

MRRT Legislation

Bill introduced to
Parliament – but will
further changes emerge?

November 2011

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There has been no pause in the fierce public debate on Australia’s proposed Minerals Resource Rent Tax (“MRRT”) since we published our summaries of the first and second Exposure Drafts (“ED1” and “ED2”) of the MRRT legislation (PwC summaries dated June 2011 and September 2011).

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The MRRT Bill (the “Bill”) and the accompanying explanatory memorandum (“EM”) were finally introduced to Parliament on 2 November 2011.

The Bill represents the culmination of an extensive consultation process between the Department of Treasury and Finance (“Treasury”) and industry that has taken place as a consequence of the release of ED1 and ED2.

Whilst this Bill is a significant milestone, the legislation’s passage is not assured and remains subject to parliamentary debate and approval. The House of Representatives commenced debate on the package of MRRT Bills on 3 November 2011 and the Bill has been referred to the House of Representatives Standing Committee on Economics who have been asked to

report back by 21 November 2011. The Committee is holding public hearings on the Bills this week in Canberra (Tuesday, 8 and Wednesday, 9 November).

The House of Representatives next sits in the week commencing Monday 21 November with a possible extension of three days in the following week (Monday 28 - Wednesday 30 November) if required. The Government aims to have the Bill passed by the House of Representatives this year but importantly ‘substantial enactment’ will not occur until the Bill is passed by the Senate. The earliest this could be expected to occur would be when the autumn sittings for both Houses commence in the New Year on 7 February 2012.

The legislation introduced by the Bill includes provisions to clarify areas not fully addressed in ED1 and ED2 and provides greater certainty on the operation of the MRRT. Despite this, there are several key areas which were the focus of submissions on ED2 that have not been changed. These include:

- Concessions for small to medium miners;
- High default instalment rates for iron ore miners; and
- The inability to separately depreciate improvements to land as individual starting base assets when using the market valuation method.

This publication sets out:

- Key observations on the Bill introduced into Parliament;
- A summary of the key amendments based on a comparison with ED2; and
- Some thoughts on what the Bill will mean for you in the context of implementation and planning.”

Go-live timeline

MRRT Bill introduced to Parliament
2 November 2011

House of Representatives initial debate of the Bill
3 November 2011

Public hearings
8 & 9 November 2011

House of Representatives Standing Committee on Economics’ report due
21 November 2011

Parliament resumes
21 November 2011

Possible date for ‘substantial enactment’
Anytime from 7 February 2012

MRRT goes live
1 July 2012

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What Does It Mean and Next Steps

The Bill is a significant milestone for the MRRT. Given the complexity of the proposed regime, companies should, as a matter of urgency, prepare for the MRRT implementation date of 1 July 2012. This preparation will require reviewing the Bill (and / or consulting with your professional advisor) to determine the impact on your business.

Key compliance and reporting systems should be up and running before 1 July 2012 to ensure that essential data can be appropriately captured.

