TR 92/5 - Income tax: gold loans and forward sales agreements

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Taxation Ruling
Income tax: gold loans and forward sales agreements

*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.]*

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What this Ruling is about

1. This Ruling explains:

A) How gold producers should treat the income derived and deductions obtained under gold loan transactions entered into after 31 December 1990.

B) The effect of the paragraph 23(o) exemption on gold loan transactions entered into before 1 January 1991.

C) When income is derived under gold forward sales contracts.

D) How a pre-paid gold sales agreement should be treated for income tax purposes.

Nothing in this Ruling purports to apply to a gold loan or forward sales contract entered into by any person other than a gold producer, nor to the taxation treatment of the lender or other parties involved in the gold loan or forward sales contract, except in so far as it applies the withholding tax provisions.

2. A gold loan will usually contain the following basic elements. A lender (often a bullion bank) makes a quantity of gold available to the borrower gold producer on the condition that an equal quantity of gold is returned at a later specified date. The intention is that the gold will be sold in the market place and the proceeds used in the borrower/producer's gold mining business. The contract usually also requires the borrower/producer to pay an additional amount of gold, known as the gold fee.

3. Under a gold forward sales contract, a gold producer promises to deliver gold at some future time in return for payment either at the

time of contracting or prior to delivery. This can be distinguished from arrangements under which a gold producer derives gold in return for a promise of payment in the future.

4. A pre-paid gold sales agreement is a particular kind of forward sales agreement. Rather than adopting a particular forward price, the producer bargains to deliver gold in the future for payment at the time the agreement is made, usually of the spot market price at that time. The producer must also pay a gold fee, a percentage of the gold not yet delivered, from time to time until the pre-paid gold is all delivered.

Ruling

A) How gold producers should treat the income derived and deductions incurred under a gold loan transactions entered into after 31 December 1990.

5. A producer who borrows gold acquires trading stock. The cost of the trading stock is the promise to repay the principal, that is the quantity of gold borrowed. The value of the promise is the spot market value of the gold at the time the loan is drawn down.

6. Payment of the gold fee is a payment in the nature of interest. If paid to a non-Australian resident, it will be liable to interest withholding tax under Division 11A of Part III.

7. The subsequent resale of the gold is a sale of trading stock and the proceeds will be assessable income of the producer.

8. The repayment of the gold loan and the payment of the gold fee with gold mined from the producer/borrower's own mine is a disposal of trading stock. The trading stock is disposed of for value, and that value is the spot market value of the borrowed gold at the time the loan was drawn down, apportioned over the amounts of gold repaid. Costs incurred in mining the gold will be deductible in the normal way (under subsection 51(1) and Division 10) and the producer/borrower should include in assessable income an amount equal to the value of the gold at the time the loan was drawn down.

9. The repayment of the gold loan and the payment of the gold fee with gold purchased in the market place is also a disposal of trading stock. Again, the trading stock is disposed of for value : the spot market value of the borrowed gold at the time the loan was drawn down, apportioned over the amounts of gold repaid. Costs incurred in buying the gold will be deductible in the normal way (under subsection 51(2)) and the producer/borrower should include an

amount equal to the value of the gold at the time the loan was drawn down in assessable income.

10. For the purposes of paragraphs 8 and 9, if the principal and the gold fee are payable at different times, it may be necessary to apportion the draw down value of the borrowed gold to determine the amount to be included in assessable income.

11. The gold fee is also a cost incurred in acquiring the trading stock. The gold fee will only be deductible when it is paid and will be taken into account by reducing the value of the trading stock.

B) The effect of the paragraph 23(o) exemption on gold loan transactions entered into prior to 1 January 1991.

12. Where a gold loan transaction was entered into and repaid prior to 1 January 1991, paragraph 23(o) will exempt a gold producer's income from the transaction and the associated sale of the borrowed gold. No deductions will be allowable to the borrower.

13. Where a gold loan which was entered into before 1 January 1991 is repaid (wholly or in part) after that date, the gold repaid is trading stock and its repayment is a disposal. The consideration for that disposal is the spot value of the borrowed gold at the time the loan was drawn down, apportioned over the amounts of gold repaid.

C) When income is derived under a forward sales contract

14. Any initial payments under a forward sales contract are derived as income when the producer fulfils its delivery obligations to the purchaser under the contract.

