of the expenditure is the lesser of: (i) the expected life of the recovery operations in the title area to which the expenditure relates; or (ii) 10 years. "Development expenditure" is defined in new section 143A. In broad terms, development expenditure is intangible expenditure incurred in undertaking authorised activities under a mining licence. The definition expressly includes expenditure incurred in acquiring a mining licence or mining information. By virtue of new section 143A(2), in the context of development expenditure, "title area" means an area constituted by a block or blocks covered by a mining licence ("licence area").

For seabed mining, it is understood that most recovery operations in a title area will be completed within the 10-year period. Notwithstanding this, the effect of subsection (2) is to put a ceiling of 10 years on the period of depreciation of development expenditure.

New section 143F provides for the taxation of any cost recapture and gain made on disposal of a licence or information.

New subsection (3) provides that any development expenditure incurred by a contractor before commencement of commercial production is treated as incurred at the time of commencement of commercial production. This means that depreciation of the expenditure does not start until the income year in which commercial production starts. The deferral of the recognition of depreciation deductions for development expenditures to the time of commencement of commercial production provides for the accumulation of lower carry

forward losses in the early years of the recovery operations thereby resulting in earlier recognition of taxable income by a contractor.

143D. Contributions to Environmental Fund

This section provides for the tax treatment of contributions made to, and payments from, an environmental fund.

New subsection (1) provides that a contribution made to an environmental fund by a contractor under the terms of a title granted to the contractor is allowed as a deduction in the income year in which the contribution was made. The following conditions must be satisfied to qualify for the deduction:

(1) There must be a contribution by a contractor to an environmental fund. "Contractor" is defined in new section 143A to mean a person who has been granted a prospecting permit, exploration licence, mining licence or retention lease. "Environmental fund" is defined in new section 143A(1) to mean a fund established under Chapter 8 of the Seabed Minerals Act to provide for the future payment of remedial work relating to mineral operations undertaken under a title (exploration licence, prospecting permit, mining licence or retention lease). The remedial work may relate to rectifying environment damage or to rehabilitating the seabed on completion of mining operations (including removal of any equipment from the seabed). The central requirement is that the contribution is an actual outgoing of the contractor. In other words, it is more than a reserve created in the contractor's financial accounts or the giving of security.

(2) The contribution must be made by the contractor under the terms of the title granted to the contractor (i.e. the contractor must be required to make the contribution under the terms of a prospecting permit, exploration licence, mining licence or retention lease).

New subsections (2) and (3) provide for the deductibility of expenditure incurred by a contractor in carrying out remedial work in relation to a title. The deduction is provided for in subsection (2). The following conditions must be satisfied to qualify for the deduction:

(1) The expenditure must be incurred in carrying out remedial work. Examples of remedial work are specified in section 304 of the Seabed Minerals Act, such as rehabilitation of the seabed (including the removal of any property used in conducting activities under a title), conservation and protection of natural resources such as sea life, and rectification of any environmental damage.

(2) The remedial work must be in respect of a title granted to the contractor. "Title" is defined in section 2 of the ITA to have the meaning in the Seabed Minerals Act, namely a prospecting permit, exploration licence, mining licence or retention lease.

(3) The remedial work must be as directed by the Seabed Mineral Authority. This would include remedial work that is specified by the Authority in the contractor's title.

(4) The remedial work must not be paid for, directly or indirectly, from money made available out of the contractor's environmental fund for the mining operations (new

subsection (3)). This is because a deduction has been allowed already for amounts contributed to the environmental fund. Thus, the deduction allowed under new subsection (2) is for expenditure incurred by a contractor on remedial work that is in excess of the contractor's contributions to an environmental fund relating to the title in respect of which the work has been undertaken.

New subsection (4) provides that amounts accumulated in an environmental fund (including interest on the investment of contributions) or withdrawn from an environmental fund to pay for remedial work as directed by the Authority are exempt income. The accumulation is treated as exempt income because ultimately it will be used to pay for remedial work, which is a deductible expense. If any part of the accumulation is returned to the contractor, then new subsection (5) includes the amount returned in the assessable income of the contractor.

New subsection (5) provides that any surplus in an environmental fund of a contractor at the time of completion of all mining operations to which the fund relates is included in the assessable income of the contractor for the income year in which the operations are completed. To the extent that the surplus represents contributions by the contractor to the fund, the inclusion in assessable income effectively reverses the deduction previously allowed for the contribution. To the extent that the surplus represents accumulations on contributions, the inclusion in assessable income ensures that any part of the accumulation that is not used in undertaking remedial work is taxed to the contractor.

143E. Ring-fencing of mining operations

This section provides for ring fencing of mining operations undertaken by a contractor. This limits the consolidation of assessable income and deductions that otherwise applies under the ITA in the calculation of the taxable income of a contractor. In the absence of ring fencing a contractor may be able to deduct exploration expenditure incurred in relation to a new title against the assessable income derived in relation to an existing title already generating taxable income, thereby delaying the Government's revenue from the existing title.

New subsection (1) provides that a deduction for expenditures or losses incurred wholly or partly by a contractor in undertaking mining operations in a title area during an income year is allowed only against the assessable income derived by the contractor from such operations in the title area during the period. "Mining operations" is defined in new section 143A to mean prospecting, exploration, or recovery operations, or operations undertaken under a retention lease. The terms "prospecting operations", "exploration operations", "recovery operations", and "retention lease" are undefined in the ITA and, therefore, by virtue of new section 143A(2), they have their meaning in the Seabed Minerals Act.

Importantly, new subsection (1) refers to "mining operations in a title area". As title area is undefined in the ITA, it has its meaning in the Seabed Minerals Act. "Title area" is defined in section 7 of the Seabed Minerals Act to mean a "permit area, licence area or lease area". This means that the following are title areas for the purposes of this section:

(1) An area constituted by a block or blocks in respect of which a prospecting permit is in force ("permit area").

