MT 2011/D1 - Miscellaneous taxes: application of the income tax and GST laws to immediate transfer farm-out arrangements

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Draft Miscellaneous Taxation Ruling

Miscellaneous taxes: application of the income tax and GST laws to immediate transfer farm-out arrangements

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Preamble

This publication is a draft for public comment. It represents the Commissioner's preliminary view about the way in which a relevant taxation provision applies, or would apply to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

You can rely on this publication (excluding appendixes) to provide you with protection from interest and penalties in the following way. If a statement turns out to be incorrect and you underpay your tax as a result, you will not have to pay a penalty. Nor will you have to pay interest on the underpayment provided you reasonably relied on the publication in good faith. However, even if you don't have to pay a penalty or interest, you will have to pay the correct amount of tax provided the time limits under the law allow it.

What this Ruling is about

1. This draft Ruling sets out the Commissioner's views on the application of the income tax and goods and services tax (GST) provisions upon entry into an immediate transfer farm-out arrangement as described in paragraph 13.[1]

2. In particular, for income tax purposes, the draft Ruling explains the application of the following provisions to immediate transfer farm-out arrangements:

- the uniform capital allowance (UCA) provisions;[2] and
- the capital gains tax (CGT) provisions;[3] and
- sections 6-5, 8-1 and 15-40 of the ITAA 1997.

3. This draft Ruling does not apply to an immediate transfer farm-out arrangement if the agreement includes clauses dealing with rights in relation to the interest in the mining tenement and those rights are more than merely incidental to the transfer of the interest in the mining tenement. In these circumstances, there will be taxation consequences not dealt with in this draft Ruling.

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[1] For the income tax law, a reference to the *Income Tax Assessment Act 1997* is referred to as the ITAA 1997; a reference to the *Income Tax Assessment Act 1936* is referred to as the ITAA 1936. For the GST law, a reference to the *A New Tax System (Goods and Services Tax) Act 1999* is referred to as the GST Act.
[2] See Division 40 of the ITAA 1997.
[3] See Part 3-1 of the ITAA 1997.

4. For example, this draft Ruling does not apply to an immediate transfer farm-out arrangement if the agreement includes a reassignment clause in relation to the interest in the mining tenement and monetary or non-monetary consideration is properly attributable to the reassignment right. The draft Ruling does, however, apply to an agreement if it merely provides for the reassignment of the interest in the mining tenement in the event that the farmee opts not to continue, or defaults on its commitments under the agreement, and the reassignment right has negligible value compared with the transfer of the interest in the mining tenement.

5. This draft Ruling does not discuss the application of the income tax and GST provisions to:

- a joint venture arrangement that is in existence or that may be formed at the time of entry into an immediate transfer farm-out arrangement; or
- a deferred transfer farm-out arrangement. A deferred transfer farm-out arrangement is discussed in Miscellaneous Taxation Ruling MT 2011/D2[4].

Background

6. Farm-out arrangements are common in the mining and petroleum industries. Broadly speaking, they are arrangements entered into for the purpose of facilitating exploration for the discovery of minerals and petroleum resources.

7. A typical arrangement provides for the owner of an interest in a mining tenement[5] (the 'farmor') to transfer a percentage of that interest to another party (the 'farmee') if the farmee meets specified exploration commitments. The arrangement may also provide for monetary payments by the farmee to the farmor either directly or indirectly.

8. Often the commercial driver for such an arrangement from the farmor's perspective is funding. That is, 'the farmor giving up future economic benefits, in the form of reserves, in exchange for a reduction in future funding obligations.'[6] For the farmee, it provides an opportunity to acquire an interest in a mining tenement.[7]

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[4] MT 2011/D2: application of the Income Tax and GST laws to deferred farm-out arrangements. Please note that this draft Ruling has not yet issued, it is due to issue on 24 August 2011 and will be available on the ATO website at www.ato.gov.au.

[5] The term 'mining tenement' is used throughout this draft Ruling as a reference to a *mining, quarrying or prospecting right* as defined in subsection 995-1(1) of the ITAA 1997.

[6] Mining and Metals Refining IFRS, May 2009, available at www.ey.com.au.

[7] Birch, Charles, 'Choosing the Right Joint Venture Structure for a Farmin or Farmout' [2002] JIATax 3; (2002) 5 (1) Journal of Australian Taxation 60.

9. Broadly, farm-out arrangements may be divided into two types of farm-out arrangements, referred to as 'immediate transfer' and 'deferred transfer' farm-out arrangements.[8] The following are broad descriptions as immediate and deferred transfer farm-out arrangements will necessarily reflect the particular terms agreed to by the parties.

Immediate transfer farm-out arrangement

10. Under an immediate transfer farm-out arrangement, an obligation to transfer a percentage interest in a mining tenement from a farmor to a farmee arises for the farmor upon entry into the agreement. Typically, the farmor and farmee will also establish a joint venture or, if a joint venture is already in existence, the farmee will become a joint venturer along with the other parties to the joint venture arrangement.

11. In return for the transfer of the interest in the mining tenement, the farmee will undertake exploration commitments and may also undertake to make cash payments to, or on behalf of, the farmor. For example, the farmee may commit to carry out exploration over a number of years to a particular dollar value and may also agree to pay an amount to the farmor or to contribute to the joint venture account or other expenses in excess of the farmee's interest thereby relieving the farmor from having to contribute that amount.

Deferred transfer farm-out arrangement

12. Under a deferred transfer farm-out arrangement, the transfer of the interest from the farmor to the farmee occurs only after the farmee has met all of the exploration commitments and has made all the required payments to, or on behalf of, the farmor. Certain exploration commitments or payments may be mandatory upon entering into the agreement, however, most (if not all) of the exploration commitments and payments are at the election of the farmee. If the farmee at a point in time elects not to continue with the arrangement, the farmee does not acquire the specified interest in the mining tenement. The income tax and GST consequences for a deferred transfer farm-out arrangement are discussed in draft Miscellaneous Taxation Ruling MT 2011/D2[9].

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[8] Birch, Charles, 'Choosing the Right Joint Venture Structure for a Farmin or Farmout' [2002] JIATax 3; (2002) 5 (1) Journal of Australian Taxation 60.

[9] Please note that this draft Ruling has not yet issued, it is due to issue on 24 August 2011 and will be available on the ATO website at www.ato.gov.au.

Class of arrangement/scheme

13. The immediate transfer farm-out arrangements covered by this draft Ruling have the following characteristics:

The farmor	***The farmee***
• Transfers a percentage interest in the mining tenement to the farmee (leaving the farmor with a reduced percentage interest in that mining tenement);[10] • May share mining information with the farmee as a part of that transfer.	• Undertakes exploration commitments, which may be referable to a period of time; an amount(s); a schedule of works; or a combination thereof; • May make cash payments directly to the farmor. These payments may or may not be referable to the exploration costs the farmor has incurred prior to the farm-out arrangement being entered into; • May make cash payments on behalf of the farmor to third parties for services or other expenses in excess of the farmee's interest thereby relieving the farmor from having to meet that obligation; • May make cash payments to a joint venture account on behalf of the farmor which is subsequently used to fund services or other expenses thereby relieving the farmor from having to contribute that amount.

14. This draft Ruling does not apply to immediate transfer farm-out arrangements having materially different features to those set out above. As it is not possible to comprehensively deal with the multitude of ways in which an immediate transfer farm-out arrangement may be structured, you may need to seek a private ruling if your arrangement is not comparable to that discussed in this draft Ruling.

[10] The parties would typically enter into a joint venture arrangement or the farmee would become a joint venturer if such an arrangement already exists.

Ruling

Characterisation of the arrangement

15. An immediate transfer farm-out arrangement is treated for income tax and GST purposes as a sale of a percentage interest in a mining tenement by a farmor to a farmee.

16. In return for the transfer of the interest in the mining tenement, the farmor receives consideration consisting of benefits that flow to it from the farmee's exploration commitments. In this draft Ruling, these benefits are referred to as 'exploration benefits'. The farmee may, in return for the transfer of the interest in the mining tenement, also make cash payments to, or on behalf of, the farmor.

17. The farmee's provision of exploration benefits to the farmor is also for reward to the extent that the transfer of the interest in the mining tenement is in return for the provision of those exploration benefits. The draft Ruling proceeds on the basis that the exploration benefits are the provision of a service by the farmee on revenue account. If this does not hold true in the farmee's particular circumstances, the conclusions reached in this draft Ruling in relation to the application of the income tax provisions will also not hold true.[11]

Mining information

18. Mining information[12] shared by the farmor with the farmee on entering into the arrangement would be treated as a non-cash benefit separate to the transfer of the interest in the mining tenement if the parties have identified consideration provided by the farmee as being for that information. The sharing of mining information in those circumstances is the provision of a service by the farmor to the farmee.

