

## Minerals Resource Rent Tax / Petroleum Resource Rent Tax

### The implementation challenge

On 23 November 2011, the Minerals Resource Rent Tax (MRRT) and extended Petroleum Resources Rent Tax (PRRT) Bills were passed by the House of Representatives. The MRRT and extended PRRT are proposed to apply from 1 July 2012.

The passage of the Bills was dependant on negotiations with the Independents to secure support for the passage of the legislation. The Greens also agreed to pass the Bills through the lower house but have reserved their position on the mining tax and related bills in the Senate.

Given this political context, all eyes are now on the progress of the Bills through the Senate. For the short term at least, the Bills have been referred to the Senate Economics Legislation Committee for enquiry and report by 14 March 2012.

However, with the possibility that the Bills will be passed by Parliament as early as March next year, this tax insight addresses the key questions of what needs to be done and when, with a focus on:

- ▶ The impact of substantive enactment on financial statements of affected taxpayers
- ▶ How affected taxpayers can manage the tax risk and compliance obligations for the MRRT/PRRT in an efficient way
- ▶ What systems and processes are needed to capture and analyse data to complete annual returns
- ▶ The next steps and what affected entities should do between now and 1 July 2012

- ▶ For a detailed explanation of the MRRT and extended PRRT, please visit our tax insight library at: [www.ey.com/au/taxissuesupdate](http://www.ey.com/au/taxissuesupdate)

## Application of the MRRT/PRRT

From 1 July 2012:

- ▶ The MRRT will apply to certain profits from the extraction of iron ore and coal (and certain related products) in Australia
- ▶ The existing PRRT regime will be extended to apply to all Australian petroleum production sourced from projects located onshore, in territorial waters and the North West Shelf project area

However, before the commencement of the MRRT/PRRT, affected taxpayers will need to execute a number of key actions to ensure they are MRRT/PRRT ready, including:

- ▶ On a project-by-project basis, conduct valuations and modelling to determine and explain the impact of the MRRT/PRRT on financial results to investors.
- ▶ An assessment of the financial statement impact (including profits, balance sheet effect and cash-flows) to comply with financial reporting obligations when the Bills are passed by the Senate and thereby substantively enacted.
- ▶ The development of a strategy for complying with the requirements of the tax from 1 July 2012. Additionally, MRRT taxpayers will need to be ready to vary default instalment rates by October 2012.
- ▶ A review of systems and processes for capturing and analysing data and filing returns.
- ▶ A legal and corporate governance review to ensure any positions taken are defensible and companies are able to fund the payments required under tax sharing and funding agreements.

The key to developing a strategy for implementation will be identifying the timelines in which these actions need to be undertaken and when key milestones arise.

With a 1 July 2012 start date and the possibility the Bills will pass through the Senate as early as March 2012, the new year will bring with it the need to focus on the delivery of implementation plans in a very short time period.

## Understanding the financial statement impact

Understanding the impact of the proposed MRRT/PRRT on financial statement preparation and disclosure is a significant issue for all affected entities. To assist in understanding these impacts, key issues that require consideration follow.

**Affected taxpayers must recognise, measure, present and disclose the current and deferred tax relating to MRRT/PRRT in their financial statements from the first reporting period ending on or after the date of substantive enactment**

**Deferred tax accounting for MRRT/PRRT should be reflected in the financial statements from the time when the legislation has been passed through both houses of parliament**

## **Is MRRT an income tax under AASB 112?**

In determining the accounting impacts of the MRRT, the threshold question arises as to whether or not the MRRT is an income tax pursuant to AASB 112 *Income Taxes* (AASB 112). The scope of AASB 112 includes a tax based on taxable profit.

In the Australian context, the Australian Accounting Standards Board (AASB) issued Interpretation 1003 *Australian Petroleum Resource Rent Tax* in 2007, which confirmed that Australian PRRT is an income tax within the scope of AASB 112.

Whilst Interpretation 1003's scope is for application to Australian PRRT, the proposed MRRT regime is modelled on the PRRT regime and has significant similarities. The MRRT is based on a mining profit that is a net amount rather than a gross amount (qualifying mining revenue minus qualifying mining expenditure). In our view, mining companies should therefore regard the proposed MRRT as an income tax pursuant to AASB 112.

## **When is transitional tax accounting required?**

Deferred tax accounting for MRRT/PRRT will be required to be reflected in your financial statements from the time when the legislation passes through both houses of parliament and is therefore substantively enacted. We believe that, with the current numbers in the Senate, this will be when the tax legislation has been passed through both houses of parliament.

