

September 2011



What do you value?

MRRT Exposure Draft Legislation: Second Round Release

The second round of the Exposure Draft (ED) legislation for the proposed Minerals Resource Rent Tax (MRRT) was released on 18 September 2011. It was accompanied by updated explanatory material (EM) and a separate ED dealing with consequential amendments and transitional provisions.

This ED represents a significant update to the original ED, with an additional 157 pages of legislation and an additional 160 pages included in the EM.

The revised ED includes legislative provisions on areas not addressed in the first ED, including provisions dealing with:

- approach to valuations
- pre-mining project interests
- grouping of entities
- balancing adjustments
- winding down and ending of mining project interests
- integrity measures, and
- administration measures.

In addition, the updated ED includes a number of significant amendments to the original ED.

There is a short period for making submissions in respect of this ED, with submissions due by Wednesday, 5 October 2011.

It is anticipated that this will be the final ED release.

This publication sets out:

- key observations on the second round release of the ED
- a summary of the new provisions, including the key amendments to the first round of the ED, and
- what the ED means for you in your MRRT implementation planning.

PwC will issue further publications shortly which will explore particular aspects of the updated ED in detail.

Affected taxpayers will need to act quickly if they wish to make submissions on the ED by the deadline of Wednesday, 5 October 2011



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Key observations

1 ***There is only a small window for making submissions on the second round release of the ED.***

The second round release of the ED contains a large number of new provisions, as well as a number of significant amendments to the provisions included in the original ED. Affected taxpayers will need to act quickly if they wish to make submissions by the deadline of Wednesday, 5 October 2011 (12 working days after the ED was released).

2 ***This ED has tightened how the arm's length principle is to be applied to determine mining revenue.***

The mining revenue calculation is now subject to a more prescriptive two-step process:

Step One: determine the arm's length value of the resource at a defined point (usually point of first sale or export), which in most cases will be downstream of the MRRT taxing point, then

Step Two: work out the arm's length value of the activities downstream of the MRRT taxing point, and deduct this from the Step One amount to calculate the value of the resource at the MRRT taxing point.

The ED also clarifies that certain assumptions must be made when undertaking Step Two to work out the downstream value. These assumptions give a prescribed hypothetical situation which the miner must use in applying the arm's length principle, and could be read as an attempt to direct miners towards some form of 'netback' transfer pricing method. However, the ED and explanatory memorandum also contain references to using the transfer pricing method that produces the 'most appropriate and reliable measure' of the arm's length amount, and refer to the Organisation for Economic Cooperation and Development (OECD) Transfer Pricing Guidelines (which suggests a greater degree of flexibility than that implied by the Step Two 'assumptions'). Despite this apparent contradiction, the ED appears intended to limit the use of "profit-split" or similar measurements to determine the downstream value. This approach may be of concern to taxpayers with high value-added downstream operations, including those with transformative operations or significant downstream beneficiation of their taxable resource.

3 ***The MRRT rules are subject to broad anti-avoidance measures.***

The ED has introduced a number of broadly drafted anti-avoidance measures. In particular, the Commissioner of Taxation is able to re-characterise the MRRT implications of a transaction where it can be demonstrated that obtaining a MRRT benefit was more than a merely *incidental purpose* of a party to the transaction. This may be compared to the general anti-avoidance provision that currently applies for income tax purposes, which can only apply where the *dominant purpose* of a party to the transaction was to enable a tax benefit to be obtained.

The application of these provisions is likely to be subject to dispute, particularly as the breadth of the provisions raises the prospect that they could apply to general tax planning not normally subject to anti-avoidance measures.

The ED now provides a more prescriptive transfer pricing process for calculating the amount of mining revenue subject to the MRRT

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Key Observations

4 *Miners will need to be prepared to make a number of early choices, including whether they need to vary their MRRT instalment rate or form an MRRT consolidated group.*

Instalments of MRRT will be payable on a quarterly basis from 1 July 2012, such that the first instalment for all taxpayers will be due on 21 October 2012. An initial instalment rate of eight per cent and three per cent has been set for iron ore and coal respectively, however, entities can independently choose an instalment rate, such that they can vary instalments to nil, if they do not expect to have a MRRT liability in the relevant year. A general interest charge will apply if this rate is not broadly consistent with the miners' ultimate MRRT liability.