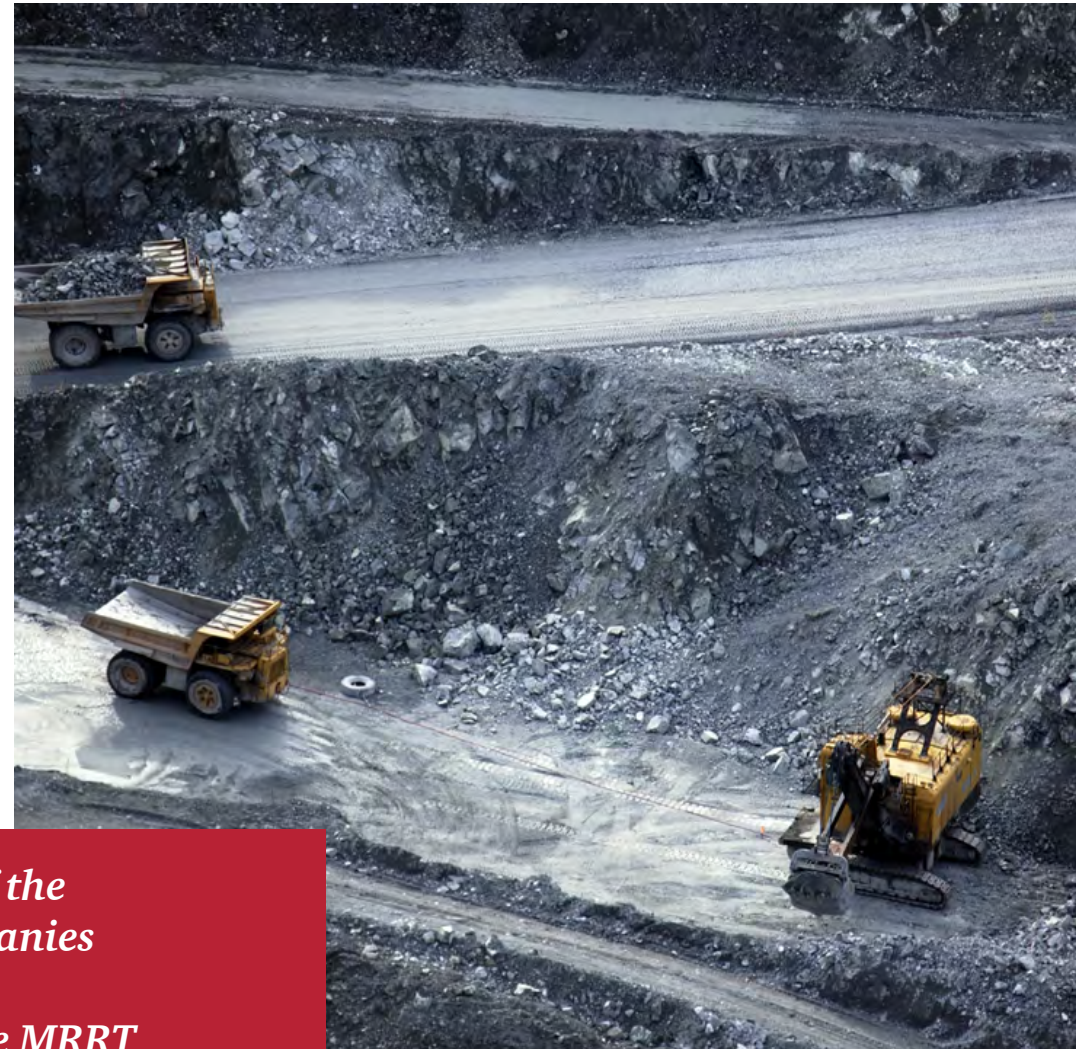
As a first step, companies should complete a detailed model to determine the impact of the MRRT so that they can make key decisions such as:

- whether to elect to use the simplified MRRT method;
- the appropriate Transfer Pricing method used to evaluate mining revenue; and
- the most beneficial starting base valuation method (book or market value).

For companies already engaged in modelling their MRRT position, the Bill includes a few key changes that should be taken into account, including:

- Valuation methods for mining revenue – the profit split method is no longer expressly disallowed and a new optional ‘safe harbour’ method has been introduced;
- Pre-mining exploration costs – costs incurred under farm-out agreements may now be deductible; and
- Starting base valuation – improvements to land that were previously disallowed can now be included in the combined starting base value under the market value method.

Existing models should be updated for these changes.



Given the complexity of the proposed regime, companies should, as a matter of urgency, prepare for the MRRT implementation date of 1 July 2012

Our Key Observations

Observation 1

The rules surrounding Transfer Pricing valuation methods for mining revenue now allow greater flexibility

As highlighted in our submission to Treasury dated 5 October 2011, ED2 significantly narrowed the basis on which the arm's length principle was to be applied under the MRRT to determine mining revenue. The modifications appeared to direct taxpayers to a cost-plus approach for valuing the activities downstream of the MRRT valuation point (the Bill amended the term from taxing point to valuation point), thereby limiting the range of transfer pricing methods which taxpayers can use to calculate the arm's length value of the resource at the valuation point. A number of taxpayer and industry submissions in response to ED2 expressed concern regarding this apparent inflexibility.

The Bill now includes modifications that remove some of this inflexibility. In particular, the Bill appears to align itself more closely with the Organisation for Economic Cooperation and Development ("OECD") Transfer Pricing guidelines and clarifies that miners can select and use the most appropriate and reliable method for their circumstances, having regard to factors such as the functions, assets and risks of the miner and the available information.

Further, the Bill now also contains an optional 'safe harbour' method. This is a form of 'netback' method which uses a cost of capital approach to value the activities downstream of the MRRT valuation point. This method may be attractive to some miners who believe the safe harbour method gives a reasonable approximation of an arm's length outcome in their circumstances. Although the safe harbour method should help improve certainty for those who elect to use it, some residual uncertainty will invariably remain regarding the appropriate 'cost of capital' that miners apply to their downstream operations.

