TR 96/5 - Income Tax: take or pay contracts

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Australian Taxation Office

Taxation Ruling
Income tax: take or pay contracts

other Rulings on this topic

IT 2429; TR 92/5; TR 93/11

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This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the ***Taxation Administration Act 1953****, is a public ruling for the purposes of that Part. Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.[Note: This is a consolidated version of this document. Refer to the Tax Office Legal Database (http://law.ato.gov.au) to check its currency and to view the details of all changes.]*

What this Ruling is about

Class of person/arrangement

1. This Ruling concerns the timing of derivation of assessable income of a taxpayer selling products under a sales contract that contains a take or pay clause. Under a take or pay clause, buyers are required to make periodic payments for a fixed quantity of the product whether or not they take those quantities. The buyer is entitled to demand delivery of the product paid for in subsequent years provided certain conditions are met.

2. Take or pay clauses are often found in long term contracts for the supply of natural resources. Therefore, this Ruling is more likely to be relevant to taxpayers who carry on eligible mining or quarrying operations as defined in section 330-30 of the *Income Tax Assessment Act 1997* ('the new Act').

Ruling

3. Where the product has already been delivered, income is derived at the time the product is sold and a debt created.

4. A payment received under a take or pay clause that gives the buyer a right to receive delivery of a product some time in the future, is not income at the time of receipt and does not become income until the product to which the payment relates is delivered or the taxpayer no longer has any contractual obligation to supply that product.

5. The taxpayer no longer has any contractual obligation to supply the product, where:

(a) the buyer has not requested delivery of the product paid for but not delivered by the end of the contract period, including any additional period that may be allowed for delivery of the product; and/or

(b) the quantity of the product paid for but not delivered exceeds the maximum production capacity stipulated in the contract for the unexpired period of the contract;

at the occurrence of either of these events, payments received in respect of the relevant product would no longer be regarded as unearned and would constitute income.

Date of effect

6. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling does 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 the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Note: The Addendum to this Ruling that issued on 6 August 1997, applies in relation to the 1997-98 or a later income year.

Explanations

7. This Office recently had cause to look at several sales contracts containing take or pay clauses. These contracts involved the sale of natural gas to public utilities. Under these take or pay clauses the buyers undertook to pay for a fixed annual quantity of natural gas whether or not they took delivery of that quantity of gas. In return for the payment, the buyers are allowed to take in subsequent years the gas paid for but not delivered subject to the buyers having first taken the minimum amount of gas contracted for in that subsequent year.

Commercial justification

8. The commercial justification for including a take or pay clause in a sales contract is to assist in arranging the finance needed for a natural resource project. It is also a means of securing a financially secure long term buyer and of sharing the economic risks between the producer and the buyer.

9. In the development of major oil and gas projects the producers and their financial backers commit themselves to a substantial capital investment in the extraction, production, transportation and associated infrastructure facilities. This capital outlay must be incurred as a necessary pre-requisite before any product can be sold.

10. The existence of long term sales contracts with take or pay clauses assists in the obtaining of finance for these projects. Lenders look to potential cash flows and the assets of the project itself for their repayment and collateral. Lenders are likely to look more favourably at a project which has existing long term sales contracts with take or pay clauses which are sufficient to cover debt servicing, operating and other costs.

11. Sales contracts with take or pay clauses are market driven. From a buyer's point of view, such a contract provides it with long term contractual security of product supply. On the other hand, producers will be neither willing nor usually able to marshal the funds necessary for the establishment of a mine or a petroleum production facility and the associated infrastructure unless they are reasonably assured of continued access to a market for the product and an adequate cash flow from sales.

12. The producers will not wish to leave themselves in a position where, having committed funds (be they their own or borrowed funds) to the development project, they are dictated to by buyers as to when and what quantities they take. Neither will they wish to risk being denied market access altogether, either because other suppliers have entered the market, or because in conditions of over supply they are unable to match competitors' prices.

