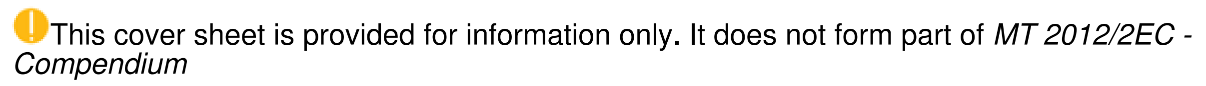
MT 2012/2EC - Compendium



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Ruling Compendium – MT 2012/2

This is a compendium of responses to the issues raised by external parties to draft MT 2011/D2 – Miscellaneous taxes: application of the income tax and GST laws to deferred transfer farm-out arrangements

This compendium of comments has been edited to maintain the anonymity of entities that commented on the draft ruling.

Summary of issues raised and responses

Issue No.	Issue raised	Tax Office Response/Action taken
1.	*Characterisation of the arrangement – is there a benefit provided by the farmee to the farmor from the farmee's exploration work and, if so, is that benefit in the form of a service?* Comments put forward the view that: • the Ruling is wrong to state that the contractual consideration that passes between the farmor and the farmee are 'benefits that flow….from the farmee's exploration commitments'. Instead, the farmee's consideration is the binding promises that the farmee makes under the farm-out arrangement contract; • even though economic benefits may accrue to the farmor as a result of the contract being carried out does not mean that the farmee is providing those benefits to the farmor, nor does the purported provision of these benefits constitute a service; • the Ruling does not specifically identify what are the 'exploration benefits' and absent this there is no basis upon which to accept the Ruling's conclusions as to whether the said benefits are received by the farmor, provided by the farmee and constitute a service which is on revenue account; and • the Ruling does not rule that exploration benefits (that is, services) are provided to the farmor by the farmee thereby suggesting it is a rebuttable assumption and this of itself creates uncertainty undermining the intent behind the Ruling.	It remains the ATO view that if a farmee is required under a deferred transfer farm-out agreement to meet certain exploration commitments, there is some benefit to the farmor from that exploration. However, the view in the Ruling acknowledges that the exploration serves the farmee's own purpose and for this reason the market value of benefits to the farmor from the exploration may not equate with the amount to be spent by the farmee. The disparity between what is spent by the farmee, and what may be the (lesser) value of the exploration benefit provided to the farmor, recognises the inherent risk/reward of this type of unique arrangement and that the farmor may be bargaining at a time when it knows very little as to the 'true' value of the interest. Additional explanation has been added to the Ruling to explain why that exploration benefit is considered a service and thus a non-cash benefit received by the farmor (see paragraphs 128 to 137 of the Ruling).

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2.	*Farmor's deduction under subsection 40-730(1) of the ITAA 1997 and timing mismatches* Comments put forward the view that there is a risk that, in the income year the interest in the mining tenement is transferred to the farmee, the farmor will not be entitled to a deduction under subsection 40-730(1) of the ITAA 1997 for the value of the exploration service if the project has moved out of the exploration phase during the farm-out and by the time the interest in the mining tenement is transferred to the farmee. This is because the farmor may be considered to have incurred expenditure in relation to development drilling for petroleum or operations in the course of working a mining property, quarrying property or petroleum field. This may lead to timing mismatches for the farmor, because the value of the exploration service is included in the farmor's assessable income (as part of the termination value for the transfer of the interest in the mining tenement) in the income year the interest in the mining tenement is transferred to the farmee.	Timing mismatches may occur for the farmor between recognising amounts as assessable income and corresponding deductions under subsection 40-730(1) of the ITAA 1997. The Ruling makes it clear that a deduction for the farmor under subsection 40-730(1) of the ITAA 1997 will be allowed by applying the tests in section 40-730 of the ITAA 1997 to the particular facts and circumstances. In particular, whether the expenditure is on an activity listed under subsection 40-730(2) of the ITAA 1997, and, therefore, does not qualify for a deduction under subsection 40-730(1) of the ITAA 1997, will depend on the particular facts and circumstances. In this regard, the explanation section of the deduction under subsection 40-730(1) of the ITAA 1997 is now less prescriptive.
3.	*Farmee's deduction under subsection 40-80(1) of the ITAA 1997 and timing mismatches* Comments make the point that a farmee may not be able to claim an immediate deduction for the first element of cost if the depreciating asset is not first used for exploration or prospecting when the farmee starts to hold it (that is, subsection 40-80(1) of the ITAA 1997 is not satisfied). If an immediate deduction is not available the cost is deducted as a decline in value over time under section 40-25 of the ITAA 1997. This creates a timing mismatch as the farmee is required to bring to account as assessable income the market value of the interest in the mining tenement to the extent that it is received in return for the exploration benefit.	It is not considered open on the words of the law to take one of the three approaches suggested. In relation to the first approach, the scheme of Division 40 of the ITAA 1997, and in particular subsection 40-25(1) of the ITAA 1997, is that a deduction for the decline in value of a depreciating asset can only be allowed after the taxpayer begins to hold the asset because: • to deduct an amount equal to the decline in value of an asset for an income year, subsection 40-25(1) of the ITAA 1997 requires the taxpayer to hold the asset during that income year; • a depreciating asset a taxpayer holds starts to decline in value from when its start time occurs (subsection 40-60(1) of the ITAA 1997)) and that start time is when the taxpayer first uses it, or has it installed ready for use for any purpose; and