Observation 2

The MRRT integrity rules have been aligned with the general anti-avoidance provisions in the income tax legislation

ED2 previously provided that a taxpayer may be subject to the MRRT integrity provisions if it could be shown that a transaction was entered into with a not incidental purpose of obtaining an MRRT benefit. As expected, industry was concerned that this phrasing could be interpreted widely, thus capturing transactions which were commercially motivated.

The Bill has addressed this issue by aligning the MRRT anti-avoidance provisions with the general anti-avoidance provisions in the income tax law (Part IVA). The Bill now refers to a sole or dominant purpose test that must be satisfied for the MRRT integrity provisions to apply. This change represents a significant move by Treasury to ensure consistency with existing income tax law.

Industry should take from this a confidence to enter transactions where significant commercial benefits are realised, with the knowledge that any secondary MRRT benefits should not be denied. Further, the extensive body of case law on Part IVA provides some clarity on the application of the 'dominant purpose' test – albeit the ATO has flagged the need for legislative reform of aspects of Part IVA due to its recent interpretation of its provisions in the Courts.

Observation 3

Exploration expenditure incurred under farm-out agreements should now be deductible expenditure for MRRT purposes

The Bill reflects the recently released Taxation Ruling on deferred farm-out arrangements.

Specifically, in an effort to provide a consistent treatment across the income tax and MRRT regimes, the Bill provides that exploration expenditure incurred by a farmee on behalf of a farmer, under a deferred farm-out arrangement, can be included as pre-mining expenditure by the farmer.

This concession reflects the commercial reality for miners who utilise farm-out arrangements as a means to access finance and spread the risk of exploring and developing their early stage mining interests.

...miners can select and use the most appropriate and reliable transfer pricing valuation method for their circumstances, having regard to factors such as the functions, assets and risks of the miner and the available information

Our Key Observations

Observation 4

The Bill primarily seeks to refine its rules and to provide clarification on how they operate

As a result of the numerous submissions on ED1 and ED2, Treasury has considered the issues raised by industry, taxpayers and professional bodies alike.

A product of this has been a general refinement of the Bill, including for example, further EM comments, more detailed wording in the Bill itself and the refinement of language. This should remove a degree of uncertainty for companies who are modelling their MRRT liability, providing for more accuracy in calculating their MRRT position.

Observation 5

An additional starting base concession has been granted – the ability to include improvements to land that would have been disposed of prior to the start time of the project interest

Treasury has recognised the inherent difficulty in calculating a market value for starting base assets and has provided an additional concession in the Bill.

The Bill now allows the inclusion of all upstream ‘improvements to land’ within the starting base to the extent that they existed on 1 May 2010. This includes assets that are consumed or destroyed before the ‘start time’ of the mine.

This concession could significantly increase the value of starting base assets and should be communicated to valuation experts conducting starting base valuations.

Despite this concession, the ability to separately depreciate improvements to land as individual starting base assets when using the market valuation method has not been introduced by the Bill.

Observation 6

All taxpayers (including smaller miners and those with transformative operations) are likely to need to undertake valuation, transfer pricing and systems changes to comply with the MRRT

A feature of the development of the Bill is that the compliance burden will fall on all iron ore and coal miners, regardless of the scale of their operations. Whilst concessions exist in the Bill for smaller miners and those with transformative operations in terms of calculating their mining revenue (under Division 175) and through relief in the threshold of MRRT profit, the nature of the Bill is that the burden of compliance will remain. This is because the concessions offer limited practical assistance or accessing them results in the miner suffering sanctions (such as a loss of carry forward attributes) that make them comparatively unattractive.

As highlighted, some additional lobbying in relation to this aspect can be expected before the Bill is passed into law.

The Bill primarily seeks to refine its rules and to provide clarification on how they operate.