13. It is for these commercial reasons that producers seek to negotiate and have in existence, prior to spending substantial amounts of money on natural resource projects, sales contracts containing take or pay clauses with buyers of financial substance. Under these contracts buyers are required to take such quantities of produce over such period of years as will, when priced on any reasonable projection of the pricing formula in the contracts, ensure repayment of the debt financing with interest and allow a reasonable return on investment to the producers after expenses.

The sales contract

14. A sales contract with a take or pay clause is essentially a contract for the sale of goods. In any contract for the sale of goods the parties may if they so desire require the buyer to pay for the goods independent of delivery. All the State and Territory Sale of Goods legislation (which applies to sales contracts with take or pay clauses)

contain provisions similar to subsection 50(2) of the *Sale of Goods Act 1896* (Qld), which provides:

> 'When, under a contract of sale, the price is payable on a day certain irrespective of delivery, and the buyer wrongfully neglects or refuses to pay such price, the seller may maintain an action for the price, although the property in the goods has not passed, and the goods have not been appropriated to the contract.'

15. Under a take or pay clause the buyer promises to pay, on an annual or other periodic basis, for a minimum quantity (generally called the minimum bill) of product whether delivered or not. It is usual for the minimum bill to be reduced by any quantities which the seller is unable to supply and also by any quantities which the buyer is prevented from taking for reasons for which he or she is excused performance by the contract.

16. If the buyer fails to take delivery of the minimum bill quantity it will be required to pay for the shortfall at a price stipulated in the contract. In return for the payment under the take or pay clause the buyer receives the following rights:

(a) the buyer is entitled to take (usually free of additional charges) in subsequent years of the contract, any quantities of product paid for but not delivered. This is subject to the buyer having first taken the minimum bill for that subsequent year; and/or

(b) the right to have the term of the contract extended for a limited period, usually six or twelve months, to enable recovery of the quantities paid for but not taken at the end of the original contract period.

Day to day operations

17. An overview of the typical ordering, supply and billing procedures adopted by a taxpayer selling gas to a public utility under a sales contract containing a take or pay clause, is as follows:

(a) The buyer gives the taxpayer a forecast of its annual gas requirements for each month of the following year, this allows the taxpayer to plan its delivery obligations.

(b) Once a week, the buyer firms up its requirement for gas by nominating each day's requirements for the following week. The buyer can change its nomination at any time before commencement of that days production.

(c) Under the sales contract a specific quantity of gas is identified as being the 'Seller's Daily Delivery Obligation'

(SDDO). If the buyer nominates a daily amount equal or less than the SDDO, the taxpayer is bound under the contract to supply that amount. If the buyer nominates an amount greater than the SDDO, the taxpayer is only obliged to make 'reasonable endeavours' to supply the extra gas.

(d) In the event that the taxpayer through its own fault cannot meet its SDDO, e.g., because of a major overhaul of its processing plant, the 'Annual Contract Quantity' (ACQ) of gas to be supplied is reduced by that amount.

(e) Upon receiving a daily order for gas the producer has to extract it from the well and treat it to a standard specified in the contract. Natural gas is a mixture of different gases, mostly methane (about 85%). Other compounds include ethane, propane, butane, pentane, carbon dioxide and nitrogen.

(f) Sales gas is a term used to describe natural gas which has been treated to remove unwanted components and raised to pipeline quality, i.e., the standard stipulated in the sales contract. The treatment process, from well head to the boundary of the plant, takes about six hours.

(g) Property in the gas passes to the buyer at the boundary of the plant site. There is a metering station at this point. There have been occasions where due to the high levels of impurities, a buyer has blocked the finished product from entering its pipeline.

(h) The sale price of the gas is fixed by a set formula under the contract. The formula takes into account a mixture of oil prices (usually a basket of seven crude oil prices), the foreign exchange rate and the Consumer Price Index. The price is recalculated every quarter.

(i) It is not unusual to have three billing periods during a month, after 10 and 20 days and at the end of the month. An invoice for the gas actually taken is issued within five working days of the end of each billing period and payment is due within seven working days of the receipt of the statement.

(j) Under the take or pay provision an annual statement of settlement is produced, usually at 1 July. Under the take or pay clause, if the buyer did not take the 'Annual Minimum Bill' (AMB), the buyer pays for the difference between the amount it has taken and the AMB at the price stipulated in the contract.

