On 18 September 2011, the Deputy Prime Minister and Treasurer, Wayne Swan, and the Minister for Resources and Energy, Martin Ferguson, released the second Exposure Draft (ED) legislation and updated Explanatory Memorandum (EM) for the proposed Minerals Resources Rent Tax (MRRT). The Government has indicated that while the policy remains the same, as previously announced, the second draft contains changes that are intended to strengthen the integrity of the tax.

The second ED legislation covers the areas not already addressed in the first ED, released on 10 June 2011, and also updates the areas covered in the first ED to take into account comments received during the initial consultation process. Nevertheless, uncertainties remain. For example, the application of several parts of the ED legislation in relation to the transfer of mining project interests that occur between 2 May 2010 and 30 June 2012 is unclear.

This KPMG Tax in Focus brief provides commentary and analysis of:

− the changes to the draft legislation included in the first ED legislation
− the new draft legislation not released with the first ED legislation.

See KPMG Tax in Focus brief TiF11-022 of 30 June 2011 for commentary and analysis of the first ED legislation and EM for the Government’s proposed MRRT.
Mining revenue

Mining revenue is determined by applying the following two-step process:

– first, determine the ‘revenue amount’
– second, reduce the ‘revenue amount’ by the ‘downstream amount’.

The ‘revenue amount’ is broadly:

– for an actual supply: the consideration received (subject to anti-profit shifting rules if the supply is not at arm’s length)
– for exportation: the arm’s length consideration of the taxable resource at the time and place of export, or
– for the use of a thing produced from the taxable resource: the arm’s length consideration of the taxable resource at the time and place of use.

The ‘downstream amount’ is broadly:

– the amounts paid or payable by the miner to procure another entity to provide downstream mining or transformative operations, or
– if the miner carries out the downstream operations or transformative operations itself, the amounts that would have been paid or payable if the miner had procured another entity to carry out those operations based on a number of assumptions.

KPMG observation

In the first ED legislation, it was at the miner’s discretion to determine the attribution methodology that would produce the most reliable measure of the mining revenue at the taxing point. The second ED legislation incorporates significant changes to the methodology for determining mining revenue and, in particular, the legislation is now prescriptive. While the current two-step methodology may provide greater clarity on how to determine mining revenue, it may result in an outcome where the ‘downstream amount’ is not reflective of all the value added to the taxable resource beyond the taxing point. For example, the current approach refers to internal downstream operations as services to the miner and includes the assumptions of competitive markets in working out the downstream returns.

It is noted the Policy Transition Group (PTG) recommended the use of arm’s length methods in working out the value of the resource at the taxing point, which is not reflected in the current ED legislation.

Mining expenditure

The second ED legislation includes some refinements to the expenditure that can be taken into account in working out the miner’s mining expenditure for a mining project interest.

In particular, it is noted that finance leases are no longer listed as excluded expenditure. As a result, finance lease expenditure will be deductible mining expenditure to the extent it is necessarily incurred in carrying on upstream operations for the mining project interest.

Starting base for pre-mining project interests

A starting base asset can also arise in relation to a pre-mining project interest that existed on 2 May 2010. However, the starting base does not begin to produce starting base losses before a mining project interest originates from the pre-mining project interest.
Market value approach
If the market value approach is chosen, an entity can choose to work out the base value of its starting base for pre-mining assets by using a ‘look-back approach’. Using this approach:

- All pre-mining starting base assets are treated as a single starting base asset.
- The base value of the asset as at 2 May 2010 is equal to the sum of all pre-mining expenditure incurred between 2 May 2000 and 1 May 2010.
- The effective life of the single asset is capped at the shorter of the longest life of any right or interest making up the mining project interest or 25 years.

KPMG observation
The MRRT also provides an allowance for pre-mining losses resulting from pre-mining expenditure. One of the requirements for a pre-mining loss allowance is that the pre-mining loss must relate to a pre-mining project interest, which is defined to be ‘an interest in an exploration right’, that an entity ‘holds’. A common arrangement in exploration projects is for an entity that does not hold the exploration right to ‘farm-in’ to the project whereby the entity only obtains their interest in the exploration right after they have met certain expenditure commitments. Where the farm-in party does not hold an interest in an exploration right, the net expenditure incurred would not seem to give rise to pre-mining losses.

Starting base adjustments
A starting base adjustment (which requires adjustments to starting base losses and, in certain cases, including an amount in mining revenue) occurs when a ‘starting base adjustment event’ happens. Examples of starting base adjustment events include the disposal of a starting base asset, or when a starting base asset is permanently no longer used in upstream mining operations.

There is an exception. A ‘starting base adjustment event’ does not happen for a starting base asset that is a right or interest that constitutes a mining project interest (or an asset that is transferred together with such a right or interest). This exception recognises that when a mining project interest is transferred from one miner to another, the tax history will be inherited by the other miner.

Adjusting MRRT liabilities
If there are changes in the circumstances affecting the amount of a previous item of mining/pre-mining revenue/expenditure, an adjustment is made so that, in net nominal terms, the correct result is achieved. This will arise where initial assumptions or estimates about future events or circumstances turn out to be incorrect.