(2) An area constituted by a block or blocks covered by an exploration licence ("licence area").

(3) An area constituted by a block or blocks covered by a mining licence ("licence area").

(4) An area constituted by a block or blocks covered by a retention lease ("lease area").

As the Seabed Minerals Act defines title area by reference to a title, ring fencing applies separately for a prospecting permit, exploration licence, retention lease and mining licence even if they cover the same area. Thus, if a contractor has more than one title, the effect of new subsection (1) is that there is a separate computation of the taxable income of the contractor for each title area. For example, if a contractor has an exploration licence for one title area and a mining licence for another title area, the expenditures or loses incurred in relation to the exploration licence cannot be deducted against the assessable income derived in relation to the mining licence.

The words "wholly or partly" contemplate apportionment of expenditures that (i) relate to more than one title area or (ii) relate to a title area and to some other activity of the contractor. This will apply particularly to the general management and administration expenses of the contractor.

If the total deductions of a contractor in respect of mining operations undertaken by the contractor in a title area during an income year exceed the total assessable income for such operations in the area for the year, new subsection (2) provides that the excess is carried forward and allowed as a deduction against the assessable income of the contractor from operations in the title area in the next following income year of the contractor. The effect of new subsection (3) is that a loss in relation to a title area can be carried forward until either the loss is fully deducted (there is no time limit on the carry forward of losses) or the mining operations in the title area cease. New subsection (4) provides that losses are carried forward and deducted in the order in which they are incurred.

New subsections (5) and (6) provide for two exceptions to the ring fencing rule.

As title area is defined by reference to a title, the title area of one title may be different from the title area of another title even if there is some overlapping area. This is particularly relevant when a contractor moves from exploration to extraction in the same area. Exploration is done under an exploration licence and extraction is done under a mining licence and, therefore, the area covered by the exploration licence is a different title area to the area covered by the mining licence because the licences are different titles. As they are different title areas, in the absence of new subsection (5), ring fencing will prevent the exploration loss under the exploration licence from being deducted against the assessable income from recovery operations under the mining licence.

New subsection (5) deals with this by providing that, if a contractor has ceased mining operations under a title (for example, exploration operations under an exploration licence) in relation to a title area and the contractor has a loss under new subsection (2) in relation to the title area, the contractor may elect, by notice in writing to the Collector, to treat the loss as a loss under new subsection (2) in relation to another title area in which the contractor undertakes mining operations if the area covered by the second-mentioned title area falls wholly within the area covered by the first-mentioned title area. It is noted that the two title areas do not have to be the same, rather the area of the second title area must be covered by the area of the first title area. Ordinarily, the title area for a mining licence will be a smaller

area than that covered by an exploration licence because of the relinquishment of areas required under the exploration licence. Provided the title area for the recovery operations falls wholly within the title area for the exploration operations, they are effectively treated as the same title area for the purposes of ring fencing.

New subsection (6) applies when the following conditions are satisfied:

(1) A contractor has ceased mining operations under a title. By virtue of the new section 143A definition of "mining operations", the mining operations may be prospecting, exploration or recovery operations, or operations under a retention lease.

(2) The contractor has a loss under subsection (2) in relation to the title area.

(3) New subsection (5) does not apply to the title area. This means that the title area is not an area in which exploration operations were undertaken and now recovery operations are undertaken in the same title area (including a smaller part of the title area under an exploration licence).

New subsection (6) applies, therefore, when a contractor has a terminal loss in relation to a title area. This can arise when the exploration operations are unsuccessful in making a commercial discovery or the recovery operations fail to generate taxable income after taking account of carry forward losses (particularly from the exploration phase of the project). It can also arise if there are high rehabilitation costs in the final year of operations and the balance in the contractor's environmental fund is not sufficient to cover the costs.

If the conditions in new subsection (6) are satisfied, the contractor may elect, by notice in writing to the Collector, to treat the loss as a loss incurred under new subsection (2) in relation to mining operations undertaken by the contractor in another title area. In other words, the terminal loss in relation to one title area can be transferred, at the election of the contractor, to another title area.

143F. Disposal of a Title or Information

This section provides for the taxation of the proceeds arising from the disposal of a title, or of prospecting or mining information.

New subsection (1) applies when a contractor:

(1) Disposes of a title or information the cost of which was deducted as exploration expenditure under new section 143C(1). This covers a prospecting permit, exploration licence, retention lease, or prospecting information acquired from the Government or under a farm-out agreement.

(2) Otherwise recovers or recoups an amount deducted as exploration expenditure under new section 143C(1).

If new subsection (1) applies, the consideration for the disposal, or the amount recovered or recouped, is included in the assessable income of the contractor in the income year in which the title or information is disposed of, or the amount is otherwise recovered or recouped. If the contractor is a non-resident, section 80 of the ITA provides that the non-resident is

taxable only on income derived from the Cook Islands. New section 83(1)(lc)(iii) of the ITA (inserted by the Bill) treats an amount included in assessable income under new section 143F(1) as derived from the Cook Islands.

The effect of new subsection (1) is to "rewrite" the deduction allowed under new section 143C(1) for exploration expenditure when the contractor recaptures that expenditure through a disposal of the title or information, or in other circumstances. In the case of the disposal of a title or information, if the consideration for the disposal exceeds the cost of the title or information, the excess is also taxed through the operation of new subsection (1). Consistent with the deduction rule in new section 143C(1), the consideration for the right or information is included in income regardless of whether the interest or information is held on revenue or capital account.

New subsection (2) applies to the disposal by a contractor of a title or mining information the cost of which was deducted under new section 143C(2). Thus, new subsection (2) applies to the disposal of (i) a prospecting permit, exploration licence, retention lease, or prospecting information except when the title or information was acquired from the Government or under a farm-out agreement, or (ii) a mining licence or (iii) mining information. New subsection (2) has the following effect:

(1) No depreciation deduction is allowed for the expenditure incurred in acquiring the title or information in the income year in which the title or information is disposed.

