COMMENT ON RECENT AND POTENTIAL DEVELOPMENTS IN THE TAXATION OF MINING AND PETROLEUM VENTURES

By J. R. Adams

The *Cliffs International* case points up some of the practical difficulties involved in negotiating the sale or purchase of mining rights. The taxation consequences of the transaction will inevitably be a matter of prime consideration and in many cases will govern the structure of the financial aspects of the deal.

The relevant principles can be applied generally to the sale or purchase of capital assets but the principles have greatest application in the mining context where the parties are frequently unable or unwilling to determine the value of what is sold at the time of sale. In such cases it is not uncommon for the parties to agree that the consideration for the sale will be an amount of cash or shares plus a promise to pay certain other monies dependent on the value or amount of minerals extracted or sold from the underlying asset acquired.

In structuring the transaction in this way the purchaser will be seeking to minimise his initial outlay by not paying for the mineral potential of the ground until it can be realised. On the other hand the vendor, whilst seeking a maximum price for the asset, will be conscious of the enhanced return to him if the ground is as valuable as he has no doubt represented it to be. In a commercial sense it is clearly the speculative and prospective nature of potential mining ventures that leads to bargains of this kind.

From a tax viewpoint there are points to watch on both sides and some of these I would like to discuss today.

In a transaction such as that mentioned above, the purchaser will obviously wish to obtain a taxation deduction for the maximum amount of his outlay and conversely the vendor will be anxious to ensure that so far as is possible, any amounts received in his hands should not be subject to tax. As will be seen, it is by no means a simple matter to have the best of both worlds whereby the purchaser obtains a deduction for his outlay and the vendor receives it free of tax.

In considering the nature of the payments made by the purchaser, a number of principles emerge from the *Cliffs International* judgments.

(a) The fact that payments are made or received in performance of a promise given as part of the consideration for the acquisition of the capital asset, does not necessarily mean that the payments are themselves of a capital nature.

(b) The relevant quality of the payments is to be determined in relation to the gaining of the income against which they are sought to be deducted.

(c) The description given to the payments by the parties cannot decide their quality.

(d) It does not matter whether the asset acquired comprises exploration rights or shares in a company holding those rights, if what is acquired is clearly of a capital nature.

(e) It is relevant to consider whether anything further is acquired by the making of the recurrent payments or whether the obligation to make them was activated by a supervening event, namely, the mining of the ground.

(f) It is relevant to consider whether the amount of the payments is fixed or is dependent on and proportionate to the use made of, or profits derived from, the assets acquired.

It is important to note that these principles cannot be rigidly applied in order to determine whether any particular receipt or payment is income or capital. As the Chief Justice said in the *Cliffs International* case, "The proper conclusion in each case in this particular area of the law is peculiarly dependent upon the particular facts and circumstances of that case".

It may be helpful to illustrate the application of these principles by considering a number of possible ways in which a sale of mining rights may be structured:

(a) A assigns his mining rights to B in consideration of a promise to pay, over 20 years, an amount equal to 10 per cent of the gross income derived from the asset which B is obliged to exploit.

In such a case the payments would be treated as the price payable for the purchase of the rights and as such would be capital and non-deductible to B. (Refer *Colonial Mutual Life Assurance Society Ltd.* v. *F.C.T.* (1953) 89 C.L.R. 428.

(b) A assigns his mining rights to B for a fixed sum of $500,000 payable as to half in cash on transfer and as to the other half by periodic payments of 20 cents per ton of minerals extracted, until the full amount shall have been satisfied.

Here I suggest that the periodic payments being made to satisfy an existing debt, namely the balance of the purchase price, could not be regarded as revenue expenditure. (Refer *In Re Income Tax Acts No. 2* [1915] 21 A.L.R. 359).

(c) A assigns his mining rights to B for a consideration of $100,000 cash. B also covenants to pay to A periodic payments calculated by reference to the minerals won from the ground up to a total of $200,000 when the obligation ceases.

In this case I doubt that one can confidently assert that the periodic payments would properly be allowable as deductions. I suggest that the Chief Justice would allow them to be deducted as royalties on the basis that they were recurrent outgoings incurred as a consequence of the mining operation, even though the promise to pay formed part of the consideration for the acquisition of the rights. On the other hand, Jacobs and Murphy JJ. would undoubtedly regard the payments as capital for the reason that their total amount was fixed and would not continue to be paid throughout the life of the mine. (Refer *Ralli Estates Ltd.* v. *C.I.T.* [1961] W.L.R. 329).

