



## Minerals Resource Rent Tax

While the framework of the law is largely in place, policy surprises in the latest draft require attention

### Are we there yet?

On 18 September 2011, Treasury released the second exposure draft legislation (draft legislation) for the proposed Minerals Resource Rent Tax (MRRT). The substantially expanded draft legislation contains some 150 new pages, and some policy surprises requiring attention.

Now that industry and stakeholders have had the chance to digest the draft legislation, it is timely to ask... are we there yet?

In our view, whilst the basic framework of the law is now largely in place, the draft legislation still has some gaps; notably with respect to how mining project interest transfers are to be dealt with in the interim period between 2 May 2010 and 1 July 2012.

Whilst there are some mechanical issues with the operation of the draft legislation that need to be addressed, some specific policy inclusions are also contentious. Four issues of particular note are discussed below.

#### 1. Anti-avoidance

The draft legislation now includes general integrity provisions which allow the Commissioner to deny MRRT benefits where a scheme is entered into for the purpose of obtaining these benefits. The concern for miners is that the threshold for application of these provisions only requires a more than incidental purpose of obtaining an MRRT benefit. This is in contrast to the general anti-avoidance rules for income tax which require a sole or dominant purpose of obtaining a tax benefit.

Less contentious are the separate anti-profit shifting rules. These ensure a miner's MRRT liability is not smaller than what it would have been if the miner and other entities were dealing wholly independently with one another.

Miners are required to undertake what is in substance a netback calculation to determine that part of the miner's revenue that is attributable to the form and place the resource was in at the taxing point

## 2. Derivation of mining revenue

The draft legislation now requires the use of an effective netback method to arrive at the amount of mining revenue at the taxing point. Mining revenue is calculated as the consideration received in relation to the mining revenue event (for example sale at port), less amounts paid for the provision of downstream operations.

Where the miner provides its own downstream services, the legislation requires it to determine the amount that would have been payable to procure another entity to provide the downstream operations, assuming that:

- ▶ The other entity was a separate and distinct entity
- ▶ The other entity were to provide the operations as a service
- ▶ There was a competitive market for those services
- ▶ The cost of providing services by the other entity was sufficient to meet the costs of that entity, including a return on actual investment, commensurate with the risks involved
- ▶ The miner and the other entity were dealing independently and at arm's length in relation to the provision of those services

A concern is that miners will find these provisions too prescriptive and not necessarily aligned with the concept of determining a true arm's length value of the resource at the taxing point.

## 3. Starting base treatment of improvements to land

Where the market value method is adopted, starting base assets relating to improvements to land will be treated as a single starting base asset (along with the tenement and mining information) and will be depreciable over the life of the tenement. However, haul roads will be excluded.

Miners have natural cause to question the issue of why other improvements such as benches, berms, catch berms and batters are not afforded separate treatment; or more generally, why any improvements to land should not be treated separately if the miner is able and willing to value them.

## 4. MRRT instalments

The MRRT instalment system as drafted requires the instalment rate to be applied to the gross final sales revenue received - typically a free on board (FOB) price - rather than the mining revenue calculated at the earlier taxing point.

Default instalment rates are contained in the legislation (8% for iron ore and 3% for coal) and apply until either the miner chooses to vary the instalment rate or a new instalment rate is notified by the Commissioner (for example after the first MRRT return is lodged).

The default rates are based on an assumption that a miner's MRRT profit will be equal to 35.6% of the gross final sales revenue for iron ore and 13.3% for coal. Miners may have cause to consider these assumptions to be high given this is after the deduction for grossed up royalties. Miners

can vary the instalment rate; however companies should exercise care as a general interest charge (currently 11.9%) will apply if the rate chosen is too low.

**With less than nine months until commencement of the MRRT, miners need to ensure they have the systems in place to implement and report on the new tax**

## What's next?

The MRRT draft legislation is scheduled to be introduced to Parliament in the Spring sittings, concluding 30 November 2011. If substantially enacted (that is, passing both houses) during this period, companies will have financial reporting obligations for the 31 December 2011 reporting period. To provide an update on these developments, we will issue a separate Tax Insight addressing financial reporting obligations.