This will depend on the outcomes delivered by the Senate Economics Legislation Committee on 14 March 2012 and the Senate debate in the 2012 Autumn sittings.

It is only when the Bills are substantively enacted that entities will be required to recognise and measure in their financial statements for that reporting period, their opening MRRT/PRRT deferred tax asset or deferred tax liability. The initial impact will be reflected through income tax expense.

Listed companies should also consider their continuous disclosure obligations and therefore whether the financial impact of the MRRT should be disclosed to the market.

Entities will need to take a reasonable approach to estimating deferred tax balances and provide some disclosure of this, depending on the materiality of the impact

## What is the practical impact for entities?

The practical impact for entities will not just be a “one-off”. There are many practical tax accounting issues that will impact financial reporting on both the transition as well as on an ongoing basis. These include:

- ▶ Measurement of the starting tax base using an appropriate valuation method for MRRT/PRRT
- ▶ Recognition of deferred tax balances
- ▶ Determination of the probability of recovery of any deferred tax assets
- ▶ Volatility of future tax expense

Each of these is discussed in further detail below.

### *Measurement of starting base using an appropriate valuation method*

AASB 112 requires entities to have determined the tax base of their assets and liabilities at, or before, reporting dates. This will require entities to determine which methodology they will adopt for the valuation of the starting base. Once the methodology has been determined, the starting base will have to be calculated in order to measure the transitional deferred tax balances.

However, the starting base election for MRRT/PRRT is not required until well after substantive enactment. For example:

- ▶ Under the MRRT an entity is generally required to lodge a starting base return to evidence their choice by the first day of the sixth month, following the end of their first MRRT year.
- ▶ For those transitioning into PRRT, the starting base choice is made by the entity that holds the interest as at 30 June 2013 and the choice is evidenced by the lodgement of a starting base return by 30 August 2013.

Therefore, where a formal starting base decision has not yet been made, entities will need to take a reasonable approach to the method they adopt in determining their transitional MRRT/PRRT deferred tax balances for reporting purposes. Essentially, entities will be required to make an estimate and provide disclosure of their estimates and assumptions, depending on the risk of a material adjustment in a later period.

If the legislation is substantively enacted with insufficient time available to undertake or finish the necessary work to determine the impact of MRRT/PRRT, the standards require the entity to make an appropriate estimate, disclosing any key assumptions. Changes to estimates may be required at later reporting dates. This would be analogous to estimating a make good provision.

Where the market value starting base methodology is used, the entity will need indicative market valuations or other evidence to support an appropriate estimate of value (pending valuations). This is required to support the starting base and the resultant deferred tax balances, at the time of preparing financial statements.

### ***Recognition of deferred tax balances***

Transition into MRRT or the extended PRRT may result in a deferred tax asset where the starting value of the project assets is greater than the accounting carrying value. This is more likely to be the case where entities elect to adopt a market value methodology for calculation of the starting base of the project.

In this situation, you will need to consider the general AASB 112 recognition criteria for deferred tax assets at:

- ▶ Substantive enactment
- ▶ Periodically at reporting dates

As a result, you will need to build and maintain detailed MRRT/PRRT models that support your forecasts of the use of the starting base deductions. You will then be required to consider the probability of use of the starting base deductions based on these models.

Further, an entity should use assumptions in estimating future MRRT/PRRT taxable income. This is to assess the probability of recoupment of the MRRT/PRRT deferred tax asset as it applies to AASB 136 impairment testing. It would be expected that there would be common assumptions and estimates used.

### ***Volatility of future tax expense***

There is likely to be an immediate material impact on tax expense on transition into the MRRT and extended PRRT. In addition, we expect there will be increased volatility of tax expense in future years due to the effect of the introduction of the MRRT. This will especially be the case where the introduction of the MRRT creates a large deferred tax asset. Changes in estimates of future taxable income will require a reassessment of the probability of recovery of recognised and unrecognised deferred tax assets, with any changes in the deferred tax assets being recognised in the current period's income tax expense.

For example, significant assumptions used in the MRRT/PRRT model such as commodity price and foreign exchange rates, may fluctuate over time which could lead to significant volatility in the tax expense of the entity. This is because a change in the underlying assumptions may lead to different deductions resulting in future recognition or de-recognition of all or part of the MRRT or PRRT deferred tax asset.

As well as the above, ongoing uplifts to carried forward expenditure and royalties, as well as significant non deductible expenditure for MRRT/PRRT purposes, can lead to a volatile tax expense.