(d) A assigns his mining rights to B for a consideration of $100,000 cash. B further covenants to make periodic payments "as or by way of royalties" to A for the life of the mine, calculated by reference to the tonnage or value of minerals extracted therefrom.

On the basis of the *Cliffs International* decision the amounts of the recurrent payments should be fully deductible.

As Mr. Hulme points out in his paper it is difficult, in the case of an outright sale, to be fully confident that one has structured the transaction to fit squarely within the *Cliffs* decision. In this area it is so true that factual situations differ markedly.

I agree that the views of Gibbs and Stephen JJ. (who were in the minority in the *Cliffs* case) are a matter of concern because of their apparently sweeping effect on recurrent payments made under a contract for the outright purchase of capital assets. On one view of them it may be argued that not only royalties but interest payable under a Contract of Sale would not be deductible for the reason that it formed part of the consideration for the purchase of the asset.

Well then, what is the solution to the problem? Mr. Hulme makes the helpful suggestion that the owner of the mining right should retain a reversionary interest in it with appropriate changes to the wording of the payments made.

Clearly this will not be a solution in every case, where either because of the nature of the right being acquired or because of the necessity to provide security or other commercial considerations, a sub-lease or licence arrangement would not be suitable. In cases where outright purchase is necessary I venture to suggest the following precautions:

(a) Refer to the initial payment as the "purchase price" and make it a reasonably substantial amount, having regard to the nature and likely potential of what is being acquired. The amount should clearly be seen to be the full consideration for the transfer of the rights being acquired. In the *Cliffs* case it may be felt that the initial payment of $US200,000 was inconsiderable particularly having regard to the evidence that it represented only reimbursement of expenses incurred by the vendors. These factors may well have influenced Gibbs and Stephen JJ. in concluding that the deferred payments formed part of the purchase price.

(b) Do not refer to any periodic or recurrent payments as part of the "purchase price" or "consideration". Gibbs and Stephen JJ. seem to have been unduly influenced by the structure of the contract in the *Cliffs* case which described the periodic payments as "Deferred Payments" and as part of the "Purchase Price". In my view Judges are influenced by the descriptions given to payments in the contract between the parties, regardless of judicial statements that such descriptions are unhelpful or indecisive.

(c) Include your royalty provision as a separate clause in the contract, preferably well towards the end of the document. The more clauses between it and the "purchase price" the better. The opening words of this clause might be: "Subject to the due and punctual payment of the royalty hereinafter referred to, the purchaser shall have the right to mine etc . . ." The clause would then go on to set out the method of calculation and manner of payment of the royalty, which should of course be described as such, and be calculated on and proportionate to the use made of or profits derived from the mine.

(d) The royalty should continue for the life of the mine and not for a fixed period of years.

(e) A maximum sum to be paid by way of royalties should not be included, nor it seems should there be any minimum royalty.

(f) Do not impose on the purchaser any obligation to exploit the asset.

(g) Give consideration to a default clause providing for what is to happen if the purchaser defaults in payment of the royalty. In that event I suggest that the vendor should be entitled to give notice to the purchaser requiring the suspension of mining operations until the default has been remedied. This should overcome the point made by Gibbs and Stephen JJ. that the periodic payments were not made for the right to mine as the mining operations could be continued whether or not the payments were made.

There may well be other provisions which many of you will consider ought to be included in order to make it clear that the royalties are being paid for the right to utilize the property rather than as part of the consideration for the purchase of the rights.

It is clear that the tax treatment of the payments made by the purchaser does not determine the classification of the monies when received by the vendor. Consider then the tax position of the vendors in the illustrations given above!! In example (a) the vendor is receiving a percentage of the gross income from the exploitation of the asset and accordingly would be assessed on it even though it was non-deductible to the purchaser. (Refer *Just* v. *F.C.T.* [1949] A.L.R. 438.)

In example (b) the receipt of the periodic payments by the vendor would probably be treated as income (certainly by Barwick C.J.).