Taxpayers affected by these new measures should consider seeking advice to determine the impact of the MRRT draft legislation on their projects and to prepare a transition and implementation strategy.

Given it is now less than nine months until the MRRT will be introduced, affected miners will also need to ensure they have the systems necessary to implement the new tax and address the associated financial reporting obligations.

We are a long standing leader in the provision of advice and compliance services to the mining industry and would be pleased to assist you in this process. If you wish to discuss any of the above issues further, please contact your local Ernst & Young advisor.

## Other new additions in the exposure draft

### Mining project interest integration test

Upstream integration of mining project interests is now based on the concept of a mine or proposed mine. This test was previously based on the existence of a single production right or integration of upstream operations.

For combined projects that are solely upstream integrated, production on the combined project will be deemed to have commenced, when production commences on *any* of the constituent mining project interests forming part of the combined project.

This means the deferral of starting base deductions on combined mining project interests, with both producing and non-producing interests that was a possible outcome under the previous draft legislation, will no longer arise unless the mining project interests are downstream (as opposed to upstream) integrated.

### Valuation principles

The legislation now contains valuation principles which, amongst other things:

- ▶ Requires valuations to be reasonable and consistent with previous valuations relating to the interest

- ▶ Requires valuations to be reconcilable with all valuations relating to the mining project interest made after 1 May 2010 (this refers to all valuations, not just MRRT valuations)
- ▶ Requires assumptions and estimates to be reasonable when considered in isolation and when considered together

## Compliance and administration

The MRRT now includes details relating to substituted accounting periods, functional currency and consolidation.

- ▶ Where substituted accounting periods and/or functional currency elections are chosen for income tax, MRRT will be calculated on the same basis.
- ▶ Taxpayers with a substituted accounting period will have their first MRRT year close early (i.e., 31 December 2012 for December year ends). This will bring forward the timing of certain elections to be made for the first MRRT year.
- ▶ Groups of entities that are part of a consolidated group or MEC group for income tax purposes can (but are not required) choose to consolidate for MRRT purposes.

Under the MRRT consolidation rules, the group's mining project interests are treated as being those of the head company of the group. As such, the group's internal transactions are ignored for MRRT purposes. However, the members of the group will be jointly and severally liable for paying the head company's MRRT liabilities. As such, consolidated groups should prepare MRRT specific tax sharing agreements, similar to those used for income tax purposes.

When a group chooses to consolidate, the head company is required to give the Commissioner notice of the choice within 21 days after the choice is made. The choice has effect on the day it is made and continues to have effect as long as the group exists. Once the choice to consolidate is made, it cannot be revoked and cannot be altered.

## Framework for pre-mining project interests

There is now a comprehensive framework for pre-mining project interests (exploration rights) and a starting base for pre-mining interests. This includes mechanics in the legislation dealing with mining project interest assets and partial asset disposals.

An optional look-back valuation approach is now available for valuing the starting base of pre-mining project interests existing at 2 May 2010, using expenditure incurred in the 10 years prior to 2 May 2010.

Pre-mining losses can be transferred to other projects with the same taxable resource without meeting common ownership requirements. However, to avoid trading in losses between taxpayers, if the common ownership requirements are not met between the loss and income projects, acquired pre-mining losses will be capped at the amount paid by

the buyer for the pre-mining project interest (and in certain cases the income project), divided by the MRRT rate.

## **Rehabilitation, winding down and ending mining project interests**

Provisions have been included to ensure that allowances do not continue to be carried forward or receive uplifts where production ceases. The day when allowances cease to be available is the 'suspension day' and is the earliest of:

- ▶ the day chosen by the miner
  - ▶ 10 years after commercial production ceases
- OR
- ▶ when the production right is terminated

Companies have an incentive to elect an early suspension day in order to obtain a refundable tax offset for rehabilitation expenditure incurred post production.