19. However, if the sharing of mining information is merely to facilitate the farmee's exploration of the mining tenement, and consequently separate consideration has not been identified for it, the farmor's sharing of that information is merely incidental to the transfer of the interest in the mining tenement rather than the provision of a non-cash benefit. In this case, the farmor's sharing of mining information with the farmee will not give rise to additional income tax or GST consequences.

20. Additionally, the farmee's sharing of mining information from its exploration work with the farmor will not give rise to additional income tax or GST consequences if it is merely a part of the exploration benefits.[13]

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[11] This is discussed further at paragraphs 58 to 63 of this draft Ruling.
[12] The term 'mining information' is used throughout this draft Ruling as a reference to *mining, quarrying or prospecting information* as defined in subsection 995-1(1) of the ITAA 1997.
[13] This is discussed further at paragraphs 64 to 66 of this draft Ruling.

Market valuation

21. If the parties are dealing with each other at arm's length, it is accepted that the market value of the exploration benefits that flow to the farmor and any cash payments made to, or on behalf of, the farmor by the farmee is equal to the market value of the interest in the mining tenement and any other benefits that are provided by the farmor.[14] The value of the exploration benefits to the farmor does not necessarily equate with the amount to be spent by the farmee on exploration work.

22. In the context of these arrangements, the relevant time for determining the market value of the interest in the mining tenement that is transferred by the farmor, or any other non-cash benefit, is at the time of entering into the farm-out agreement. The market valuation must take into account all the facts and surrounding circumstances.[15]

Application of the UCA provisions to the farmor

Balancing adjustment event

23. A balancing adjustment event occurs for the interest in the mining tenement transferred by the farmor when the farmee begins to hold the interest in the mining tenement under item 5 of the table in section 40-40 of the ITAA 1997. When the farmee begins to hold the interest in the mining tenement under 5 of the table in section 40-40 of the ITAA 1997 is discussed at paragraph 29.

24. A balancing adjustment amount is included in the farmor's assessable income if the termination value of the interest in the mining tenement that is transferred by the farmor is more than its adjustable value just before the event occurred.

25. The adjustable value of the interest in the mining tenement transferred by the farmor is a reasonable proportion of the adjustable value of the interest in the mining tenement before it was split into two assets[16] along with a reasonable proportion of any other capital costs involved in splitting the asset.[17]

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[14] This is consistent with the view the Commissioner takes in Goods and Services Tax Ruling GSTR 2001/6: non-monetary consideration (paragraphs 19 and 138).
[15] This is discussed further at paragraphs 67 to 74 of this draft Ruling.
[16] The two assets being the interest the farmor retains and the interest the farmor transfers to the farmee.
[17] Section 40-205 of the ITAA 1997.

26. The termination value of the interest in the mining tenement transferred by the farmor is the sum of:

- any payments made by the farmee, to or on behalf of, the farmor or the amount of the farmor's right to receive such amounts;[18] and
- the market value of the exploration benefits, or the rights to those benefits, that flow to the farmor.[19]

Exploration or prospecting expenditure deductions

27. The interest in the mining tenement that the farmor transfers to the farmee is in return for exploration or prospecting to the extent that the transfer of the interest secures exploration benefits for the farmor. The farmor is therefore entitled to a deduction under subsection 40-730(1)[20] of the ITAA 1997 to that extent. The amount of the deduction is equal to the market value of the interest in the mining tenement at the time of entry into the farm-out agreement to the extent that the interest in the mining tenement secures the farmor's right to the exploration benefits. This is illustrated by Example 1 at paragraph 128.

28. The deduction is allowed in the income year in which the expenditure is incurred. In the context of an immediate transfer farm-out arrangement, this is the income year in which the immediate transfer farm-out agreement is executed. This is on the basis that the farmor has an obligation to transfer the interest in the mining tenement at that time.[21]

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[18] See items 1 and 3 of the table in paragraph 40-305(1)(b) of the ITAA 1997.
[19] See items 4 and 6 of the table in paragraph 40-305(1)(b) of the ITAA 1997. This is discussed further at paragraphs 78 to 84 of this draft Ruling.
[20] This is if all of the other requirements of the provision have been satisfied and subsections 40-730(2) and 40-730(3) of the ITAA 1997 do not apply.
[21] This is discussed further at paragraphs 85 to 96 of this draft Ruling.

Application of the UCA provisions to the farmee

Decline in value deduction for the interest in the mining tenement

29. The farmee begins to hold the interest in the mining tenement under under item 5 of the table in section 40-40 of the ITAA 1997 at the time when the agreement is executed and the farmee is able to exercise rights[22] in relation to the interest in the mining tenement and there is a reasonable expectation that legal ownership will transfer to the farmee. Whether this is the case will necessarily depend on the particular facts and circumstances. However, the fact that completion of the agreement is conditional (for example on Ministerial approval) does not prevent the farmee beginning to hold the interest in the mining tenement under item 5 of the table in section 40-40 of the ITAA 1997 at the time when the agreement is executed. There is no further balancing adjustment event when the farmee becomes the legal owner of the interest in the mining tenement under item 10 of the table is section 40-40 of the ITAA 1997.[23]

30. The first element of cost of the interest in the mining tenement is the same amount as the farmor's termination value of that interest.

31. The farmee is entitled to a decline in value deduction for the first element of cost of the interest in the mining tenement to the extent it is used for a taxable purpose.[24]

32. If the farmee's first use of the interest in the mining tenement is for exploration or prospecting, the farmee's decline in value deduction is the cost of the interest.[25] That is, the farmee is entitled to an immediate deduction for the cost of the interest. The deduction is allowed in the income year in which the start time for the interest in the mining tenement occurs.[26] That is, the income year in which the interest in the mining tenement is first used for exploration or prospecting.

33. If it is not first used for exploration or prospecting, then the farmee is entitled to an annual decline in value deduction for the interest in the mining tenement under section 40-25 of the ITAA 1997.[27]

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[22] For example, to explore the mining tenement or to become a joint venture participant (whereby the joint venture operator acts on behalf of the farmee and the other participants in exploring the tenement) or to become the joint venture operator (thus acting on its own behalf as well as other participants).
[23] This is discussed further at paragraphs 97 to 99 of this draft Ruling.
[24] See section 40-25 of the ITAA 1997.
[25] The effect of subsection 40-80(1) of the ITAA 1997 as it applies to section 40-25 of the ITAA 1997.
[26] Section 40-60 of the ITAA 1997.
[27] This is discussed further at paragraphs 100 to 102 of this draft Ruling.

Exploration or prospecting expenditure deductions

34. The farmee is entitled to a deduction for expenditure incurred on exploration or prospecting under subsection 40-730(1)[28] of the ITAA 1997 to the extent that it does not form part of the cost of a depreciating asset.[29] The deduction is allowed in the income year in which the expenditure is incurred.[30]

Deduction for expenditure on mining information

35. If the parties have identified consideration provided by the farmee as being for mining information shared[31] by the farmor with the farmee, then:

- the farmee is entitled to a deduction for expenditure incurred in obtaining mining, quarrying or prospecting information associated with searching for and evaluating areas containing minerals or quarry materials;[32]
- the farmee is entitled to that deduction under subsection 40-730(1) of the ITAA 1997; and
- the deduction is allowed in the income year in which the expenditure is incurred.[33]

Application of the CGT provisions

CGT consequences for the farmor

36. CGT event A1 happens[34] to the farmor for the interest in the mining tenement that is transferred by the farmor to the farmee.[35] However, subsection 118-24(1) of the ITAA 1997 applies to disregard any capital gain or loss on the transfer of the interest in the mining tenement if the decline in value of the interest in the mining tenement is, (or would be, if it was used), worked out under the UCA provisions. This is subject to the exclusions set out in subsection 118-24(2) of the ITAA 1997 which are not considered relevant to these circumstances.

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[28] This is if all of the other requirements of the provision have been satisfied and subsections 40-730(2) and 40-730(3) of the ITAA 1997 do not apply.
[29] See subsection 40-730(3) of the ITAA 1997.
[30] This is discussed further at paragraphs 103 and 104 of this draft Ruling.
[31] That is, the farmor continues to hold that mining information.
[32] See paragraph 40-730(4)(d) of the ITAA 1997.
[33] This is discussed further at paragraph 105 of this draft Ruling.
[34] See subsection 104-10(3) of the ITAA 1997 as to when the event happens.
[35] Section 104-10 of the ITAA 1997.