In examples (c) and (d) the receipt of the periodical and recurrent payments would, I suggest, be treated as income.

One further matter arises out of the decision in *Cliffs International.* Section 23(pa) of the *Income Tax Assessment Act* provides an exemption from tax in respect of "income derived by a person from the sale transfer or assignment by the person of his rights to mine" for gold or for any prescribed mineral provided that person is a bona fide prospector as defined. This provision is of course almost identical to the former s.23(p) which was of vital importance to prospectors during the nickel boom, when mining rights were freely traded for substantial consideration.

A not uncommon feature of such transactions was a provision requiring payment of a royalty to the prospector calculated on the value of minerals extracted for the life of the mine.

In order to bring the royalty income within the scope of s.23(p) such agreements usually recited the royalty as part of the consideration for the sale of the rights to mine. This, it was assumed, would be sufficient to attract the operation of the exemption from tax in respect of not only the cash or shares paid at the outset but also for the recurrent payments of royalty over the life of the mine. I am aware of at least one case where after initial resistance the Commissioner accepted that s.23(p) exempted such a royalty. In the light of the *Cliffs* case the exemption of a royalty in such circumstances would appear to be doubtful. In the *Cliffs* case, both Barwick C.J. and Jacobs J., held that the recurrent payments were not made "for the shares" but only as a consequence of the purchase of the shares in the sense that the promise to pay was contained in the agreement. In effect they held that the payments became payable because of the mining operations. I suggest that it is clearly arguable that in the hands of the recipient such payments would be income derived not from the sale but as a consequence of the sale, in which case I doubt that s.23(pa) could apply.

Clearly, therefore, where a bona fide prospector is the vendor of mining rights care will need to be taken to ensure that any royalty or other periodic payments are structured so as to form part of the purchase price. This would of course prejudice the purchaser's attempts to obtain full deductibility for any royalty paid. How these two conflicting interests can be equitably balanced cannot be readily predicted and will in each case, no doubt, depend upon commercial considerations.

COMMENT ON RECENT AND POTENTIAL DEVELOPMENTS IN THE TAXATION OF MINING AND PETROLEUM VENTURES

By W. A. Clayton

Mr. Hulme's paper has, in part, developed a theme upon which I would like to expand. He has drawn our attention to certain interpretative problems of s.122J and the Commissioner of Taxation's attempt to overcome them by applying the law in accordance with the Treasurer's announcement notwithstanding this is contrary to the wording of the Section.

I suggest that there are several other problems of this kind contained within s.122J as well as within s.122K.

1. SECTION 122J

A. Basics

Section 122J of the Income Tax Assessment Act applies to expenditure on exploration or prospecting. The meaning of "exploration or prospecting" is defined in s.122J(6) by reference to a number of technical functions such as geological mapping, geophysical surveys, search by drilling or other means.

Having regard to the construction of s.122J and the definition mentioned above, what constitutes expenditure on exploration or prospecting? Is it limited to expenditure incurred in the direct performance of those functions contained in the definition or is it possible to look at these words in a broader or more realistic way?

To illustrate the point I am trying to make, consider that company NICK to which Mr. Hulme referred in his paper. Assume the facts are slightly different in that NICK is exploring in Western Australia but has a Sydney administrative office. During the period of its exploration the company incurred $1 million, part of which would include expenditure of that office. You will appreciate that the expenditure could include wages of general office employees or employees meeting statutory requirements unassociated with exploration, general costs of running the office, perhaps bank interest in respect of overdraft facilities which may be used for general or specific exploration purposes, the costs of maintaining a share registry etc. Do all these expenditures constitute expenditure on exploration or prospecting?

In practice it would seem that the Commissioner generally regards all expenditure incurred during the exploration phase as falling within s.122J. However, would he be of the same view if someone like SMARTA acquires the shares in NICK and through some mechanism seeks to utilise the losses of the company?

What views might be open to the Commissioner? Firstly, the Commissioner could adopt a narrow view of s.122J and consequently argue that the indirect expenditure is not within its terms, is of a capital nature, being preparatory to the carrying on of a business, and not deductible under any section. The Commissioner might argue that the expenditure is deductible under s.51(1). In fact, if he could successfully do so he may not need to even adopt the narrow view to s.122J. The expenditure would be deductible under s.51(1) and at the time the question arises of a deduction being available under s.122J or such other section in Division 10 he could rely upon s.82 and contend that the expenditure was previously allowed under another section. Of course any deduction available under s.51(1) would be in a prior year and would no doubt be effectively lost as NICK would not be able to meet the tests contained in s.80.