In addition, certain wholly owned groups can elect to be treated as a single entity (consolidated group) for MRRT purposes. This can have a number of advantages. The choice to consolidate only has effect from the day it is made (and notice of the choice needs to be provided to the Commissioner of Taxation with 21 days), such that groups may need to be prepared to make the election from the first day the MRRT is proposed to apply (i.e. 1 July 2012).

5 *A look back approach is available for valuing pre-mining interests (e.g. exploration leases) existing as at 1 May 2010.*

As a compliance saving measure, the look back approach can be applied to determine the value of a pre-mining interest existing at 1 May 2010. This will determine the value as being equal to the sum of all pre-mining expenditure (e.g. exploration) incurred in the ten years prior to 2 May 2010.

6 *Miners will need to reassess the MRRT impact of financing options as a consequence of a change in the treatment of finance leases.*

Under the revised EM, finance leases are no longer treated as excluded expenditure. Rather, finance lease payments will be deductible as incurred. The ability to obtain an immediate deduction for the implied principal value of the leased asset has been removed.

The impact of this change for miners will depend on how the implied interest rate applying to its finance leases compares to the rate at which MRRT losses are augmented (i.e. Long Term Bond Rate + seven per cent).

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What does it mean and next steps from here

Most immediately, companies should review the ED in detail (and / or consult with their professional adviser) to determine whether the proposed legislation applies appropriately to their particular circumstances, and whether a submission should be lodged to highlight deficiencies in the current drafting. Submissions need to be lodged by Wednesday, 5 October 2011.

Importantly, the release of the second MRRT ED provides taxpayers with further certainty in planning their response to the MRRT, with the proposed approach to all of the key issues now identified.

Given the complexity of the proposed MRRT regime, the impending start date and the significant system and information requirements associated with implementation, it will be important that affected companies develop a plan to prepare for the tax as soon as possible.

Key points to address will include:

- identifying project interests and whether they can or must be combined
- identifying the taxing point
- establishing a method for determining the taxable revenue at the taxing point
- valuing starting base assets
- establishing a system to identify and track upstream, downstream and joint costs
- modelling the impact of the MRRT on the value of your operations
- determining the accounting and external reporting impact of the MRRT on your operations, and
- planning for system and process changes.



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Expertise

PwC has a market leading energy and resources practice comprising dedicated tax, transfer pricing, valuations, consulting, accounting, legal and industry specialists who can deliver an integrated service offering to you. This can help in the design and implementation of your response to the MRRT.

We have a deep knowledge of the technical issues developed through active participation in the consultation process and assisting our clients with their response to the various resource rent tax proposals. In addition, PwC has been extensively involved in advising clients on the intricacies of the offshore PRRT regime since its introduction in 1987. This hands-on technical knowledge is combined with our practical industry expertise and insights developed through working with clients of all sizes in the affected industries.

We have developed a framework implementation plan that can be tailored to your specific needs which sets out the key actions across each of the issues outlined above. In particular, we can provide the following services to assist you in ensuring your business is MRRT-ready:

- Taxation services in relation to the technical interpretation and practical application of the MRRT.
- Valuation services to assist in calculating, documenting and supporting your calculation of the transitional starting base.
- Transfer pricing services to assist in calculating the taxable revenue at the taxing point.
- Technical accounting services in relation to the accounting and external reporting impact of the MRRT.

- Consulting services to help you develop best practice systems and processes including implementing upgraded accounting systems, business processes and stakeholder engagement strategies.
- Deal services to help you properly understand the impact of the MRRT on any proposed merger or acquisition and plan the appropriate strategy for managing such impacts.
- Legal services in relation to contract reviews and resource rent tax sharing and funding arrangements.

We will also be holding various technical sessions and releasing further publications on the MRRT in due course. Please liaise with your usual PwC contact or our resource tax specialists listed on this page if you have any questions or if you would like to discuss the impact of the MRRT on your business.