Entities should consider developing strategies to anticipate and manage this uncertainty and appropriately explain this impact to their board, audit committee and the market. In our experience, this will involve monitoring and modelling future effective tax rates, as well as the education of both internal and external stakeholders.

**Entities should consider developing strategies to anticipate and manage income tax expense volatility and to appropriately explain this impact to boards, audit committees and the market**

## Treatment of state royalties

State royalties are currently not treated as an income tax for accounting purposes, but as an operating cost. Under the proposed MRRT and extended PRRT, the tax liability of an entity will be reduced for state royalties or other resource taxes paid.

This raises an issue of how such payments should be presented from commencement of the MRRT and extended PRRT in light of AASB 112. Two options can potentially apply to the recognition of royalties:

1. Royalties remain as an expense and included in determining profit before tax (PBT)
2. Royalties are recognised as an advance payment of MRRT

In our view, state royalties should be treated as an above the PBT line expense, on the basis that the royalty amount has to be converted into a royalty credit in calculating MRRT/PRRT taxable profit, rather than applied as an offset reducing MRRT/PRRT tax payable. This is still subject to debate by the accounting bodies and entities should continue to monitor the standard setting process for further developments.

## Preparation of tax sharing and funding agreements

Tax consolidated groups manage their tax obligations and liabilities through tax sharing and tax funding agreements. These specify how group members share and discharge their tax liabilities. In addition, many groups have a tax funding accounting policy that determines how tax expense and tax liabilities are to be allocated for financial reporting purposes. Taxpayer groups subject to the MRRT or extended PRRT will need to consider the modification of these legal agreements and the accounting policy. This is required in order to clarify how the documents apply to the MRRT/PRRT liability and MRRT/PRRT tax expense.

## What should companies be doing now in relation to reporting obligations?

If the Bills are passed by Parliament, affected taxpayers will need to ensure they are able to assess the impact of the MRRT/PRRT on forecast profits and tax expense in their first financial reports after the time the legislation is substantively enacted. This may be as early as March 2012.

In order to meet this timeline, affected taxpayers will need to have undertaken the following:

- ▶ At a minimum, conducted high-level valuations or appropriate estimates (if using market value) to determine the starting base. With limited valuation experts available, these specialist skills should be sought well in advance of 1 July 2012 to secure such services.
- ▶ Modelling of forecast MRRT/PRRT on a project-by-project basis to enable probability testing and determine instalments.
- ▶ Develop an understanding of the impacts on effective tax rates both on transition and later.
- ▶ Calculation of transitional deferred tax balances.

Leveraging existing systems and data structures is key to facilitating an efficient implementation framework for MRRT and the extended PRRT

## Implementing MRRT/PRRT processes and systems

While many companies have commenced internal projects aimed at getting ready for the transition to the MRRT or extended PRRT, the following section focuses on creating and maintaining a sustainable MRRT/PRRT process and system to satisfy compliance requirements post-transition. The key to facilitating a successful MRRT/ PRRT implementation include:

- ▶ The development of a clear framework for managing the MRRT/PRRT in the context of the organisation's internal structures
- ▶ Leveraging existing systems and data structures wherever possible

Below, we outline our recommended approach to establishing an MRRT or extended PRRT compliance framework that addresses the following elements:

- ▶ **Governance:** defining the ownership, policy responsibilities and accountabilities in relation to the MRRT/PRRT
- ▶ **People:** the focus being on roles, communication and required training
- ▶ **Infrastructure and operations:** what the process should look like including documentation, review and the use of technology

It is important that MRRT and extended PRRT processes are integrated to achieve risk management, process efficiencies and improvement opportunities

### Governance: defining the policy and ownership

The unique feature of the MRRT and extended PRRT is that they are both a federal tax in their own right. They are also deductible when determining your company's income tax liability when paid. They therefore impact both tax accounting calculations and income tax returns.

Given this, the existing tax policies or charter of a taxpayer covering the authorities, roles and responsibilities for the management of income tax, should be expanded to cover the MRRT and extended PRRT. For some, it may be preferable to create a separate MRRT or PRRT policy. In our view however, all taxes including MRRT and PRRT should be covered by the one approach to support tax risk governance.

It may be necessary to apply different operational models for different taxes, as some of the data required may be gathered and sourced in a different way from income tax or other operational taxes. Ultimately, the Australian Tax Office (ATO) will seek to ensure that MRRT and PRRT taxpayers properly manage the tax and each company must be able to withstand intense scrutiny immediately once implemented.

