



## TECHNICAL UPDATE

### **MINERALS RESOURCE RENT TAX (MRRT): POLICY TRANSITION GROUP RELEASES ISSUES PAPER**

► **IN THE LATEST INSTALMENT TOWARDS THE DEVELOPMENT OF THE MRRT, THE POLICY TRANSITION GROUP (PTG) HAS RELEASED AN ISSUES PAPER OUTLINING THE KEY IMPLEMENTATION ISSUES AND POTENTIAL DESIGN OPTIONS ASSOCIATED WITH THE DEVELOPMENT OF THE MRRT AND SEEKS FEEDBACK ON THOSE ISSUES FROM INDUSTRY AND STAKEHOLDERS.**

The Issues Paper also includes chapters addressing issues associated with extending the existing Petroleum Resource Rent Tax (PRRT) to all oil and gas projects and policy alternatives to promote future exploration expenditure. This Technical Update will address only the MRRT aspects of the Issues Paper.

The following is a summary of some of the key technical issues associated with the design of the MRRT raised in the Issues Paper.

For more background on the proposed design of the MRRT regime, please refer to our earlier [Technical Update](#).

#### **Identifying the "project"**

As the MRRT is a project based tax, it will be necessary for the legislation to define the boundaries of a project, as well as to identify the beginning and end of a project. The definition is important as a number of aspects of the MRRT regime will rely on the definition of a "project" – for example, the undepreciated starting base of a pre-announcement project is transferred to the new owner if the relevant project interest is sold, and unused royalty credits are quarantined to the relevant project.

The Issues Paper canvasses whether the "project" should be defined by reference to State and Territory production licences, environmental approvals legislation or by other means. The Issues Paper expresses a preference for aligning the "project" with the State and Territory production licences, but notes that this may result in inconsistencies between each State and Territory.

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### Taxing point

The MRRT taxable profit is to be calculated based on the value of the commodity, determined at its first saleable form (at mine gate), less all costs at that point. Identifying the precise taxing point and the valuation methodology will therefore be important components of the MRRT regime.

The Issues Paper notes that assessable receipts and deductible expenses must be determined “upstream” of the taxing point. However, the meaning of terms such as “first saleable form” and “mine gate” lack clarity, and the two terms do not necessarily suggest the same taxing point.

The Issues Paper suggests that the PTG is inclined towards setting the taxing point early in the production value chain (prior to beneficiation), and proposes that the taxing point occur after initial crushing and screening.

### Valuing the resource revenue

Where the first arm’s length sale of the commodity occurs after the taxing point, a methodology for determining the assessable value of the resource will need to be applied. In this regard, the Issues Paper suggests that the transfer pricing methodologies recommended by the OECD “could be useful” in deriving an “arm’s length” value at the taxing point.

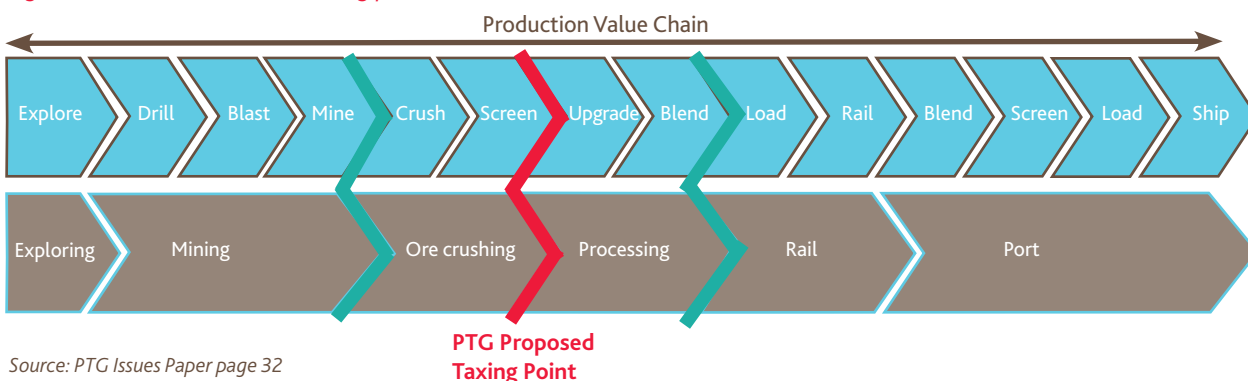
Assuming that a transfer pricing approach is extended to the MRRT for the purpose of valuing the resource at the taxing point, the Issues Paper discusses whether the calculation should be left to the entity and the ATO to determine, or whether the legislation should prescribe a valuation methodology. The Issues Paper does not express a preference between the two approaches.