(k) The AMB is set as a percentage of the ACQ, usually about 95%. The annual statement of settlement under the take or pay provision lists the ACQ and any adjustments to the AMB and the amount of gas delivered. It then calculates the excess, if any, of the amount of adjusted AMB over the amount of gas delivered and that excess is the quantity of gas which has not been taken up (the make-up gas). The purchase price of the make-up gas is shown in the annual statement of settlement.

(l) The buyer has thirty days to pay the amount stated in the annual statement of settlement and has access to the make-up gas for the period of the contract or for such further period as the contract may allow.

(m) Make up gas can be accessed only after that year's AMB has been met. Because of the capacity limitations on the production plant, it is usual for the contract to provide for a maximum quantity of gas that the taxpayer is contractually bound to deliver in any one year. The maximum is often expressed as the ACQ plus a percentage of ACQ.

(n) If a taxpayer fails to supply make-up gas which is properly due under the contract, the buyer could have a claim for the return of the make-up payment as well as an action for damages.

Income tax consequences

18. In the situation where the gas has been delivered and the taxpayer is entitled to issue an invoice for that gas, income is derived at the time the gas is sold and a debt created: *J Rowe & Son Pty Ltd v. FC of T* 71 ATC 4157; (1971) 2 ATR 497. So when gas has been supplied and the taxpayer is entitled to bill on day 10, 20 and at the end of the month, then income is derived at day 10, 20 and at the end of the month.

19. The situation with respect to the make-up gas is more complicated. Make-up gas is that quantity of gas that has been identified in the annual statement of settlement as being gas that fell short of the annual minimum bill. Under the take or pay provision, the buyer has to pay for this gas and can only access it in a subsequent year and then only if the buyer has first taken the minimum amount of gas for that year.

20. At the time of issuing the annual statement of settlement, a recoverable debt is created for an amount in respect of the make-up gas. The taxpayer is not obliged to take any further steps before

becoming entitled to the payment. When the amount is paid it is beneficially received by the taxpayer and there is no legal restriction on how the taxpayer must use the amount. This raises the question of whether a payment received in respect of make-up gas is income derived at the time of receipt, or whether it does not have that character until the make-up gas is actually supplied or the taxpayer is no longer obliged to supply the make-up gas.

21. The relevant subsection of the new Act is section 6-5 which provides, as far as is relevant, for the assessable income of a resident taxpayer to include the ordinary income derived directly or indirectly from all sources, whether in or out of Australia, during the income year. The words 'ordinary income derived' are the crucial words in this case as it is necessary to calculate the quantum of 'ordinary income derived' for each of the years of income of the contract.

22. In *Commissioner of Taxes (SA) v. Executor Trustee & Agency Co of SA Ltd* (1938) 63 CLR 108; (1938) 5 ATD 98 (*Carden's* case), Dixon J (at CLR 152; ATD 130, respectively) spoke about the concept of 'income' in the following terms:

> 'Income, profits and gains are conceptions of the world of affairs and particularly of business. ...But in nearly every department of enterprise and employment the course of affairs and the practice of business have developed methods of estimating or computing in terms of money the result over an interval of time produced by the operations of the business, by the work of the individual or by the use of capital. The practice of these methods of computation and the general recognition of the principles upon which they proceed are responsible in a great measure for the conceptions of income, profit and gain and, therefore, may be said to enter into the determination or definition of the subject which the legislature has undertaken to tax. The Courts have always regarded the ascertainment of income as governed by the principles recognised or followed in business and commerce, unless the legislature has itself made some specific provision affecting a particular matter or question.'

> 'The word "income" being used without relevant definition, is left to be understood in the sense which it has in the vocabulary of business affairs. To apply the concept which the word in that sense expresses is not to substitute some other test for the one prescribed in the Act; it is to give effect to the Act as it stands. Nothing in the Act is contradicted or ignored when a receipt of money as a prepayment under a contract for future services is said not to constitute by itself a derivation of assessable income.