(2) If the consideration for the disposal exceeds the written down value of the title or information at the time of the disposal, the excess is included in the assessable income of the contractor for the income year in which the title or information is disposed. If the contractor is a non-resident, section 80 of the ITA provides that the non-resident is taxable only on income derived from the Cook Islands. New section 83(1)(lc)(iii) of the ITA treats an amount included in assessable income under new section 143F(2) as derived from the Cook Islands.

(3) If the written down value of the title or information at the time of disposal exceeds the consideration for the disposal, the contractor is allowed a deduction for the excess in the income year in which the title or information is disposed.

New subsection (3) provides that the written down value of a title or information is the acquisition cost of the title or information reduced by the depreciation deductions allowed to the contractor in respect of the title or information under new section 143C(2).

Example

Contractor paid $100,000 for a mining licence. The expected life of the recovery operations under the licence is 4 years. The commencement of commercial production is the first day of the second year in which the licence was held and the licence was sold on the first day of the fourth year for $75,000. Contractor is allowed a deduction of $25,000 for the second and third years of holding the licence. At the time of disposal, the written down value of the licence is $50,000 ($100,000 - $50,000).

> The consideration for the disposal is $75,000 and the written down value is $50,000 and, therefore, $25,000 is deemed to be derived from the Cook Islands under section 83(1)(lc)(iii) and included in Contractor's assessable income under subsection (2)(a).
>
> If the consideration for the disposal is $125,000, then $75,000 ($125,000 - $50,000) is deemed to be derived from the Cook Islands under section 83(1)(lc)(iii) and included in assessable income under new subsection (2)(a).
>
> If the consideration for the disposal is $25,000, then a deduction is allowed under subsection new (2)(b) for $25,000, which is the difference between the written down value of the licence ($50,000) and the consideration received ($25,000).

New subsection (4) applies to any other deducted development expenditure that is recovered or recouped by a contractor. The effect of new subsection (4) is that the amount recovered or recouped is included in the assessable income of the contactor in the income year in which the amount is recovered or recouped. The amount is deemed to be derived from the Cook Islands under new section 83(1)(lc)(iii)).

New subsections (1) and (2) are expressed to be subject to new section 143G, which modifies the application of the subsections in the case of farm-out agreements. Of particular relevance is the exclusion of the value of work commitments from the consideration for the disposal of a title under a farm-out agreement.

143G. Farm-out agreements

This section provides for the income tax treatment of farm-out agreements. The rules in new section 143F(1) and (2) are expressed to be subject to new section 143G.

A contractor may enter into a farm-out agreement to reduce or share the risk associated with mining operations, particularly exploration. Under a farm-out agreement, the contractor ("farmor") may transfer a percentage interest in a title (such as an exploration licence) to another person ("farmee") in exchange for the farmee agreeing to meet some or all of the farmor's work commitments under the title for a specified period. Increasingly, under farm-out agreements, the consideration provided by the farmee for the transfer may include a cash amount in addition to the agreement to undertake some or all of the farmor's work commitments. The interest in the title may be transferred immediately on entering into the agreement (an "immediate transfer farm-out agreement") or the transfer may be deferred until the farmee has completed the work commitments ("deferred transfer farm-out agreement"). The cash component of the consideration may be payable on entering into the agreement even if the transfer of the interest is deferred. Further, the cash consideration paid upfront may be retained by the contractor even if the farmee does not complete the agreed work commitments.

New subsection (1) specifies the conditions that must be satisfied for the section to apply:

(1) A contractor must have entered into an agreement with a person (referred to as the "transferee") for the transfer of an interest in a title. While "title" has the meaning in the Seabed Minerals Act (i.e. a prospecting permit, exploration licence, retention lease

and mining licence), a farm-out agreement will normally relate to an exploration licence.

(b) The consideration given by the transferee wholly or partly for the interest in the title includes the transferee undertaking some or all the contractor's work commitments under the title. This is the key requirement for the section to apply. If the consideration is cash only, then the section has no application and the rules in new section 143F apply.

New subsection (2) applies when the interest in the title is transferred at the time the parties entered into the agreement (i.e. the agreement is an immediate transfer farm-out agreement). In this case, the consideration received by the contractor for the interest in the title does not include the value of any work undertaken by the transferee on behalf of the contractor under the transfer agreement. This is relevant to the application of new section 143F and means that the value of the work commitments is not included in the assessable income of the contractor under new section 143F(1) or the consideration received by the contractor for the right under new section 143F(2). This is an incentive intended to encourage exploration.

Example 1

Atlantis Ltd has been granted an exploration licence under the Seabed Minerals Act to explore for seabed minerals in the seabed area specified in the licence. The licence was granted for three years and Atlantis paid $100,000 for the licence. At the end of the three-year period, the licence was renewed for a further period of three years.

At the start of the renewal period, Atlantis enters into an agreement to transfer a 50% interest in the licence to King Neptune Ltd in return for: (i) King Neptune agreeing to undertake all of Atlantis' work commitments under the renewal of the licence; and (ii) a cash amount of $1,000,000 on signing of the agreement. The agreement provides that the 50% interest in the licence is transferred at the time of entering into the agreement. If the work commitments are not completed the agreement provides for the retransfer of the interest in the licence to Atlantis.

By virtue of new section 143C(1), Atlantis is allowed a deduction for the $100,000 paid for the licence. The transfer of the interest in the licence means that the interest in the licence is divided into two parts: (i) the 50% interest retained by Atlantis; and (ii) the 50% interest transferred to King Neptune. New section 143F(1) includes the consideration for the transfer of the 50% interest in the licence in Atlantis' assessable income. In the absence of new section 143G(2), the consideration received by Atlantis for the 50% interest transferred is the sum of $1,000,000 plus the market value of the work commitments relating to the 50% interest retained by Atlantis. The effect of new section 143G(2) is that the consideration received by Atlantis for the transfer is limited to the cash consideration (i.e. it does not include the value of the work commitments). Consequently, the amount included in assessable income under new section 143F(1) is $1,000,000. The $1,000,000 included in assessable income effectively comprises $100,000 in deduction recapture for the 50% interest transferred and $900,000 gain on disposal of the 50% interest.