Key Amendments – Snapshot

Outlined below is a brief summary of the key amendments of the Bill. These are discussed in further detail at Appendix A

Topic	Impact to miner	Summary
Transfer Pricing	✓	TP rules have been made more flexible and potentially allow all OECD methods (including <i>profit split</i> for transformative operations) to be used as well as a general <i>safe harbour</i> method.
Deferred farm-out arrangements	✓	Exploration expenditure incurred by other entities under a farm-out agreement may now be deductible expenditure.
Starting Base Allowances	✓	Land improvements that are consumed/destroyed prior to starting base start time can now be included in the starting base value under the market valuation method.
Splitting Mining Project Interests	Neutral	Clarity has been provided over mining project splits for JV partners and where only a portion of a project interest's resource is intended to be mined.
Pre-Mining Project Interests	Neutral	In order to bring the pre-mining project interest legislation in line with those regarding mining project interests, clarity has been provided over the operation of royalty credits and transferring, splitting and ending of pre-mining project interests.
Anti-Profit Shifting Rules	✗	The anti-profit shifting rules have been expanded to place further onus on miners to act as <i>independent parties</i> and provides additional powers to the Commissioner to make amendments to MRRT components.
Integrity Provisions	✓	The integrity provisions have been aligned with the general anti-avoidance provisions in the income tax legislation and are now less onerous.
Rehabilitation Offsets	Neutral	Only the entity legally responsible for the rehabilitation expenditure (i.e. the primary entity) can claim an MRRT deduction.
Currency translation	✓	Clarity has been provided on the translation rules for various MRRT amounts.
Carbon tax	✓	Taxpayers are permitted to deduct (for MRRT purposes) upstream expenditure they <i>necessarily incurred</i> in respect of the "Carbon Tax".
Partial disposal of starting base assets	Neutral	Starting base assets will be depreciated separately for pre and post disposal periods.
Consequential amendments to the income tax legislation	✓	Further clarity provided to taxpayers surrounding the wider tax implications from the enactment of the MRRT.
Mining ventures	✓	Further clarity on the definition of mining ventures.
Starting base returns	Neutral	Requirement to lodge a starting base return places further administrative requirements on taxpayers, but is of importance in clearly substantiating starting base choices.
Consolidation	✓	Taxpayers now given an option to be treated as a consolidated group for MRRT purposes (prior to 1 July 2012) which can provide compliance benefits.
Concessions for all taxpayers (including small miners and those with transformative operations)	✗	The burden of compliance will largely still fall on taxpayers, either because the concessions offer limited practical assistance or accessing them results in the miner suffering sanctions (i.e. loss of certain allowances).

Our 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. We can help with 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:

- Definitive advice on 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 mining revenue at the valuation point.
- Technical accounting services in relation to the tax effect accounting 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 and develop a strategy to manage this impact.
- Legal services in relation to contract reviews and MRRT tax sharing/funding arrangements.

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



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Appendix A

Key Amendments and New Areas

Transfer pricing

ED2, released in September 2011, significantly narrowed the basis on which the arm's length principle was to be applied to calculate mining revenue. The modifications appeared to direct taxpayers to a cost-plus (or equity return) approach for valuing the activities downstream of the MRRT valuation point. This did not seem consistent with the recommendation by the Government-commissioned MRRT Policy Transition Group (PTG) that taxpayers should have the flexibility to use the arm's length pricing method most appropriate to their circumstances.

The Bill contains further modifications which remove some of the inflexibility imposed by ED1 and ED2. In particular, the Bill is now more consistent with accepted OECD Transfer Pricing Guidelines and clarifies that miners can select and use the most appropriate and reliable method for their circumstances, having regard to factors such as the functions, assets and risks of the miner and the available information.

In applying the most appropriate method, there remain a number of relatively prescriptive 'assumptions' which a miner must make (broadly, that the downstream operations are a distinct and separate hypothetical entity, dealing at arm's length with the upstream operations under competitive market conditions).

Miners must also assume that the notional downstream entity does not take title to the resource. This clearly allocates commercial risk associated with ownership of the resource to the notional upstream entity.

However these assumptions are only required to be made to the extent that they are relevant to the chosen method and the Bill is no longer structured such that the assumptions limit the methods available to the miner.

The updated EM to the Bill also provides some helpful guidance and clarification largely absent from ED2, including:

- Clarification that the Bill does not mandate a netback approach (arguably implied by ED2).
- Confirmation that regard may be had to the OECD Guidelines in selecting and applying the most appropriate method (all five OECD transfer pricing methods are explicitly listed as potentially applicable under the MRRT, depending on the fact pattern).
- More guidance and examples on the types of situations where particular methods may be appropriate and how these methods might be applied, including guidance on netback approaches and the profit split method. For example, this includes recognition that the profit split method may be appropriate for vertically integrated, transformative operations, such as coal to electricity generation or steel production.