37. The farmor may also acquire a right to require the interest in the mining tenement to be reassigned to the farmor if the farmee does not meet its exploration or payment commitments. On the basis that capital proceeds are not attributable to this right, and it is merely incidental to the transfer of the interest in the mining tenement, there are no additional CGT consequences for the farmor.[36]

CGT consequences for the farmee

38. The farmee acquires a CGT asset (being the interest in the mining tenement). However, aside from this, there are no CGT consequences upon entry into the agreement for the farmee in respect of the things it provides under the immediate transfer farm-out arrangement as described at paragraph 13.

39. The farmee may also acquire a right to reassign the interest in the mining tenement to the farmor if, for example, exploration reveals insufficient quantities of minerals. On the basis that no cost is attributable to this right, and it is merely incidental to the acquisition of the interest in the mining tenement, there are no additional CGT consequences for the farmee.[37]

Application of the ordinary income and deduction provisions

Farmor sharing mining information for identified consideration

40. If the parties have identified consideration provided by the farmee as being for mining information shared[38] by the farmor with the farmee on entering into the arrangement, the consideration is assessable income of the farmor under section 6-5 or 15-40 of the ITAA 1997. It is assessable income of the farmor in the income year in which it is derived (section 6-5 of the ITAA 1997) or received (section 15-40 of the ITAA 1997).[39]

Farmee's reward for providing exploration benefits

41. To the extent that the interest in the mining tenement received by the farmee is reward for the provision of exploration benefits (a non-cash benefit) by the farmee to the farmor, the market value of the interest in the mining tenement is assessable income to the farmee under section 6-5 of the ITAA 1997. It is assessable income in an income year to the extent that there is a provision of exploration benefits to the farmor.[40]

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[36] See also paragraphs 106 and 107 of this draft Ruling.
[37] See also paragraphs 108 and 109 of this draft Ruling.
[38] That is, the farmor continues to hold that information.
[39] This is discussed further at paragraphs 110 to 112 of this draft Ruling.
[40] This is discussed further at paragraphs 113 to 115 of this draft Ruling.

Farmee's exploration related expenditure

42. If the farmee's expenditure relates to its exploration work and is of a revenue nature but is not exploration or prospecting expenditure for the purposes of subsection 40-730(1) of the ITAA 1997, the expenditure is deductible under section 8-1 of the ITAA 1997 if the requirements of section 8-1 of the ITAA 1997 are satisfied. The deduction is allowed in the income year in which the expenditure is incurred.[41]

Application of the GST provisions

43. If the farmor's supply of the interest in the mining tenement is for non-monetary consideration only (that is, the exploration benefits that flow to the farmor from the farmee's exploration commitments), it is a barter transaction. The farmee also makes a supply to the farmor of the exploration benefits for non-monetary consideration. On the basis of it being an arm's length transaction, the GST-inclusive market value of the exploration benefits to the farmor is equal to the GST-inclusive market value of the interest in the mining tenement that is transferred to the farmee.[42] The farmor and the farmee each make a taxable supply[43] and a creditable acquisition[44].

44. However, if the farmee makes cash payments to, or on behalf of, the farmor in addition to the exploration benefits that flow to the farmor, the supply of the interest in the mining tenement is for both monetary and non-monetary consideration. The GST-inclusive market value of the interest in the mining tenement is equal to that monetary consideration and the GST-inclusive market value of the non-monetary consideration being the exploration benefits.

45. If the parties have identified consideration provided by the farmee as being for mining information shared by the farmor with the farmee on entering into the arrangement, that sharing is treated as a supply by the farmor separate from the supply of the interest in the mining tenement. The consideration attributable to the interest in the mining tenement would not include any consideration identified for the mining information. The farmor makes a taxable supply of that mining information and it is a creditable acquisition for the farmee.[45]

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[41] See also paragraph 116 of this draft Ruling.
[42] Paragraph 138, GSTR 2001/6.
[43] Assuming the requirements of section 9-5 of the GST Act are satisfied and it is not part of a supply that is a GST-free supply of a going concern.
[44] Assuming the requirements of section 11-5 of the GST are satisfied.
[45] This is discussed further at paragraphs 117 to 121 of this draft Ruling.

The net GST outcome

46. The basic attribution rules under Division 29 of the GST Act apply.[46] If, for example, the farmor and the farmee are each registered for GST and account for GST on a non-cash basis, the farmor and farmee can exchange invoices that are also tax invoices, upon entering into the agreement and thus attribute GST payable[47] and any input tax credits[48] on that basis[49] to the same tax period.

47. The farmor will have a net GST payable position and the farmee will have a net GST refund position to the extent that the consideration for the supply of the interest in the mining tenement is monetary. This outcome is illustrated by Example 1 at paragraph 128.

48. If the farmee's consideration is non-monetary only, it is a barter transaction. For each entity, the GST payable and input tax credit will offset each other giving rise to a nil net GST outcome (assuming the acquisition by each party is for a fully creditable purpose).[50]

GST going concern

49. Paragraph 195 of Goods and Services Tax Ruling GSTR 2002/5[51] explains that it is possible for a joint venturer[52] entity to make a GST-free 'supply of a going concern', including when part of the enterprise conducted by the joint venturer is supplied, providing all of the requirements of section 38-325 of the GST Act, as explained in Goods and Services Tax Ruling GSTR 2002/5, are satisfied.

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[46] If total consideration is not known the attribution rules under *A New Tax System (Goods and Services Tax) (Particular Attribution Rules Where Total Consideration Not Known) Determination (No. 1) 2000* apply instead of the basic attribution rules.

[47] Paragraph 29-5(1)(b) of the GST Act.

[48] Paragraph 29-10(1)(b) and subsection 29-10(3) of the GST Act. Division 93 of the GST Act is also relevant to claiming input tax credits. Under that Division, an entitlement to an input tax credit for a creditable acquisition may cease if the input tax credit is not included in a GST return within four years from the due date of the GST return for which the credits would have been attributable under subsection 29-10(1) or (2) of the GST Act.

[49] That is, instead of on the basis of when consideration is received (paragraph 29-5(1)(a) of the GST Act) or provided (paragraph 29-10(1)(a) of the GST Act). Goods and Services Tax Ruling GSTR 2001/6: non-monetary consideration, explains the application of the attribution rules where consideration is non-monetary (see paragraphs 166 to 197).

[50] This outcome differs if the supply by the farmor to the farmee is part of a supply that is a GST-free supply of a going concern. See below at paragraph 50 of this draft Ruling.

[51] Goods and Services Tax Ruling GSTR 2002/5**:** when is a 'supply of a going concern' GST-free?

[52] For further explanation concerning joint venture arrangements see Goods and Services Tax Ruling GSTR 2004/2: Goods and services tax: What is a joint venture for GST purposes?

50. If a supply by a joint venturer farmor (which includes the supply of the interest in the mining tenement) is the supply of a going concern that is a GST-free supply under section 38-325 of the GST Act, the farmee will not have any input tax credits to claim and the farmor will have no GST payable in respect of that supply. However, GST is payable by the farmee in respect of its supply of the exploration benefits to the farmor and the farmor may be entitled to input tax credits.

Summary table

51. The significant income tax and GST consequences for the farmor and farmee upon entering into an immediate transfer farm-out arrangement are summarised in the following table.

Consequences for the farmor	***Consequences for the farmee***
Income tax consequences	
A balancing adjustment event occurs for the interest in the mining tenement that is transferred by the farmor. The excess of termination value over adjustable value is assessable income of the farmor in the income year in which the farmee begins to hold the interest in the mining tenement under item 5 in the table in section 40-40 of the ITAA 1997. (See paragraphs 23 to 26.)	There is an immediate deduction for the cost of the interest in the mining tenement if it is first used for exploration or prospecting and the requirements of subsection 40-80(1) and section 40-25 of the ITAA 1997 are satisfied. The deduction is allowed in the income year in which the interest in the mining tenement is first used for exploration or prospecting. (See paragraphs 29 to 33.)
CGT event A1 also happens but any capital gain or loss is disregarded. (See paragraph 36.)	The farmee acquires a CGT asset. (See paragraph 38.)
There is a deduction for the farmor under subsection 40-730(1) of the ITAA 1997 to the extent the transfer of the interest in the mining tenement secures exploration benefits for the farmor. The deduction is allowed in the income year in which the farm-out agreement is executed and the farmor has an obligation to transfer the interest in the mining tenement. (See paragraphs 27 and 28.)	The farmee has assessable income under section 6-5 of the ITAA 1997 to the extent that the interest in the mining tenement is reward for its provision of exploration benefits. The amount is equal to the market value of the interest in the mining tenement, reduced to the extent of any payments. It is assessable income of the farmee in an income year to the extent that the farmee provides exploration benefits to the farmor pursuant to its exploration commitments. (See paragraph 41.)

