

2015

EXPOSURE DRAFT

TAX RELIEF FOR CERTAIN MINING ARRANGEMENTS

EXPLANATORY MATERIAL

(Circulated by the authority of the
Treasurer, the Hon J. B. Hockey MP)

Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

<i>Abbreviation</i>	<i>Definition</i>
FIFO	farm-in farm-out
UCA	uniform capital allowance
CGT	capital gains tax
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
2014 amendments	<i>Tax and Superannuation Laws Amendment (2014 Measures No. 3) Act 2014</i>

Chapter 1

Tax Relief for Certain Mining Arrangements

Outline of chapter

1.1 The Exposure Draft provides tax relief to taxpayers entering into certain arrangements in relation to mining, quarrying and prospecting rights. Relief will apply to farm-in farm-out (FIFO) arrangements and interest realignment arrangements.

1.2 The relief is provided in situations where recently enacted integrity rules would otherwise operate to disadvantage taxpayers who engage in genuine exploration activities, and other legitimate arrangements.

Context of amendments

1.3 The *Tax and Superannuation Laws Amendment (2014 Measures No. 3) Act 2014* (the 2014 amendments) amended the uniform capital allowance (UCA) provisions in Division 40 of the *Income Tax Assessment Act 1997* (ITAA 1997). The 2014 amendments limited the immediate deduction available for expenditure on mining rights (see section 40-80 of the ITAA 1997).

1.4 The immediate deduction exists to support the exploration for resources. The Explanatory Memorandum to the 2014 amendments provides that the purpose of limiting the deduction was to address integrity concerns that deductions were being claimed for the acquisition of resources that had already been discovered.

1.5 As originally announced in the 2013-14 Budget, the limitation of the immediate deduction would have provided relief for taxpayers entering into FIFO arrangements. The enactment of this relief, however, was deferred. In the 2014-15 Budget, the Government announced a further decision to provide relief to taxpayers who realign their interests in mining, quarrying and prospecting rights to facilitate common development projects. These realignments are known as interest realignment arrangements.

Operation of the Current Law

Disposals of Mining, Quarrying and Prospecting Rights Generally

1.6 Interest realignment and FIFO arrangements involve the disposal of mining, quarrying or prospecting rights. The current law applies differently depending on when the rights were acquired. Disposals of rights acquired between 20 September 1985 and 1 July 2001 (pre-UCA rights) are subject to the capital gains tax (CGT) rules. Disposals of rights acquired from 1 July 2001 (UCA Rights) are subject to the UCA regime, which commenced on that date (see section 40-77 of the *Income Tax (Transitional Provisions) Act 1997*).

1.7 Expenditure that was incurred in acquiring pre-UCA assets is included in the cost base of the asset for CGT purposes. The capital gain or capital loss on the disposal of the right is recognised under the CGT rules. Generally, a capital gain or capital loss is the difference between:

- the capital proceeds received by a taxpayer when a CGT event happens to an asset; and
- the cost base of the asset.

1.8 Generally, where an asset has been disposed of for non-cash consideration, the capital proceeds received are taken to include the market value of the property the taxpayer receives, or is entitled to receive, in respect of the CGT event happening (paragraph 116-20(1)(b) of the ITAA 1997).

1.9 For UCA rights, taxpayers may deduct an amount equal to the decline in value of the right (depreciating asset) they hold during an income year. The decline in value is generally worked out by reference to the effective life of the asset.

1.10 When a UCA right is disposed of, a balancing adjustment event is triggered (section 40-285 of the ITAA 1997). This adjustment brings to account any difference between the tax written-down value (adjustable value) of the asset and the amount received on disposal (termination value). If the termination value exceeds the adjustable value, the difference is included in assessable income. Deductions are generally available if the adjustable value exceeds the termination value.

1.11 Generally, where an asset is disposed of for non-cash consideration, the termination value of the asset includes the market value of any benefits received (item 4 of the table in paragraph 40-305(1)(b) of the ITAA 1997). Similarly, where an asset has been acquired for non-cash consideration, the first element of the asset's cost includes the market

value of that non-cash consideration (item 4 of the table in paragraph 40-185(1)(b) of the ITAA 1997).

Interest Realignment Arrangements

1.12 An interest realignment occurs where the parties to a joint venture exchange interests in mining, quarrying or prospecting rights to pursue a single development project, with a view to aligning the ownership of individual rights with the ownership of the overall venture.

Example 1.1 Simple Interest Realignment Example

Two mining companies own mining rights with respect to neighbouring tenements, each worth \$25 million. The two companies decide to form a joint venture as equal partners. As part of the joint venture, each company transfers 50 per cent of their original right to the other. Both companies now own 50 per cent of each right, collectively the common development project.

Each company's rights now reflect their interest in the common development project. This is an example of an interest realignment arrangement.