## **Adjustments to starting base, mining revenue and mining expenditure**

Where a company chooses to either dispose of a starting base asset, ceases to use the starting base asset for upstream purposes or never uses the starting base asset for upstream operations, an adjustment is made to the starting base or revenue, depending on the value of the starting base asset at the time of the adjustment.

Adjustments are also made to mining revenue and expenditure if assumptions adopted prove inconsistent with the circumstances post that time. This will result in a change in mining revenue or expenditure at the later time.

## **Reporting and record retention**

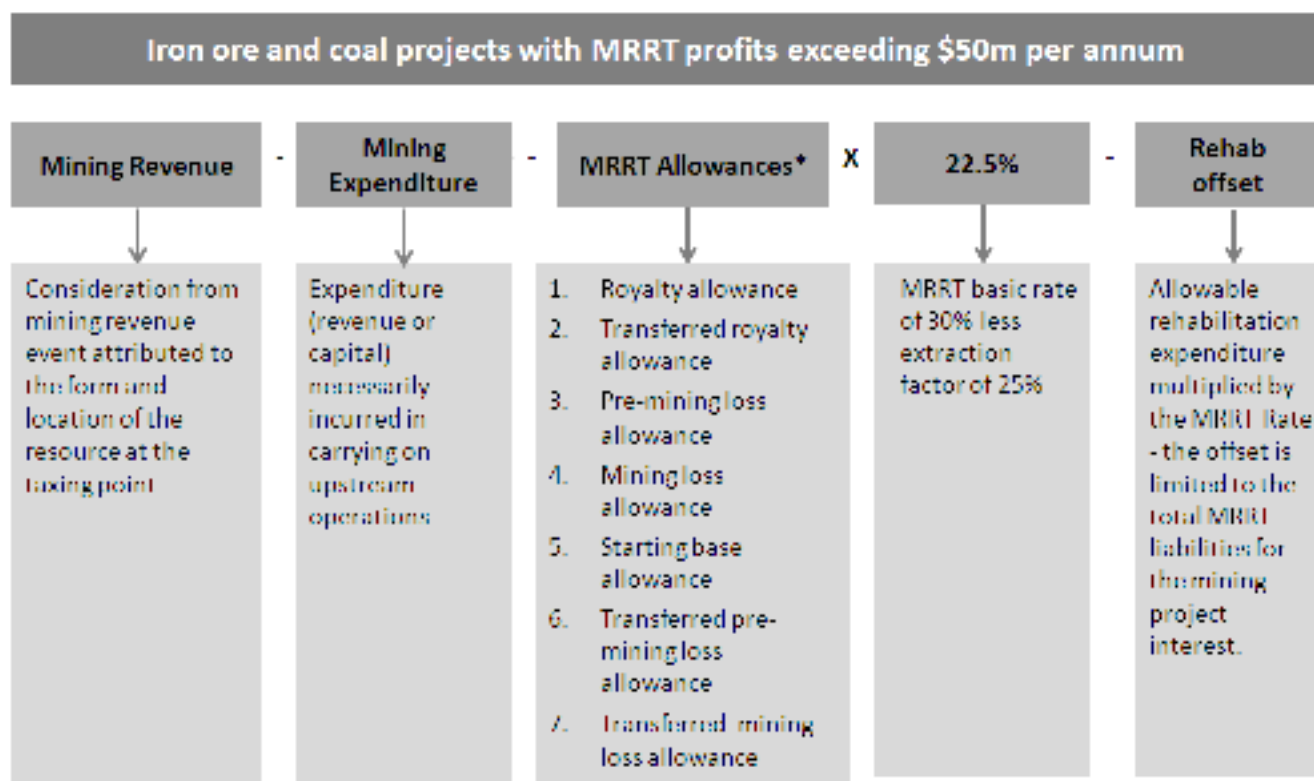
The MRRT legislation requires that MRRT taxpayers maintain records of every act, transaction, event or circumstance relating to mining operations or pre-mining operations. These are relevant and are required to determine whether the taxpayer is liable to pay MRRT in any given MRRT year.

