

TAXATION RULING NO. IT 2506

INCOME TAX : FINANCE OF MINING VENTURES BY PRODUCTION
PAYMENT ARRANGEMENTS

F.O.I. EMBARGO: May be released

REF

N.O. REF: 85/7139-2

DATE OF EFFECT: Immediate

B.O. REF:

DATE ORIG. MEMO ISSUED:

F.O.I. INDEX DETAIL

REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1211434	PRODUCTION PAYMENT	25(1)
	ARRANGEMENTS	51(1)
	INTEREST WITHHOLDING	128B
	TAX	

PREAMBLE

From time to time this office has been asked to express an opinion on the income tax treatment of production payment arrangements.

2. Production payment arrangements have been used to finance capital costs in mining ventures. The owner (sometimes called the grantee) of a production payment is the party that provides the finance and in return obtains, from the mining company vendor (or grantor), rights to minerals or the proceeds of sales of the minerals recovered from specified deposits.

3. The return to the production payment owner is quantified by reference to the amount paid for the production payment plus an amount reflecting the fact that funds have been advanced to the mining company ahead of production. The provision of the finance does not result in the creation of a general obligation in the mining company. The owner of the production payment is not normally entitled to repayment unless minerals are produced from the deposits specified and then is entitled to benefit only as, and to the extent that, minerals are produced. However, the finance is normally secured over the sales proceeds or the mining company's assets in relation to the specified deposits.

4. A production payment agreement may provide for the owner to be entitled in kind to extracted minerals. In fact, however, it is generally not contemplated that minerals will be physically delivered to the owner; rather, the mining company sells the production on behalf of the owner and accounts to the owner accordingly. The rights to minerals, like rights to proceeds of sales of minerals, ensure that production sales, usually of some specified percentage, will be dedicated to the discharge of the production payment.

5. Typically, though not necessarily, the production payment owner is a special purpose company that borrows funds from outside Australia to advance to the mining company. Proceeds from the production payment agreement are calculated to meet the

overseas borrowing commitments plus some relatively small amount by way of a fee and costs for the special purpose company for its involvement in the arrangements.

6. A production payment agreement that involves the transfer of rights to production or the proceeds from that production is to be distinguished from a forward purchase agreement where the mining company agrees to sell minerals to the finance provider when they are produced. The mining company in a forward purchase agreement agrees to transfer the property in minerals at a future date and the finance provider takes all the proceeds from the sales of the minerals acquired. By way of contrast, the forward purchase agreement is essentially a transaction of a trading rather than a financing nature and the taxation treatment may be quite different to that of a production payment agreement.

RULING

7. Enquirers have been advised by the Australian Taxation Office that a production payment agreement as described above is considered to be essentially in the nature of a loan, representing a transaction on capital account as between the owner of the production payment and the mining company. In the circumstances, the income tax treatment of production payment arrangements is as follows:-

- (a) the purchase price of the production payment does not constitute assessable income of the mining company;
- (b) the owner is not entitled to a deduction for the purchase price;
- (c) the mining company is entitled to deductions, in the years of payment, for so much of the repayments to the owner out of production or the production proceeds as does not represent a repayment of the capital sum or part thereof;
- (d) the amounts deductible in terms of (c) are assessable income of the owner;
- (e) where the advanced funds have been borrowed, the owner would be entitled to deductions for interest paid, and for establishment and commitment fees, etc.; and
- (f) where the interest in (e) is paid to an overseas lender, it would be subject to interest withholding tax unless a specific exemption applies.

COMMISSIONER OF TAXATION
3 November 1988