We believe that valuation is one of the key issues which must be determined fairly. If the principles of a resource rent tax are to be applied, the methodology must excise **all** value attributable to post-taxing point (ie: downstream) processing and transport. Although achieving this may be difficult, our concern is that application of the methods proposed in the Issues Paper may result in downstream value being included in the assessable value calculation.

### Deductible expenses

Deductible expenditure under the MRRT should be broadly consistent with the existing arrangements for the PRRT, which implies that the test for deductibility should be based on whether eligible expenditure is directly related to a resource project and incurred upstream of the taxing point.

Figure 1: Possible value chain taxing points



Source: PTG Issues Paper page 32

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The Issues Paper also makes the following points:

- Closing-down expenditure should be deductible under the MRRT.
- Funds deposited as environmental bonds are not proposed to be deductible.
- Exploration expenditure related to developing a resource deposit that gives rise to MRRT profit should be deductible. The Issues Paper suggests that the definition of “exploration expenditure” should be based on that used for the PRRT. However, it should be noted that the definition of “exploration expenditure” under section 37 of the *Petroleum Resource Rent Tax Assessment Act 1987* is arguably more restrictive than the definition of “exploration” in section 40-730(4) of the *Income Tax Assessment Act 1997*.
- Although hedging gains and losses are not specifically excluded from the PRRT regime, the Issues Paper states that hedging arrangements would need to relate directly to the production of a resource in order to be included in the MRRT base. On this point, the Issues Paper suggests that where sales would occur irrespective of the hedging program, the gains or losses arising on hedging should be excluded from the MRRT base. We are concerned about the approach taken by the Issues Paper on this point. We understand that a sale contingent on an appropriate hedge being in place is highly unusual. The PTG’s view therefore appears too restrictive.

#### Excluded expenditures

The categories of non-deductible expenditure under the MRRT are to be broadly consistent with those under the PRRT. The PRRT regime provides that the following expenditures are specifically excluded from being deductible (and would therefore be excluded expenditure under the MRRT regime):

- Interest and financing costs
- Payments for the acquisition of an existing permit, lease or licence, access authority or project (similarly, receipts from the disposal of such assets would not be assessable under the MRRT regime);

- Indirect expenditures, such as general head office administration or accounting costs where they are not directly related to the project (however administration and accounting costs that are **directly** related to a project would be deductible).

It appears that the PTG prefers that private override royalty payments be treated as non-deductible, and that native title costs be treated as deductible (where those payments can be considered direct project expenditure).

#### Treatment of losses and royalties

MRRT losses will be transferable to offset MRRT profits the taxpayer derives from other projects, with unapplied MRRT losses to be carried forward and uplifted at the Long Term Bond Rate + 7 per cent. MRRT losses are not intended to be refundable.