It will be important that affected companies develop an implementation plan to prepare for the MRRT as soon as possible



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Appendix A: Key amendments and new areas

Key amendments	Comments	Legislative Reference
Transfer Pricing	<p>As indicated above, the mining revenue calculation provision now provides a more prescriptive two-step process for performing the necessary transfer pricing analysis to calculate the value of the resource at the MRRT taxing point, as follows:</p> <p>Step One <i>Calculate an arm's length value of the resource at point of first sale or export:</i> Step One continues to be the computation of a revenue amount based on consideration received from the first 'supply' of the resource (usually corresponding to the point at which the resource is sold), which typically occurs downstream of the MRRT taxing point. The pricing of the 'supply' of the resource is required to be arm's length by virtue of the operation of the anti-profit shifting provisions (discussed further below). Further, if the resource is exported (or if something produced from the resource is used or exported) before a supply (sale) occurs, an arm's length consideration at that point should be calculated and used as the Step One revenue amount.</p> <p>Step Two <i>Reduce the Step One amount by the 'downstream' amount:</i> This step requires the value calculated in Step One to be split between the value upstream and downstream of the taxing point, via application of arm's length transfer pricing methods (where the downstream activity has not already been outsourced to a third party). However, the second ED has clarified that certain assumptions must be made when undertaking this step to calculate the downstream value, which have the potential to affect which method is selected and how it is to be applied. These assumptions include:</p> <ol style="list-style-type: none">1. the downstream operations are performed by a (hypothetical) 'service provider' to the miner2. there is a competitive market for those services, and3. the price for the services is sufficient to meet the costs of the downstream operations, including cost of capital commensurate with the risks involved. <p>Step Two requires that downstream activities which have been outsourced by the miner (e.g. outsourced rail and port activities) are to be valued at the <i>actual amount paid</i> to the party performing those downstream activities. This appears to clarify the question of how to value the downstream activities in situations such as where there is a long term agreement for use of downstream infrastructure but the historic amount agreed and amount actually paid are higher or lower than current market rates. Whilst it may be debatable whether this approach is fully consistent with the intent of the MRRT Policy Transition Group (PTG) recommendations in relation to ensuring the revenue taxed by the MRRT doesn't capture the value of the downstream operations, it has the advantage of ensuring that a miner cannot be subjected to MRRT on profits that were not realised.</p>	<p><i>Division 19</i> <i>Chapter 4</i></p>

Appendix A: Key amendments and new areas

<i>Key amendments</i>	<i>Comments</i>	<i>Legislative Reference</i>
<i>Transfer Pricing</i>	<p>The modifications within the second ED, in particular the ‘assumptions’ that the miner will be required to make in working out the downstream value, give a prescribed, hypothetical situation which the miner must use in applying the arm’s length principle. Further, these could be read as an attempt to direct miners towards some form of ‘netback’ transfer pricing method (i.e. they arguably limit the range of transfer pricing methods which taxpayers can use to calculate the arm’s length value of the resource at the taxing point). However, the second ED also states that the transfer pricing method to be used by the miner (at both Step One and Step Two) is that which produces the ‘most appropriate and reliable measure’ of the arm’s length amount, and the second ED and EM refer to the OECD Transfer Pricing Guidelines in this regard. It is unclear how the apparent limited flexibility implied by the Step Two ‘assumptions’ reconciles to the references to the OECD Guidelines and the ‘most appropriate and reliable measure’ requirement.</p>	<i>Division 19 Chapter 4</i>
<i>Combining mining project interests and integration</i>	<p>Following submissions on the first round of the ED and associated EM, the concept of what constitutes integration of two or more mining project interests has been redrafted. Integration is one of the conditions that must be met before mining project interests can combine.</p> <p>As recommended by the PTG, the concept of a “mine” has been introduced into the ED for determining whether two or more project interests are upstream integrated. The requirement that the project interests relate to the same mine or proposed mine replaces the previous approach that turned on the concept of whether the mining project interests were being operated as a “harmonious whole”. The EM has also been updated to provide examples and guidance on interpreting the concept of a “mine”.</p> <p>Amendments have also been made to the definition of mining operations. In particular, the concept of mining operations has been extended to include activities up to the point a taxable resource is brought to the location where it is sold. The effect of this amendment is to increase the scope of the downstream integration test.</p>	<i>Division 255 Chapter 9</i>
<i>Other</i>	<p>There are a range of other important amendments reflected in the ED. Two important changes are:</p> <ol style="list-style-type: none">1. Treatment of finance leases - Finance leases are no longer to be treated as excluded expenditure. Rather, finance lease payments will be deductible as incurred. The ability to obtain an immediate deduction for the implied principal value of the leased asset has been removed.2. Ability to cancel losses / starting base assets relating to a project Interest – The ED provides for the ability to cancel losses or starting base assets relating to a project interest. This provides miners the ability to combine integrated project interests that may not have otherwise been able to combine.	<i>Division 21 Chapter 5</i> <i>Division 115 Chapter 9</i>