1.13 When parties enter into an interest realignment arrangement, a balancing adjustment event occurs to each party in relation to the rights transferred. An amount is immediately brought to account reflecting the difference between the market value of the new right and the adjustable value of the original right. Prior to the 2014 amendments, each party would be entitled to an immediate deduction for each right acquired under the arrangement if they subsequently first used their new right for exploration or prospecting. This would result in a tax neutral outcome provided there was no other consideration involved.

1.14 The cost of the new right acquired, however, will not qualify for an immediate deduction under the amended section 40-80. As such, the cost of the new right (including the market value of the original right) is deductible only over the lesser of the right's effective life or 15 years. This outcome is not necessary to achieve the integrity objectives of the 2014 amendments and may have the effect of impeding interest realignment arrangements that encourage the joint development of resource discoveries.

Example 1.2 Interest Realignment Tax Outcomes

Further to Example 1.1, the termination value of each company's transferred right is \$12.5 million (the market value of the new right received). Assuming the parties were previously entitled to an immediate deduction for the costs of the rights, \$12.5 million will be

included in each company's assessable income. The 2014 amendments apply to the companies and the companies are not entitled to an immediate deduction for the cost of the new rights. \$12.5 million is deductible to each party over the lesser of the right's effective life or 15 years. This produces a net income tax liability in the original income year for the transaction.

Farm-in Farm-out Arrangements

1.15 A FIFO arrangement broadly involves the exchange of an interest in a mining, quarrying or prospecting right in return for an 'exploration benefit', usually an entitlement to receive exploration services or to have exploration expenditure funded by the other party. The initial owner of the right is known as the farmor. The person providing the exploration benefit in exchange for the right is known as the farmee. The farmee may provide other consideration or commitments that do not relate to exploration benefits.

1.16 There are two broad types of FIFO arrangements – immediate transfers and deferred transfers. An immediate transfer occurs where the farmor transfers the right at the time the farm out agreement is entered into. A deferred transfer farm-out occurs where the farmor provides a right or option to the farmee to have right transferred to them after the agreed exploration or prospecting is carried out.

1.17 Under either type of arrangement, the farmee may agree to meet the expenses of the farmor in holding the farmor's right so the farmor is 'free carried' in respect of its retained right in the tenement. This free-carried commitment may include land tax payments and licence fees in addition to exploration commitments in relation to the farmor's retained right. This is in addition to any expenses the farmee meets for their own costs in owning, or potentially owning, a right in the tenement.

1.18 The tax treatment of FIFO arrangements, prior to the 2014 amendments, is outlined in the Australian Tax Office's Miscellaneous Tax Rulings [MT 2012/1](#) and [MT 2012/2](#). Under these rulings, a FIFO arrangement will generally have tax neutral outcomes for the farmor and the farmee to the extent the arrangement involved exploration benefits. However, where the arrangement includes the payment of cash or other consideration for the farmor's original right, tax consequences may arise.

1.19 The rulings' broadly tax neutral outcome relied on the availability of an immediate deduction under section 40-80 for the farmee's cost of acquiring the right. This deduction would offset an amount that is included in the farmee's assessable income that reflected

the value of the mining, quarrying or prospecting right received as a reward for services or as the capital proceeds of CGT event D1.

1.20 In light of the 2014 amendments, an immediate deduction will be unavailable and the farmee's cost will only be deductible over the lesser of the right's effective life or 15 years. Further amendments are necessary to ensure that FIFO arrangements do not have these tax consequences where those consequences could impede genuine exploration activity.

Summary of new law

1.21 The Exposure Draft provides tax relief for taxpayers entering into arrangements that support genuine exploration activity and other arrangements that do not raise integrity concerns.

1.22 Part 1 of the Exposure Draft provides roll-over relief for taxpayers entering into interest realignment arrangements.

1.23 Part 2 provides a number of relief mechanisms for taxpayers entering into FIFO arrangements.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
<i>Interest Realignment Arrangements</i>	
<p>A capital gains tax roll-over will apply in relation to mining, quarrying or prospecting rights acquired prior to 1 July 2001 and disposed of under an interest realignment arrangement.</p> <p>A balancing adjustment event roll-over will apply to arrangements involving rights acquired on or after 1 July 2001.</p>	<p>Interest realignment arrangements will often result in a tax liability arising in the form of a capital gain or depreciating asset balancing adjustment event. Any liability will not be offset as the new right acquired is ineligible for an immediate deduction under section 40-80 of the ITAA 1997.</p>
<i>Farm-in Farm-out Arrangements</i>	
<p>The capital proceeds of the CGT event will be reduced by the value of the exploration benefit received.</p>	<p>CGT event A1 occurs to the farmor when, under a FIFO arrangement, they dispose of a mining, quarrying or prospecting right acquired before 1 July 2001.</p>