Consequences for the farmor	***Consequences for the farmee***
	There is a deduction under: • subsection 40-730(1) of the ITAA 1997 for expenditure for exploration or prospecting that does not form part of the cost of a depreciating asset; • section 8-1 of the ITAA 1997 for other types of revenue expenses if the requirements under section 8-1 of the ITAA 1997 are satisfied. The deductions are allowed in the income year(s) in which the expenditure is incurred. (See paragraphs 34 and 42.)
If separate consideration is attributed to the sharing of mining information	
The consideration received for the mining information is assessable income for the farmor under section 6-5 or 15-40 of the ITAA 1997, in the income year in which it is derived or received, respectively. (See paragraph 40.)	If the information obtained is associated with searching for and evaluating areas containing minerals or quarry materials, there is a deduction for the farmee's expenditure under subsection 40-730(1) of the ITAA 1997 in the income year in which it is incurred. (See paragraph 35.)
GST consequences	
The farmor makes a taxable supply[53] of the interest in the mining tenement to the farmee and has a GST liability. (See paragraph 43.)	The farmee makes a creditable acquisition[54] of the interest in the mining tenement and is entitled to input tax credits. (See paragraph 43.)
The farmor makes a creditable acquisition of exploration benefits and is entitled to input tax credits. (See paragraph 43.)	The farmee makes a taxable supply of exploration benefits to the farmor and has a GST liability. (See paragraph 43.)
If separate consideration is attributed to the sharing of mining information	
The farmor makes a taxable supply of the information to the farmee and has a GST liability. (See paragraph 45.)	The farmee makes a creditable acquisition of the information and is entitled to input tax credits. (See paragraph 45.)

[53] Assuming the requirements of section 9-5 of the GST Act are satisfied and it is not part of a supply that is a GST-free supply of a going concern under section 38-325 of the GST Act.
[54] Assuming the requirements of section 11-5 of the GST Act are satisfied.

Consequences for the farmor	*Consequences for the farmee*
Attribution Upon entering into the agreement the farmor and the farmee can exchange invoices that are also tax invoices for their respective supplies. Assuming that the farmor and the farmee are each registered for GST and account for GST on a non-cash basis, they can each attribute GST payable and input tax credits to a tax period on this basis (rather than on the basis of when consideration is received or provided). (See paragraph 46.)	

Date of effect

52. This draft Ruling applies to an immediate transfer farm–out agreement[55] dated on or after the issue of this draft Ruling if the farmor started to hold the mining tenement that is the subject of the agreement under a contract entered into on or after 1 July 2001.

53. If the farmor started to hold the mining tenement under a contract entered into before 1 July 2001 Income Tax Ruling IT 2378 is relevant.

54. As the income tax and GST treatment of immediate transfer farm-out arrangements has been the subject of earlier discussion papers that have expressed a different view in some respects to that in this draft Ruling, and the complexity of the issues has resulted in this draft Ruling not being issued earlier, the date of effect is prospective.

55. This draft Ruling will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this draft Ruling.

56. The Commissioner invites comments on what, if any, transitional arrangements are appropriate in implementing the final Ruling.

Commissioner of Taxation
27 July 2011

[55] It must be an immediate transfer farm-out arrangement of the type covered by this draft Ruling. See paragraphs 1 to 5 and 13.

Appendix 1 – Explanation

57. The Explanation section of the draft Ruling is set out in three Parts:

- *Part A* sets out the Commissioner's approach to these types of arrangements, which is relevant for the application of both the income tax and GST laws (paragraphs 58 to 74);
- *Part B* explains the application of the income tax law to these types of arrangements (paragraphs 75 to 116); and
- *Part C* explains the application of the GST law to these types of arrangements (paragraphs 117 to 127).

Part A – General approach to these arrangements

Characterisation of the arrangement

58. To determine how the income tax and GST laws apply to these arrangements, it is necessary to consider the character of the arrangement between the farmor and the farmee. Paragraph 13 sets out the features of immediate transfer farm-out arrangements covered by this draft Ruling.

59. This type of arrangement is treated as a sale of a percentage interest in the mining tenement by the farmor to the farmee.

What the farmor receives

60. In return for the transfer of the interest in the mining tenement, the farmor receives exploration benefits that flow to it from the farmee's exploration commitments along with any cash payments made to, or on behalf of, the farmor by the farmee.

Exploration benefits that flow to the farmor

61. A reference to the exploration benefits that flow to the farmor from the farmee's exploration commitments does not necessarily equate those benefits with the amount to be spent by the farmee on exploration.

62. It is recognised that, as the farmee is acquiring an interest in the mining tenement, its exploration commitments are in part for its own benefit. However, the farmor is also benefiting to some extent from those exploration commitments. In a typical immediate transfer farm-out agreement, the farmor's transfer of the interest in the mining tenement is executed in return for those exploration commitments and any cash payment commitments. The exploration commitments are, or are part of, the consideration that supports the existence of the contract between the parties.

63. To the extent that the farmee's exploration commitments benefit the farmor, the farmor is considered to have received an exploration benefit in the nature of a service from the farmee. A reference in this draft Ruling to the exploration benefits that flow to the farmor is recognition of this.

Mining information

64. Mining information shared by the farmor with the farmee on entering into the arrangement would be treated as a non-cash benefit separate to the transfer of the interest in the mining tenement if the parties have identified consideration provided by the farmee as being for that information. The sharing of information in those circumstances is the provision of a service by the farmor to the farmee.

65. However, if the sharing of mining information is merely to facilitate the farmee's exploration of the mining tenement, and consequently separate consideration has not been identified for it, the farmor's sharing of that information is merely incidental to the transfer of the interest in the mining tenement rather than the provision of a non-cash benefit. In this case, the farmor's sharing of mining information with the farmee will not give rise to additional income tax or GST consequences.

66. Additionally, the farmee's sharing of mining information from its exploration work with the farmor will not give rise to additional income tax or GST consequences if it is merely a part of the exploration benefits.

Market valuation

67. As the farmor receives a non-cash exploration benefit (at least in part) for its transfer of the interest in the mining tenement, it is necessary to consider market value[56] for both UCA and GST purposes.

[56] For GST purposes, it is the GST-inclusive market value of the non-cash benefit. For UCA purposes, Subdivision 27-B of the ITAA 1997 is relevant. It is the GST-inclusive market value for UCA purposes to the extent that the relevant entity cannot claim an input tax credit. For example, if the farmee is entitled to a full input tax credit in relation to the acquisition of an interest in the mining tenement, the relevant amount for UCA purposes would be the GST-exclusive amount.

68. The Commissioner accepts that, if the parties are dealing at arm's length, one way to work out the market value of the exploration benefits provided by the farmee for the interest in the mining tenement is to treat the market value of the exploration benefits that flow to the farmor and any cash payments made to, or on behalf of, the farmor by the farmee as equal to the market value of the interest in the mining tenement that is to be transferred by the farmor and any other benefits that are provided by the farmor. The relevant time for the valuation is at the time when the farm-out arrangement is entered into.[57]

69. To put it another way, it is possible to treat the market value of the exploration benefits provided by the farmee to the farmor as equal to the market value of the interest in the mining tenement transferred by the farmor at the time when the farm-out arrangement is entered into, reduced by any cash payments made by the farmee.[58]

Determining the market value

70. Determining market value is a question of objective fact.

71. Market value is worked out on the basis of what a willing but not anxious provider of the thing would agree on with a willing but not anxious acquirer of the thing as payment for it. This may be determined by reference to a hypothetical market.

