TAXATION RULING NO. IT 2378

INCOME TAX : CAPITAL GAINS : DISPOSAL OF PROSPECTING OR MINING RIGHT : DISPOSAL OF RIGHT TO RECEIVE INCOME : FARM-OUT ARRANGEMENTS

F.O.I. EMBARGO: May be released

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I 1210311	CAPITAL GAINS - DISPOSAL OF PROSPECTING OR MINING RIGHT DISPOSAL OF RIGHT TO RECEIVE INCOME INCOME TAX - BALANCING ADJUSTMENTS	122K, 124AM 160ZZG PART IIIA

PREAMBLE The purpose of this Ruling is to address a number of concerns that have been raised about the practical application of Part IIIA of the Income Tax Assessment Act 1936 ("the Act") - Capital Gains and Capital Losses - as it affects transactions commonly referred to as farm-out arrangements entered into for the purpose of exploration for and discovery of minerals. For the purposes of the Act the term "minerals" is defined in sub-section 6(1) to include petroleum. The term "farm-out" is used in the mining industry to describe a wide variety of arrangements including any arrangement under which the holder of a prospecting or mining right assigns or disposes of a portion of that right to another person in return for any form of consideration. The person acquiring an interest is sometimes referred to as the "farmee" and the person disposing of the interest the "farmor".

2. The ruling does not attempt to canvass all the issues which may arise under the wide variety of arrangements entered into by such persons but aims to illustrate, by way of basic examples, the common basis upon which the consideration for the disposal of an interest in a prospecting or mining right under a farm-out arrangement has been determined for income tax purposes and will be determined for capital gains purposes. Further rulings will be issued as other aspects of the application of the capital gains legislation to farm-outs are identified as requiring clarification.

3. In Australia, under the relevant legislation governing the issue of a licence or authority ("a prospecting right") the holder generally is entitled to prospect, search or explore for minerals and remove amounts for assaying and testing but is not authorised extract or recover large quantities of minerals or

mineral bearing soil from the area that is the subject of the right until a mining lease or licence ("a mining right") is acquired. The holder of a prospecting right is usually obliged under the terms and conditions of the right to either incur a specified amount of exploration expenditure or conduct a programme of exploration over a stipulated period of time.

4. The holder of the right will often spread the risks and costs of the exploration programme associated with the prospecting right by entering into a farm-out arrangement in return for cash, a commitment to undertake a specified amount of exploration expenditure, or a combination of both. Such arrangements can take various forms. The farm-out agreement might, for example, specify that the holder of the right will assign a percentage of its interest in the right to another person in return for (say) a commitment by the other person to drill three wells. Similarly, the parties to a farm-out agreement may agree on, and include in the agreement, terms under which the actual assignment/disposal will occur at the time of the agreement; progressively as commitments are met; after the three wells have been drilled; or at some other time such as at the option of the farmee after a specified amount of expenditure has been incurred. Also under such agreements the holder of a prospecting right may agree to assign - in the form of cash or production - a portion of any income ("a right to income") that might be derived from the property to another person, without a transfer of an interest in the property itself, in return for the other person drilling the wells.

5. The determination of the consideration for the disposal, loss, destruction or termination of use of property (including a prospecting or mining right) in respect of which deductions have been allowed or allowable under the Act has been a feature of the income tax law for many years.

6. For example, sections 122K and 124AM of the Act in Division 10 - General Mining - and Division 10AA - Prospecting and Mining for Petroleum - respectively, where they apply, provide for balancing adjustments to be made where deductions have been allowed or are allowable under the relevant Division in respect of property of a taxpayer which is disposed of, lost or destroyed, or the use of which for mining or exploration or prospecting purposes has been terminated. These sections do not apply of course where the disposal of the interest under the farm-out agreement occurs before any expenditure is incurred in respect of which deductions would be allowable or where the expenditures concerned are not of a capital nature. The expenditures concerned are those classified as allowable capital expenditure and exploration and prospecting expenditure. They include plant unless an election is made that the relevant Division not apply, in which case balancing adjustments on disposal of plant will be made under section 59 of the Act. In this context property is defined to include a mining or prospecting right and includes an interest therein - sub-sections 122(1) and 124(1).