New subsection (3) applies when the interest is transferred after the transferee has completed the specified work commitments under the agreement (i.e. the agreement is a deferred transfer farm-out agreement). The tax treatment of a deferred transfer farm-out agreement is more complex because a cash amount may be received by the contractor in advance of the transfer of the interest in the title and the contractor may be permitted to retain the cash even though the interest is not transferred because the transferee did not complete the agreed work commitments. In the case of a deferred transfer farm-out agreement, new subsection (3) provides that:

(1) Any amount in money payable under the agreement before the transfer of the title is included in the assessable income of the contractor in the income year in which the amount is payable. This is the case regardless of whether the interest in the title is subsequently transferred. In other words, the taxing event is the arising of the liability to pay the cash amount and not the disposal of the interest in the title.

(2) The value of any work undertaken by the transferee on behalf of the contractor is not included in the consideration received by the contractor for the transfer of the interest in the title or otherwise included in the assessable income of the contractor. It is necessary to refer to both possibilities as the interest in the title may not be transferred.

If an interest in a title is subsequently transferred under a deferred transfer farm-out agreement, new subsection (4) provides that the consideration received by the contractor for the title does not include any amount included in assessable income under new subsection (3). This is intended to prevent double counting (as the amount has already been taxed when payable under new subsection (3)).

Example 2

Atlantis Ltd has been granted an exploration licence under the Seabed Minerals Act to explore for seabed minerals in the seabed area specified in the licence. The licence was granted for three years. Atlantis paid $100,000 for the licence. At the end of the three-year period, the licence was renewed for a further period of three years.

At the start of the renewal period, Atlantis enters into an agreement to transfer a 50% interest in the licence to King Neptune Ltd in return for: (i) King Neptune agreeing to undertake all of Atlantis' work commitments under the renewal of the licence; and (ii) a cash amount of $1,000,000 on signing of the agreement. The agreement provides that the 50% interest in the licence is transferred when King Neptune completes the work commitments. The agreement provides that King Neptune has a right to access and use the title area for the purposes of undertaking the work commitments.

King Neptune completes the agreed work commitments and, at the end of three years after entering into the agreement, the 50% interest in the licence is transferred by Atlantis to King Neptune.

By virtue of new section 143C(1), Atlantis is allowed a deduction for the $100,000 paid for the licence.

The combined effect of new subsections (3) and (4) for Atlantis is –

(1) The $1,000,000 received by Atlantis upfront is included in its assessable income in the income year the agreement is entered into as that is the time the amount is payable.

(2) There are no tax consequences for Atlantis in respect of the work commitments undertaken by King Neptune. The value of the work commitments is not included in either the consideration received by Atlantis for the transfer of the interest nor the assessable income of Atlantis.

(3) No amount is included in assessable income under new section 143F on the actual transfer of the interest in the licence as the $1,000,000 has already been taxed.

143H. Disposal of an interest in an entity holding a title

This section provides for the taxation of indirect disposals of titles (i.e. instead of the contractor disposing of the title, the owner of an interest in a contractor disposes their interest in the contractor). As a title or an interest in a title is immovable property for the purposes of the ITA, the rules are framed by reference to immovable property rather titles.

New subsection (1) provides that the assessable income of a person for an income year includes the gain arising on disposal of an interest in an entity, if the interest derives more 20% or more of its value, directly or indirectly, from immovable property in the Cook Islands. New subsection (2) provides for the amount of the gain included in assessable income. If interest disposed of derive more than 50% of its value, directly or indirectly, from immovable property in the Cook Islands, the whole of the net gain is included in assessable income charged to tax. In any other case (i.e. 20%-50%), the net gain is included in assessable income on a pro rata basis.

As the entity holding the interest is likely to be a non-resident, section 80 of the ITA provides that the non-resident is taxable only on income derived from the Cook Islands. New section 83(1)(lc)(ii) of the ITA treats an amount taxable under new subsection (1) as derived from the Cook Islands. The terms of new subsection (1) are similar to new section 83(1)(lc)(ii) inserted by the Bill and the detailed discussion on that provision is relevant to the application of new subsection (1). In summary, new subsection (1) applies when:

(1) A person has disposed of an interest in an entity. "Entity" is defined in section 2 to mean a government and, a company, partnership, trust, or similar body or association. The reference to similar bodies or associations is intended to include a foreign-formed body or association that is similar to a body or association formed in the Cook Islands, such as a foundation formed in a civil law country that is similar to a trust. The meaning of "interest" will depend on the nature of the entity. It will include shares and other membership interests in a company, an interest in a partnership or trust, and

any other ownership interest in an entity. The main example of a disposal is the sale or transfer of the interest in the entity.

(2) The interest derives 50% or more of its value, directly or indirectly, from immovable property in the Cook Islands. "Immovable property" is defined in section 2 to include a title, and mining and prospecting information. "Title" is defined in section 2 of the ITA to have the meaning in the Seabed Minerals Act, namely an exploration licence, prospecting permit, retention lease and mining licence. "Mining information" and "prospecting information" are defined in new section 143A. "Mining information" means information associated with recovery operations and "prospecting information" means information associated with prospecting or exploration operations, or operations associated with a retention lease.

An interest in an entity derives its value *directly* from immovable property when the entity owns the property. An interest in an entity derives its value *indirectly* from immovable property when it relates to the capital of an entity that in turn owns an interest in other entities owning immovable property.

The reference is to the "value" of the interest being derived from immovable property, which means that the determination of the threshold is based on the market value of the property and not its cost.

"Cook Islands" is defined in section 2 and includes the territorial waters and exclusive economic zone of the Cook Islands.