Appendix A: Key amendments and new areas

<i>New areas</i>	<i>Comments</i>	<i>Legislative Reference</i>
<i>Winding down</i>	<p>From the time a mining project interest is “suspended”, allowance components will no longer be able to be carried forward and uplifted. Rather, they will be cancelled at the end of each MRRT year on a use it or lose it basis. Similar rules apply to pre-mining project interests.</p> <p>The taxpayer can nominate the suspension time as any day within ten years after commercial production has ceased (at which time the mining project interest is automatically suspended).</p> <p>A refundable rehabilitation tax offset may be available for upstream rehabilitation expenditure following suspension of a mining project interest. The maximum offset available is capped to the total MRRT a miner has paid, or is liable to pay, in relation to any mining project interest that it has ever had, adjusted for previous rehabilitation tax offsets and low-profit offsets already taken into account.</p>	<p><i>Divisions 130, 135, 155 and 225</i></p> <p><i>Chapter 11</i></p>
<i>Pre-mining project interests</i>	<p>Many aspects of the MRRT apply to pre-mining project interests (broadly an exploration right, including a Mine Development Licence) in the same way as they apply to mining project interests. However, there are key differences relating to the valuation of starting base assets, the timing of starting base losses and the ability to transfer pre-mining losses.</p> <p>Where the market value approach is chosen to value starting base assets for a pre-mining project interest that existed on 2 May 2010, an entity may elect to utilise a “look back” approach. This approach has the effect of treating all starting base assets as a single asset which has an initial base value equal to the sum of all pre-mining expenditure incurred in the ten years prior to 2 May 2010.</p> <p>The starting base of a pre-mining project interest that existed on 2 May 2010 does not begin to produce starting base losses until such time as a mining project interest is originated from the pre-mining project interest and production – other than incidental production – commences for the mining project interest.</p>	<p><i>Division 140</i></p> <p><i>Chapter 12</i></p>