<p>The termination value of the part of the right transferred will be reduced by the value of the exploration benefit received.</p> <p>The adjustable value of the entire right is allocated to the cost of the retained part when the right is split immediately before the balancing adjustment event.</p>	<p>A balancing adjustment event occurs to the farmor when, under a FIFO arrangement, they transfers part of a mining, quarrying or prospecting right acquired after 1 July 2001.</p>
<p>The farmor's entitlement to deduct the expense is reduced to the same extent the termination value of the farmor's original right was reduced.</p>	<p>The farmor is entitled to a deduction for the expenditure incurred in acquiring the exploration benefit (section 40-730 or section 8-1 of the ITAA 1997). The expenditure is the market value of the part of the mining, quarrying or prospecting right transferred.</p>
<p>The receipt of the right is treated as non-assessable non-exempt income to the extent the cost of the right was the farmee providing exploration benefits to the farmor.</p> <p>CGT event D1 does not occur if the right created in the other entity (the farmor) is a right to receive an exploration benefit under a FIFO arrangement.</p>	<p>The receipt of a mining, quarrying or prospecting right under a FIFO arrangement is assessable to the farmee under sections 6-5 or 15-2 of the ITAA 1997.</p> <p>The receipt is also treated as the capital proceeds of CGT event D1.</p>
<p>The first element of the cost of the right received is reduced by the market value of the exploration benefits provided.</p>	<p>The first element of the farmee's cost of acquiring the mining, quarrying or prospecting right includes the market value of exploration benefits provided under the arrangement.</p>
<p>The cost base and reduced cost base of the entitlement are reduced by the market value of the entitlement.</p> <p>The capital proceeds of the C2 event are also reduced by the market value of any exploration benefits received.</p>	<p>On entering into a FIFO arrangement, the farmor will acquire a CGT asset that is the right to receive exploration benefits. When exploration benefits are received, CGT event C2 occurs to the farmor.</p>

Detailed explanation of new law

Part 1: Interest Realignment Arrangements

1.24 Roll-over relief is provided for taxpayers who enter into interest realignment arrangements. An interest realignment arrangement is an arrangement that involves two or more parties that each hold mining,

quarrying or prospecting rights that relate to a common development project the parties propose to jointly undertake. The project must relate to mining or quarrying operations as defined in subsection 40-730(7) of the ITAA 1997. *[Exposure Draft, item 1, paragraph 40-363(5)(a) of the ITAA 1997]*

1.25 The purpose of the arrangement must be to align the interests that each party has in each right with their interest in the common development project. The interests of the parties are to be determined by reference to the estimated reserves underlying the relevant rights. The estimation of reserves is to be conducted using an appropriate industry practice. *[Exposure Draft, item 1, subsection 40-363(6) and paragraph 40-363(5)(b) of the ITAA 1997]*

1.26 The arrangement must not involve any other transfer of a mining, quarrying or prospecting right. *[Exposure Draft, item 1, paragraph 40-363(5)(c) of the ITAA 1997]*

1.27 The exact form of roll-over relief will depend on the type of rights disposed of under the arrangement. Generally:

- where the original rights were acquired prior to 20 September 1985 (pre-CGT rights), the rights received under the arrangement will continue to have pre-CGT status;
- where the original rights were acquired between 20 September 1985 and 1 July 2001 (post-CGT and pre-UCA rights), CGT roll-over relief will apply. Rights received under the arrangement will be deemed to have been acquired during that period; and
- where the original rights were acquired after 1 July 2001 (UCA rights), balancing adjustment roll-over relief will be available.

UCA Balancing Adjustment Relief

1.28 Balancing adjustment event roll-over relief applies to interest realignments where the taxpayer's original interest was acquired after 1 July 2001. *[Exposure Draft, item 1, subsection 40-363(1) of the ITAA 1997]*

1.29 Taxpayers may choose to apply the roll-over. The choice must be made in writing within six months of the end of the relevant income year. The Commissioner may allow a longer period. *[Exposure Draft, item 1, subsection 40-363(2) of the ITAA 1997]*

1.30 The effect of the roll-over is that a standard balancing adjustment (section 40-285) does not occur. *[Exposure Draft, item 1, paragraph 40-363(3)(a) of the ITAA 1997]*

1.31 The adjustable value of the taxpayer's original right is transferred to the new right received. *[Exposure Draft, item 1, paragraph 40-363(3)(c) of the ITAA 1997]*

Other Proceeds

1.32 As part of an interest realignment, a taxpayer may also provide or receive consideration other than mining, quarrying and prospecting rights. Consideration in the form of money is a common example that is often exchanged when parties have rights that do not equate to their interest in the common development project.

1.33 For the party to an interest realignment that provides other consideration (the payer), the amount, or an equivalent amount, is added to the cost of the right received (see item 4 of the table in paragraph 40-185(1)(b) of the ITAA 1997).