New subsection (1) follows closely the taxing right in Article 13(4) of the OECD Model Tax Treaty and Article 13(5) of the UN Model Tax Treaty. The only difference is that a lower threshold applies (more than 20%) combined with the pro rata rule in new subsection (2) if the interest derives 50% or less of its value from immovable property in the Cook Islands. The taxing rule in new subsection (1) may be excluded if a tax treaty applies that does not include the equivalent of Article 13(4) of the OECD Model tax treaty or Article 13(5) of the UN Model, or the scope of the Article is narrower than under the OECD or UN Models (e.g. the treaty rule may confined to the disposal of shares in a company or the value threshold may be higher).

New subsections (3) and (4) are intended to facilitate collection of the income tax payable by a non-resident if the conditions in new subsection (1) are satisfied. New subsection (3) provides that, if there is a 10% or more change in the underlying ownership of a contractor, the contractor must immediately notify the Collector, in writing, of the change. This ensures that the Collector has access to information indicating that a person may be liable for tax under new subsection (1). It is particularly relevant when the disposal of the interest occurs offshore, although it is not limited to offshore transactions. The 10% threshold corresponds with the standard notion of a direct (rather than portfolio) investment. A threshold is necessary so that the reporting obligation does not fall on the contractor in relation to small transactions.

Further, new subsection (4) provides that, if the person disposing of the interest to which a notice is lodged under new subsection (3) is a non-resident, the contractor is liable to pay the Cook Islands tax arising as a result of the application of new subsection (1) on behalf of the non-resident. This avoids the difficulty in attempting to collect the tax from the non-resident

person who is likely to have no assets or employees in the Cook Islands. Importantly, the primary liability for Cook Islands tax rests with the non-resident, with new subsection (4) providing a mechanism for the collection of the tax. New subsection (4) simply provides a mechanism for the collection of the tax. As the primary liability remains with the non-resident, the non-resident will be entitled to any double tax relief (such as a foreign tax credit) in their country of residence in relation to the Cooks Islands tax on the gain.

143I. Withholding tax

This section provides for the imposition of withholding tax on a services fee paid by a contractor to a non-resident subcontractor. It is common for the mining sector to use a high level of subcontractors to provide services relating to the mining operations, such as drilling and geological survey services. The cost of the services is a deductible expense for the contractor and, therefore, it is important there is corresponding taxation of the service fee otherwise there is asymmetric tax treatment – the cost of the service is deductible to the contractor receiving the services but there is no corresponding taxation of the fee to the subcontractor providing the services. Asymmetric tax treatment of subcontractors can lead to revenue leakage from the mining sector.

Section 46 of the ITA includes in the assessable income of a person "all profits or gains derived from any business". *Prima facie*, therefore, the service fees derived by subcontractors are included in the assessable income of the subcontractor. However, if the subcontractor is a non-resident person, an amount is included in assessable income only if it is derived from the Cook Islands (section 80 of the ITA). Section 83(1) specifies the classes of income derived from the Cook Islands. Section 83(1)(a) provides that income derived from any business carried on in the Cook Islands is derived from the Cook Islands and section 83(1)(j) provides that income derived from "contracts...wholly or partly performed in the Cook Islands" is derived from the Cook Islands. Section 83(1)(a) may not apply if the short-term nature of the services provided by a subcontractor is not sufficient to amount to a business carried on in the Cook Islands. Nevertheless, section 83(1)(j) will apply as the services provided by a subcontractor are performed by the subcontractor wholly or partly in the Cook Islands. The difficulty, though, is collection.

The short-term nature of the services means the subcontractor is likely to have performed the services and left the Cook Islands before the Collector even knows about the services. It is very difficult to collect the tax due from a non-resident subcontractor who does not have a business operation in the Cook Islands on an assessment basis. Hence the need for a withholding tax to apply to such income.

New subsection (1) provides for the imposition of the withholding tax. It applies if the following conditions are satisfied:

(1) There must be a provision of services.

(2) The services must be provided by a non-resident subcontractor. "Subcontractor" is defined in new section 143A(1) to mean a person supplying services to a contractor in respect of mining operations (i.e. prospecting, exploration, recovery operations, and operations under a retention lease). A person providing services in the capacity as employee is not a subcontractor. "Person" is defined in new section 143A to have the meaning in section 2 of the ITA and to include an entity. Taking account of the

definition of "entity" in section 2, a subcontractor may be an individual, body of persons, company, partnership, trust, government, and any similar body or association.

New subsection (9) provides rules for determining whether a subcontractor is a non-resident subcontractor. Paragraph (a) applies to individuals and companies and provides that they are non-resident if they are not a resident under section 82. An individual is a resident under new section 82(1) if the individual has their home in the Cook Islands and is personally present in the Cook Islands for more than 183 days in a 12-month period. Thus, a subcontractor who is an individual and who does not have a home in the Cook Islands is a non-resident subcontractor.

A company is a resident under section 82(2) if the company is incorporated or has its head office in the Cook Islands. Thus, a subcontractor that is a company that is incorporated outside the Cook Islands and has its head office outside the Cook Islands is a non-resident contractor.

Section 82 provides resident tests only for individuals and companies. To accommodate the broader definition of "person" in new section 143A(1), paragraph (b) provides a test of non-residence for a subcontractor other than an individual or company. A subcontractor is a non-resident under paragraph (b) if the subcontractor is formed, organised, or settled outside the Cook Islands. Thus, for example, the following are non-residents: a partnership formed outside the Cook Islands; a body or association of persons organised outside the Cook Islands; or a trust settled outside the Cook Island.

(3) The services must be provided by the subcontractor in respect of mining operations in the Cook Islands. "Mining operations" is defined in new section 143A to mean prospecting, exploration, or recovery operations, or operations under a retention lease. By virtue of new section 143A(2), "prospecting operations", "exploration operations", "recovery operations", and "retention lease" have their meaning in the Seabed Minerals Act. "Cook Islands" is defined in section 2 to include the territorial sea and exclusive economic zone of the Cook Islands.