Moving on from Mr. Hulme's example, consider a company which is carrying on exploration activities as well as other successful activities outside the mining sphere. Such a company may wish to regard a smaller part of its outgoings as being within s.122J and so include as much of its expenditure as possible within s.51(1). In these circumstances no doubt the company would be inclined to the narrow view of s.122J. In fact where companies carry on a number of activities it is not usual to allocate general overheads between s.122J and other heads of expenditure.

The contrary position would apply where the other activities of the explorer are at that time loss making and so he wishes to minimise carry forward losses.

This point could be developed further but perhaps it is sufficient to emphasise two points. Firstly, seeking to utilise the deductions of defunct mining companies may have some dangers to overcome. Secondly, tax planners should give careful consideration to the extent to which a taxpayer's expenditure falls within s.122J as compared with other sections especially having regard to the activities and the tax position of the taxpayer.

B. Section 122J(3)

Mr. Hulme raised the problem of expenditure on exploration or prospecting incurred in 1974 or previous years and which is deemed to be allowed capital expenditure incurred after 1977.

I can only but agree with his comments. The Act is deficient and technically no deduction is available.

C. Section 122J and Section 122K

Another interesting aspect of s.122J is its inter-relationship with s.122K following the amendments made to s.122J in 1974.

This inter-relationship might best be illustrated by several examples. Take the simple situation of the disposition in 1979 of drilling equipment acquired in 1975 at a cost of $1 million in respect of which deductions of $100,000 have previously been allowed. In the first instance, let's assume that the proceeds of sale are $100,000. I suggest that the drilling equipment clearly is property so that s.122K operates to provide a deduction of $800,000 being the difference between the undeducted expenditure on the equipment and the proceeds of sale.

If we change the facts so that the proceeds of sale are $1 million and not $100,000, s.122K would include in the assessable income of the taxpayer an amount of $100,000 (being a recapture of the deductions previously allowed).

Now consider the s.122J side of these transactions. Section 122J provides for deductions in respect of expenditure falling within its terms to the extent of net mining income. The section does not contain any exclusion of undeducted expenditure where there is a disposition of the property to which the expenditure relates. Accordingly, unless the general double deduction provisions of s.82 apply, a "double deduction" might be obtained in both examples in respect of part of the cost of the drilling equipment.

Section 82 provides that where in respect of any amount a deduction would be allowable under more than one section, and whether it would be so allowable in the same or different years, the Commissioner may allow the deduction under the section he considers the most appropriate. In relation to the disposition of the equipment for a consideration of $100,000 it could be argued that there is no amount in respect of which a deduction would be allowable under more than one section — there is a deduction of $800,000 allowable under s.122K and there are deductions aggregating $1 million allowable under s.122J in one or more subsequent years provided there is sufficient income from mining.

Section 82(2) would not seem to apply. That section seems to be directed at a section such as s.26(a) and denies the taking into account of expenditure in calculating a profit or loss which has been allowed or is allowable as a deduction in a prior year. This is not the case. The deduction might be allowable in a future year.

If these views be correct a deduction of $1.9 million would be available in respect of expenditure of only $1 million.

Where the proceeds of disposition are $1 million the position is clear. There is no question of s.82 applying. The taxpayer would obtain a deduction under s.122J for the expenditure of $1 million on the drilling equipment notwithstanding that in a prior year of income it has been disposed of for an amount equal to its cost.

The inter-relationship of s.122J and s.122K should be compared with the circumstances where there is a disposition of plant, the cost of which was included in the residual capital expenditure or residual previous capital expenditure. In these latter circumstances, the relevant sections contain provisions (s.122C(1)(c)(iv) and s.122DA(1)(a)(ii)) to reduce the amount of residual capital expenditure or the residual previous capital expenditure, as the case may be, by the amount included in those balances which has not been allowed and which is not allowable as a deduction in prior years.