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3. cont	Comments raise three potential ways of addressing this timing mismatch: • the 'first use' should be referable to the 'use' of the mining tenement by the farmee during the time that the farmee undertakes the exploration under the farm-out arrangement. This would result in the farmee having 'first use' of the asset before the farmee begins to hold the asset. • the farmee defers including the market value of the interest in the mining tenement (to the extent it is received in return for providing exploration benefits), in its assessable income until the corresponding deductions for the decline in value of the interest in the mining tenement are available. • the market value of the interest in the mining tenement can be excluded from the farmee's assessable income and also its first element of cost (for that interest).	• under subsection 40-80(1) of the ITAA 1997, the decline in value of the depreciating asset for the purposes of the deduction under subsection 40-25(1) of the ITAA 1997 is the asset's cost if the asset's first use is for exploration or prospecting for minerals, or quarry materials, obtainable by mining operations and the other requirements of the provision are satisfied. As subsection 40-25(1) of the ITAA 1997 is a gateway provision to subsection 40-80(1) of the ITAA 1997, it follows that the first use of the depreciating asset for the purposes of subsection 40-80(1) of the ITAA 1997 cannot be before a taxpayer begins to hold the asset. In relation to the second approach, the income year of derivation is determined based on the income year in which the income is actually derived which is in turn based on established case law. In relation to the third approach, this is not supportable under the law.
4.	*Inconsistency between paragraph 29 and paragraphs 62 and 199 of the draft Ruling.* Paragraph 29 of the draft Ruling states that ***all*** necessary approvals have to be granted for the transfer of the interest to take place. Paragraphs 62 and 199 of the draft Ruling state that the fact that completion of the agreement is conditional on gaining Foreign Investment Review Board or Ministerial approval does not prevent the farmee from becoming a holder. As such, there is an inconsistency.	Paragraph 28 of the Ruling refers to the transfer of the legal title to the tenement once all approvals etcetera have been obtained. This has been clarified in the Ruling. The later paragraphs refer to 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. As an entity can hold a depreciating asset before becoming the asset's legal owner there is not any inconsistency. However, changes have been made to the Ruling in relation to the approvals impacting on when a farmee becomes the holder of an interest in the mining tenement under a deferred transfer farm-out arrangement (see paragraphs 59 to 63 of the Ruling).

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5.	*Determining market value - paragraphs 148 to 152 of the draft Ruling* Industry is of the view that, if parties are dealing with each other at arm's length, and the farm-out agreement specifies a market value, this is evidence of the common law test as to the market value. This would alleviate the need for industry to go through the process of obtaining an independent market value in these circumstances.	Paragraph 148 of the Ruling now states that if the agreement specifies the market value of the interest in the mining tenement, then that value would be part of the evidence to be taken into account in determining the market value of the interest in the mining tenement. The Ruling, at paragraphs 144 to 147, also makes it clear that determining market value is a question of objective fact taking account of facts and surrounding circumstances. Further, paragraph 150 of the Ruling provides some guidance in determining the market value of the interest in the mining tenement at the greenfields stage by stating that the price a willing but not anxious purchaser might pay at this stage may be minimal.
6.	*'Free-carry' arrangements not covered by the Ruling* Comments note that a 'free-carry' arrangement (see Issue No.2 in the compendium to MT 2012/1 for a description of a 'free-carry' arrangement) would not be covered by the Ruling. This is because the arrangement, as described in the Ruling, requires that the farmee (that is, itself or through contractors) conducts the exploration activities on the mining tenement.	This Ruling does not deal with a free carry arrangement but rather deals with the more typical features of a deferred transfer farm-out arrangement. As it is not possible to deal with all of the ways in which a deferred transfer farm-out arrangement may be structured, it may be necessary to seek a private ruling if a free carry in the deferred farm-out context arises. Free carry arrangements have been included in Miscellaneous Taxation Ruling MT 2012/1 (the immediate transfer farm-out Ruling) as they are more typically found in such arrangements.
7.	*When the farmee begins to hold its interest in the mining tenement under item 5 of the table in section 40-40 of the ITAA 1997* Comments explain that, prior to conditions such as Foreign Investment Review Board or Ministerial approval being satisfied, the farmee is not in a position to exercise its rights in relation to the interest in the mining tenement and therefore would not satisfy the requirements to hold the interest in the mining tenement under item 5 of section 40-40 of the ITAA 1997.	The Ruling has been amended to take account of these comments (see paragraphs 59 to 63 of the Ruling). The changes acknowledge that when a farmee becomes the holder of an interest in the mining tenement under a deferred transfer farm-out arrangement will depend on the particular facts and circumstances. In particular, under a deferred transfer farm-out agreement, it is recognised that the farmee may not have a right to become the legal owner of the interest in the mining tenement until requisite approvals have been obtained and that this may therefore mean that the farmee cannot begin 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 right is exercised.