In particular, the policies should be specific to standardise:

- ▶ Acceptable MRRT/PRRT revenue identification and calculation methodologies
- ▶ Cost identification and calculation methodologies (leveraging project accounting or activity based costing models)
- ▶ Aggregation approach where multiple projects or businesses exist
- ▶ Quality assurance reviews, certifications required and responsibilities
- ▶ Level of documentation required to defend MRRT/PRRT positions taken, including escalation of interpretive issues

**The most critical element of a sustainable compliance process will be people, their skills and competencies, their roles and their understanding of the requirements of MRRT/PRRT**

## **People: roles and responsibilities, communication and training**

In any sustainable compliance process and system, the most critical element will be people, their skills and competencies, their roles and their understanding of the requirements of MRRT/ PRRT. Wherever possible, an entity should leverage existing roles to provide the necessary support. Your company should seek to ensure your data, systems and evidence is gathered as part of your normal accounting and reporting processes.

The initial transition project should have answered many of the following questions and all stakeholders should be clear on what they now need to do:

- ▶ Who will own MRRT/PRRT within your organisation? Who will define the policy?
- ▶ Who will prepare and / or review tax calculations? Who will supply data? Who will be trained to help support the above?
- ▶ Are additional resources required? Where?
- ▶ How will you communicate your MRRT/PRRT expertise to senior management, overseas parents and investment assessment committees; and how will you incorporate this into your project assessment guidelines, internal audit, financial data recording systems and shared services operations?

Given that both the MRRT and PRRT are a tax, they will, quite likely, be ultimately owned by the tax function. Despite this, their impact will be felt throughout the organisation. Whilst the tax function may not have to prepare the calculations, it may be required to manage the risk around MRRT/PRRT deliverables and their outcomes. As with the offshore PRRT experience, these calculations can be prepared by finance, shared service centres, at business unit level or outsourced to tax service providers.

Ultimately, who does the preparation will be dependent upon the tax operational model and resourcing structure in place within your organisation. Our view is however, that unless there is inadequate attention to managing taxes or there are currently issues about tax deliverables and resourcing, each taxpayer should leverage its existing operational model wherever possible.

**Early and consistent communication on MRRT /PRRT requirements to data suppliers through workshops, meetings and training is critical to manage risk and efficiency**

This will usually mean, at a minimum:

- ▶ Developing detailed instructions to help calculate revenue at the taxing point and to identify the costs of activities relevant to that point, including apportionable costs
- ▶ Developing calculation templates to ensure consistency of approach across business units
- ▶ Training fixed asset register (FAR) personnel on MRRT/PRRT data requirements
- ▶ Inclusion of MRRT/PRRT in the compliance cycle and compliance calendar
- ▶ Formal processes for the review and management of queries and payments

Data suppliers are key stakeholders within the MRRT/PRRT compliance process. They may include teams responsible for general ledgers, fixed assets, projects, payroll, finance, project finance, capex or accounts payable. They may also include joint venture operators supplying data to the company.

Early and consistent communication is critical. This may take place in the form of workshops, training sessions or meetings to ensure that all stakeholders are kept informed of the changing requirements until start date. Preferably, a communication program should be implemented as part of the normal annual compliance cycle.

Training materials and guidance should also be prepared and delivered before the 1 July 2012 start date to ensure that policy, processes and any system changes are properly implemented and in place from the start. To achieve this, all the necessary design changes, templates, tools, policies and procedures need to be delivered, tested and ready to go by this time.

## **Infrastructure and operations**

It is necessary to have the right infrastructure and operations to support any compliance process. Not having well thought out operational infrastructure can lead to inefficiencies, errors, increased costs and missed timeframes. We recommend the following areas be addressed to comply with the MRRT/PRRT:

### ***Process and procedures***

From a process perspective, the MRRT/PRRT should follow a standard approach in line with the current income tax process, as outlined below.

