

Pricing Knowledge Network

Focusing on the impact of major intercompany pricing issues

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PKN Alert Australia - Proposed Australian mining tax includes domestic transfer pricing rules

A Transfer Pricing Publication

The much anticipated Exposure Draft (ED) legislation for Australia's proposed Minerals Resource Rent Tax (MRRT) was released on 10 June 2011, accompanied by detailed explanatory material. The release of the ED is a critical step towards the implementation of the proposed MRRT legislation; currently scheduled to apply from 1 July 2012.

A hotly debated and politically charged Australian federal government initiative, the MRRT is designed to be a profits-based tax on the economic rents from the extraction of coal and iron ore in Australia (other minerals are not covered by the proposed tax). Of particular interest to PKN readers, a key component of the MRRT requires application of generally accepted transfer pricing approaches, albeit in a domestic context.

The release of a second ED and the introduction of the legislation into parliament are expected to occur before the end of 2011. As a next step, affected taxpayers should review the ED in detail and/or consult with their professional advisor to plan their response to the MRRT and determine whether any submissions are needed to reflect their personal circumstances. Any such submissions need to be made by 14 July 2011.



As anticipated, the calculation of ‘taxable revenue’, i.e. the first input into the profit base calculation to which the new tax will apply, will require a transfer pricing analysis for most taxpayers. MRRT taxable revenue is to be calculated as the arm’s length value of the resource at the ‘taxing point’, which is generally at the ‘run-of-mine’ (ROM) stockpile (i.e. after extraction of the resource, but before any downstream processing and/or transportation) as the MRRT is designed to capture only the economic return associated with the resource itself, and not returns associated with downstream activities. This taxing point is therefore generally *before* the point at which most coal and iron ore producers actually sell the resource (to third parties or related parties). The ED and the explanatory material require taxpayers to perform a transfer pricing analysis to calculate the arm’s length value at taxing point.

The ED and explanatory material suggests that the arm’s length principle is to be applied in a manner largely consistent with existing internationally accepted transfer pricing principles. However, we expect that, as with the application of the arm’s length principle to any new transaction or situation, determining the mining revenue at the taxing point may be complex in the case of many projects and potentially the subject of significant contention. This will be exacerbated by the fact that iron ore and coal supply chains often include complex and/or valuable functions, assets and risks both upstream and downstream of the MRRT taxing point, and often involve multiple tenements and multiple joint venture partners (most of which will be required to calculate MRRT liability on an individual basis). The challenges likely to be encountered by taxpayers will include identifying comparable arm’s length benchmarks, particularly in situations where there is significant downstream value, for example in the form of downstream intangibles and/or large downstream transformative operations.

Key observations:

Our initial observations regarding the transfer pricing aspects inherent in the ED and the explanatory material are as follows:

- **Two step arm’s length pricing process.** The mining revenue calculation is broken down into the following two steps:
 1. *Calculation of an arm’s length value of the resource at the point of first ‘supply’:* This will generally be the first sale or use of the resource or (if it occurs sooner) the point of export. This point of first ‘supply’ will be downstream of the taxing point in the large majority of cases. Where first supply takes place between the producer and an offshore related party, e.g. an offshore marketing organisation, the arm’s length value will presumably already have been subject to some form of transfer pricing analysis, though where first supply is to a domestic related party an additional transfer pricing exercise will be required.
 2. *Attributing part of the arm’s length value calculated in step one to the resource at the taxing point:* This step requires the arm’s length value calculated in step 1 to be split between the value upstream and downstream of the taxing point, i.e. ROM stockpile in most instances. The ED has little guidance on the principles that should be followed at this step, and simply says the amount to attribute to the taxing point is

the amount that is ‘reasonably attributable’. However the explanatory material makes it clear that the intention is that the arm’s length principle should be applied in determining the ‘reasonably attributable’ amount, meaning that the application of transfer pricing principles will be involved in both step one and step two. Given the clear direction in the explanatory material, we assume that the final legislation will also clarify a requirement to apply arm’s length principles (the ED includes a comment that an additional provision specifying attribution factors may ultimately be included).