Appendix A: Key amendments and new areas

<i>New areas</i>	<i>Comments</i>	<i>Legislative Reference</i>
<i>Adjustments</i>	<p>Broadly, the ED provides for adjustments to a miner's MRRT liability in the following cases:</p> <ol style="list-style-type: none">i. Change in circumstances adjustment - The existence or quantum of an MRRT amount was based on assumptions or estimates relating to future circumstances and those estimates or assumptions turn out to be incorrect. An example is where a particular asset was originally intended to be used solely in upstream operations, but was ultimately used in both downstream and upstream operations. In this circumstance, an adjustment to mining revenue and mining expenditure is required in the year the circumstances changed, to place the mining project interest in the same MRRT position as if the new circumstance had been taken into account originally.ii. Starting base adjustment – A starting base asset is disposed or no longer used, installed ready for use, or being constructed for use in upstream operations. Where this occurs, an adjustment amount arises, broadly equal to the amount received for disposal of the asset less the adjustable value (e.g. written down value) of the asset for MRRT purposes. A gain will be applied against any starting base losses, with any excess included in mining revenue. A loss will increase the starting base losses.	<i>Divisions 160 and 165 Chapter 13</i>
<i>Valuations</i>	<p>Guidance provided in Division 170 sets out one basic principle and five supporting sub-principles for valuations performed for the purpose of complying with the MRRT. To the extent there is any conflict between the basic principle and the sub principles the basic principle is to prevail.</p> <p>The basic principle is: A valuation relating to a mining project interest or pre-mining interest project interest is to be reasonable having regard to the objects of MRRT law.</p> <p>The five sub principles and their practical implications are discussed in turn:</p> <ol style="list-style-type: none">i. Valuations are to be performed without the benefit of hindsight: Namely, starting base valuations required as at 1 May 2010 should only take into account those facts, estimates and predictions which existed at 1 May 2010. Practically if there has been a development between 1 May 2010 and the date the valuation has been prepared (e.g. an increased likelihood of project expansion due to prevailing infrastructure conditions), then that development (increased likelihood of expansion) should not be taken into account when preparing the valuation.ii. The sum of values of all items in a set must equal the value of the set: This sub principle exists to ensure valuations avoid double counting. From a practical perspective, the sum of downstream plant and equipment, upstream plant and equipment and all other assets including mining rights should equal the total value of the project. Where market valuations exist for taxpayers at the valuation date, it would be prudent to consider the impact this may have on starting base valuations.	<i>Division 170 Chapter 14</i>

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<i>New areas</i>	<i>Comments</i>	<i>Legislative Reference</i>
<i>Valuations</i>	<p>iii. Identical assets are to be treated identically: In practice, it is rare that two assets would be considered identical by a valuer, however this sub principle lays the foundation for valuers to appropriately document reasons for any divergence from valuation benchmarks, and provides support for the basic principle that valuations are performed reasonably.</p> <p>iv. Appropriate assumptions are to be applied consistently: It is recognised that valuations require the use of estimates and assumptions. This principle requires such estimates and assumptions to be:</p> <ul style="list-style-type: none">a. reasonable when considered in isolation (e.g. adopting an estimate for resource to reserve conversion that falls within an observable, defensible and accepted range)b. reasonable in conjunction with all other assumptions (e.g. adopting a USD commodity forecast and associated currency forecast that when considered together provide reasonable AUD forecasts), andc. to be made consistently (e.g. adopting the same currency forecasts for the valuation of each project within a portfolio of valuations). <p>v. Previous valuations are to be taken into account: Practically, this applies where a valuation is required for another purpose beside a starting base allowance. In such circumstances, the valuation arrived at for the alternate purpose should be reconcilable to the valuations performed when determining the value for the starting base purposes.</p>	<p><i>Division 170</i> <i>Chapter 14</i></p>
<i>Accounting for the MRRT</i>	<p>Specific MRRT rules have been drafted to cover the treatment of non-cash benefits, functional currencies and substituted accounting periods.</p> <p>The MRRT non-cash benefit rules effectively convert non-cash transactions into equivalent transactions denominated in money. The rules are designed to try to ensure that there is neither an advantage nor a disadvantage to using non-cash transactions.</p> <p>The MRRT functional currency rules automatically apply to an entity that has a valid functional currency election for income tax purposes. For MRRT purposes, only the mining profit and the amount of an allowance component that is applied to work out an MRRT allowance are converted to Australian dollars.</p> <p>Whilst the standard MRRT year follows a financial year from 1 July to 30 June, the MRRT law specifies that those entities with a substituted accounting period for income tax purposes must also adopt the same period for MRRT purposes. The first MRRT year for all entities commences on 1 July 2012 – entities with a substituted accounting period will have a short first MRRT year. Specific provisions are included in the MRRT law setting out adjustments required for amounts included in long and short accounting periods as applicable.</p>	<p><i>Divisions 185, 190 and 195</i> <i>Chapter 15</i></p>