(4) The non-resident subcontractor must have derived a fee for the provision of the services.

If these conditions are satisfied, the non-resident subcontractor is liable for withholding tax at the rate of 15% of the gross amount of the fee.

New subsection (1) is subject to new subsection (2), which provides that there is no withholding tax if the services were rendered by a non-resident subcontractor through a permanent establishment in the Cook Islands. "Permanent establishment" is defined in section 2 (inserted by the Bill). The basic notion of a permanent establishment is that it is a fixed place of business through which the business of a person is carried on. This includes, for example, an office or other space made available to a person in the Cook Islands. The concept of permanent establishment is well understood internationally, particularly in relation to tax treaties. The rule of thumb under tax treaties is that a presence in a country for six months or more is regarded as a permanent establishment. The definition expressly includes the furnishing of services through employees or other personnel in the Cook Islands if the

services continue for the same or a connected project for a period or periods aggregating more than six months within any twelve-month period.

If the subcontractor has a permanent establishment in the Cook Islands through which the services fee is derived, the intention is that the fee is taxed to the subcontractor on a normal assessment basis. To facilitate this, new subsection (3) provides that a services fee derived by a subcontractor from mining operations in the Cook Islands is derived from the Cook Islands for the purposes of section 83 and is subject to tax under section 39.

While the formal liability for the tax is on the non-resident subcontractor, new subsection (4) provides for collection of the tax from the contractor paying the fee. The contractor is obliged to withhold the tax from gross amount of the fee at the rate of 15%. Thus, the structure of the non-resident subcontractor withholding tax is the same as for other withholding taxes imposed under Part VII of the ITA with the formal liability for the tax imposed on the non-resident recipient of the fee and the tax collected from the payer of the fee.

New subsection (5) provides that a contractor is required to withhold tax at the earlier of: (i) the time the fee is credited to the account of the non-resident subcontractor (paragraph (a)); or (ii) the time of actual payment (paragraph (b)). In the ordinary case, withholding will be required at the time of payment. However, the rule in paragraph (a) is included to avoid planning to defer the payment of withholding tax by crediting the amount to an inter-company account rather than actually paying the fee. This is particularly relevant when the contractor and non-resident subcontractor are related parties.

New subsection (6) provides that the tax withheld by a contractor from a fee paid to a non-resident subcontractor must be paid to the Collector by the 20th day after the end of the month in which the obligation to withhold arises under new subsection (5). In the ordinary case, the obligation to withhold arises at the time of payment and, therefore, the tax withheld must be paid to the Collector within 20 days after the end of the month in which the tax was withheld.

New subsection (7) provides that withholding tax imposed under new subsection (1) is a final tax on the fee for the provision of services and the fee is not included in the assessable income of the subcontractor.

New subsection (8) provides that certain provisions in Part VII of the ITA apply to the subcontractor withholding tax on the basis that the services fee is withholding income and the tax is withholding tax. The sections in Part VII that apply are:

(1) Section 103(2) and (3) – section 103(2) empowers the Collector to extend the time for payment of withholding tax by a contractor and section 103(3) obliges the contractor to notify the Collector in writing of payments made that are subject to withholding tax. Section 103(1) does not apply as the obligation to pay non-resident subcontractor withholding tax is specified in new section 143I(6).

(2) Section 104 – obliges a contractor to deliver to the Collector an annual statement setting out services fees paid to subcontractors and the tax withheld therefrom for the year.

(3) Section 107 – provides for the payment of subcontractor withholding tax by the subcontractor if the contractor fails to withhold and pay the tax to the Collector.

(4) Section 108 – provides for the recovery of withholding tax from a contractor who has failed to withhold the tax or, if they have withheld the tax, they have failed to pay the withheld tax to the Collector.

(5) Section 109 – provides for the making of assessments of subcontractor withholding tax if there is default in the payment of the tax.

143J. Imposition of additional profits tax

This section provides for the imposition of additional profits tax in relation to mining operations.

New subsection (1) provides that contractor that has a positive cash balance in relation to a title area for an income year is liable to pay additional profits tax for that year. The conditions for the imposition of additional profits tax are—

(1) Additional profits tax is imposed on a contractor. In broad terms, a "contractor" is a person who has been issued with an exploration licence, prospecting permit, retention lease or mining licence under the Seabed Minerals Act (see new section 143A definition).

(2) The tax is imposed only when the contractor has a positive cash balance for an income year. The cash balance for a contractor for an income year is computed in accordance with new section 143K. If the contractor has a negative cash balance for an income year, the negative amount is carried forward as a deduction in computing the cash balance for the next income year at an uplift equal to 120% (see new section 143K(1)(a)(iv) and (3)).

(3) The tax is imposed by reference to a "title area". As title area is undefined in the ITA, it has its meaning in the Seabed Minerals Act (see new section 143A(2)). "Title area" is defined in section 7 of the Seabed Minerals Act to mean a "permit area, licence area or lease area". This means that the following are title areas for the purposes of this section:

   (a) An area constituted by a block or blocks in respect of which a prospecting permit is in force ("permit area").

   (b) An area constituted by a block or blocks covered by an exploration licence ("licence area").

   (c) An area constituted by a block or blocks covered by a mining licence ("licence area").

   (d) An area constituted by a block or blocks covered by a retention lease ("lease area").

   As the Seabed Minerals Act defines title area by reference to a title, the additional profits tax is imposed separately for a prospecting permit, exploration licence, retention lease and mining licence even if they cover the same area. Thus, if a contractor has more than one title, there is a separate computation of the cash balance

of the contractor for each title area. For example, if a contractor has an exploration licence for one title area and a mining licence for another title area, a negative cash balance for the title area covered by the exploration licence cannot be deducted against a positive cash balance for the title area covered by mining licence. This means that title areas are also ring fenced for the purposes of the additional profits tax. This is consistent with the ring fencing that applies under the income tax as a result of new section 143E and means that the taxable income or loss calculation that is done on a title area basis applies also for the purposes of the additional profits tax.