72. This is based upon the common law test for market value as developed in *Spencer v. The Commonwealth.*[59] The High Court provided a summary of this test in *Abrahams v. FC of T*[60] where Williams J said (at page 29) that market value is:

> the price which a willing but not anxious vender could reasonably expect to obtain and a hypothetical willing but not anxious purchaser could reasonably expect to have to pay… if the vendor and purchaser had got together and agreed on a price in friendly negotiation…

73. Relevant to the question of valuation are the facts and surrounding circumstances including the terms of the agreement and what is known about the mining tenement at the time of entering into the farm-out agreement. That is, the value of an interest in a mining tenement when little is known about the mining tenement is likely to be different to its value at a later stage of exploration or development when more is known about the mining tenement.

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[57] This is consistent with the view the Commissioner takes in Goods and Services Tax Ruling GSTR 2001/6: non-monetary consideration (paragraphs 19 and 138).
[58] Excluding any consideration specifically recognised by the parties as being for any mining information provided by the farmor to the farmee (see paragraph 64).
[59] (1907) 5 CLR 418.
[60] (1944) 70 CLR 23.

74. For example, the price that a willing but not anxious purchaser might pay at the greenfields stage where there has been no exploration discoveries and, consequently, eventual production from that area is very uncertain, may be minimal.

Part B – application of the income tax law

75. This Part of the explanation considers:

- the application of the UCA provisions;
- the application of the CGT provisions; and
- the application of sections 6-5, 8-1 and 15-40 of the ITAA 1997.

Application of the UCA provisions

76. A 'mining, quarrying or prospecting right' is a depreciating asset[61] and includes an interest in the relevant authority, licence, permit, right or lease.[62] The interest in the mining tenement held by the farmor is therefore a depreciating asset.

77. The UCA provisions apply in relation to the interest in the mining tenement that is transferred by the farmor to the farmee.

Application of the UCA provisions to the farmor

Splitting of the mining tenement

78. When the farmor transfers part of their interest in the mining tenement to the farmee, the farmor's interest is split into two depreciating assets, the interest they retain and the interest they transfer to the farmee.[63]

79. The first element of cost of each of the two depreciating assets, as a result of the split, is worked out under section 40-205 of the ITAA 1997 as being a reasonable proportion of both the adjustable value of the depreciating asset that the farmor held and any other capital costs involved in splitting that depreciating asset.

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[61] See paragraph 40-30(2)(a) of the ITAA 1997.
[62] See paragraph (c) of the definition of *mining, quarrying or prospecting right* in subsection 995-1(1) of the ITAA 1997.
[63] Section 40-115 of the ITAA 1997.

The occurring of a balancing adjustment event

80. No balancing adjustment event occurs by reason only of the split into the two depreciating assets.[64] A balancing adjustment event does, however, occur for the interest in the mining tenement transferred by the farmor to the farmee.[65]

When the balancing adjustment event occurs

81. A balancing adjustment event occurs for the interest in the mining tenement transferred by the farmor to the farmee when the farmee begins to hold the interest in the mining tenement under item 5 of the table in section 40-40 of the ITAA 1997. When the farmee begins to hold the interest in the tenement under this item is explained further at paragraphs 97 to 99.

Balancing adjustment amount

82. A balancing adjustment amount is worked out for the event under section 40-285 of the ITAA 1997, being the difference between the termination value and adjustable value of the interest in the mining tenement transferred by the farmor. The adjustable value of the interest to the farmor is the amount apportioned to the interest under section 40-205 of the ITAA 1997 (as explained in paragraph 79).

83. The termination value of a depreciating asset is worked out at the time when the balancing adjustment event occurs.[66] As no item of the table in subsection 40-300(2) of the ITAA 1997 applies to the interest in the mining tenement transferred by the farmor, the termination value of the interest in the mining tenement for the farmor is the sum of the applicable amounts set out in the table in paragraph 40-305(1)(b) of the ITAA 1997 that the farmor is taken to have received under the balancing adjustment event.[67]

84. Dependent upon the terms of the agreement, the termination value of the interest in the mining tenement transferred by the farmor to the farmee may be comprised of amounts received;[68] or the amount of a right granted to receive an amount;[69] in addition to the non-cash benefits that flow to the farmor from the right to require the farmee to carry out the exploration work.[70]

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[64] Subsection 40-295(3) of the ITAA 1997.
[65] Subsection 40-295(1) of the ITAA 1997.
[66] Subsection 40-300(1) of the ITAA 1997.
[67] Paragraph 40-305(1)(a) of the ITAA 1997 does not apply.
[68] See item 1 of the table in paragraph 40-305(1)(b) of the ITAA 1997.
[69] See item 3 of the table in paragraph 40-305(1)(b) of the ITAA 1997.
[70] See item 6 of the table in paragraph 40-305(1)(b) of the ITAA 1997. The term 'non-cash benefit' is defined in subsection 995-1(1) of the ITAA 1997.

Exploration or prospecting expenditure deductions

85. Broadly speaking, expenditure incurred by an entity on exploration or prospecting is deductible under subsection 40-730(1) of the ITAA 1997 if the entity carried on mining operations, or proposed to carry on such operations, or is in the business of exploration or prospecting.

86. Consistent with the view that the farmor transfers the interest in the mining tenement to the farmee in return (at least to some extent)[71] for the farmee's exploration benefits, it can be said that the farmor transfers the interest in the mining tenement to the farmee to secure those benefits.

87. In order for that transfer of the interest by the farmor to be deductible under subsection 40-730(1) of the ITAA 1997, it must constitute expenditure incurred by the farmor.

88. The term 'expenditure' is not defined in the ITAA 1997. It therefore takes on its ordinary meaning in the context in which it appears.[72]

89. Expenditure is defined in the Macquarie dictionary as *the act of expending, disbursement or consumption.* Similarly, the Oxford dictionary defines expenditure as *the process or an instance of spending or using up.*

90. In the context in which the term 'expenditure' appears in subsection 40-730(1) of the ITAA 1997, the farmor has disbursed, consumed, or used up the interest in the mining tenement by transferring it to the farmee. As such, that disbursement, consumption or using up of the interest in the mining tenement can be said to be expenditure for the purposes of subsection 40-730(1) of the ITAA 1997.

91. Support for this view can be found in *Oram (Inspector of Taxes) v. Johnson*[73] where Walton J states:

> So I return to basically to para 4(1)*(b)*, 'the amount of any expenditure'. It seems to me that, although one does in general terms talk about expenditure of time and expenditure of effort, having regard particularly to the opening words of para 4(1), where the expenditure is to be a 'deduction', the primary matter which is thought of by the legislature in para 4(1)(*b)* is ***something which is passing out from the person*** who is making the expenditure. ***That will most normally and naturally be money***, accordingly presenting no problems in calculation; ***but that will not necessarily be the case***. I instance the case (it may be fanciful, but I think it is a possible one and tests the principle) of the taxpayer employing a bricklayer to do some casual bricklaying about the premises, the remuneration for the bricklayer being three bottles of whisky at the end of the week. It seems to me that that would be expenditure by

[71] That is, it might also be provided in return for cash payments.
[72] As expressed in *CIC Insurance Ltd v. Bankstown Football Club Ltd* (1997) 187 CLR 384 at 408 per Brennan CJ, Dawson, Toohey and Gummow JJ.
[73] (1980) 2 All ER 1, at [5].

> the taxpayer, because out of his stock he would have to give something away to the person who was laying the bricks, and I do not think that that would present any real problems of valuation or other difficulty. [Emphasis added]

92. The passage in *Oram* was approved by Australian authority in *Department of Employment, Education, Training & Youth Affairs v. Duscher.*[74]

93. The Commissioner takes the view that the argument in *Oram* that '*an amount* of expenditure' can include non-cash expenditure is more persuasive when considering the single term 'expenditure' that is used in subsection 40-730(1) of the ITAA 1997.

94. Accordingly, it is the Commissioner's view that the farmor has incurred 'expenditure' that is deductible under subsection 40-730(1)[75] of the ITAA 1997. This view is consistent with the Commissioner's view expressed at paragraph 16 of Taxation Ruling IT 2668,[76] that the provision of a non-cash benefit can be a loss or outgoing for the purposes of section 8-1 of the ITAA 1997.

95. The deduction is allowed in the income year in which the expenditure is incurred. In the context of an immediate transfer farm-out arrangement, this is the income year in which the immediate transfer farm-out agreement is executed. This is on the basis that the farmor has an obligation to transfer the interest in the mining tenement at that time.

96. The amount of the expenditure is the market value of the interest in the mining tenement at the time of entry into the farm-out agreement to the extent that it secures the farmor's right to the exploration benefits. To the extent that the transfer of the interest in the mining tenement secures payments (whether to, or on behalf of the farmor) or other benefits for the farmor, the market value of the mining tenement is not deductible under section 40-730 of the ITAA 1997 for the farmor.