1.34 For the party receiving the consideration (the payee), the amount of other consideration (and only that amount) is included in their assessable income in the income year in which the balancing adjustment event occurred. This is achieved by deeming the adjustable value of the right provided to be the market value of the right received and applying an otherwise standard balancing adjustment calculation (termination value less adjustable value). *[Exposure Draft, item 1, subsection 40-363 (4) and paragraph 40-363(3)(b) of the ITAA 1997]*

Example 1.3 Interest Realignment with Additional Consideration

Brian and Mark are partners in a mining operation and each owns mining rights relating to the project. Each partner acquired his right after 1 July 2001.

Brian and Mark agree to enter into an interest realignment such that they will each hold a 50 per cent interest in each of the original rights. This will align with their interests in the joint venture.

Brian's agrees to transfer 50 per cent of his right. That 50 per cent part has an adjustable value of \$100 million. Mark agrees to transfer 50 per cent of his right. Mark's 50 per cent part has an adjustable value of \$50 million. Brian's right is expected to contain more reserves than Mark's right and is more valuable to the joint venture. Mark, therefore, agrees to transfer \$50 million to Brian in addition to providing the 50 per cent interest in his mining right.

The \$50 million should be included in Brian's assessable income and added to the cost of Mark's new right. This reflects that Brian is disposing of a significant portion of his right for cash, which is not subject to the roll-over relief offered for the exchange of rights.

Mark has not received any consideration other than a mining right so no amount will be included in his assessable income. The adjustable value of Mark's original right is transferred to the cost of Mark's new right. To this, Mark adds \$50 million, being the amount of other consideration provided, for a total cost of \$100 million.

Interest Realignment Adjustments

1.35 An interest realignment adjustment occurs where, pursuant to the interest realignment arrangement, additional payments are made between the parties because of changes in the perceived contributions of the parties to the joint venture. This may arise where the estimates about the level of reserves in each right are varied. The interest realignment arrangement may provide that the party that is now believed to have contributed less reserves to the project owes compensation to the other parties. *[Exposure Draft, item 1, subsection 40-364(7) of the ITAA 1997]*

1.36 Where additional consideration is received under an interest realignment adjustment, a similar outcome will apply as if the consideration was made upfront. The only difference is that the tax outcome will arise in the income year in which the adjustment payment is made (it will not be necessary to reopen an earlier income tax assessment).

1.37 The amount of any adjustment payment will be included in the payee's assessable income and the payer's cost for their right received. The outcome will apply to any adjustment to the extent it included consideration other than a mining, quarrying or prospecting right. *[Exposure Draft, item 1, subsections 40-364(1) and (2) of the ITAA 1997]*

1.38 If the interest realignment adjustment takes the form of a contribution of an additional mining right, the adjustment provisions will not apply. This transaction would be treated as a new interest realignment arrangement.

1.39 Further amendments are made to disregard the tax consequences of the contractual right that exists between the parties in relation to the adjustment:

- The market value of the contractual right is not included in the termination value of the recipient's original mining, quarrying or prospecting right. *[Exposure Draft, item 1, subsection 40-364(3) of the ITAA 1997]*
- The market value of the contractual right is not included in the cost of a mining, quarrying or prospecting right acquired by the person providing the contractual right. *[Exposure Draft, item 1, subsection 40-364(4) of the ITAA 1997]*

- CGT event D1 does not occur to the person who provides the contractual right. [*Exposure Draft, item 1, subsection 40-364(5) of the ITAA 1997*]
- CGT event C2 does not occur to the person who receives an adjustment under a contractual right. [*Exposure Draft, item 1, subsection 40-364(6) of the ITAA 1997*]

Example 1.4 Interest Realignment Adjustments

Further to Example 1.3, 12 months after the interest realignment, additional estimates of the reserves in the common development project are made. The estimates reveal that Brian's original right had even more reserves than expected while the estimate of reserves in Mark's original right remains unchanged.

Pursuant to the terms of the interest realignment arrangement, Mark provides an additional \$10 million to Brian. Brian includes the \$10 million in his assessable income. Mark includes the \$10 million in the second element cost of the right he received from Brian. This inclusion flows through to increase the remaining adjustable value of the right (see section 40-85).

CGT Relief

1.40 CGT roll-over relief applies to interest realignments where the taxpayer's original right was acquired prior to 1 July 2001.

1.41 The consequences, generally, for the roll-over are that any capital gain or loss is disregarded and the cost base of the original right is transferred to the right acquired. The specific consequences are detailed in existing Subdivision 124-A and new Subdivision 124-S. [*Exposure Draft, item 2, sections 124-1220 and 124-1225 of the ITAA 1997*]

1.42 Where more than one right is provided, or more than one new right is received, the cost base of each new right must be determined on a reasonable basis. This allocation of the original cost base or cost bases is by reference to the number, market value and character of the original and new rights. [*Exposure Draft, item 2, section 124-1235 of the ITAA 1997*]

1.43 The character of the rights could refer to the estimated reserves of the rights, provided this was a reliable comparator, or other features. The reference to market value does not require a professional valuation to be obtained but is included as a factor to be considered when selecting a particular characteristic, such as reserves, on which to allocate cost bases to achieve the required reasonable allocation of cost bases.