New subsection (4) provides that the exceptions to ring fencing in new section 143E(5) and (6) are carried through to the additional profits tax. If a contractor has made an election under new section 143E(5) or (6), the two title areas are treated as a single title area for the purposes of the additional profits tax. New section 143E(5) applies when a contractor has ceased mining operations under a title (for example, exploration operations under an exploration licence) in relation to a title area and the contractor has a loss under new section 143E(2) in relation to the title area. The contractor may elect, by notice in writing to the Collector, to treat the loss as a loss under new section 143E(2) in relation to another title area in which the contractor undertakes mining operations if the area covered by the second-mentioned title area falls wholly within the area covered by the first-mentioned title area. Ordinarily, the title area for a mining licence will be a smaller area than that covered by an exploration licence because of the relinquishment of areas required under the exploration licence. Provided the title area for the recovery operations falls wholly within the title area for the exploration operations, the contractor can elect to treat them as the same title area for the purposes of ring fencing. If the election is made, it applies also for the purposes of the additional profits tax.

New section 143E(6) applies when a contractor has a terminal loss in relation to a title area. This will most likely arise when the exploration operations were unsuccessful in finding a commercial discovery. It can arise also if the recovery activities fail to generate taxable income after taking account of carry forward losses (particularly from the exploration phase of the project). If the conditions in new section 143E(6) are satisfied, a contractor may elect to treat the loss as a loss incurred under new section 143E(2) in relation to mining operations undertaken by the contractor in another title area. In other words, the terminal loss in relation to one title area can be transferred, at the election of the contractor, to another title area. If the election is made, it applies also for the purposes of the additional profits tax.

Additional profits tax is imposed annually by reference to the contractor's income year. This is the period of 12 months ending on December 31 (section 2 of the ITA definition of "income year" and "year") unless the contractor has permission to use a substituted balance date under section 9 of the ITA.

Subsection (2) provides that the additional profits tax payable by a contractor in relation to a title area for an income year is 25% of the positive cash balance of the contractor for the year.

New subsection (3) makes it clear that the mining additional profits tax payable by a contractor for an income year is in addition to the income tax imposed on the taxable income of the contractor for the year.

143K. Cash balance

This section provides for the computation of the cash balance of a contractor for an income year for a title area. As stated above, the additional profits tax is computed by reference to the contractor's cash balance for a title area for an income year. The starting point in determining the cash balance of a contractor for an income year for a title area is the taxable income or loss of the contractor for the year for the area. As a result of new section 143E, if a contractor has more than one title area, the taxable income or loss is calculated separately for each title area.

New subsection (1) applies when a contractor has taxable income for the title area for the income year and provides for adjustments to the amount of the taxable income to convert it into a cash balance amount (positive or negative). Paragraph (a) provides for the deduction of amounts from taxable income and paragraph (b) provides for add backs to taxable income.

The following amounts are deducted from the taxable income for an income year of a contractor for a title area under paragraph (a):

(1) The total capital expenditure incurred by the contractor for the income year in acquiring plant, machinery, equipment, or other property depreciated under the ITA to the extent that the property is used to derive amounts included in assessable income in relation to the title area (paragraph (a)(i)). A deduction for the depreciation of plant, machinery, equipment or other property is allowed under section 60(1) of the ITA. Expenditure is deducted under paragraph (a)(i) only to the extent that the property is used to derive amounts included in assessable income in relation to the title area. The words "to the extent" contemplate apportionment when the property is used partly to derive assessable income in relation to a title area and partly for some other use. The most likely circumstance requiring apportionment is when the property is to be used partly in relation to one title area and partly in relation to another title area. Another possibility is that the property is to be used by the contractor partly in deriving assessable income in relation to a title area and partly for some other purpose (such as a non-mining activity) or to derive exempt income.

    The effect of paragraph (a)(i) is to deduct the entire cost of acquiring property that is depreciated under the ITA in relation to a title area. Consequently, while the cost of the property is deducted over the useful life of the property for the purposes of the income tax, the cost is deducted outright for the purposes of the additional profits tax.

(2) The total development expenditure to the extent incurred by the contractor for the year to derive amounts included in the contractor's assessable income in relation to the title area. "Development expenditure" is defined in new section 143A(1). In broad terms, development expenditure is intangible expenditure incurred in undertaking authorised activities under a mining licence. The definition expressly includes expenditure incurred in acquiring a mining licence or mining information. The deduction does not apply to exploration expenditure as it has already been deducted outright under new section 143C(1) in computing taxable income.

    Development expenditure is deducted under paragraph (a)(ii) only to the extent that the expenditure is incurred by the contractor in deriving amounts included in the assessable income of the contractor in relation to the title area. The words "to the

extent" contemplate apportionment when development expenditure is incurred partly to derive amounts included in assessable income in relation to the title area and partly for some other purpose (such as to derive assessable income in relation to another title area). See discussion above on apportionment in relation to depreciable property.

The effect of paragraph (a)(ii) is to fully deduct development expenditure in the income year in which it is incurred. Consequently, while development expenditure is deducted over the expected life of the recovery operations to which the expenditure relates for the purposes of the income tax, the cost is deducted outright for the purposes of the additional profits tax.

(3) The income tax paid or payable by the contractor on the taxable income of the contractor for the year in relation to the title area (paragraph (a)(iii)). This reflects the order of the two taxes. The income tax is computed first and then is deducted under the additional profits tax.

(4) The adjusted negative cash balance for the title area brought forward from the previous income year (paragraph (a)(iv)). New subsection (3) provides that, if the cash balance for an income year is negative, the adjusted negative cash balance for that year is the negative cash balance increased by 120%. This means that a negative cash balance for an income year is carried forward uplifted by a factor that approximates the contractor's rate of return (i.e. 20%). For example, if the negative cash balance is $100, the amount carried forward to the next income year as the adjusted negative cash balance is $120.