7. For the purposes of the application of the income tax

balancing adjustment provisions, a disposal of an interest in a prospecting right under a farm-out arrangement for a commitment to undertake exploration expenditure without any further consideration is a disposal of property otherwise than by sale. In such circumstances, paragraphs 122K(4)(c) and 124AM(7)(c) would have the effect that the consideration for the disposal is the value, if any, of the property at the date of disposal.

8. Sub-section 160ZD(2) operates in these circumstances to deem the consideration for the disposal for capital gains purposes to be the market value (see paragraphs 13 and 14 for the meaning of this term) of the asset at the time of disposal. The time of disposal, ascertained in accordance with the provisions of section 160U, would generally depend on the terms of the agreement between the parties. In the case of an up-front transfer of an interest in a prospecting right at the wildcat or grass roots stage the market value at the time of disposal would generally be low if not nil. In the event that a discovery is made subsequent to the date of disposal which greatly increases the then value of the interest, that, of course, will not alter, with the benefit of hindsight, what was the market-value at the date of disposal. By the same token, if unsuccessful exploration subsequent to the date of disposal results in a reduction in the then value of the interest, that will not alter what was the market value of the interest at the date of disposal.

9. Sub-section 16OZD(2) in effect parallels the operation of paragraphs 122K(4)(c) and 124AM(7)(c) and, as with those provisions, its application does not automatically lead to a positive market value. In this context the terms "value" and "market value" are considered to be interchangeable. That is, the consideration will be the same, for capital gains purposes, as that adopted for general income tax purposes. Section 160D of the capital gains provisions does not operate to deem the consideration to be the sum of the future expenditure commitments. Rather, the consideration is the market value of the interest (the price it could fetch on an open market) at the date of disposal rather than its intrinsic value.

10. Where a prospecting right or interest therein is disposed of, an amount will be included in assessable income under the income tax balancing adjustment provisions where the sum of the deductions allowed or allowable and the consideration for the disposal, or the value of the property at the date of disposal, exceeds the total expenditure of a capital nature of the taxpayer in respect of the property. An amount will be included in assessable income in respect of a capital gain only to the extent, if any, that the consideration for the disposal is greater than the relevant indexed cost base of the asset concerned.

RULING

11. The determination of the consideration for the disposal of a prospecting right or an interest therein under a farm-out arrangement where the party farming-in is able to acquire the interest by undertaking exploration expenditure commitments is a question of fact which can only be determined in light of the

circumstances which exist at the time of disposal. As mentioned above, it can be expected that the value of an interest disposed of at the grass roots or wildcat exploration stage would be low: however the value would be expected to be higher if the interest were disposed of after exploration had indicated that deposits or reserves warranted development and production. Moreover, the discovery of minerals in adjacent permit areas may have the effect of increasing the market value of the interest disposed of even though the interest may or may not subsequently prove to be worth developing.

12. Determinations of the value of a prospecting or mining right may be required for various purposes. For example, valuations may be required to be submitted for the purposes of the Petroleum (Submerged Lands) (Registration Fees) Act 1967, for stamp duty purposes under the relevant legislation in a State or Territory, in connection with Stock Exchange listing requirements and under section 38 of the Companies (Acquisition of Shares) Code. In some instances such valuations are required to be supported by an expert's report. At the grass roots or wildcat exploration stage it is accepted for those purposes that such values are highly subjective as well as being heavily discounted for the risk factors involved.

13. Any such valuations may give some assistance in determining the market value of the prospecting or mining right for income tax and capital gains purposes. Market value is not defined in the Act but guidance as to its meaning may be drawn from principles enunciated in Spencer v. Commonwealth of Australia (1907) 5 CLR418 where Isaacs J (at p.440) said :

> "To arrive at the value of the land at that date, we have, as I conceive, to suppose it sold then, not by means of a forced sale, but by voluntary bargaining between the plaintiff and a purchaser, willing to trade but neither of them so anxious to do so that he would overlook any ordinary business considerations.
> We must further suppose both to be perfectly acquainted with the land, and cognizant of all circumstances which might affect its value, either advantageously or prejudicially, including its situation, character, quality, proximity to conveniences or inconveniences, its surrounding features, the then present demand for land, and the likelihood, as then appearing to persons best capable of forming an opinion, of a rise or fall for what reason soever, in the amount which one would otherwise be willing to fix as the value of the property."