Application of the UCA provisions to the farmee

When the farmee starts to hold its interest

97. The farmee becomes the economic owner of the interest in the mining tenement under item 5 of the table in section 40-40 of the ITAA 1997 when the agreement is executed and the farmee is able to exercise rights in relation to the interest in the mining tenement and there is a reasonable expectation that legal ownership will transfer to the farmee.

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[74] (1996) 24 AAR 239, at [48].
[75] This is if all the other requirements of the provision have been satisfied and subsections 40-730(2) and 40-730(3) of the ITAA 1997 do not apply.
[76] Income Tax – Barter and countertrade transactions.

98. Whether this is the case will necessarily depend on the particular facts and circumstances. Relevant considerations include:

- whether the farmee exercises, or has a right to exercise immediately, the subject matter of the interest in the mining tenement. That is, whether the farmee:
  - has a right to explore the area covered by the mining tenement; or
  - becomes a joint venture participant whereby the joint venture operator acts on behalf of the farmee and the other participants in exploring the tenement through expending funds from the joint venture account contributed to by the farmee; or
  - becomes the joint venture operator thus acting on its own behalf as well as on behalf of other participants.
- whether there are circumstances which would indicate that, contrary to the agreement, the farmee does not have a reasonable expectation of becoming the legal owner of the interest. However, the fact that completion of the agreement is conditional, for example, upon Foreign Investment Review Board or Ministerial approval, does not prevent the farmee from starting to hold the interest in the mining tenement under item 5 of the table in section 40-40 of the ITAA 1997 at the time when the agreement is executed. It would normally be expected that the farm-out agreement is entered into on the basis of a reasonable expectation that the farmee will become the legal owner of the interest in the mining tenement.

99. The farmee becomes the legal owner of the interest in the mining tenement under item 10 of the table in section 40-40 of the ITAA 1997 once Ministerial (or other similar types of) approval is given to the transfer of the interest in the mining tenement. The change from item 5 to item 10 of the table in section 40-40 of the ITAA 1997 under which the farmee holds the interest in the mining tenement does not cause a further balancing adjustment event to occur.

First element of cost – interest in the mining tenement

100. The first element of cost of the interest the farmee starts to hold in the mining tenement is the same amount as the termination value of that interest to the farmor.[77]

[77] See items 1 and 5 of the table in section 40-185 of the ITAA 1997.

101. If the farmee first uses the interest in the mining tenement transferred by the farmor to it for exploration or prospecting, the farmee is entitled to an immediate deduction for the cost of the interest under section 40-25 of the ITAA 1997 by applying subsection 40-80(1) of the ITAA 1997. The deduction is allowed in the income year in which the start time for the interest in the mining tenement occurs.[78] That is, the income year in which the interest in the mining tenement is first used for exploration or prospecting.

102. If it is not first used for exploration or prospecting, then the farmee is entitled to an annual decline in value deduction for the interest in the mining tenement under section 40-25 of the ITAA 1997.

Exploration or prospecting expenditure deductions

103. There are deductions available to the farmee in respect of expenditure incurred by the farmee in meeting its exploration commitments.

104. The farmee is entitled to a deduction under subsection 40-730(1) of the ITAA 1997 for expenditure the farmee incurs on exploration or prospecting of the mining tenement that does not form part of the cost of a depreciating asset for the purposes of subsection 40-80(1) of the ITAA 1997.[79] The deduction is allowed in the income year in which the expenditure is incurred.

Deduction for expenditure on mining information

105. If the parties have identified consideration provided by the farmee as being for mining information shared[80] by the farmor with the farmee, the farmee is entitled to a deduction for expenditure incurred in obtaining mining, quarrying or prospecting information associated with searching for and evaluating areas containing minerals or quarry materials.[81] The farmee is entitled to that deduction under subsection 40-730(1) of the ITAA 1997. The deduction is allowed in the income year in which the expenditure is incurred.

[78] Section 40-60 of the ITAA 1997.
[79] Subsection 40-730(3) of the ITAA 1997.
[80] That is, the farmor continues to hold that mining information.
[81] See paragraph 40-730(4)(d) of the ITAA 1997.

Application of the CGT provisions

CGT consequences for the farmor

106. CGT event A1 happens[82] to the farmor for the interest in the mining tenement that is transferred by the farmor to the farmee.[83] However, subsection 118-24(1) of the ITAA 1997 applies to disregard any capital gain or loss on the transfer of the interest in the mining tenement if the decline in value of the interest in the mining tenement is, (or would be, if it was used), worked out under the UCA provisions. This is subject to the exclusions set out in subsection 118-24(2) of the ITAA 1997, which are not considered relevant to these circumstances.

107. The farmor may also acquire a right to require the interest in the mining tenement to be reassigned to the farmor if the farmee does not meet its exploration or payment commitments. On the basis that capital proceeds are not attributable to this right, and it is merely incidental to the transfer of the interest in the mining tenement, there are no additional CGT consequences for the farmor.

CGT consequences for the farmee

108. The farmee acquires a CGT asset (being the interest in the mining tenement). However, aside from this, there are no CGT consequences upon entry into the agreement for the farmee in respect of the things it provides under the immediate transfer farm-out arrangement as described at paragraph 13.

109. The farmee may also acquire a right to reassign the interest in the mining tenement to the farmor if, for example, exploration reveals insufficient quantities of minerals. On the basis that no cost is attributable to this right, and it is merely incidental to the acquisition of the interest in the mining tenement, there are no additional CGT consequences for the farmee.

Application of the ordinary income and deduction provisions

Farmor sharing mining information for identified consideration

110. If the parties have identified any consideration provided by the farmee as being for mining information shared[84] by the farmor with the farmee on entering into the arrangement, the consideration is assessable income of the farmor under section 6-5 or section 15-40 of the ITAA 1997. It is assessable income of the farmor in the income year in which it is derived (section 6-5 of the ITAA 1997) or received (section 15-40 of the ITAA 1997).

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[82] See subsection 104-10(3) of the ITAA 1997 as to when the event happens.
[83] Section 104-10 of the ITAA 1997.
[84] That is, the farmor continues to hold that information.

111. Consideration received for dealing with or disclosing mining information is assessable as ordinary income under section 6-5 of the ITAA 1997 if the information:

- is obtained for the purpose of profit making; or
- is dealt with or disclosed under an agreement for the provision of a service that involves sharing the information with another person and has no adverse effect on the profit-yielding structure of the business.

112. Section 15-40 of the ITAA 1997 provides that a taxpayer's assessable income includes any amount[85] received for providing mining information to another entity if:

- the taxpayer continues to hold the information for UCA purposes;[86] and
- the amount is not assessable as ordinary income under section 6-5 of the ITAA 1997.

Farmee's reward for providing exploration benefits

113. Reward for the provision of a non-cash benefit can be assessable as ordinary income under section 6-5 of the ITAA 1997. That is so even if the provision of the non-cash benefit is an isolated transaction rather than regularly provided as part of a business or profession of providing such benefits.[87]

114. As the consideration received by the farmee (that is, the interest in the mining tenement from the farmor) is reward for the provision by the farmee of exploration benefits, it is assessable income of the farmee under section 6-5 of the ITAA 1997. That is, the provision of the exploration benefits are treated in the nature of a service by the farmee on revenue account.

115. It is assessable income in an income year to the extent that it has been earned in that income year by the provision of exploration benefits to the farmor. That is, it is assessable as it is earned in those income years according to the principle enunciated in *Arthur Murray (NSW) Pty Ltd v. FC of T*[88] As an example, during the earn-in period it may be reasonable for the farmee to recognise so much of the value of the interest in the mining tenement (net of any cash payments made by the farmee for that interest) in an income year as is proportionate to the percentage of the exploration spend in that income year.

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[85] An amount can include the value of a non-cash benefit (see sections 21 and 21A of the ITAA 1936.
[86] See section 40-40 of the ITAA 1997.
[87] See *Brent v. Commissioner of Taxation* (1971) 125 CLR 418; R.W Parsons, *Income Taxation in Australia,* Law Book Company, 1985, paragraphs 2.374 and 2.375.
[88] (1965) 114 CLR 314; 9 AITR 673; 14 ATD 98.