Other Proceeds

1.44 Consideration other than mining, quarrying and prospecting rights are not eligible for CGT roll-over relief (they are ineligible proceeds and are attributed to an ineligible part of the original right). A partial roll-over remains available for the eligible part of the transaction. *[Exposure Draft, item 2, section 124-1230 of the ITAA 1997]*

1.45 For the party to an interest realignment that provides other consideration (the payer), the amount, or an equivalent amount, is added to the cost base of the right received. *[Exposure Draft, item 2, subsection 124-1225(2) of the ITAA 1997]*

1.46 The mechanism for assessing the ineligible proceeds differs slightly from the mechanism that applies to UCA rights. Under the UCA roll-over, all of the proceeds other than the relevant rights are assessable and the entire adjustable value of the right is transferred to the new right. Under the CGT roll-over, the cost base is apportioned and only that part that relates to the eligible proceeds is used in the roll-over. A standard CGT event applies in relation to both the ineligible proceeds and the ineligible part of the original cost base to which they relate. As a result, some of the cost base may be applied to reduce the amount of any capital gain arising from the ineligible proceeds.

Example 1.5 CGT Interest Realignment with Additional Consideration

Assume the same facts as in Example 1.3 except that both Mark and Brian acquired their interests between 20 September 1985 and 1 July 2001. Assume that the cost bases of their rights are equal to the adjustable value of those rights in Example 1.3.

Brian receives \$50 million in cash that is an ineligible proceed. The cost base of his transferred right (\$100 million) is apportioned between the eligible and ineligible parts of the right on a reasonable basis. Assume that this apportionment results in a \$25 million cost base for the ineligible part and \$75 million for the eligible part.

Brian makes a \$25 million capital gain (\$50 million cash proceeds less \$25 million ineligible part cost base). Any capital gain or loss made on the eligible part of the interest is disregarded. The cost base and reduced cost base of Brian's new interest is \$75 million, the cost base of the eligible part.

Mark receives a complete roll-over. He makes no capital gain or loss and the cost base of his original interest (\$50 million) is transferred to the new interest he received. To this, Mark adds \$50 million, being the amount of other consideration provided, for a total cost base of \$100 million.

Preserving UCA and CGT Status of Rights

1.47 Where a taxpayer disposes of a right under an interest realignment arrangement, the replacement right should have the same status as if it was acquired at the same time as the original asset.

1.48 That is, if the original asset has a pre-CGT status because it was acquired prior to 20 September 1985, the right received under the arrangement will continue to have the same status. [*Exposure Draft, item 2, section 124-1240 of the ITAA 1997*]

1.49 A similar outcome arises for assets acquired between 20 September 1985 and 1 July 2001. Such an asset is a post-CGT and pre-UCA asset. If disposed of under an interest realignment arrangement, the replacement right will have the same status as if it had been acquired during that period. [*Exposure Draft, item 4, subsection 40-77(ID) of the Income Tax (Transitional Provisions) Act 1997*]

Disposals of Multiple Rights

1.50 There may be occasions where a party to an interest realignment arrangement is disposing of multiple rights. Some of those rights may have different CGT and UCA statuses. Indeed, it is possible that a taxpayer could dispose of a pre-CGT asset, a pre-UCA CGT asset and a UCA asset.

1.51 In these situations, each new right acquired will be split into two or three notional assets. This ensures that, following the roll-over, the taxpayer is in the same position in relation to the value of assets with specific tax characteristics. Different mechanisms apply depending on what combination of rights and asset statuses are disposed of under the arrangement.

1.52 Where a taxpayer disposes of both pre-CGT and post-CGT assets (but no UCA assets), each asset received under the arrangement is split into two assets, a pre-CGT asset and a post-CGT asset. The cost base of the post-CGT asset is determined by allocating the total cost bases of the original post-CGT assets between the new rights in proportion to the market values of each right received (disregarding the split). [*Exposure Draft, item 2, section 124-1245 of the ITAA 1997*]

Example 1.6 Pre-CGT and Post-CGT Right Roll-Over

Paul has three mining rights, parts of which he disposes of under an interest realignment arrangement. The parts disposed have the following characteristics:

<i>Right</i>	<i>CGT Status</i>	<i>Market Value</i>	<i>Cost Base</i>
Right A	Pre-CGT	\$100 million	NA
Right B	Post-CGT	\$180 million	\$110 million
Right C	Post-CGT	\$120 million	\$90 million

Under the arrangement, Paul receives two new mining rights. The rights have market values of \$150 million and \$250 million respectively.