> On the contrary, if the statement accords with ordinary business concepts in the community - and we are bound by the case stated to accept that it does - it applies the provisions of the Act according to their true meaning.'

23. In the *Arthur Murray* case, the taxpayer had adopted a practice of selling courses of dancing lessons of varying duration. Although the students had no legal right to refunds if courses were abandoned, amounts received as fees were credited in the taxpayer's books of account to an 'Untaught Lessons Account'. At regular intervals, the amount of fees attributable to lessons that had been given was transferred from the 'Untaught Lessons Account' to an 'Earned Tuition Account'. Amounts paid for lessons which remained untaught were also transferred to the 'Earned Tuition Account' when it became apparent that the students would not attend. The income tax returns of the taxpayer were prepared on the footing that only the amounts credited to the 'Earned Tuition Account' were assessable income.

24. The *Arthur Murray* case was an appeal to the High Court by way of case stated and the Court held that it was not appropriate to assess the taxpayer on a cash receipts basis. Two factors which influenced the Court to favour the taxpayer's method of returning income were the possibility of the taxpayer being required to refund some of the amounts it had received for dancing lessons and the correct accounting treatment of payments received in advance of services to be rendered.

25. In discussing the possibility of having to make a refund, the Court was not seeking to find any contractual obligation to do so (there was none) but rather whether in a practical sense a situation could arise where a refund would have to be made. After referring to the circumstance in which the payments were received, i.e., that they had become the beneficial property of the taxpayer and there was no legal impediment which prevented the taxpayer from enjoying the receipt, the Court said (at CLR 319; AITR 689 and ATD 100):

> 'But those circumstances nevertheless make it surely necessary, as a matter of business good sense, that the recipient should treat each amount of fees received but not yet earned as subject to the contingency that the whole or some part of it may have in effect to be paid back, even if only as damages, should the agreed *quid pro quo* not be rendered in due course. The possibility of having to make such a payment back (we speak, of course, in practical terms) is an inherent characteristic of the receipt itself. In our opinion it would be out of accord with the realities of the situation to hold, while the possibility remains, that the amount received has the quality of income derived by the company.'

26. The mere possibility of having to refund money received cannot, of course, be itself sufficient to defer derivation of income. If it were, a vendor of goods would not derive income from a sale during a period where the possibility of a damages claim in respect of the goods existed. However, what is crucial to the Court's reasoning in the above passage is the possibility of a refund 'should the agreed *quid pro quo* not be rendered in due course'.

27. The situation with respect to sales contracts with take or pay clauses is that the obligation to deliver make-up gas in the future is the *quid pro quo* for receiving the payment. In circumstances where the buyer requests make-up gas in accordance with the provisions of the contract and the taxpayer is not able to deliver, or the product offered to the buyer is not up to the required standard, e.g., high levels of impurities or low levels of propane and butane, the buyer might have a claim for a return of the price instead of or as well as an action in damages. In any event, in the practical terms explained by the High Court in *Arthur Murray*, the buyer would be entitled to a refund.

28. Following on from their statement about the relevance of the possibility of a refund, quoted above in paragraph 27, the High Court said (at CLR 319; AITR 689 and ATD 100):

> 'For that reason it is not surprising to find, as the parties in the present case agree is the fact, that according to established accountancy and commercial principles in the community the books of a business either selling goods or providing services are so kept with respect to amounts received in advance of the goods being sold or of the services being provided that the amounts are not entered to the credit of any revenue account until the sale takes place or the services are rendered: in the meantime they are credited to what is in effect a suspense account, and their transfer to an income account takes place only when the discharge of the obligations for which they are the prepayment justifies their being treated as having finally acquired the character of income.'

29. A similar decision was reached in *Country Magazine Pty Ltd v. FC of T* (1968) 117 CLR 162; (1968) 15 ATD 86; (1968) 10 AITR 573, where the taxpayer's treatment of not returning advance payments for magazine subscriptions until the magazines were published and subsequently sent to the subscribers was approved by the High Court.