The discussion paper canvasses the following issues in relation to the transferability and uplift of MRRT losses:

- **Transfer of MRRT losses between projects:** The Issues Paper considers whether such transfers should be automatic or at the discretion of the taxpayer, stating a preference for automatic transfer on the basis that applying a MRRT loss against a MRRT profit from another project (rather than choosing to carry the loss forward to access the uplift), is more consistent with the policy intent.
- **Transfers of MRRT losses within wholly owned groups:** Whilst the terms of reference provide that project losses will be transferable to offset MRRT profits of other projects owned by the taxpayer, they do not address whether project losses may be transferred to a related entity. The Issues Paper canvasses two ideas on this topic. One is to allow transferability of MRRT losses between entities within a wholly owned group where the group makes an irrevocable election. Another is to allow transferability between entities only where the group is a consolidated group for income tax purposes. Under either scenario, project losses of group members would be automatically transferred.

In our view, a disadvantage with the latter approach is that the decision to form a consolidated group is one that is driven by



income tax considerations. Restricting the transfer of MRRT losses based on the decision to consolidate would unreasonably penalise those groups that choose not to consolidate.

- **Transfers of MRRT losses from acquired projects:** The Issues Paper states that allowing MRRT losses to be transferred from an acquired project could result in a "market" for MRRT losses, resulting in a form of refundability. To address this potential issue, the Issues Paper suggests that a continuity of ownership rule should apply as a condition for transferring MRRT losses between projects.
- **Loss ordering rules:** Generally, transferable losses would take precedence over quarantined losses. This ordering is required to give effect to the principle of non-refundability.

With regard to the crediting of royalties, the Issues Paper confirms that credits for State and Territory royalties will be quarantined to the project (they cannot be transferred to other projects or refunded). Unused royalty credits will be carried forward and uplifted at the Long Term Bond Rate + 7 per cent. The Issues Paper also states that State and Territory royalties will be credited "at least up to amount imposed at the time of announcement, including scheduled increases and appropriate indexation factors". The application of this principle will be very quickly tested after the South Australian government increased royalty rates in its most recent budget.

### Starting base

The terms of reference state that the starting base for project assets will be based on either the book value (excluding the value of the resource) or market value (as at 1 May 2010), at the election of the taxpayer.

Capital expenditure incurred between 2 May 2010 and 30 June 2012 will be added to the starting base and depreciated against mining operations from 1 July 2012.

Where the book value method is chosen, the starting base will be depreciated over the first 5 years. The undepreciated value will be uplifted at the Long Term Bond Rate + 7 per cent. Where the market value method is chosen, there will be no uplift and

depreciation will be based on an appropriate effective life of the assets, but not exceeding 25 years.

According to the terms of reference, "project assets" for the purposes of the MRRT will be defined to include tangible assets, improvements to land and mining rights.

Any undepreciated starting base and carried forward MRRT losses are to be transferred to a new owner if the project interest is sold.

The Issues Paper outlines a range of issues associated with the starting base, including:

- **New capital expenditure incurred prior to 1 July 2012:** As interim investment (ie: capital expenditure incurred between 2 May 2010 and 30 June 2012) is proposed to be added to the starting base and depreciated, there is an incentive to defer capital expenditure until 1 July 2012 (from which date an immediate deduction would be available). The Issues Paper notes that if the capital expenditure in this period were to be treated on the same basis as it would be if it were incurred on or after 1 July 2012, it would be a deviation from the terms of reference. It is unclear as to whether the PTG will propose a change to this particular aspect of the terms of reference.
- **Treatment of starting base and starting base losses:** The Issues Paper suggests that as the starting base is intended to protect pre-announcement projects from the MRRT, the undepreciated starting base (and losses from unutilised starting base depreciation deductions) should not be transferable to offset against the MRRT profits of new projects. Interestingly, the Issues Paper notes that the terms of reference are silent as to whether MRRT losses attributable to depreciation of the starting base where the market value method is chosen should be uplifted (even though the starting base to which they relate is not).
- **Changes in the assets of a project:** Where an asset is removed from the starting base, a corresponding adjustment should be made to the starting base, with any net gain or loss treated as an assessable receipt (or deductible expense).