Each new right is split into two assets, a pre-CGT asset and a post-CGT asset.

Paul applies the statutory formula:

$$\text{Total post-CGT cost base} \times \frac{\text{Market value of new right}}{\text{Market value of all new rights}}$$

The total of the cost bases of the original post-CGT rights is:

$$\$110 \text{ million} + \$90 \text{ million} = \$200 \text{ million}$$

The total of the market values of the new rights is:

$$\$150 \text{ million} + \$250 \text{ million} = \$400 \text{ million}$$

The cost base of the post-CGT asset split from the first new licence (market value \$150 million) is:

$$\$200 \text{ million} \times \frac{\$150 \text{ million}}{\$400 \text{ million}} = \$75 \text{ million}$$

The cost base of the post-CGT asset split from the second new licence (market value \$250 million) is:

$$\$200 \text{ million} \times \frac{\$250 \text{ million}}{\$400 \text{ million}} = \$125 \text{ million}$$

1.53 Where the assets disposed of include UCA assets and pre-UCA assets, the rights received will be split to include a new UCA asset. The other split asset will be either a pre-CGT asset or post-CGT asset according to the status of the pre-UCA assets disposed of. If assets of all three statuses are disposed of, the rights received are split into three assets and the rules outlined in paragraph Example 1.6 and Example 1.6 apply to the two pre-UCA assets. [*Exposure Draft, item 2, section 124-1250 of the ITAA 1997*]

1.54 To the extent a taxpayer disposes of UCA rights, the new right will also be a UCA right. *[Exposure Draft, item 4, subsection 40-77(1E) of the Income Tax (Transitional Provisions) Act 1997]*

Part 2: Farm-in Farm-out Arrangements

1.55 Tax relief is provided to taxpayers entering into FIFO arrangements that support exploration and prospecting operations. A FIFO arrangement is eligible for tax relief if it is an arrangement where the farmor:

- transfers part of their mining, quarrying or prospecting right to the farmee (an immediate transfer); or
- agrees to a future transfer or grants an option in relation to a future transfer (a deferred transfer),

to the farmee in return for the farmee agreeing to provide exploration benefits to the farmor. *[Exposure Draft, item 9, subsection 40-1135(1)]*

Exploration Benefits

1.56 The concept of exploration benefits is critical to the existence of an eligible FIFO arrangement and the extent of tax relief provided. The relief is intended to support exploration activities. Benefits provided under a FIFO arrangement that are not exploration benefits are not eligible to receive tax relief.

1.57 Exploration benefits includes two types of activity undertaken by a farmee on the farmor's behalf:

- The farmee may conduct the exploration activities itself or it may directly engage the service of a third party to undertake the activities. *[Exposure Draft, item 9, subparagraph 40-1135(2)(a)(i) of the ITAA 1997]*
- Alternatively, the farmee may free-carry the farmor in respect of exploration expenses. That is, the farmee may meet, on the farmor's behalf, the obligations that the farmor incurs. This must occur by way of the farmee funding the expenses prior to their being paid by the farmor. Reimbursement of the farmor's expenses is not an exploration benefit. *[Exposure Draft, item 9, subparagraph 40-1135(2)(a)(iii) of the ITAA 1997]*

1.58 Two limitations apply to the concept of what may be an exploration benefit.

- The benefit must be on the farmor's behalf and must relate to the part of the farmor's right not transferred under the arrangement. *[Exposure Draft, item 9, paragraph 40-1135(2)(b) of the ITAA 1997]*
 - In an immediate transfer, the benefit must relate to the farmor's retained right.
 - In a deferred transfer arrangement, the benefit must relate to that part of the farmor's right that is not liable to be transferred.
- Secondly, the expenditure must be of a kind that would be deductible to the farmor if the farmor had undertaken the activity itself. That is, the farmor would have been entitled to a deduction under section 40-730, or would have been entitled to include the expense in the cost of its mining, quarrying or prospecting information or in the cost of another depreciating asset that satisfied section 40-80. *[Exposure Draft, item 9, paragraph 40-1135(2)(c) of the ITAA 1997]*

1.59 An exploration benefit includes the right to receive an exploration benefit. *[Exposure Draft, item 9, subparagraphs 40-1135(2)(a)(ii) and (iv) of the ITAA 1997]*

Example 1.7 Exploration Benefits

A farmor and farmee are equal partners in a joint venture. The venturers establish a joint venture operator to manage exploration activities for the project. The operator is responsible for paying for exploration activities. The operator is funded by cash-calls on the venturers. Cash-call funds are placed in the joint venture's cash account and remain the property of whomever placed them there. When they are expended, they are expended on behalf of the venturers and the venturers incur that expenditure in proportion to their participating interest in the project.