It would also seem that where there is a disposition of prospecting rights (which are specifically defined as being property) in most circumstances this question of a double deduction will also arise. Expenditure need only be excluded from the balance of s.122J in the following two circumstances:

(i) where the expenditure was included in a s.122B notice;

(ii) where the proceeds from the sale of the rights are income to the vendor and are exempt under s.23(pa) of the Act.

However, where a company prospects with a view to future mining and it occasionally disposes of information or property rights I question whether the consideration received for such a disposition of rights is income to the recipient.

2. SECTION 122K

Section 122K provides for the allowance of further deductions or alternatively the recapture of deductions previously allowed upon the disposition etc. of property. More particularly three tests must be met:

1. Property has been disposed of, lost or destroyed or the use for prescribed purposes has been otherwise terminated. (Property for the purposes of Division 10 has its normal meaning and is also defined to include a mining or prospecting right);
2. Expenditure has been incurred in respect of that property; and
3. Deductions have been allowed or are allowable under Division 10 or its previous equivalents in respect of that expenditure.

In relation to this latter point the section only applies where deductions "have been allowed or are allowable". These words are used throughout Division 10, although in some cases in the singular rather than the plural. In such circumstances the context clearly contemplates deductions which are available in past or in the current year of income. Having regard to the construction of s.122K and in particular the reference in s.122K(2) to those deductions previously referred to in s.122K(1) as being the deductions to be taken into account in computing the balancing deduction or the assessable income, I believe it is clear they must also have the same meaning in s.122K.

It follows that s.122K has no application when deductions have not been claimed in respect of the expenditure on the property which has been disposed of etc. In the case of expenditure on exploration or prospecting incurred after 1974 this may not pose a problem — the expenditure on the property remains within s.122J and is deductible in future years in accordance with the provisions of that section.

However there is a problem where the expenditure falls within the definition of allowable capital expenditure (s.122A) or is deemed to be such by s.122J(3). As mentioned previously, both the definition of residual capital expenditure and residual previous capital expenditure contain exclusions for the undeducted expenditure on property which has been disposed of etc.

It follows, for example, that if a mining company incurs expenditure of $1 million in the acquisition of a continuous miner and fails to claim any deductions in respect of that miner, say, because the company has losses in earlier years and fails to exercise an election under s.122D(4) or s.122DB(4) then if that continuous miner is sold or scrapped there is no entitlement to a deduction in respect of its cost reduced by the consideration for sale or in the case of scrapping for the expenditure of acquisition.

Obviously this anomaly is not the intention of the Act. However it has existed within the various Divisions which have applied to the taxation of mining companies since the introduction in 1951 of s.124 the forerunner to s.122K. Notwithstanding it would seem that the Commissioner has administered the section in an equitable manner, by allowing balancing deductions upon the disposition etc. of property notwithstanding previous deductions have not been claimed.

Mining and Prospecting Rights

There is some lack of clarity as to the extent to which s.122K applies to dispositions of property such as mining rights but more particularly prospecting rights. There also is a lack of clarity where there has been a termination of mining or prospecting in respect of such items of property.

It is generally accepted that where a taxpayer disposes of a right to mine or a right to prospect s.122K applies since those rights are property.

In relation to a right to mine a taxpayer may incur expenditure in the acquisition of that right which may be allowable capital expenditure through the operation of s.122B, the taxpayer may incur expenditure in the development of the mine itself, in the construction of buildings or other improvements and even perhaps in expenditure on housing and welfare at the mine site. It is generally considered that all such expenditure would be regarded as expenditure incurred in respect of the mining right and so when that right is disposed of or its use terminated then all such expenditure is taken into account in determining the balancing deduction or the amount which is to be included in assessable income under s.122K.

In the case of a prospecting right a taxpayer would incur direct expenditure in carrying out the prospecting functions upon the prospecting right. The taxpayer may incur substantial indirect expenditure and the Commissioner may also regard this as being expenditure on exploration or prospecting. The aggregate of such expenditure would be incurred in respect of the prospecting right and so would be taken into account in calculating any deduction or assessable income under s.122K. Of course, there will be a difficulty in allocating these indirect costs to particular prospecting rights and presumably this merely becomes the decision of the taxpayer with which, in practical terms, the Tax Office has little capacity to disagree.