D) How a pre-paid gold sales agreement should be treated

15. The money paid up front on a pre-paid gold sales agreement will only be income derived when the producer fulfils its delivery obligations to the purchaser under the contract.

16. Any gold fee payable by a producer under a pre-paid gold sales agreement to a purchaser who is not a resident of Australia is interest

or in the nature of interest and will be liable to interest withholding tax under Division 11A of Part III.

Date of effect

17. This Ruling sets out the current practice of the Australian Taxation Office and is not concerned with a change in interpretation. Consequently, it applies (subject to any limitations imposed by statute) for income years commencing both before and after the date on which it is issued.

Explanations

A) How gold producers should treat the income derived and deductions incurred under gold loan transactions entered into after 31 December 1990.

18. Many articles have been published which discuss the nature of the gold loan transaction. Because it has elements of both a financing arrangement and a transfer of property, the many learned authors have hesitated to definitively pigeon-hole the arrangement. Their discussions usually point out that the arrangement is not a sale of goods as that phrase is defined in the legislation relating to sales of goods, nor is it a simple barter or exchange of the gold, nor even a bailment of the gold. Further, because the borrower is entitled to sell the "borrowed" gold some hesitate to call the agreement a loan.

19. Without detailing the various arguments for and against each of the above characterisations in this Ruling, it is the view of this Office that a gold loan falls within a particular category of loan called a *mutuum*. A *mutuum* has been described as "a loan for consumption; a loan of chattels, upon an agreement that the borrower may consume them, returning to the lender an equivalent in kind and quantity; as, a loan of corn, wine or money which is to be used or consumed, and is to be replaced by other corn, wine or money". (see Black's Law Dictionary, 5th edition).

20. A *mutuum* is sometimes referred to as an improper loan because it requires the transfer of the relevant property. (A proper loan is one under which property in the thing lent does not pass.) But, it is clear

that, while it remains a loan of property, a *mutuum* involves a transfer in the ownership of the property lent.

21. Consideration must be given to the trading stock provisions of the Act because property in the gold is transferred from the lender to the producer/borrower. The gold is acquired for the purpose of sale and will therefore fall within the subsection 6(1) definition of trading stock because the business of the producer/borrower is or includes that of trading in gold.

22. The producer/borrower is therefore entitled to a deduction for the acquisition of the borrowed gold. The cost incurred by producer/borrower in acquiring the borrowed gold (the 'principal') is the promise to repay the quantity of gold borrowed and any gold fee required by the contract. Having said that, there are two issues to consider:

. when are those amounts incurred; and

. what amounts in dollar terms are incurred?

23. For subsection 51(1) purposes, the deductibility of any expense incurred in respect of the acquisition of the gold can only be determined by reference to the terms of the contract or arrangement entered into (see *Ogilvy and Mather Pty Ltd v. FC of T* 90 ATC 4836 21 ATR 841; *Nilsen Development Laboratories v. FC of T* 81 ATC 4031 at 4037, 11 ATR 505 at 510).

24. The promise to pay the gold loan principal is regarded as being presently due rather than presently owing. At the time of acquiring (that is, borrowing) the gold, the producer/borrower has encountered a pecuniary liability to pay the consideration given under the contract. Therefore, the principal part of the cost of borrowing the gold is incurred at the time of borrowing.

25. Section 21 determines the amount of the deduction. That section operates if the consideration on any transaction is given in a form other than money to deem the money value of the consideration to have been given. Therefore, a deduction equal to the market value of the principal due to be repaid is allowable as a deduction. The relevant market value is the spot price of gold at the time when the loan is drawn down.

26. The gold fee is also part of the cost incurred in acquiring the trading stock (the borrowed gold). It is our understanding that the gold loan contract usually provides that the gold is to be repaid by certain specified dates. At the time of borrowing, the gold fee is not yet owing. It is levied as a percentage of the gold outstanding on (or up to) particular dates, when it is due for payment. The fee is incurred only at the time for payment, and will be taken into account by

reducing the value of the trading stock. (The effect of the withholding tax provisions on the payment of the gold fee is discussed at paragraph 29.)

27. As the borrowed gold is treated as trading stock, the proceeds of its sale form part of the assessable income of the producer/borrower under subsection 25(1) of the Act.