The following amounts are added back to the taxable income of a contractor in relation to a title area for an income year under paragraph (b):

(1) The the total deduction allowed to the contractor under section 60 for depreciation of plant, machinery, equipment, or other property for the year in relation to the title area (paragraph (b)(i)). This add-back is necessary to avoid double counting (i.e. a deduction for both: (i) the annual depreciation of depreciable property as part of the computation of taxable income; and (ii) a deduction for the full amount of the capital cost of acquiring depreciable property under new subsection (1)(a)(i))). The combined effect of new subsections (1)(a)(i) and (1)(b)(i) is that, for the purposes of the additional profits tax, there is 100% write off of the cost of acquiring depreciable property in relation to a title area in the income year that the property is acquired.

(2) The total deduction allowed for depreciation of development expenditure incurred by the contractor for the year in relation to the title area. Again, this add-back is necessary to avoid double counting (i.e. a deduction for both: (i) the annual depreciation of development expenditure as part of the computation of taxable income; and (ii) a deduction for the full amount of the expenditure under new subsection (1)(a)(ii)). The combined effect of n ew subsections (1)(a)(ii) and (1)(b)(ii) is that, for the purposes of the additional profits tax, there is 100% write off of the cost of development expenditure incurred in an income year in relation to a title area. There is no need to make an adjustment in relation to exploration expenditure as that is expensed in computing taxable income (see new section 143C(1)).

(3) The total deduction allowed for interest and other financial charges in computing the taxable income of the contractor for the year in relation to the title area (paragraph (b)(iii)). If interest and other financing costs are taken into account in computing the cash balance, it would create a bias in favour of debt financing over equity financing (as dividends are not regarded as expenditure but rather a distribution of profits). It is for the contractor to decide how to finance a mining project absent additional profits tax considerations. Also, the negative cash balance uplift is intended to compensate for both the return on equity and interest on debt so that there is neutrality in the treatment of the different sources of funding of mining operations.

(4) The total deduction allowed in relation to a derivative financial instrument or a foreign currency hedge in computing the taxable income of the contractor for the year in relation to the title area (paragraph (b)(iv)). While there is a cost associated with reducing the risk relating to cash flows, this cost is excluded because it does not directly affect the value of the extracted resource.

(5) The excess carried forward under new section 143E in relation to the title area for the income year (paragraph (b)(v)). This amount is added back as the negative cash balance for an income year uplifted by 120% is deducted under paragraph (a)(iv)). Again, this add-back is to prevent double counting.

New subsection (2) applies when a contractor has a loss for an income year and provides for adjustments to the amount of the loss to convert it into a cash balance amount. Paragraph (a) provides that the amount of the loss is increased by the amounts specified in subsection (1)(a) (see above) and paragraph (b) provides that the amount of the loss is reduced by the amounts specified in subsection (1)(b). Ordinarily, the effect of the adjustments will be to increase the amount of the loss because of the outright deduction of capital costs.

New subsection (4) provides that, if a contractor commenced mining operations in a title area before the commencement date of application of the additional profits tax, the cash balance of the contractor for the first income year of the contractor commencing on or after the commencement date is calculated on the basis that the additional profits tax applied from the commencement of the mining operations. This ensures that the contractor can take account of expenditure incurred (particularly exploration expenditure) before the commencement date in computing the additional profits tax for the first income year after the commencement date.

143L. Procedure relating to additional profits tax

This section provides for procedural matters relating to the imposition and collection of additional profits tax.

New subsection (1) obliges a contractor who is liable for additional profits tax for an income year to furnish an additional profits tax return for the year by the same date as the income tax return is due for that year. As a contractor will be subject to provisional tax, section 15(2) of the ITA provides that the due date for furnishing an income tax return is as specified in the Third Schedule of the ITA. New subsection (2) provides that an additional profits tax return must be lodged in the form and manner prescribed by the Collector (see section 2 definition of "prescribed").

New subsection (3) provides that the additional profits tax payable by a contractor for an income year is due on the same date as the income tax is due by the contractor for that year. As with income tax, additional profits tax is collected through provisional tax payments under new section 143M.

New subsection (4) obliges a contractor keep such accounts, documents, and records as enable the computation of the additional profits tax payable by the contractor for an income year.

New subsection (5) provides that the income tax provisions relating to the following apply for the purposes of additional profits:

(1) The assessment and collection of additional profits tax and penal tax imposed in respect of an additional profits tax liability, including the keeping of records and investigations. An exception is specified for provisional tax as new section 143M provides a provisional tax regime for additional profits tax. The assessment provisions are in Part III of the ITA, the collection and recovery provisions are in Part XI of the ITA and the provisions relating to record-keeping and investigations are in Part XIV of the ITA.

(2) Appeals relating to a liability for additional profits tax or to penal tax imposed in respect of an additional profits tax liability. These are set out in Part IV of the ITA.

(3) The application for a refund of additional profits tax overpaid. This is set out in Part XII of the ITA.

(4) Offences and penal tax. These are set out in Part XIII of the ITA.

The rules relating to income tax apply for the purposes of the additional profits tax with the necessary changes made. The main change will be that the reference to "income tax" is treated as a reference to "additional profits tax".

143M. Provisional tax instalments of additional profits tax

This section provides for the payment of provisional tax instalments in relation to additional profits tax.

Subsection (1) provides that a contractor liable for additional profits tax for an income year is obliged to pay the tax in two instalments.

Subsection (2) provides that instalments of additional profits tax for an income year are due and payable at the same time as instalments of provisional tax payable by the person for the year are due and payable. The due dates for payment of instalments of provisional tax are specified in section 179 of the ITA as follows:

(1) The first instalment of provisional tax for an income year is due and payable on the date that the contractor is required to furnish its return of income derived in the preceding year (as set out in the Third Schedule).