The Bill now also contains an optional 'safe harbour' method. This is a form of 'netback' method which uses a cost of capital approach to value the activities downstream of the MRRT valuation point. This method may be attractive to miners who take the view that the safe harbour method produces a reasonable approximation of an arm's length outcome in their circumstances. The safe harbour method should help improve certainty for miners who elect to use it, although some residual uncertainty will invariably remain regarding the calculation of an appropriate 'cost of capital' to apply to downstream operations.

Deferred farm-out arrangements

Taxation Ruling (MT) 2011/D2 was released on 24 August 2011 to clarify the ATO's view on deferred farm-out arrangements from an income tax perspective. The Bill now includes provisions to ensure that the treatment of farm-outs for MRRT purposes will be consistent with the income tax treatment proposed in the draft ruling.

Prior to the release of the Bill, exploration expenditure could only be included in pre-mining expenditure if it was incurred by the entity which owned the pre-mining project interest. The Bill now allows exploration incurred by other entities on behalf of the miner (i.e. as part of a farm-out arrangement) to also be included.

Specifically, where this other entity (the farmee) is given an interest in the project interest as consideration for exploration services, the value of that consideration is included in the farmor's pre-mining expenditure. Alternatively, where no consideration is given (i.e. where the farmee did not meet the requirements of the farm-out arrangement) the amount of expenditure incurred by the farmee is included by the miner (the farmor) in pre-mining expenditure.





Starting base allowances

The Bill recognises the inherent difficulty in valuing a project interest under the market value approach and allows for the inclusion of improvements to land that existed on 1 May 2010 in the starting base valuation, even if those improvements were consumed or destroyed by the start time (the later of 1 July 2012 and the day in which production commences) of the project interest.

Previously, the definition of a starting base asset required that it be used, installed ready for use, or constructed for the carrying on of upstream mining operations.

Clarification has also been given on the effect of combining projects where these projects use different valuation methods for starting base (i.e. both book value and market value approaches adopted). In this situation, the two starting base assets are maintained as separate assets and depreciated using the prescribed formula under each valuation method. The result is two available starting base allowances. In this situation, the starting base loss allowance calculated under the book value approach is used first. This logic applies even where more than two project interests are combined. In this situation, starting base assets which have been valued using the same method are combined, with the result being two categories of starting base assets as above.

Splitting mining project interests

In mining operations, a situation where an entity enters into a joint venture (“JV”) to share in the risks and output of a mining project will often arise. Recognising this, the Bill has confirmed that a mining project split occurs in this circumstance. This creates two (or more) separate interests which are assigned to the entities engaged in the JV, thereby providing certainty over how JV partners should determine their MRRT liability.

For completeness, the Bill also covers mining project interests where only a portion of the resource is intended to be mined. In this circumstance, the EM considers that the residual (i.e. remaining resource) will also represent a separate mining project interest. This will be of relevance to entities engaged in JV agreements and farm-out arrangements where the output is limited to either a period of time or quantity of resource and a residual is expected.

Pre-mining project interests

The Bill now provides greater clarity on how pre-mining project interests operate. This includes amendments regarding royalty credits and the rules that apply to transferring, splitting and ending pre-mining project interests.

Royalty credits

The Bill now recognises that pre-mining project interests also attract royalties, and confirms that in calculating a royalty credit, the same methodology should be adopted for both mining projects and pre-mining project interests.

The Bill also provides that royalty credits generated by a pre-mining project interest can be utilised to reduce pre-mining profits in the same manner as for mining profits.

Transferring pre-mining project interests

ED2 provided that, in the context of a *pre-mining project transfer*, the *pre-mining expenditure* and *pre-mining revenue* history would be transferrable to the acquiring entity (subject to certain limitations).

The Bill now makes it clear that this is also true of royalty credits. Where there are royalty credits (and therefore an available royalty allowance) relating to a pre-mining project interest, these can now be transferred to an acquiring entity.

Through this amendment, Treasury has recognised the importance of delivering allowances to purchasers in order to ensure projects remain as attractive as possible to potential acquirers.

Appendix A

Splitting pre-mining project interests

As a matter of clarification, the Bill includes minor amendments to confirm that a *pre-mining project split* is taken to happen where a *pre-mining project* converts to a *mining project*.

This amendment confirms the continuation of a pre-mining project's MRRT history upon conversion into a mining project interest.

Ending pre-mining project interests

The Bill has provided further clarity on the transition between pre-mining project interests and mining project interests.