28. The gold subsequently mined by the producer will also form part of the trading stock of the gold miner and the costs incurred in mining the gold will be deductible to the producer in the normal way under subsection 51(1) and Division 10. If that gold is used to pay either the principal of the loan or the gold fee that will amount to a disposal of trading stock and an amount should be included in the producer/borrower's assessable income.

29. The producer/borrower transfers the property in the gold produced from its mine to the lender to satisfy its obligations under the loan. That is, the consideration received for the disposal of the gold is the original granting of the loan. Again, by applying section 21, the producer/borrower should include in its assessable income an amount equal to the value of the gold at the time the loan was drawn down. This means that the dollar value of the gold at the time the loan is drawn down must, in effect, be apportioned over both the principal and any gold fee if the entire amount is not all paid at the one time.

30. If the producer/borrower is not able to produce a sufficient quantity of gold from its mine to fulfil its obligations under the loan and is required to buy enough gold to repay the loan, the cost of bought gold will be deductible. Like the gold originally borrowed, the bought gold is regarded as forming part of the producer's trading stock. And again, on repayment of the loan the consideration - the value of the borrowed gold at the time it was drawn down - will be included in the assessable income of the borrower.

31. Although we have treated the loan of the gold as an acquisition of trading stock, the whole arrangement is considered to be something more than a spot purchase and forward sale of gold. It is our understanding that the gold fee is generally calculated as a percentage of the borrowed gold which remains outstanding. Accordingly, the gold fee, when considered from the lender's perspective, is in substance an amount which is "interest, or in the nature of interest" within the terms of the definition of interest given in section 128A. Therefore, if the lender of the gold is not a resident of Australia, the producer/borrower will be liable to deduct withholding tax from the fee pursuant to Division 11A of Part III.

32. The gold fee is considered to be a cost which is also incurred in the original acquisition of the borrowed gold. This expense will be, in

effect, deductible at the time when the gold fee is paid and the quantum of the deduction will be the value of the reduction in the payer's trading stock.

B) The effect of the paragraph 23(o) exemption on gold loan transaction entered into prior to 1 January 1991.

33. If the gold loan transaction was entered into prior to 1 January 1991 and is repaid after that date, the income tax consequences set out in Part A of this explanation must be reconsidered. (Effectively, we are looking at a situation where the principal and gold fee are repaid after 1 January 1991.) Amounts must continue to be included in the assessable income of the producer/borrower if gold is taken from trading stock to pay the loan. And the trading stock of the producer/borrower is reduced accordingly, giving the applicable deduction against that income

C) When income is derived under a forward sales contract

34. It should be noted that this part of the Ruling deals with forward sales contracts as outlined in paragraphs 3 and 4 and not futures contracts, the treatment of which is set out in Taxation Ruling IT 2085.

35. Forward sales contracts are also used by gold mining companies as a means of financing their mining operations, the mining company often being entitled to receive payment on entering into the contract. With payment being received prior to delivery of the gold, it has been suggested that by entering into forward sales contracts prior to 1 January 1991 the income derived under the contracts would be exempt from tax under paragraph 23(o). This suggestion is based on the assumption that the income is necessarily derived when payment is received.

36. Many tests have been propounded and expressions have been adopted by the Courts in attempting to state when income is derived. One view is that the income of a trading business is derived when its stock is sold and a debt is created. Another view is that income from the sale of goods is not earned, and thus not derived, if any further step is required before the taxpayer is entitled to payment (cf. *J. Rowe and Sons Pty Ltd v. FC of T* (1971) 124 CLR 421; 71 ATC 4157; 2 ATR 497 and *Arthur Murray (NSW) Pty Ltd v. FC of T* (1965); 114 CLR 314; 14 ATD 98; 9 AITR 673). In any case, because the Act gives no guidance, in determining when income is derived and what is the proper method of accounting to be used in ascertaining

that income, ordinary business concepts and the principles and practices of accountancy are taken into account.