In the event that the necessary records have not been kept, taxpayers will need to reconstruct their records. As a general rule, taxpayers will need to retain their records for at least five years from when the circumstance occurred to which the record relates.

Rules also now require companies to provide purchasers of mining and pre mining project interests with sufficient information to fulfil the purchaser's MRRT obligations.

# MRRT refresher

## How is a miner's MRRT liability calculated?



\* Allowances applied in the order shown

MRRT key concepts	
What is the effective MRRT rate?	22.5% (calculated as the basic MRRT rate of 30% reduced by a 25% extraction factor).
Is MRRT deductible for income tax?	Yes.
What is a mining project interest?	An entitlement to a share of the output of an undertaking to extract taxable resources from an area or land covered by a production right.
Can mining project interests be combined?	Mining project interests can be combined where the projects are integrated (upstream integration exists through existence of single mine, or, downstream integration exists through commonality of operations and where an election is made). Where a combination exists, certain attributes including royalty credits, mining losses and starting base losses/assets are able to be shared. Upstream integrated projects that can combine must combine.
Can a group choose to consolidate for MRRT purposes?	The head company of an income tax consolidated group may choose to consolidate for MRRT. Where consolidation is chosen, all mining project interests are treated as being held by the head company.
What is a pre-mining project interest?	An exploration right being an authority, right for a purpose of exploration or prospecting for taxable resources in a particular area in Australia.

What resources does the MRRT apply to?	<ul style="list-style-type: none"> <li>▶ Iron ore</li> <li>▶ Coal, or</li> <li>▶ Anything produced by the <i>in situ</i> consumption of coal or iron ore, or</li> <li>▶ Coal seam gas extracted as a necessary incident of coal mining or a proposed coal mine</li> </ul>
What is the taxing point?	The taxing point sets the project ring fence and is used to define activities upstream and downstream of the taxing point. The taxing point is generally just before the resource leaves the run of mine (ROM) stockpile.
What is mining revenue and how is it calculated?	<p>Mining revenue arises when a mining revenue event occurs in relation to a taxable resource. Mining revenue is calculated as the consideration received less amounts paid, for (or amounts that would be payable to procure another entity to provide) downstream activities or operations.</p> <p>Mining revenue also includes other amounts such as compensation for the loss of taxable resources and recoupments of mining expenditure.</p>
What is mining expenditure?	<p>Any amount paid or payable by a miner to the extent that it is necessarily incurred in carrying on upstream mining operations, being operations relating to the extraction of taxable resources and getting them to their taxing point. This can be either capital or revenue expenditure.</p> <p>Excluded expenditure includes financing costs, hedging and foreign exchange costs, mining and private override royalties, hire purchase costs, non-adjacent buildings used in administrative or accounting activities, rehabilitation bonds and income tax/GST.</p>
What concessions are available for small miners?	<p>Miners with group mining profits of \$50 million or less will have no MRRT liability through access to a low profit offset. Group mining profits take into account the profits of connected entities (broadly where a 40% shareholding test is held).</p> <p>The offset is phased out for group mining profits between \$50 million and \$100 million.</p> <p>Small miners also have access to a voluntary election to adopt a simplified MRRT method. This is available to miners who meet either of two profits tests:</p> <ol style="list-style-type: none"> <li>1. Where group profit is less than \$50 million. Group profit for the purpose of this test is the group's earnings before interest and taxes (EBIT) disregarding Commonwealth, State or Territory royalties, private override royalty expenses, non-project related expenditure and any exceptional earnings or expenses, or</li> <li>2. Where group profit is less than \$250 million and no entity included in the group profit calculation has a project interest where royalties paid are less than 25% of the profits attributable to that project.</li> </ol> <p>Miners who opt into the simplified MRRT regime are not required to lodge an MRRT return for that year; however all allowances and starting base losses are extinguished. The decision to opt in is made on an annual basis. Miners will need to take care in deciding to opt in as allowances and starting base losses previously extinguished are permanently lost, even if the simplified MRRT regime is not applied in future years.</p>
What is an MRRT year?	Generally a financial year starting on or after 1 July 2012. Taxpayers with a substituted accounting period (SAP) for income tax will be required to use the same SAP for MRRT purposes. For SAP taxpayers, the first MRRT year may be short, commencing 1 July 2012 to the end of their accounting period.
What happens on acquisitions and disposals of interests?	On disposal of mining project interest the buyer inherits the MRRT history of the interest. Where a part interest is sold, the project is split and the buyer inherits the split percentage of the mining project's MRRT attributes including allowances.
What is a royalty allowance?	<p>Mining royalties paid to a Commonwealth, State or Territory government are creditable for MRRT purposes as a deduction equivalent (divided by .225).</p> <p>Unused mining royalties are carried forward and uplifted at the Long Term Bond Rate (LTBR) for the preceding year plus 7%.</p>
What is a transferred royalty allowance?	Royalty allowances may be transferred where projects are integrated at all times starting at the time the royalty credit arises and ending at the end of the transfer year.