Each time the venture operator calls for funds for exploration or prospecting, each venturer would normally contribute 50 per cent of the funds. The venture operator would then expend those funds on behalf of each of the venturers.

The venturers enter into a FIFO arrangement whereby the farmee agrees to meet all of the cash calls made on the farmor. In return, the farmor agrees to a deferred transfer of part of its mining right to the farmee. Following the potential transfer, each venturer would own 50 per cent of the rights in the joint venture.

Following the establishment of the arrangement, the operator issues cash calls to meet a \$10 million exploration expense. Each venturer incurs an expense of \$5 million because they are equal partners in the venture. Under the terms of the FIFO arrangement, the farmee contributes \$10 million to the joint venture account, which the operator then expends.

The farmee has provided an exploration benefit of \$5 million being the amount that related to the right the farmor intends to retain.

Tax Relief for the Farmor

1.60 For the farmor, the value of any consideration received for disposing of a right under a FIFO arrangement is reduced to the extent the consideration is an exploration benefit.

1.61 For a UCA right disposed of, the termination value of the right is reduced by the market value of the exploration benefit. *[Exposure Draft, item 9, subsection 40-1105(1) of the ITAA 1997]*

1.62 If the right disposed of was a pre-UCA right, the capital proceeds of the CGT event are reduced by the same amount because the market value of the exploration benefits is deemed to be zero. *[Exposure Draft, item 14, subsection 116-115(1) of the ITAA 1997]*

1.63 On entering into the FIFO arrangement, the farmor acquires a contractual right to receive exploration benefits. This right is a CGT asset. When the contractual right expires (e.g. because the farmor receives the underlying exploration benefits), CGT event C2 occurs to the farmor. The cost base and reduced cost base of this contractual right is reduced by the value of the entitlement to receive exploration benefits. *[Exposure Draft, item 9, section 40-1125 of the ITAA 1997]*

1.64 To prevent any capital gain from arising in relation to exploration benefits received pursuant to the contractual right, the capital proceeds of the event are deemed to be zero to the extent they are exploration benefits. *[Exposure Draft, item 14, subsection 116-115(2) of the ITAA 1997]*

Example 1.8 Tax Relief for the Farmor

A farmor enters in a FIFO arrangement. The farmor transfers a part of his mining right to the farmee. The part of the right has an adjustable value of nil.

In return, the farmor receives \$2 million cash and a contractual right to receive exploration benefits. The termination value of the farmor's transferred mining right is \$2 million. The market value of the exploration benefit is netted out.

The farmor has a balancing adjustment event and includes \$2 million in its assessable income (\$2 million termination value less a nil adjustable value).

In the following year, the farmee provides a number of exploration benefits to the farmor pursuant to the arrangement. CGT event C2 occurs to the farmor, however the cost base and capital proceeds are both nil (assuming no incidental costs).

Tax Relief for the Farmee

1.65 For the farmee, any tax outcome arising from entering into the FIFO arrangement is reduced to the extent the farmee agrees to provide exploration benefits. Any income that would be included in the farmee's assessable income because it was a reward for providing exploration benefits is treated as non-assessable non-exempt income. *[Exposure Draft, item 9, section 40-1120 of the ITAA 1997]*

1.66 Similarly, CGT event D1 does not apply to bring about a capital gain for the farmee for creating a right in the farmor to receive exploration benefits. *[Exposure Draft, item 10, paragraph 104-35(5)(g) of the ITAA 1997]*

Limits to Corresponding Deductions

1.67 To ensure tax neutral outcomes, some corresponding deductions and other benefits are reduced to the extent of the tax relief provided.

1.68 The depreciable cost of the transferred right in the hands of the farmee is reduced by the market value of exploration benefits provided. This reflects the tax relief provided for the farmee's assessable income and CGT consequences for acquiring the right. *[Exposure Draft, item 9, subsection 40-1105(2) of the ITAA 1997]*

1.69 The farmor is not entitled to include any of the adjustable value of its entire right in the balancing adjustment event calculation that applies to the transferred part of the right. When the farmor transfers part of a right, the right is taken to have been split into two depreciating assets immediately before the disposal (section 40-115). The adjustable value of the entire asset is normally apportioned to become the cost of each split asset (section 40-205). Under a FIFO arrangement, however, the entire adjustable value is allocated to the retained part. *[Exposure Draft, item 9, section 40-1110 of the ITAA 1997]*

1.70 To the extent a farmor is entitled to a deduction for expenditure that is the expenditure of its original mining, quarrying or prospecting right, the deduction is reduced to the same extent as the termination value of the farmor's right was reduced. *[Exposure Draft, item 9, subsections 40-1115(1) and (2) of the ITAA 1997]*