The adjustment arises and is accounted for in the period in which it becomes more likely than not that the original assumptions or estimates were incorrect. Broadly, the adjustment follows the original treatment. Examples of circumstances intended to be captured by these provisions are bad debts or changes in the extent an asset is used for upstream operations.

Relevantly, the time of the adjustment arises when it becomes ‘more likely than not’ that the original assumptions or estimates were incorrect. Given this subjectivity, uncertainties may arise when determining when the adjustment is triggered.

Winding down and the ending of mining project interests
Towards the end of a mining project interest’s life, special rules will apply from the ‘suspension day’, being the earliest of:

- the day chosen by the miner (after commercial production has ceased)
- the day 10 years after commercial production most recently took place, or
- the ‘termination day’ (the day when no entity has the mining project interest).
The consequences of a ‘suspension day’ occurring are broadly:

- the allowance components can no longer be carried forward and uplifted (i.e. they are extinguished)
- rehabilitation tax offsets may be available.

Beyond these consequences, the mining project interest is otherwise unaffected. Therefore:

- The mining project interest may still have an MRRT liability for each year after the ‘suspension day’.
- The mining project interest will continue to accrue allowances within each year and have the ability to utilise them during the year (whether against the mining project interest’s own mining revenue or transferred to another mining project interest).

After the ‘termination day’ (for example, when there is no longer a production right), even though the project interest has ended, the entity that had the mining project interest at the ‘termination day’ is deemed to continue to have the interest. This rule ensures that mining revenue derived after the termination day does not escape taxation.

**Rehabilitation tax offset**

A miner has a rehabilitation tax offset for a mining project interest for a year if:

- there was an MRRT liability for the interest for a previous MRRT year
- the ‘suspension day’ has occurred
- the miner incurred upstream rehabilitation expenditure
- a mining loss has been cancelled as a result of the suspension day having occurred.

The amount of the offset is the allowable rehabilitation expenditure multiplied by the MRRT rate (however the offset cannot exceed the MRRT liabilities of the mining project interest for all MRRT years).

The rehabilitation tax offset is a refundable tax offset. If the offset exceeds the amount of the MRRT liability in any particular year, the Commissioner will pay the excess to the miner.

**Consolidated groups**

A group of entities that are a consolidated group or a MEC group, for income tax purposes, can choose to consolidate for MRRT purposes.

An MRRT consolidated group is treated as a single entity, so the group’s 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. Specifically, the subsidiary members are treated as being part of the head company for:

- working out the mining project interests and pre-mining project interests the entities have
- working out the MRRT payable
- working out the allowance components
- working out the entities’ instalment income for an instalment quarter.

An entity that joins an MRRT group transfers its mining project interests and pre-mining interests to the head company and the head company inherits the subsidiary’s MRRT asset treatment and allowance components. The complex income tax allocable cost amount calculations do not apply for MRRT purposes.

When an entity leaves an MRRT consolidated group, the head entity is treated as transferring to the leaving entity the mining project interests it takes with it, thereby allowing the leaving entity access to the allowance components.
Integration and combination
The second ED legislation also includes changes to the rules for integration and combination of mining project interests.

Upstream integration of mining project interests relating to the same taxable resource is required if the mining project interests relate to the same mine or proposed mine.

If integrated mining project interests cannot combine, because allowance components are not transferable, the miner can choose to cancel the allowance components that are preventing combination.

Foreign currency
In the absence of a valid choice to use a functional currency, a miner’s MRRT liability is calculated by measuring amounts in Australian dollars, even where those amounts are denominated in a foreign currency. The rules for translating foreign currency amounts into Australian dollars are similar to the translation rules for income tax purposes.

The functional currency rules for MRRT automatically apply to an entity that has a valid choice in effect to use an applicable functional currency for income tax purposes. Miners who have made a valid functional currency choice, account for individual transactions in a currency other than Australian dollars with the net amount (mining profit, pre-mining profit and mining allowances) then translated into Australian dollars.

Substituted accounting periods
An entity that uses an accounting period for income tax purposes other than the standard 1 July to 30 June year must use the same substituted accounting period for its MRRT year.

All entities start their MRRT year on 1 July 2012, being a hard start date. Therefore, an entity which has a substituted accounting period will have a short first MRRT year.

The MRRT draft legislation provides specific rules to deal with entities that change their accounting periods. Broadly speaking:

− Any overlap between the old and new periods is counted as part of the old period and therefore the old period will be a long MRRT year (greater than 12 months).
− Any gap between the old and the new periods is treated as a short MRRT year (less than 12 months).

Calculations that are designed to work on an annual basis (such as the starting base and allowance uplift factors) are also adjusted when entities change their accounting periods.

Integrity measures
The MRRT legislation includes general anti-avoidance rules and anti-profit shifting rules.