What is a pre-mining loss allowance?	Expenditure incurred before a mining project interest comes into existence is able to be used to reduce MRRT profits. Pre-mining losses can be applied where the mining project interest originates from the pre-mining project interest (i.e., the exploration right). Pre-mining expenditure is reduced by any pre-mining revenue (including sale of taxable resources extracted as part of exploration or recoupments of exploration expenditure).  Unused pre-mining loss allowances are carried forward and uplifted at the LTBR for the preceding year plus 7% for the first 10 years after the loss arises, but only at LTBR thereafter.
What is a mining loss allowance?	Unused general expenditure related to a mining project interest can be carried forward and uplifted at the LTBR for the preceding year plus 7%.
What is a transferred pre-mining loss allowance?	Pre-mining loss allowances arise from pre-mining expenditure and do not need to meet the ownership tests, and may be transferred to any other projects of the same type (i.e., iron ore or coal). To transfer to another entity, the entity must be closely associated with the miner at the end of the year.
What is a transferred mining loss allowance?	Mining losses may be transferred between projects of the same type (i.e., iron ore to iron ore, and coal to coal) where the project interests satisfy the common ownership test and the loss cannot be attributed to a year where the alternative valuation method was used.

Starting base valuation approaches		
	Book value	Market value
Method description	This method uses the book values of starting base assets as recorded in the most recent audited financial report before 2 May 2010.	Under this method, the total starting base amount is the sum of the market value of all starting base assets as at 2 May 2010.*
Starting base assets	Includes any kind of property, legal or equitable right used in upstream activities but excludes mining rights and interests, information, goodwill and improvements to land.	Includes any kind of property, legal or equitable right used in upstream project activities including mining rights and interests, information, goodwill and improvements to land.
Interim expenditure	Expenditure incurred to 30 June 2012 in relation to CGT assets, depreciating assets or mine development expenditure.	Expenditure incurred to 30 June 2012 in relation to CGT assets, depreciating assets or mine development expenditure.
Calculation of decline in value	Write off rates are prescribed in the legislation using a diminishing value method over 5 years.	Starting base assets are written off, using the diminishing value method, over the asset's remaining life or 25 years ending 1 July 2037, whichever is earlier.
Uplifts	The initial value of the starting base assets plus interim expenditure, are uplifted at the LTBR for the preceding year plus 7%.  Starting base losses are uplifted at the LTBR for the preceding year plus 7%.	The initial value of the starting base assets plus interim expenditure is not uplifted.  Starting base losses are uplifted at the CPI rate.

\*Under the market value method exploration assets held at 2 May 2010 may be optionally valued using a look back approach based on expenditure incurred in the 10 years prior to 2 May 2010.

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