Farmee's exploration related expenditure

116. A farmee's expenditure that relates to its exploration work but which is not incurred on exploration or prospecting for the purposes of subsection 40-730(1) of the ITAA 1997 is deductible under section 8-1 of the ITAA 1997 if it is of a revenue character and meets the other requirements of section 8-1 of the ITAA 1997. An example is salary or wages of employees involved in general administration work for the farmee. The deduction is allowed in the income year in which the expenditure is incurred.

Part C – application of the GST law

Supply and consideration

117. Under the terms of an immediate transfer farm-out arrangement, there is a supply[89] by the farmor to the farmee of an interest in a mining tenement.

118. The consideration for that supply is any payment or any act or forbearance in connection with, in response to, or for the inducement of, that supply of the interest in the mining tenement.[90] Thus, consideration for GST purposes is of wide import[91] and the consideration from the farmee to the farmor for the supply of the interest in the mining tenement includes any payments made to, or on behalf of, the farmor as well as the exploration benefits that flow to the farmor from the farmee's exploration commitments under the farm-out agreement. The farmor therefore makes a taxable supply[92] of the interest in the mining tenement to the farmee. The farmee makes a creditable acquisition[93] of the interest in the mining tenement.

119. The exploration benefits that flow to the farmor as a result of the farmee's exploration commitments is also a supply[94] of services by the farmee to the farmor and, to this extent, there is a barter transaction.[95] The farmee therefore makes a taxable supply of the exploration benefits to the farmor. The farmor makes a creditable acquisition of the exploration benefits.

120. If consideration for the farmor's supply of the interest in the mining tenement consists of both monetary and non-monetary consideration (that is, cash payments plus non-cash benefits), the value of the farmor's and the farmee's supplies can be worked out as explained at paragraphs 67 to 74.

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[89] Section 9-10 of the GST Act.
[90] Section 9-15 of the GST Act.
[91] See further explanation at paragraph 79 of Goods and Services Tax Ruling GSTR 2001/4: GST consequences of court orders and out-of-court settlements.
[92] Assuming the other requirements of section 9-5 of the GST Act are satisfied and it is not part of a supply that is a GST-free supply of a going concern.
[93] Assuming the other requirements of section 11-5 of the GST Act are satisfied.
[94] Section 9-10 of the GST Act.
[95] See Goods and Services Tax Ruling GSTR 2001/6.

121. If the parties have identified consideration provided by the farmee as being for mining information shared by the farmor with the farmee on entering into the arrangement, that sharing is treated as a supply by the farmor separate from the supply of the interest in the mining tenement. The consideration attributable to the interest in the mining tenement would not include any consideration identified for the mining information.

The net GST outcome

122. The basic attribution rules under Division 29 of the GST Act apply as follows:

Farmor or farmee accounts for GST on a non cash basis	***Farmor or farmee accounts for GST on a cash basis***
• GST payable is attributable under subsection 29-5(1) of the GST Act to the tax period in which any of the consideration is received[96] for the supply[97] or, if before consideration is received an invoice is issued relating to the supply, the tax period in which the invoice is issued.	• GST payable is attributable under subsection 29-5(2) of the GST Act to a tax period to the extent that consideration is received for the supply in that tax period.
• input tax credits are attributable under subsection 29-10(1) of the GST Act to the tax period in which any of the consideration is provided for the acquisition[98] or if before consideration is provided an invoice is issued relating to the acquisition, the tax period in which the invoice is issued.	• input tax credits are attributable under subsection 29-10(2) of the GST Act to a tax period to the extent that consideration is provided for the acquisition in that tax period.
To claim an input tax credit the claimant must also hold a tax invoice. If a tax invoice is not held, the input tax credit is attributable to a tax period when a tax invoice is held and the input tax credit is claimed.[99]	

123. Assuming both the farmor and farmee are registered for GST and account on a non-cash basis, each can claim any input tax credits as soon as they hold a tax invoice from the other party.

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[96] Goods and Services Tax Ruling GSTR 2001/6 Goods and services tax: non-monetary consideration explains the application of the attribution rules where consideration is non-monetary (see paragraphs 166 to 197).

[97] For the farmor, the interest in the mining tenement; for the farmee, the exploration benefits.

[98] For the farmor, the exploration benefits; for the farmee the interest in the mining tenement.

[99] Subsections 29-10(3) and (4) of the GST Act. Under Division 93 of the GST Act, an entitlement to input tax credits for creditable acquisitions may cease if the input tax credits are not included in a GST return within four years from the due date of the GST return for which the credits would have been attributable under subsection 29-10(1) or (2) of the GST Act.

124. To the extent that the consideration for the supply of the interest in the mining tenement is monetary consideration, the farmor will have a net GST payable position and the farmee will have a net GST refund position. This is illustrated in Example 1 at paragraph 128.

125. If the farmee's consideration is non-monetary only, it is a barter transaction and therefore the GST payable and input tax credits for each entity will offset each other giving rise to a nil net GST outcome.[100]

GST going concern

126. Paragraph 195 of Goods and Services Tax Ruling GSTR 2002/5[101] explains that it is possible for a joint venturer[102] entity to make a GST-free 'supply of a going concern', including when part of the enterprise conducted by the joint venturer is supplied, providing all of the requirements of section 38-325 of the GST Act, as explained in Goods and Services Tax Ruling GSTR 2002/5, are satisfied.

127. If a supply by a joint venturer farmor (which includes the supply of the interest in the mining tenement) is the supply of a going concern that is a GST-free supply under section 38-325 of the GST Act, the farmee will not have any input tax credits to claim and the farmor will have no GST payable in respect of that supply. However, GST is payable by the farmee in respect of its supply of the exploration benefits to the farmor and the farmor may be entitled to input tax credits.

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[100] There is a different outcome if the supply by the farmor to the farmee is part of a supply of a going concern that is a GST-free supply under section 38-325 of the GST Act. In that case, the farmee will not claim any input tax credits for its acquisition of that going concern and the farmor will not have any GST payable. See paragraphs 126 and 127 of this draft Ruling.

[101] Goods and Services Tax Ruling GSTR 2002/5**:** when is a 'supply of a going concern' GST-free?

[102] For further explanation concerning joint venture arrangements see Goods and Services Tax Ruling GSTR 2004/2: Goods and services tax: What is a joint venture for GST purposes?

Appendix 2 – Example

Example 1 – cash payments and non-cash exploration benefits

128. The facts for this example are as follows:

- Farmor Co holds a 100% interest in a mining tenement.
- The mining tenement is at the exploration stage and therefore the mining tenement has no adjustable value for tax purposes (that is, a deduction has previously been claimed in full for the cost of the mining tenement by Farmor Co under section 40-25 of the ITAA 1997 applying subsection 40-80(1) of the ITAA 1997).
- Farmor Co and Farmee Co enter into an immediate transfer farm-out agreement. The parties are dealing with each other at arm's length. Farmor Co agrees to transfer a 90% interest in the mining tenement to Farmee Co under the agreement, leaving Farmor Co with a 10% interest.
- Farmor Co shares mining information with Farmee Co, but separate consideration is not identified for that element of the arrangement.
- Farmee Co agrees to complete all exploration work to the value of $880,000 (GST-inclusive) on the mining tenement over the next 3 years. It is assumed that all expenditure relates to exploration or prospecting for minerals or quarry materials for the purposes of carrying on 'mining operations'.[103]
- Farmee Co agrees to pay Farmor Co $110,000 (GST-inclusive) upon signing the agreement.
- The market valuation of the 90% interest in the mining tenement is $132,000 (GST-inclusive). This market valuation is based on all the facts and surrounding circumstances including the terms of the agreement and what is known about the mining tenement at the time of entry into the agreement.

[103] See subsection 40-730(7) of the ITAA 1997.