The objective of the general anti-avoidance rules are to deter avoidance schemes that are designed to obtain MRRT benefits by taking advantage of the MRRT law in circumstances other than intended by the MRRT law. The rules apply if an entity gets a MRRT benefit from a scheme entered into on or after 2 May 2010 (being the reduction of a MRRT liability or...
the increase of a low profit or rehabilitation offset) and a purpose (whether or not the dominant purpose but not including an incidental purpose) of entering into the scheme was to give the entity or another entity an MRRT benefit. The Commissioner can negate the benefit any entity gets from the scheme by making a determination.

The objective of the general anti-profit shifting rules is to ensure dealings that do not reflect those between independent parties do not inappropriately reduce an entity’s MRRT liability. The rules effectively require that when a miner operates under conditions that are different to comparable circumstances between independent entities dealing at arm’s length, the miner must ensure that amounts used to determine its mining profit, allowances and offsets are comparable to those determined under independent conditions. Unlike the general anti-avoidance rules, the general anti-profit shifting rules are not dependent on an entity having the purpose of avoiding MRRT, nor does it depend on the Commissioner of Taxation determining that the rules should apply.

**KPMG observation**

Unlike the anti-avoidance provisions in the income tax law, the proposed MRRT anti-avoidance rules do not introduce a ‘sole or dominant’ purpose test, but merely require a purpose of getting a MRRT benefit from a scheme, as long as that purpose is more than incidental. The EM to the draft legislation suggests that in determining whether the MRRT anti-avoidance rules apply, consideration may be given to whether the income tax anti-avoidance rules apply to the relevant scheme.

Additionally, there is a proposed transitional provision to extend the MRRT anti-avoidance rules in certain circumstances to schemes entered into before 2 May 2010. In effect, this would mean the rules would have retrospective operation to schemes entered into before the announcement of the resource taxation measures by the Government on 2 May 2010.

**MRRT instalments**

An entity is liable to pay instalments of MRRT on a quarterly basis if it has mining revenue or pre-mining revenue, and an instalment rate above nil. The instalment quarters are the same as for income tax (September, December, March and June). Each quarterly instalment is due on the 21st day of the month after the end of the quarter.

The amount of the instalment is calculated as the ‘instalment income for the quarter’ multiplied by the ‘applicable instalment rate’. Instalment income is ‘broadly, the revenue for the quarter.

Similar to income tax PAYG instalments, an entity may use the instalment rate provided by the Commissioner or choose its own instalment rate. If the Commissioner has not given the entity a rate and the entity has not chosen a rate, the following default rates apply:
- 8 percent for iron ore, or
- 3 percent for all other taxable resources (coal or coal seam gas).

Again, similar to income tax PAYG instalments, a general interest charge will apply if the miner self assesses the instalment rate and the rate used is too low.
MRRT returns and final payments

As a general rule, a miner that holds a mining project interest or a pre-mining interest must lodge an MRRT return electronically. This is the case even if the miner is not liable to pay MRRT for the MRRT year. Small miners that have elected to use the simplified MRRT method are not required to lodge a return.

The due date for lodgement of the return is the first day of the sixth month after the end of the MRRT year. This is the same date the MRRT is due and payable.

Planning for the MRRT

What you should do now

- Evaluate your exposure to MRRT and the ‘mining project interests’ and ‘pre-mining project interests’, as defined under MRRT rules.
- Consider the methodology to establish how mining revenue will be calculated.
- Consider the application of the integration and combination rules, in particular the implications for projects with a starting base.
- Valuation and modelling of the alternative starting base options as at 1 May 2010 to consider whether market or book value starting base will be the most appropriate for each project.
- Consider the existing (and projected) State royalties and how they will align for MRRT deductions.
- Establish systems to identify and record eligible interim expenditure incurred prior to 1 July 2012 which is to be included in the project’s starting base.
- Review accounting and tax management procedures for MRRT implementation.

How KPMG can help

The commencement of the MRRT on 1 July 2012 is less than 12 months away. For organisations impacted by the proposed reforms, it should be a strategic priority to prepare an analysis and a plan outlining the key steps needed between now and the 1 July 2012 implementation date, and beyond, to ensure the organisation is fully prepared for the transition and any likely impacts.

Since the resource taxation reforms were announced, KPMG has been working closely with participants in the resources industry, foreign investors, government and key industry bodies as they respond to the proposed changes. Drawing on the strength of our knowledge, including our experience from working with the existing PRRT and state royalty regimes, KPMG can bring to you a team of people to help your organisation as it responds to the complexities and challenges of these tax reforms.

KPMG provides specialist skills and deep industry knowledge in relation to matters relevant to the proposed MRRT including tax, transfer pricing, financial modelling, valuations, accounting and transaction advisory services.

KPMG observation

As a miner would not be notified of an individual instalment rate at the time the MRRT regime commences (e.g. because no MRRT returns have been lodged), it is expected that MRRT instalments will be based on the default rates during the first MRRT year. The default rate should be able to be varied, however, where the varied rate is too low, general interest charges would be imposed. Accordingly, appropriate planning will be required around MRRT instalments from a cash flow perspective and to ensure any exposure from general interest charges as a result of varying instalment rates is mitigated.
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