Specifically, the Bill confirms that the effects of a termination do not apply where a mining project interest resulted from a pre-mining project interest. The effect of these changes is that the allowances attaching to a pre-mining project interest will be inherited by the mining project interest (upon transition), and as such, be available to the interest holder.

These amendments ensure that a project's MRRT history is grandfathered from the exploration phase through to the development and production phases.

Anti-profit shifting rules

The anti-profit shifting rules have been expanded since the release of ED2. The Bill now places a further onus on miners to transact as independent parties would in a commercial environment.

The Bill also provides powers for the Commissioner of Taxation (the "Commissioner") to make amendments to MRRT (e.g. mining profits and allowances) where the Commissioner considers a miner did not act independently.

The EM has identified that agreements such as leases may be subject to these provisions where a comparability analysis shows that costs have been unevenly spread across MRRT income years. Practically, this will require miners to recognise costs on a commercial basis and should prevent miners augmenting costs over longer than intended periods.

Integrity Provisions

Schemes which produced an incidental MRRT tax benefit were likely to have been caught under the integrity provisions of ED2. This created uncertainty around the level of tax benefit that would be caught under the integrity provisions and increased the need for companies to demonstrate a strong commercial purpose for relevant transactions/matters.

The Bill addresses this issue by aligning the MRRT integrity provisions with the general anti-avoidance provisions (Part IVA) contained in the income tax legislation. The Bill now refers to a requirement for a sole or dominant purpose before a scheme is caught within the integrity provisions.

This shift in wording means miners are better placed to implement commercially driven business structures where there is a merely incidental MRRT benefit.

Rehabilitation offsets

In the context of rehabilitation offsets, the Bill confirms that a primary entity is taken to have incurred the rehabilitation expense, regardless of which entity in the group actually paid the amount. In doing so, it seeks to prevent a double deduction being claimed in respect of rehabilitation.

Practically, group companies (not consolidated for income tax purposes), partnerships and other related entities should monitor their internal processes to ensure that rehabilitation costs are appropriately captured by the primary entity.

Currency translation rules

Although ED2 included provisions in relation to foreign currency translation and functional currency, the Bill has provided some further clarity in these areas.

The general requirement is that amounts calculated for the purposes of the MRRT are to be translated from the relevant functional currency to Australian dollars on the last day of the MRRT year and that instalment income should be translated on the last day of the instalment quarter. In this regard, the Bill specifically mentions mining profits, pre-mining profits, allowance components, rehabilitation tax offsets and amounts under the simplified MRRT method.

Expenditure incurred to comply with Carbon Tax requirements

In a similar vein to the income tax test, for expenditure to be classified as deductible for MRRT purposes, it must be necessarily incurred in generating mining revenue.

The EM provides an updated example to reflect the arrival of "Carbon Tax" legislation. It demonstrates that where expenditure is required to comply with the Carbon Tax in relation to a miner's upstream operations (the example given is a purchase of 300 hectares of forest to offset emissions), this expenditure will be deductible for MRRT purposes.

Appendix A

Consequential Amendments

Partial disposal of starting base assets

The Bill includes further legislative changes dealing with the partial disposal of starting base assets. If a starting base asset is partially disposed of (i.e. via sale, destruction or consumption), then the depreciation of that asset is calculated separately for the period before and the period after disposal.

Income tax legislation

The EM details certain consequential amendments to the income tax legislation required as a result of the introduction of the MRRT. Importantly, payments of MRRT and payments of MRRT instalments will be deductible for income tax purposes.

Similarly, refunds of MRRT and MRRT recoupment's will be treated as assessable income. This includes rehabilitation tax offsets refunded to the miner.

Mining ventures

The Bill clarifies the definition of a mining venture as an undertaking where the purpose is to extract taxable resource from an area covered by one or more production rights. Generally, but not always, this refers to a joint venture arrangement.

Starting base returns

The Bill now details how miners make the choice between the market value or book value approach to value their starting base assets. A separate starting base return will need to be lodged by the day on which an entity's MRRT return is due for the first MRRT year (or on a later date if allowed by the Commissioner).

Importantly, if a project interest is transferred after 1 July 2012 and before the starting base return is lodged, the transferee is required to lodge the return by the same time that the transferor would have been required to, assuming it had continued to hold the interest.

Consolidation prior to 1 July 2012

The Bill provides an ability to be a consolidated MRRT group prior to the MRRT start date of 1 July 2012, in recognition that the group may undertake activities that affect the operation of the MRRT before the start date. This may result in substantial compliance benefits.



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