Income tax – Farmor Co

129. The net income tax consequences for Farmor Co are summarised as follows.

Event	**Assessable/ (Deductible)**	**Timing**
*As the GST-*exclusive *market value of the 90% interest in the mining tenement that is transferred from Farmor Co to Farmee Co is $120,000 and the GST-exclusive cash payment to Farmor Co by Farmee Co is $100,000, the GST-exclusive market value of the exploration benefits that flow to Farmor Co from Farmee Co's exploration commitments is $20,000.*		
1 – In return for Farmor Co transferring a 90% interest in the mining tenement to Farmee Co, Farmor Co receives cash and exploration benefits.	$100,000 under item 1 of the table in paragraph 40-305(1)(b) of the ITAA 1997 $20,000 under item 6 of the table in paragraph 40-305(1)(b) of the ITAA 1997 (see paragraphs 80 to 84)	When Farmee Co starts to hold the interest in the mining tenement. (see paragraph 81)
2 – Farmor Co ventures the 90% interest in the mining tenement partly in return for the exploration benefits.	($20,000) subsection 40-730(1) of the ITAA 1997 (see paragraphs 85 to 96)	When the farm-out agreement is executed and the Farmor Co has an obligation to transfer the interest in the mining tenement. (see paragraph 95)
Net income tax outcome for Farmor Co Farmor Co is effectively assessed on the $100,000 cash payment it receives.	**$100,000**	

Income tax – Farmee Co

130. The net income tax consequence for Farmee Co is summarised as follows.

Event	Assessable/ (Deductible)	Timing
3 – Farmee Co pays cash and provides exploration benefits to Farmor Co in return for the 90% interest in the mining tenement.	($100,000) under item 1 of the table in paragraph 40-185(1)(b) of the ITAA 1997 ($20,000) under Item 5 of the table in paragraph 40-185(1)(b) of the ITAA 1997 The $120,000 is the first element of cost but is immediately deductible if the 90% interest is first used for exploration or prospecting: subsections 40-80(1) and 40-25(1) of the ITAA 1997 (see paragraphs 100 to 102)	When Farmee Co's interest in the mining tenement is first used for exploration or prospecting. (see paragraph 101)
4 – Farmee Co provides exploration benefits (on revenue account) to Farmor Co for which it earns part of its 90% interest in the mining tenement (the benefit equates to a market value of $20,000).	$20,000 section 6-5 of the ITAA 1997 (see paragraphs 113 to 115)	To the extent that Farmee Co provides exploration benefits to Farmor Co in an income year.[104] (see paragraph 115)
5 – Farmee Co incurs exploration expenditure in the course of undertaking the exploration it committed to under the agreement.	($800,000) section 40-730 and/or 8-1 of the ITAA 1997 (see paragraphs 103 and 104)	When the expenditure is incurred. (see paragraph 104)
Net income tax outcome for Farmee Co	**($900,000)**	

[104] *Arthur Murray (*NSW*) Pty Ltd v. FC of T* (1965) 114 CLR 314; 9 AITR 673; 14 ATD 98.

GST outcomes for Farmor Co and Farmee Co

131. The combined net GST consequences for Farmor Co and Farmee Co is summarised as follows. It assumes that:

- Farmor Co and Farmee Co are each registered for GST and account for GST on a non-cash basis; and
- the supplies are taxable supplies and the acquisitions are creditable acquisitions for a fully creditable purpose.

Event	**GST payable/input tax credits (ITCs)**	**Attribution to a tax period** (non-cash basis)
1 – Farmor Co makes a taxable supply of the 90% interest in the mining tenement to Farmee Co. Farmor Co receives $110,000 (GST-inclusive) and an exploration non-cash benefit with a market value of $22,000 (GST-inclusive).	GST payable of $12,000 (1/11th of $132,000 GST-inclusive) (or $120,000 GST-exclusive x 10% = $12,000 GST payable) (paragraph 118)	Earlier of the issue of an invoice, or receipt of any consideration, by Farmor Co (paragraph 122)
2 – Farmee Co makes a creditable acquisition of the 90% interest in the mining tenement supplied by Farmor Co. Farmee Co pays $110,000 cash and a non-cash benefit (exploration benefits) to the value of $22,000 (GST-inclusive).	ITCs available of $12,000 (1/11th of $132,000) (paragraph 118)	When any of the consideration is provided by Farmee Co and Farmee Co holds a tax invoice; or an invoice that is also a tax invoice is issued by Farmor Co to Farmee Co for the interest in the mining tenement. (paragraph 122)
3 – Farmee Co makes a taxable supply of exploration benefits to Farmor Co.	GST payable of $2,000 (1/11th x $22,000 = $2,000)) (paragraph 119)	Earlier of the issue of an invoice, or receipt of any consideration by Farmee Co (paragraph 122)
4 – Farmor Co makes a creditable acquisition of exploration benefits.	ITCs available of ($2,000) (1/11th of $22,000)) (paragraph 119)	When any of the consideration is provided by Farmor Co and Farmor Co holds a tax invoice; or an invoice that is also a tax invoice is issued by Farmee Co to Farmor Co for the exploration benefits. (paragraph 122)

Event	**GST payable/input tax credits (ITCs)**	**Attribution to a tax period** (non-cash basis)
Net GST outcomes *Farmor Co* – pays GST of $12,000 and claims an ITC of $2,000. Farmor Co has net GST payable of $10,000 – this relates to the cash received from Farmee Co. *Farmee Co* – pays GST of $2,000 and claims an ITC of $12,000. Farmee Co has a net GST refund of $10,000 – this relates to the cash paid to Farmor Co.		

Appendix 3 – Alternative view

132. An alternative view as to what consideration is paid to the farmor for the transfer of the interest in the mining tenement by the farmor under an immediate transfer farm-out agreement, is that no consideration is provided to the farmor for income tax purposes unless there is a direct cash payment to, or property consideration provided, by the farmee that is capable of valuation.

133. According to this view, in the unlikely event that cash payments are to be made by the farmee 'on behalf of the farmor' to the joint venture account in order to meet expenditure commitments of the joint venture pursuant to an immediate transfer farm-out agreement, the payment of such amounts is not included in the termination value for a balancing adjustment event occurring for the farmor.

134. This is because, at the time of signing the immediate farm-out agreement, the farmor generally has no legal liability to pay anything into the joint venture account. Consequently, there is no amount 'received' or no 'liability' terminated as a direct consequence of the transfer of the interest of the mining tenement. As such, these amounts should not be included in termination value because it is not *for* a balancing adjustment event occurring for the farmor.

135. Further, under a 'disproportionate spend' immediate farm-out arrangement where a farmor is 'free-carried' in respect of their interest in the mining tenement, there may arise the provision of a non-cash benefit to the farmor. As a result, this would potentially be included in termination value for a balancing adjustment event occurring for the farmor.

136. However, under this alternative view, the provision of such a non-cash benefit is not related to the transfer of the interest in the mining tenement. As such, it should not be included in termination value because it is not *for* a balancing adjustment event occurring for the farmor.

137. Alternatively, if the provision of this non-cash benefit is *for* a balancing adjustment event occurring for the farmor, it has no determinable value and is never ascribed a separate value under the terms of an immediate transfer farm-out arrangement.[105]

138. Under this alternative view, immediate transfer farm-out agreements can be viewed as merely setting out conditions/contractual obligations imposed upon the parties. The farmee merely carries out the exploration work on its own account and bears the risks and rewards of that exploration work.

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[105] It is also stated that this position is generally consistent with Income Tax Ruling IT 2378 which provides that a permit at a greenfields exploration stage has no determinable value.

139. Therefore, there is no consideration provided to the farmor for income tax purposes unless there is a direct cash payment to, or property consideration provided by, the farmee that is capable of valuation.

The Commissioner's views in relation to the alternative view

140. While the Commissioner accepts that the farmee does undertake exploration work and makes cash payments for its own benefit and at its own risk, there are nonetheless benefits provided by the farmee to the farmor from the farmee's exploration and payment commitments.

141. This is evidenced by the agreements entered into and the fact that the farmor agrees to transfer a percentage interest in the mining tenement to the farmee in return for the farmee undertaking those commitments (the exploration commitments are, or are part of, the consideration provided by the farmee that supports the existence of the contract between the parties). As a result, those commitments are *for* the balancing adjustment event occurring for the farmor. Consequently, they are to be included in termination value because it is *for* a balancing adjustment event occurring for the farmor.

Appendix 4 – Your comments

142. You are invited to comment on this draft Ruling. Comments are also sought as to what, if any, transitional arrangements are appropriate in implementing the final version of this Ruling (see further at paragraph 56 of this draft Ruling). Please forward your comments to the relevant contact officer by the due date.

143. A compendium of comments is also prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- publish on the Tax Office website at www.ato.gov.au

Please advise if you do not want your comments included in the edited version of the compendium.

Due date:	**9 September 2011**
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Appendix 5 – Detailed contents list

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Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

IT 2378; IT 2668; GSTR 2001/6; GSTR 2001/4; GSTR 2002/5; GSTR 2004/2

Subject references:

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disposal of petroleum mining & exploration rights
economic rights & entitlements
farm-out arrangements
GST farm-in, farm-out
GST mining & energy
mining & exploration rights
mining & petroleum
mining property
non-cash benefits
petroleum mining & exploration rights

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