- **No prescribed transfer pricing method or methods.** The ED and explanatory material do not prescribe any particular transfer pricing method or methods to be used in most circumstances, but instead provide the flexibility for the taxpayer to use the most reliable method in the circumstances. The explanatory material suggests that existing transfer pricing principles and guidelines (such as the OECD Guidelines) may be relevant and mentions each of the five transfer pricing methods from the OECD Guidelines including basic examples of where each method might be applicable.
- **Alternative transfer pricing method.** A prescriptive, optional ‘alternative’ transfer pricing method is available for smaller miners (less than 10 million tonnes of saleable resource per year) and for miners with transformative operations (i.e. operations that extract the resource and transform it into a different product) that existed before 2 May 2010. This method is a simplified ‘netback’ approach (similar to a ‘resale minus’ method in the OECD Guidelines), calculated as the arm’s length supply consideration minus downstream operating costs, depreciation of downstream assets and a prescribed rate of return on those downstream assets at the long term bond rate (LTBR) +7%. Whilst this method may be a useful practical approach for some small miners, our view is that it is likely to overvalue the resource at the taxing point for many mining supply chains, particularly where there are significant transformative operations, and therefore significant ‘value’ downstream of the taxing point. Eligible taxpayers will need to carefully consider the costs and benefits before deciding whether to use this optional ‘safe harbour’ method.
- **Interaction with starting base valuations.** The MRRT allows taxpayers to bring existing assets upstream of the taxing point into the MRRT regime at their market value, and then depreciate this market value over time. Although at face value the starting base valuations may appear to be a separate exercise from the calculation of arm’s length mining revenue at the taxing point, in reality the two exercises are likely to be closely linked. The explanatory material to the ED recognises this and explicitly states that the principles used to market value starting base assets should be consistent with those used in determining the value of the resource at the taxing point. The implication for taxpayers is they will need to ensure they identify the relevant linkages and ensure there is internal consistency between the approaches used in both exercises. This means that transfer pricing analysis may be required well in advance of the preparation of the first MRRT return.

- Consistency with Australia’s international transfer pricing rules.** The arm’s length mining revenue provisions in the ED and the associated explanatory material appear similar in many respects to Australia’s existing international transfer pricing rules contained in Division 13 of the Income Tax Assessment Act 1936. However, there are some differences; in particular, the ED includes a requirement to use the most reliable transfer pricing method ‘having regard to the miner’s circumstances’. The commentary in the explanatory material to the ED make it clear that this means that all the relevant circumstances of the miner must be taken into account and that the method must produce a result which is reasonable and makes sense on a commercial basis in the circumstances. Arguably this reference to the miner’s circumstances may be interpreted as a response to the Commissioner’s loss in the recent SNF transfer pricing court case and subsequent appeal (refer to our earlier PKN dated 8 June 2011 for a summary of the appeal decision), whereby the courts ruled that Division 13 did not include a requirement to take into account all the circumstances of the taxpayer (in particular, the persistent losses incurred by the taxpayer in that case). Whether this will make a practical difference in the context of the Australian resources industry remains to be seen, but it perhaps provides an insight as to the Australian Taxation Office’s ‘dream’ transfer pricing legislation in a ‘post-SNF’ world.
- Power to deem an arm’s length consideration.** Similar to Australia’s international transfer pricing rules, in situations where it is not possible to work out an arm’s length consideration, either because of insufficient information or some other reason, the Commissioner will have the power to deem an arm’s length consideration for MRRT purposes. This, combined with the requirement to have regard to the miner’s circumstances, is likely to mean that the burden of proof on taxpayers to demonstrate the arm’s length nature of the mining revenue is at least as great as the burden of proof under Australia’s existing international transfer pricing rules.

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