

Pricing Knowledge Network

Focusing on the impact of major intercompany pricing issues

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PKN Alert - Australian mining tax - updated draft legislation tightens domestic transfer pricing rules

A Transfer Pricing Publication

The domestic debate on Australia's proposed Minerals Resource Rent Tax (MRRT) has continued to rage since our last PKN advising on the release of the first Exposure Draft (ED) MRRT legislation ([PKN dated 16 June 2011](#)). In that PKN we highlighted the potential application of OECD transfer pricing methods to isolate an arm's length 'upstream' value of the resource (which is taxed by the MRRT) from value associated with 'downstream' activities.

The second ED legislation and accompanying updated explanatory material were released on 18 September 2011. The release of the second ED is a further important step towards the implementation of the proposed MRRT legislation; currently scheduled to apply from 1 July 2012.

Of principal interest for PKN readers is that modifications within the second ED attempt to clarify the context in which the OECD transfer pricing methods can be applied, and these modifications arguably constitute a significant tightening of how the arm's length principle is to be applied under the MRRT. The second ED also creates uncertainty regarding the degree of flexibility taxpayers will have in the choice of transfer pricing method under the MRRT, in that it could be read as



directing taxpayers to a cost-plus (or equity return) approach for valuing the activities downstream of the MRRT taxing point.

Affected taxpayers should carefully review the second ED and/or consult with their professional advisor to evaluate whether the changes in the second ED affect their MRRT implementation. As per the first ED, taxpayers also have the option to submit a response to Treasury regarding the impact on the proposed legislation on their personal circumstances. Any such submissions need to be made by 5 October 2011.

To recap, key transfer pricing aspects of the MRRT, as outlined in our earlier PKN dated 16 June 2011, are as follows:

- The MRRT is designed to be a profits-based tax on the economic rents from the extraction of coal and iron ore in Australia.
- The ‘revenue’ amount which is the first input into the MRRT profit calculation is 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, i.e. upstream value, and not returns associated with downstream activities.
- This taxing point is generally *before* the point at which most coal and iron ore producers actually sell the resource (to third parties or related parties), therefore determining the arm’s length value at the taxing point will require a transfer pricing analysis for most taxpayers, albeit in a domestic context.
- The second ED confirms that the arm’s length value at the taxing point is to be identified via a two step process:

Step 1: *Calculating an arm’s length value of the resource at the point of first sale or export:* This point will usually be downstream of the taxing point and, where it does not coincide with an arm’s length sale, a transfer pricing analysis is required to determine the arm’s length value at this point.

Step 2: *Reducing the Step 1 amount by the ‘downstream’ amount:* This step requires the value calculated in Step 1 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, which have the potential to affect which method is selected and how it is to be applied. These assumptions include:

1. downstream operations are performed by a (hypothetical) ‘service provider’ to the miner
2. there is a competitive market for those services

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3. the price for the services is sufficient to meet the costs of the downstream operations, including cost of capital commensurate with the risks involved.

The second ED also includes anti-profit shifting measures, which are based on the arm's length principle and are very broad ranging in their application.

Our initial observations on the above aspects of the second ED are as follows:

- **Tightening of how arm's length principle is to be applied.** 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 and could be read as an attempt to direct miners towards some form of 'netback' transfer pricing method, i.e. they arguably try to 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 1 and Step 2) is that which produces the 'most appropriate and reliable measure' of the arm's length amount and the second ED and explanatory material refer to the OECD Transfer Pricing Guidelines in this regard. It is unclear how the apparent limited flexibility implied by the Step 2 'assumptions' reconciles to the references to the OECD Guidelines and the 'most appropriate and reliable measure' requirement.
- **Outsourced downstream functions to be valued at cost.** The second ED clearly stipulates that in calculating the value of the resource at the taxing point, downstream activities which have been outsourced by the miner are to be valued at the *actual amount paid* 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. However it is 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 value associated with the downstream operations.
- **New anti-profit shifting rules.** The new anti-profit shifting provisions mentioned above mean 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).

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