However the real difficulty of s.122K in relation to mining and prospecting rights arises not where there is a disposition of those rights, but where there is a termination of their use and it must be determined whether that termination is a termination of use for prescribed purposes.

The definition of prescribed purposes in Division 10 is vague and its meaning is far from clear. The only conclusion I can draw is that a prescribed purpose is either the function of carrying on mining operations or the function of carrying on exploration activities.

It follows that if a taxpayer terminates those activities it would seem s.122K has application. Termination could take several forms. There could be a temporary cessation of activities with an intention to recommence at some future time, there could be a complete abandonment of activities and rights or there could be a situation which lies between these two extremes.

I would suggest that a termination for the purposes of s.122K lies somewhere between. Having regard to the fact the section requires, in computing the recaptured deduction or further deduction, that the taxpayer must take into account the value of the property on the date of termination of use, it is obviously not necessary for the taxpayer to have relinquished his interest in the property.

Accordingly, in the case of a mining right I believe that s.122K applies where a taxpayer terminates mining operations and does not propose to recommence them.

Similarly where a taxpayer ceases to carry on exploration activities in respect of a prospecting right and also intends not to recommence them nor to carry on mining operations on that site, s.122K should also apply.

This would mean that the permanent cessation of exploration activities on a particular prospecting right would result in the triggering of a balancing deduction (if deductions have previously been allowed or are allowable) in respect of all the expenditure in respect of that right at the time of cessation.

In the case of successful mining companies this question of s.122K applying upon the cessation of exploration activities would have no relevance to post-1974 expenditure as this no doubt would be fully deductible under s.122J in the year it is incurred. However, it would have relevance to less successful companies. I doubt whether these latter companies are claiming their deductions on that basis. I suspect they are merely awaiting an entitlement to the balance of deductions under s.122J. However as I have pointed out there would appear circumstances where the availability of a deduction under s.122K might not prejudice a future deduction under s.122J.

Computation Problem

I have suggested above that s.122K applies to the disposition of property such as plant or prospecting rights where the expenditure was incurred after 1974 and is contained within s.122J. However, having regard to the requirement of s.122K that deductions have been allowed or are allowable there may be circumstances where it is impossible to determine whether deductions have been allowed and if so, how much.

For example, consider expenditure of $1 million in 1975 on drilling equipment for use in prospecting and the expenditure of $1 million in each of the next two subsequent years on various other prospecting activities. Assume further that in 1978 a deduction of $1 million is obtained under s.122J and that in 1979 there is a disposition of the drilling equipment. How do we determine how much, if any, of the expenditure on the drilling equipment has been allowed as a deduction. Do we adopt a first-in-first-out approach, a last-in-first-out approach or an average of expenditure?

An analogy to this question is the pouring of three glasses of milk into a bowl and then taking out one glass of milk and seeking to determine how much of the first glass has been removed.

From the above example it might be said that we cannot determine whether a deduction has been allowed or is allowable so s.122K does not apply. In such circumstances then there is still an advantage to the taxpayer since any consideration received will not reduce the aggregate of deductions obtained in respect of the drilling equipment.

Of course there will be situations where the deductions which have been allowed or are allowable can be clearly calculated.

Section 122K and Section 59

A further deficiency of s.122K but not of a kind similar to those previously mentioned is observed when comparing the section with s.59. If an assessable amount arises under s.59 it need not be returned as assessable income but may be offset against undeducted expenditure of the current or prior years. There is no equivalent right contained in s.122K. This deficiency should not be overlooked when considering whether to elect under s.122H that depreciation should apply, especially where the relevant items of plant are likely to be sold in the future at values significantly in excess of the undeducted costs.

3. SUMMARY

In summary I have raised several problems which have emphasised deficiencies or uncertainties in Division 10. Some of these might convey unintended advantage to taxpayers whilst others may result in unintended disadvantage. Notwithstanding the Taxation Office appears to be administering Division 10 in an equitable manner. However, in times when taxpayers are taking fine points of law against the Commissioner in other areas and with a possibility that they may seek to take such fine points against him in Division 10 and with taxpayers showing greater interest in defunct mining companies with a view to utilizing their expenditures, how long can we expect the Commissioner to adopt his present attitude?