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<i>New areas</i>	<i>Comments</i>	<i>Legislative Reference</i>
<i>Entities</i>	<p>A group of entities can elect to consolidate for MRRT purposes if they are part of the same income tax consolidated group or a multiple entry consolidated (MEC) group. A MRRT consolidated group is treated as a single entity, so that the group's mining and pre-mining project interests are treated as being those of the head company of the group and the group's internal transactions are usually ignored for MRRT purposes.</p> <p>A group that chooses to consolidate for MRRT purposes will be able to do some things that a group that does not consolidate would not be able to do. For example, the group may be able to combine project interests held by different members of the group if those interests satisfy the upstream integration test or the downstream integration test. This could otherwise only happen to interests held by the same entity.</p> <p>The choice to consolidate has effect from the day it was made and continues to have effect (irrevocably) as long as the group exists. The group has 21 days from the date the choice is made to give the Commissioner notice in the approved form.</p> <p>The members of the group will be jointly and severally liable for paying the head company's MRRT liabilities if the head company does not pay them.</p> <p>The MRRT law applies to partnerships, trusts and unincorporated associations as if they each were an entity. That is, the liability for MRRT will rest with each of these types of entities. A distinction is made for unincorporated joint ventures whereby the MRRT law treats each joint venturer as having its own mining project interest or pre-mining project interest.</p>	<i>Division 215</i> <i>Chapter 16</i>
<i>Integrity measures</i>	<p>The ED introduces two MRRT integrity measures; a general anti-profit shifting rule and a general anti-avoidance rule.</p> <p>The general profit shifting rule seeks to ensure that a MRRT liability is not smaller than what that liability would have been if the parties were dealing wholly independently with one another. To the extent the dealing between the parties are demonstrated to be inconsistent with wholly independent dealings, adjustments are made to the MRRT liability. Broadly, this is achieved by applying OECD transfer pricing methodologies to price the transaction based on comparable circumstances between entities dealing wholly independently with each other.</p> <p>This new general profit shifting rule means the MRRT will use the arm's length principle not only to determine the value of the resource at the taxing point, but also to any other arrangements which affect the amount of profits taxed by the MRRT. This could potentially encompass a very wide range of commercial and /or financial aspects of the miners operations, including, for example, the price paid for upstream services outsourced to related or unrelated parties (which will form a cost or 'deduction' in the MRRT profit calculation).</p>	<i>Divisions 205 and 210</i> <i>Chapter 17</i>

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<i>New areas</i>	<i>Comments</i>	<i>Legislative Reference</i>
<i>Integrity measures</i>	<p>The general anti-avoidance rule will apply where an entity has obtained an MRRT benefit from a scheme and it is concluded that the scheme was entered into, or carried out, with a more than incidental purpose of getting a MRRT benefit from the scheme. If these rules apply, the Commissioner may make a determination that has the effect of negating the MRRT benefit obtained by the entity under the scheme.</p>	<i>Divisions 205 and 210 Chapter 17</i>
<i>Administration</i>	<p>A number of administrative provisions and amendments to existing taxation laws are necessary to provide the administrative framework for the MRRT. Key points include:</p> <ul style="list-style-type: none">• MRRT instalments will be payable on a quarterly basis from 1 July 2012. The first instalment will be due on 21 October 2012.• A default instalment rate of eight per cent for iron ore and three per cent for coal will apply in the absence of the Commissioner providing an instalment rate or the entity choosing an instalment rate.• Entities can choose an instalment rate, however the general interest charge can apply if this rate results in the instalments being too low (i.e. less than 85 per cent of the benchmark instalment rate by reference to the final MRRT liability).• The instalment rate is applied to instalment income, which is broadly consideration received for the supply of taxable resources (e.g. revenue from downstream sale of product).• Generally, miners will be required to electronically lodge an annual MRRT return and make payment of any outstanding MRRT liability on the first day of the sixth month after the end of the year (e.g. 1 December 2013 for 30 June balancers).• Entities that transfer a mining project interest must provide the acquiring entity an information notice within 21 days in relation to information the acquiring entity requires to determine the MRRT liability relating to that interest. This will include information on allowance components, starting base balances, mining revenue and expenditure etc.	<i>Chapter 18 Minerals Resource Rent Tax (Consequential Amendments and Transitional Provisions)</i>



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