37. In determining when the ordinary accounting practices of mining companies might suggest that income from forward sales can be said to be earned, regard should be had to Australian Accounting Standard 7 (AAS) and Approved Accounting Standard ASRB 1022. According to paragraph 40 of the AAS and paragraph .60 of the ASRB, mining companies should not bring sales revenue to account until the product to be sold is in the form in which it is sold, and either property in the product has passed to the purchaser or the property has at least moved out of the vendor's control. Therefore, it would seem appropriate that income which arises from forward sales contracts is only derived when the gold is delivered to the purchaser. Accordingly, it is the view of this Office that income derived from forward sales contracts entered into prior to 1 January 1991 will be assessable when the mining company fulfils its delivery obligations.

D) How a pre-paid gold sales agreement should be treated for income tax purposes.

38. The pre-paid sales agreement is effectively a particular type of forward sales agreement. Therefore, the amounts received by the producer under a pre-paid sales agreement will be assessed in the same way as for an ordinary forward sale.

39. The gold fee payable by the producer is considered to be a payment of an amount which is in the nature of interest in the same way as that payable under the gold loan (refer to paragraph 31). Therefore, if the purchaser is not a resident of Australia, the producer will be liable to deduct withholding tax from the payment of any such fee.

Example

40. On 1 July 1991 Gold Mines borrows 4,000 oz. of gold from Bullion Bankers Ltd. The spot price of gold on that date is A$450/oz. Gold Mines is liable to repay the loan is four yearly instalments of at least 1,000 oz., the final payment being payable by 30 June 1995. Gold Mines is also liable to pay a gold fee of 2% of the quantity of gold outstanding under the loan at six monthly intervals. Gold Mines sells the borrowed gold to Dealers in Gold Ltd on 3 July 1991 when the spot price of gold is A$445/oz.

41. Gold Mines is entitled to a deduction for the cost of the borrowed gold as the gold is regarded as trading stock as at 1 July 1991 (paragraph 21). The amount of the deduction is simply the quantity of gold borrowed multiplied by the spot price of gold at the time of drawing down the loan, that is, 4,000 oz. x $450/oz. = $1.8m (paragraph 22).

42. The proceeds of the sale of the borrowed gold, that is, 4,000 oz. x $445/oz. = $1.78m., is assessable income (paragraph 23).

43. Between 1 July and 31 December 1991, Gold Mines produces gold from its own mining operations. (The costs incurred in producing that gold is deductible in the normal ways.) And on 31 December 1991, when the spot price of the gold on that day is $430/oz., it uses 80 oz. of that gold to pay its first instalment of the gold fee.

44. Gold Mines is entitled to a deduction of 80 oz. x $430/oz., that is $34,400, as the payment of the gold fee is regarded as part of the consideration paid for the acquisition of the borrowed gold (paragraph 23). But it must also include an amount in its assessable income for the disposal of its trading stock. As explained in paragraphs 26 and 27, the amount to be included in assessable income is determined by apportioning the value of the borrowed gold over the amount of gold to be repaid. Therefore, the assessable income is:

AY = Oz. gold paid x (Draw down value/Total gold owed)
= 80 oz. x ($1.8m / 4320 oz.)
= $33,333

45. On 30 June 1992, Gold Mines repays the first instalment of the principal and second instalment of the gold fee from gold. Again, it uses gold from its own mine. Gold Mines will be entitled to a deduction for the spot market value of the gold fee in the same way as is explained in paragraph ae, but remember that the deduction for the principal has already been allowed.

46. Again, Gold Mines will also have to include an amount in its assessable income for the disposal of its trading stock. This is also calculated in the same way as in paragraph ae. The amount of assessable income is 1,080 oz. x $416.66 = $450,000.

47. Suppose now that Gold Mines continues to meet its obligations under the gold loan in this way until 31 December 1994, but finds that it only has enough gold on hand to meet its instalment of the gold fee

but not the third instalment of the principal. As Gold Mines therefore purchases 1,000 oz. of gold in the market place at the then spot price $475/oz., it is entitled to a deduction of $475,000. It would also be liable to include an amount in assessable income equal to 1,000 oz. x $416.66 = $416,666.66.

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- ITAA 1936 23(o)
- ITAA 1936 25
- ITAA 1936 28
- ITAA 1936 51
- ITAA 1936 128A

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- Nilsen Development Laboratories v. FC of T 81 ATC 4031; 11 ATR 505
- J Rowe and Sons Pty Ltd v. FC of T (1971) 124 CLR 421; 71 ATC 4157; 2 ATR 497
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