1.71 To the extent that a farmor incurs an expense that is met by the farmee providing exploration benefits, the deductibility of that expense to the farmor is reduced to the same extent as the termination value of the farmor's right was reduced. This applies to all deductions, including those that arise from exploration or prospecting expenditure and immediate deductions available because the expenditure is included in the cost of a depreciating asset first used for exploration or prospecting. *[Exposure Draft, item 9, subsections 40-1115(3) and (4) of the ITAA 1997]*

1.72 Consistently, if the farmor improves mining, quarrying or prospecting information they hold because they have received an exploration benefit, the farmor is not entitled to include any expenditure in the cost of the information to the extent it relates to exploration benefits received. *[Exposure Draft, item 9, section 40-1130 of the ITAA 1997]*

Changes to an Exploration Benefit

1.73 When an exploration benefit is first provided on entering a FIFO arrangement, the benefit is a contractual right or entitlement to receive exploration benefits over time. At this point, tax relief is provided to the farmor and farmee. If the farmor later receives non-exploration benefits in relation to the right, it is necessary to claw back the tax relief provided.

1.74 The potential for the claw back is established at the time the FIFO arrangement is entered into. The first element of the cost base and reduced cost base of the CGT asset that is the contractual right to receive exploration benefits is reduced by the market value of that right. *[Exposure Draft, item 9, section 40-1125 of the ITAA 1997]*

1.75 When the contractual right expires (e.g. because the farmee fulfils the obligation or the parties renegotiate the arrangement), CGT event C2 occurs to the farmor. The capital proceeds of the event that are genuine exploration benefits are given a market value of zero. To the extent the proceeds include benefits that are not exploration benefits, there is likely to be a capital gain. The extent of the gain is increased because of the reduction in the cost base of the contractual right. The rules ensure that the gain is recognised in the later income year, avoiding the need to reopen any income tax assessments made for earlier income years.

Example 1.9 Changes to an Exploration Benefit

A farmor disposed of a part of a mining right under a FIFO arrangement. The right has an adjustable value of nil per section 40-1110. In return, the farmor received an entitlement to exploration benefits. The entitlement had a market value of \$100 million.

The farmor receives no other consideration for the mining right and the termination value of the right is therefore zero. The farmor does not have any tax liability when disposing of the right.

In the following income year, the farmee provides exploration services to the farmor worth \$50 million. The exploration is successful and substantial resource deposits are discovered.

CGT event C2 occurs to the farmor. The capital proceeds and the cost base are both nil because the event relates entirely to exploration benefits (it is assumed there were no incidental costs). No capital gain or loss arises.

In the third year, the parties agree to suspend further exploration and agree that the farmee can complete its obligations under the arrangement through contributions to development. The farmee provides \$50 million worth of contributions to the development of the farmor's retained right and discharges its obligations.

CGT event C2 occurs again to the farmor in relation to the second half of the exploration benefit. The capital proceeds are \$50 million. The cost base remains nil, resulting in a capital gain of \$50 million. This reflects the amount that would not have received the original tax relief if it was known then that the right would not be realised through the receipt of exploration benefits.

Consequential amendments

1.76 Rights and obligations that arise under a FIFO arrangement and relate to the provision of exploration benefits are exempted from the Taxation of Financial Arrangement regime contained in Division 230 of the ITAA 1997. While the rights and obligations may amount to a financial arrangement (section 230-45), it is intended that the UCA and CGT rules alone will provide the tax outcomes for these arrangements. *[Exposure Draft, item 15, subsection 230-460(17A) of the ITAA 1997]*

1.77 Definitions of 'interest realignment arrangement', 'interest realignment adjustment', 'farm-in farm-out arrangement' and 'exploration benefit' are added to the ITAA 1997 dictionary. *[Exposure Draft, items 3 and 16, subsection 995-1(1) of the ITAA 1997]*

1.78 Legislative signposts to the operative amendments made by Part 2 are inserted into the list of non-assessable non-exempt income provisions, the list of cost base modifications in section 112-97 and the list of capital proceeds modifications in section 116-25. *[Exposure Draft, items 6 and 11 to 13, sections 11-55, 112-97 and 116-25 of the ITAA 1997]*

1.79 Notes cross-referencing the operative amendments made by Part 2 are attached to the Division 40 rules for determining cost and termination value. *[Exposure Draft, items 7 and 8, notes to section 40-175 and subsections 40-180(4) and 40-300(3) of the ITAA 1997]*

Application provisions

1.80 The amendments in Part 1 apply to: *[Exposure Draft, item 5]*

- mining rights that a taxpayer starts to hold, or balancing adjustment events that happen in respect of mining rights, after 7.30 pm on 14 May 2013 because of an interest realignment; and
- CGT events that happen after 7.30 pm on 14 May 2013 because of an interest realignment.

1.81 The amendments in Part 2 apply to FIFO arrangements entered into after 7.30 pm on 14 May 2013. *[Exposure Draft, item 17]*