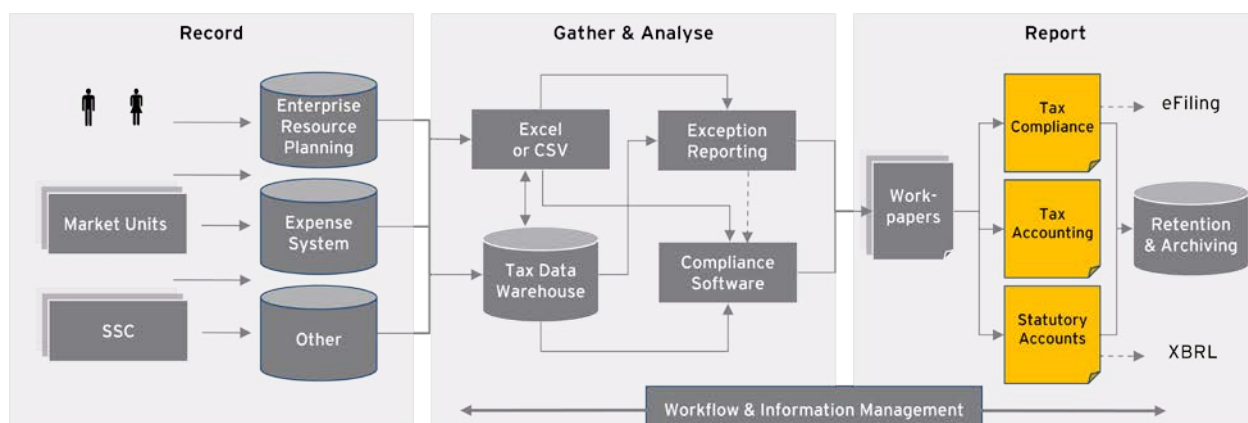
Phase	Activities
Plan	<ul style="list-style-type: none"> <li>▶ Agree roles and responsibilities, scope and priorities between stakeholders</li> <li>▶ Agree timeframes and deliverables including projects in scope</li> <li>▶ Communicate with stakeholders</li> <li>▶ Agree data sources and formats</li> <li>▶ Agree tax accounting implications</li> <li>▶ Ensure compliance systems are in place ready for calculations (i.e., roll forward, copy)</li> </ul>

Phase	Activities
Gather	<ul style="list-style-type: none"> <li>▶ Gather data from various sources including general ledger, project based systems, fixed assets</li> </ul>
Analyse	<ul style="list-style-type: none"> <li>▶ Prepare the calculation per the MRRT/PRRT rules using appropriate data</li> <li>▶ Apply appropriate apportionment methodology</li> <li>▶ Ensure an appropriate review has taken place</li> <li>▶ Post journals to the ledger for tax accounting purposes</li> <li>▶ Prepare MRRT/PRRT tax forms for lodgement with the ATO</li> </ul>
Deliver	<ul style="list-style-type: none"> <li>▶ Finalise MRRT/PRRT tax forms</li> <li>▶ Lodge MRRT/PRRT tax forms with ATO</li> </ul>
Evaluate	<ul style="list-style-type: none"> <li>▶ Review the process to ensure any improvements are identified and implemented before the next reporting cycle</li> <li>▶ Gather data from various sources including general ledger, project based systems, fixed assets</li> </ul>

Most companies will perform the MRRT/PRRT process on a quarterly cycle for instalment purposes and to meet overseas head office requirements. This will be true for those required to comply with USGAAP.

### Data and systems

The most important part of any compliance process is to ensure there is sufficient and appropriate data available that can be automated from the various source systems. We call this a 'record to report' approach.



### ***Record - Data sources***

Having the right data in the right format is one area that can create efficient processes. Data that is not tax sensitised upfront requires additional effort and analysis by the tax department, which can in turn lead to the creation of many spreadsheets. This was evident from our experience with the existing PRRT system where companies did not seek to sensitise data for compliance purposes.

Some taxpayers have already started a process of 'tagging' to get access to data pre and post taxing point, within their general ledger systems. This can identify project revenue and costs at the different stages of the project lifecycle, which will then be used for MRRT/ PRRT compliance.

In our view, this is an area of critical focus. By using appropriate analysis and tagging, a taxpayer can leverage existing systems and records to:

- ▶ Identify all revenues subject to netback calculations to determine the taxing point revenue
- ▶ Identify qualifying expenditure directly deductible or which can be apportioned to an MRRT/ PRRT project (using project accounting, activity based costing methods, etc.)
- ▶ Determine relevant state based royalties paid or accrued in your system, and tagging relevant accounts or transactions

As well as this, taxpayers will need to consider:

- ▶ Recording and tracking MRRT/PRRT losses, history, exploration and production categorisation
- ▶ The use of the FAR to record starting base allowances pre and post 2 May 2010, as well as the application of market value versus the book value method
- ▶ Tracking transfers of MRRT/PRRT losses and allowances across projects and the application of augmentation/uplifts

Another area of significant focus will be fixed assets. For example, to calculate the starting base allowance available under the MRRT, a taxpayer must identify the MRRT qualifying property in relation to upstream mining operations before 2 May 2010. They must also identify certain additional expenditure incurred between 2 May 2010 and 1 July 2012. This will require the creation and maintenance of an MRRT tax fixed asset register that tracks and maintains these amounts and their decline in value. It will be important for tax compliance and reporting processes, that differences between the income tax and MRRT fixed asset registers are appropriately reconciled. A similar situation applies to the extended PRRT.