14. Moreover, the concept of market value does not mean that there has to be a gathering of buyers and sellers or an open market for property. In Building and Civil Engineering Holidays Scheme Management, Ltd v. Post Office [1965] 1 All E.R. Lord Denning M.R. stated that the word "market" in that instance was not used in the sense of the Sale of Goods Act, 1893. He said (at p.169):

> 'It does not connote a market where buyers and sellers congregate. The "market value" here means the price at which the goods could be expected to be bought and sold as between willing seller and willing buyer, even though there may be only one seller or one buyer, and even though one or both may be hypothetical rather than real.'

15. Against that background the parties to the farm-out arrangement should seek to reach agreement on, and specify, either in the written agreement between the parties or in a written statement by the parties, the agreed fair and reasonable value , if any, of the percentage interest disposed of at the time of the disposal. The parties may be required to reconcile the valuation with the agreed work programme commitments if these appear inconsistent e.g., a nil or very low valuation with very large work programme commitments. This reconciliation, if required, may need to be supported by a statement setting out the basis of valuation and assumptions used.

16. The following hypothetical examples illustrate some of the factors which would have a bearing on the determination of the value of a prospecting right as it progresses from the high risk stage, i.e., where there are no known deposits of minerals, to the low risk stage, i.e., where there are well defined reserves of minerals.

Wildcat or grass roots exploration ("high risk stage")

17. Spec Co, a newly incorporated company, acquired permit no. SP4000 for a cost of $30,000 from a State government on 20 January 1986. One of the conditions of issue of the permit was that $700,000 was to be spent over the next 3 years in exploring the property for a mineral. The area which is the subject of the permit was considered to be in the high risk category, i.e., some of the geological indicators usually regarded as being required for a sound prospect were not present or were yet to be proven. Nevertheless geologists employed by the company thought the area had potential. Spec Co decided to spread the costs of exploration by entering into a farm-out agreement with Drill Co, an innovative company in the exploration field. Before deciding to enter into an agreement with Spec Co, Drill Co's own geologists sought to value the property. Even though they were unable to place a tangible value on the tenement, Drill Co decided that the project was worth proceeding with.

18. The agreement subsequently entered into by the parties specified that Drill Co would undertake to carry out half of the exploration work (to the value of $350,000) over the next 3 years in return for a 40 per cent interest in the property.

19. Spec Co's geologists also having been unable to arrive at a value for the property, it was agreed by the partners that the tenement had a NIL value. It was subsequently registered and attracted a nominal duty of $6 under the relevant Stamp Duties Act.

20. Given the details of the farm-out agreement and the facts that the parties were dealing with each other at arm's length, and that agreement had been reached on a NIL value for the property disposed of/acquired, that valuation could be expected to be accepted by the Australian Taxation Office as the market value for income tax and capital gains purposes. (However, as indicated in paragraph 15, in certain circumstances the parties to a farm-out agreement may be required to reconcile a nil or very low valuation with commitments to expenditure on work programmes that appear inconsistent with such a valuation.)

Proven or tested properties ("low risk stage")

21. Analysis carried out by both Spec Co and Drill Co at the end of the initial exploration phase confirmed that the mineral was available in economic quantities. In the meantime the price of the mineral had risen. The prospect effectively had thus shifted from what could be regarded as the high risk to the low risk category. However, before a final decision was made to go ahead with development and production further drilling to the value of $950,000 was required to prove up the size of the reserves.

22. Furthermore, Drill Co had indicated a wish to acquire a further 5 per cent interest in the right. It was therefore necessary to determine the market value of such an interest and the form of consideration to be given by Drill Co. Both parties carried out valuations of the property as well as estimates of the income which would be generated from the tenements and the after tax cost of drilling, development and production expenditures. After discounting for elements of perceived risk it was agreed and specified in the agreement between the parties that a fair and reasonable assessment of the value of the property (i.e., the 5 per cent to be disposed of) was $500,000.

23. The alternatives considered by both parties were that Drill Co could either pay $500,000 in cash to Spec Co to acquire the additional 5 per cent interest, with each party bearing the costs of further drilling according to their respective future percentage interests, i.e., Spec Co - $522,500 (55 per cent) Drill Co $427,500 (45 per cent), or Drill Co could acquire the additional 5 per cent interest by undertaking the total cost of drilling to the value of $950,000. Under the second option Drill Co would effectively substitute $522,500 of increased expenditure commitments for the $500,000 up-front cash payment. For Drill Co this substitution would be equivalent to payment by instalment of the $500,000 deemed consideration i.e. the agreed value of the 5 per cent interest, with payment in the form of increased expenditure commitments rather than cash. For Spec Co the future expenditure commitments would be in substitution for cash payment: they would pay for the 5 per cent interest that Spec Co sells by in effect, adding $500,000 value to Spec Co's remaining interest in the prospecting right. This increase would result from Spec Co's right to have Drill Co undertake $500,000 worth of expenditure commitments, which would relieve Spec Co from undertaking future expenditure in respect of Spec Co's retained interest in the prospecting right.