30. In the case of sales contracts with take or pay clauses, the contract is one for the sale of a product. The product is the trading stock of the producer. With respect to gas, it would become trading stock of the taxpayer from the time it is recovered and would remain trading stock throughout the treatment process and until property in

the gas passed to the buyer at the metering station situated at the boundary of the production site.

31. In a trading situation income is generally derived when a sale takes place in accordance with the contract. This Office has recognised that income from gold forward sales is only derived when the gold is delivered to the purchaser: see Taxation Ruling TR 92/5 'Income tax: gold loans and forward sales agreements' at paragraph 37. This approach is consistent with accounting standard AASB 1022 'Accounting for the Extractive Industries' which states:

> '.60 Sales revenue shall not be brought to account until the product is in the form in which it is to be sold (that is, no further processing needs to be carried out by, or on behalf of, the vendor) and:
>
> (a) the property in the product has passed to the purchaser; or
>
> (b) without such passing of property, the product has moved finally from the physical control of the vendor pursuant to an enforceable sales contract; it can be established that the product is for the purchaser's account pursuant to the sales contract; and the vendor, in the event of loss or damage, would have a claim for the sale proceeds against a third party such as a carrier or insurer.'

32. When an order is placed for the supply of gas, expenditure must be incurred in extracting the gas from the ground and treating it to the required standard specified in the contract. Practically every head of expenditure incurred by a gas producer increases in proportion to the quantity of saleable gas produced. Expenditure such as extraction royalties payable to the Crown, labour costs, administration costs and the wear and tear on the plant involved in the extraction and processing of the gas all increase with the quantity of gas produced.

33. Accordingly, the conclusion is reached that payments received in respect of make-up gas under a sales contract containing a take or pay clause, are not income at the time of receipt and do not have the character of income until the make-up gas is actually supplied or the taxpayer no longer has any contractual obligation to supply the gas.

34. A taxpayer no longer has a contractual obligation to supply gas in a situation where the period of the contract expires (including any extension of time to allow make-up gas to be taken) and the buyer has not requested delivery of all its entitlement to make-up gas. In addition, it is usual for contracts to specify the maximum quantity of gas that a taxpayer is required to deliver in any year (e.g., ACQ plus 25% of ACQ). A situation could arise where the total make-up gas entitlements exceed the maximum gas that the taxpayer may be required to deliver over the remaining term of the contract. Where this happens the taxpayer no longer has a contractual obligation to

supply the excess gas and any payments received in respect of that gas would no longer be regarded as unearned and would constitute income derived. This is consistent with the decision in *Arthur Murray* to regard as income, the fees paid by students to whom tuition remained to be given but in respect of which it was considered unlikely that they would attend.

35. Payments for make-up gas reflect the difficulties in accurately forecasting future gas consumer needs. Future forecasts, sometimes for as long as twenty years, are based upon estimated population growths and gas usage. However, the availability and cost of alternative sources of energy will impact on the forecasts. So too will economic conditions. A decline in demand for gas would follow an economic recession as would the collapse of a particular industry that consumed large quantities of gas. At best, the buyers hope to get it right over the twenty or so years the contract has to run and if in some years the annual consumption is below their forecast and a payment for make-up gas is made it would be regarded as a normal incident of such a contract.

36. The payments for make-up gas are not 'abnormal' receipts but regular features of these particular kind of sales contracts. Nor are they penalties to secure performance, the fact that the buyer obtains rights to request make-up gas be delivered in the future prevents such a conclusion. Likewise, the make-up payments are not liquidated damages. The payments are not based on any estimate of monetary damage suffered by the supplier but rather they are based on the normal sale price of gas. The payments are consideration for a sale and not an assessment of damages.

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- ITAA 1997 330-30

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- Commissioner of Taxes (SA) v. Executor Trustee & Agency Co of SA Ltd (1938) 63 CLR 108; (1938) 5 ATD 98
- Country Magazine Pty Ltd v. FC of T (1968) 117 CLR 162; (1968) 15 ATD 86; (1968) 10 AITR 573
- J Rowe & Son Pty Ltd v. FC of T 71 ATC 4157; (1971) 2 ATR 497