For those that have not started this process, you will need to ensure that data is available for compliance purposes from 1 July 2012.

### ***Report - Use of tax technology***

Using tax technology in the right way can help achieve timeframes, improve data quality and audit trail. The various options that should be considered by companies required to comply with the MRRT/PRRT include:

Regardless of the tax technology used, the ultimate goal is to reduce the cost of compliance through identification and automation of the majority of the tax calculation

- ▶ **Spreadsheets:** for most companies, these may be used depending upon the size and scale of your operations (i.e., centralised versus decentralised approach)
- ▶ **Commercial off-the-shelf products (COTS):** these will aid in compliance with both tax accounting and tax return filing requirements for MRRT, PRRT and income tax
- ▶ **In-house developed software:** some companies will build their own systems to ensure compliance

Regardless of the tax technology used, the ultimate goal is to reduce the cost of compliance through identification and automation of the majority of the tax calculation.

We recommend that you utilise a software evaluation process that ensures your specific requirements will be met by either your existing systems or the appropriate tax technology solution, and that it will support your MRRT or PRRT compliance activities.

## ATO and corporate governance

We expect ATO sensitivity around the transition into the MRRT/PRRT regime. We anticipate particular sensitivity with respect to the application of the starting base allowances and their valuation. Taxpayers under either regime should be prepared to support their positions and valuation methodologies to ensure they are in accordance with the new legislation. In this regard we note that the integrity measures and record keeping requirements are particularly onerous.

Further, those taxpayers seeking fiscal certainty as to the application of the MRRT/PRRT may choose to obtain a ruling from the ATO. In doing so, you will need to provide a full and true disclosure of material facts.

Taxpayers should ensure they have sound processes in place to contemporaneously document both the technical and factual elements of their positions to enable efficient dealings with the ATO. Some examples of areas of focus might include:

- ▶ Starting base allowances
- ▶ Determination of taxing point in each project
- ▶ Revenue and expense allocation methodologies and their implementation
- ▶ Data mapping through to tax compliance calculations
- ▶ Analysis of the completeness of the calculation

## Next Steps

As the legislation continues to be debated in Parliament into the next year, MRRT and extended PRRT taxpayers should act now on the following:

- ▶ **Seeking advice and valuations** to determine the impact of the MRRT and extended PRRT Bills on your projects.
- ▶ **Modelling** of forecast MRRT/PRRT on a project-by-project basis, to enable probability testing, financial reporting disclosure and determine instalment payments (which commence in the first year for MRRT taxpayers).
- ▶ **Education sessions** on the likely impact of MRRT/PRRT with key finance personnel and other stakeholders including investment analysts.
- ▶ **Workshops** to consider an appropriate MRRT/PRRT operational model, to identify data systems affected and to plan revenue models.
- ▶ **Monitoring M&A transactions** including ensuring sufficient information is obtained to substantiate the MRRT position on the acquisition of a project and understanding the impact of various transactions. For example, under MRRT deferred farm-in arrangements provide the farmer (and not the farmee) with the benefit of any pre-mining expenditure incurred by the farmee, on the relevant pre-mining interests.
- ▶ **Updating corporate governance charters** and seeking fiscal certainty as to the application of the MRRT/PRRT by way of private rulings or advance pricing agreements.
- ▶ **Preparing tax sharing and funding agreements** for MRRT/PRRT purposes where an election to form a tax consolidated group is made - particularly with respect to compensation for the use of MRRT/PRRT losses and the accounting for these in financial statements.

We are a long standing leader in the implementation of sustainable compliance offerings to the mining industry and are the leading tax advisor to PRRT taxpayers, lodging a significant majority of all tax agent prepared PRRT returns. In doing so, we have built a wealth of experience and understanding of the revenue authority's approach to PRRT compliance which is directly relevant to the extended PRRT and the new MRRT.

We would be pleased to assist you in this process. If you wish to discuss any of the matters covered in this insight in further detail, please contact your local Ernst & Young advisor.

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