“If the principles of a resource rent tax are to be applied, the methodology must excise all value attributable to post-taxing point (i.e. downstream) processing and transport. Although achieving this may be difficult, our concern is that application of the methods proposed in the Issues Paper may result in downstream value being included in the assessable value calculation.”

- **Assets included in the starting base:** Although the terms of reference state that “project assets” includes tangible assets, improvements to land and mining rights, the question of whether intangible assets other than mining rights (such as mining information or intellectual property) fall within the definition of project assets needs to be determined.
- **Starting base election:** The election of a market value or book value starting base is at the discretion of the taxpayer. Guidelines will be required as to whether joint venturers can make different choices, whether the election is irrevocable and whether to use a default option in the absence of an election.

#### **Market valuation**

The Issues Paper notes that only assets directly related to the upstream part of the value chain will be relevant in establishing a market value starting base. This means that the valuer will need to isolate and value those assets.

In terms of prescribing a specific valuation methodology, the Issues Paper acknowledges that tax law does not generally dictate how market value is to be determined, and goes on to state that a range of principles of valuation are outlined in the ATO’s publication *Market Valuation for Tax Purposes*. The Issues Paper then notes that :

*“the PTG will examine the need for further advice regarding the methodologies for establishing the starting base using the market value method. The PTG seeks feedback from industry on methodologies for valuing discrete projects.”*

#### **Book value approach**

The PTG will examine the following issues associated with the book value approach:

- Discretions in respect of capitalisation practices may lead to different starting base outcomes for similar projects.
- Book values may be understated due to impairment write-downs of some assets.

- Book values may not appropriately reflect assets such as exploration and overburden removal.
- Not all companies prepare accounts in accordance with the Australian or international accounting standards.

#### **\$50 million exclusion threshold**

There will be no MRRT liability for taxpayers whose resource profit is less than \$50 million per annum. In relation to this exclusion, the Issues Paper makes the following points:

- The threshold is an annual profits test (ie: assessable receipts less deductible expenditure within a given year). Importantly, starting base depreciation and carried forward losses would be excluded for the purposes of the \$50 million test.
- The threshold will apply to taxpayers, not to projects. This will require an aggregation methodology to be developed.
- Where the threshold applies, the Issues Paper suggests that allowing the entity to preserve and carry forward its royalty credits would constitute an inappropriate “double benefit”. This may be addressed by either reducing the uncredited royalties where the \$50 million threshold applies, or denying any credit for royalties incurred in years during which the threshold is not exceeded.
- The threshold will apply such that taxpayers who exceed the threshold will pay MRRT on their entire profits (both above and below the \$50 million). The Issues Paper recognises that entities near the threshold may alter their production or expenditure decisions to fall within the threshold, and suggests that this distortionary effect could be addressed by a phased withdrawal of the threshold.
- The Issues Paper recognises that the threshold will do little to reduce compliance costs for small miners as they will be required to determine if they are above or below the threshold each year.

### Further BDO comments

At a political level, the Issues Paper (perhaps somewhat ambitiously) highlights that its review is limited predominantly to technical issues around the design and implementation of the MRRT - it is not within the scope of the PTG's review to revisit the design parameters of the MRRT. However, it remains to be seen whether political pressure will result in material changes to the existing MRRT design parameters, especially given the current composition of Parliament.

In the meantime, entities involved in the iron ore and coal mining industries will need to plan for a range of issues associated with the implementation of the MRRT regime, including reviewing how best to value their transitional projects, how best to fund new projects after the implementation of the MRRT regime, and establishing mechanisms to identify the taxing point and to value the relevant resource at the taxing point.

The PTG is also proceeding with a range of formal consultations across Australia, and BDO will be actively involved in those consultation forums. Therefore, clients should consult with their BDO adviser on how the MRRT regime is likely to affect their business, so as to ensure that their views are effectively communicated to the PTG during the consultation process.

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### MORE INFORMATION

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