24. Under either the cash or no cash alternative Spec Co would be liable to tax on the basis of the $500,000 consideration for the disposal of the 5 per cent interest, and Drill Co would include $500,000 in its cost base as consideration for its acquisition of the 5 per cent interest. The tax payable by Spec Co on assessment in respect of the $500,000 would depend upon the amount of any balancing adjustment and real capital gain in respect of the part sold. Under the first option Spec Co could be entitled to an income tax deduction for, and to include in its CGT cost base, expenditure on drilling equal to $522,500 (55 per cent of $950,000), which could largely be met out of the $500,000 cash proceeds, to offset any balancing adjustment and real capital gain.

25. Under the second option Spec Co would not receive any cash but neither would it be liable to pay any of the drilling costs and, since Drill Co incurs all of the drilling costs under this option, Spec Co will not be entitled to a deduction for such expenditure to offset any balancing adjustment and real capital gain. However in recognition of Spec Co's right under the second option to have Drill Co undertake capital expenditures which Spec Co would otherwise have had to undertake in respect of its interest in the prospecting right, Spec Co will, at the time of disposal, include in its cost base under the second option the $500,000 agreed market value of the 5% interest disposed of, (or, from Spec Co's perspective, the value of the right to future expenditures to be undertaken by Drill Co in respect of Spec Co's interest). In other words, Spec Co is assessed on the $500,000 but also includes this same amount in its cost base.

26. From Drill Co's point of view option one would mean that it may be entitled to a deduction for expenditure on drilling equal to $427,500 (45 per cent of $950,000), as well as having that expenditure plus the $500,000 cash payment included in its relevant cost base. Under the second option Drill Co would still include the $500,000 agreed value - the deemed consideration - in its cost base, and be liable to spend $950,000 on drilling and obtain an income tax deduction for that amount. However, as $500,000 of the expenditure on drilling represents the consideration for the acquisition of the 5% interest (and is thus included up-front in Drill Co's cost base) in substitution for expenditure which Spec Co would otherwise have had to undertake in respect of its retained interest (and which is therefore included in Spec Co's cost base) only a proportion - 450/950 - of the $950,000 expenditure as it is undertaken is added to Drill Co's cost base, which will thus total $950,000, equal to the total of its expenditure.

27. On the basis that the parties were dealing with each other at arm's length, and again subject to the valuation being capable of being supported by a statement setting out the basis of valuation, if required, the $500,000 value under the cash or no-cash alternative could be expected to be accepted by the Australian Taxation Office as the market value, and thus the

consideration for the disposal for income tax and capital gains purposes.

28. In other words, at the time of the second farm-out agreement the exploration prospect had moved from the high risk, wildcat stage to a low risk stage ready for development: it was clear by that time that the prospect had a significant net current value.

Disposal of right to receive income from mining operations - section 160ZZG

29. Section 160ZZG of Part IIIA of the Act deals with the disposal of a right to receive income from mining operations without the transferor disposing of any part of the prospecting or mining right itself.

30. It applies where a person who owns a prospecting or mining right transfers to another person a right to receive a share of income that may be derived from mining operations carried on pursuant to the prospecting or mining right. Where such a transfer or disposal occurs the provision operates such that the transfer does not amount to a disposal of the prospecting or mining right but rather a disposal of the right to receive income from the property. The right disposed of is taken to have been created immediately before the disposal without the transferor having paid or given any consideration for its acquisition.

31. A petroleum mining company recently sought advice whether the scope of section 160ZZG extends to farm-out arrangements involving a transfer of a right to receive income where that right arises from the transfer to the transferee of an interest in the prospecting or mining right itself.

32. The company was advised that the scope of section 160ZZG does not extend to farm-out arrangements involving the transfer of an interest in the prospecting or mining right even though that carried with it a right to receive a corresponding share of any income from the prospecting or mining right.

COMMISSIONER OF TAXATION
24 December 1986