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8.	*Date of effect issues* Comments consider that the Ruling should be prospective from the date the final Ruling issues rather than applying from 24 August 2011, being the date the draft Ruling issued.	The date of effect clause (paragraph 123) has been amended to: • state that the Ruling applies to a deferred transfer farm-out arrangement entered into after 24 August 2011 if the farmor started to hold the mining tenement that is the subject of the arrangement on or after 1 July 2001. This differs from the draft Ruling. The draft Ruling proposed to apply to agreements dated on or after 24 August 2011. As a consequence of the change to the date of effect clause, the Ruling would not, for example, apply to an arrangement that had been negotiated and the terms agreed to prior to 24 August 2011 even though the contract was signed just after 24 August 2011. This date of effect as opposed to a later date of effect (being the date the final Ruling issued) will ensure that those taxpayers who have entered into deferred transfer farm-out arrangements after the date of issue of the draft Ruling are not disadvantaged if they have relied upon views in the draft Ruling; and • ensure that the Ruling does have application if an interest in a mining tenement is acquired through Government grant rather than under a contract. The Ruling now refers to an interest the farmor started to hold on or after 1 July 2001. Further: • as the Ruling applies to arrangements entered into after 24 August 2011, the Ruling has no application to deferred transfer farm-out arrangements entered into on and from 1 July 2001 and the agreement is executed or the terms of the arrangement are finalised on or before 24 August 2011; and • the Ruling does not apply to a deferred transfer farm-out arrangement if the farmor started to hold the interest in the mining tenement (that is the subject of the arrangement) before 1 July 2001. In this case, Income Tax Ruling IT 2378 may be relevant.

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9.	*Industry suggested changes not adopted in the draft Ruling* Prior to the issue of the draft Ruling, industry had made a number of suggested amendments to the draft Ruling in relation to:issues 2, 4 and 5. Comments state that these changes were not adopted in the draft Ruling and there was no response on why these changes were not adopted.	Since the issue of the draft Ruling, further consultation with industry has taken place. During that consultation, the issues relating to these changes have been discussed with industry. Industry has been made aware of the response to these issues. See also the responses to these issues above in this compendium.
10.	*GST - total consideration is not known* Payment of third party expenses (such as fees, rates and charges) by the farmee on behalf of the farmor may mean that total consideration for the farmor's supply of exclusive use and access rights is unknown. Although the *A New Tax System (Goods and Services Tax) (Particular Attribution Rules Where Total Consideration Not Known) Determination (No.1) 2000* (Legislative Instrument) may be relied upon if total consideration is unknown, the farmee must still hold a tax invoice to claim an input tax credit. Applying to the Commissioner to exercise his discretion to treat a document as a tax invoice is cumbersome and the draft Ruling is silent on the issue. It is suggested that Division 156 of the GST Act could apply to treat the supply of exclusive use and access rights as a progressive or periodic supply with each payment being in respect of a separate supply and alleviating the need to apply to the Commissioner to exercise his discretion.	Paragraph 102(d)(iii) of draft GST Ruling GSTR 2011/D1 and paragraphs 95 and 96 of GST Ruling GSTR 2000/29 discuss circumstances when it may be appropriate for the Commissioner to exercise the discretion to treat a document as a tax invoice where total consideration for a supply is not known. We have not provided any further guidance in the farm-out rulings (that is, MT 2012/1 or MT 2012/2) as this is an issue that arises more broadly than just farm-out arrangements and thus it is more appropriately dealt with in the context of the tax invoice ruling. **Division 156** Division 156 of the GST Act is explained in GST Ruling GSTR 2000/35. An entity is entitled to rely on that Ruling if the arrangement comes within that Ruling. It will depend upon the terms of the particular arrangement as to whether it is possible to identify what are the progressive or periodic components of the supply and thus the components to which the payment of rates, fees, charges etcetera relate as the rights to exclusive use and access may be for the earn-in period or a lesser period, the total consideration may not be known and the actual amount and timing of each payment may not be known.