

Targeting the immediate deduction for
mining rights and information first used
for exploration

Proposal Paper
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REQUEST FOR FEEDBACK AND COMMENTS

The Government seeks your feedback and comments on the measure outlined in this proposal paper. The information obtained through this process will inform the Government's approach to the implementation and also assist in meeting the requirements of the Office of Best Practice Regulation.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Closing date for submissions: Friday, 12 July 2013

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FOREWORD



It is important that Australia secures a fair, competitive and sustainable tax base for the future prosperity of this nation. Left unchecked, abuse of tax expenditures for unintended purposes will erode the sustainability of government support and erode confidence in the broader tax system.

It also means other taxpayers must either face a larger tax burden or accept a lower level of government services.

The Government is committed to taking what action it can to protect the integrity of Australia's corporate tax base. As part of this, we are better targeting the immediate deduction for assets first used for exploration.

This reform will ensure that this important tax concession is focussed on genuine exploration activity. It will address a practice whereby the cost of acquiring an interest in natural resources is able to be claimed as exploration activity.

This discussion paper demonstrates our commitment to a thorough consultation process. We will always endeavour to engage in a genuine process of consultation to identify and prevent unintended consequences.

These are important and necessary reforms that will improve the integrity of Australia's tax system. I welcome your participation in this process.

A handwritten signature in black ink, appearing to read 'D. Bradbury'. The signature is stylized and fluid.

The Hon David Bradbury MP
Assistant Treasurer

1. OVERVIEW

1. Australia's income tax system supports the exploration for resources by allowing an immediate deduction for the cost of depreciating assets that are first used in exploration. This is an important concession, which recognises resources exploration is a vital activity that has spill over benefits to the economy.
2. Concerns have emerged in recent years that the immediate deduction is being claimed in circumstances that go beyond the policy intent of supporting exploration activity. This integrity concern arises where the immediate deduction is claimed for the cost of acquiring mining rights and information, where the price paid reflects the value of resources that have already been discovered. The growing numbers of claims being made are presenting base erosion concerns, and are undermining the sustainability of this tax concession.
3. To address these integrity concerns, the tax concession will be tightened to better target genuine exploration activity. Mining rights and information that are first used for exploration will be depreciated over their effective life, or 15 years if this is shorter.
4. To ensure that genuine exploration activity continues to benefit from the immediate deduction, the Government has targeted the measure so that the costs of depreciating assets clearly involved in genuine exploration activity continue to be immediately deductible. This will be achieved by continuing to allow an immediate deduction for:
 - 4.1. co-exploration (or 'farm-in, farm-out') arrangements, often used by small explorers;
 - 4.2. the costs of acquiring a mining right from a relevant government issuing authority;
 - 4.3. the costs of acquiring mining information from a relevant government authority; and
 - 4.4. the costs incurred by a taxpayer themselves in generating new information or improving existing information.

2. CASE FOR CHANGE

2.1 WHAT IS THE POLICY INTENT?

5. The normal treatment of the cost of depreciating assets in the tax law is to depreciate them over their effective life (or capped effective life). This is the case regardless of the tax treatment applied to the vendor in respect of a sale.

6. The immediate deduction for depreciating assets first used for exploration is a concessional treatment that is designed to encourage exploration, which is a particularly risky activity. The concession is appropriate because the amount of investment in exploration affects the ability of the resources sector to continue to grow and support the nation's growth into the future.

7. The knowledge that exploration generates has value, even when the resources discovered are unable to be immediately developed. This is because future changes in market conditions and technology may make a currently uneconomic resource viable, and because the benefits of that knowledge may flow beyond the businesses undertaking the exploration activity. In addition, information about one exploration lease may provide information about resources that may be available in nearby areas.

8. Equivalent concessional treatment is not provided for depreciating assets used in mine, quarry or petroleum field development and production. For example, the cost of acquiring rights that give access to resources for subsequent development and production would be depreciated over the effective life of the relevant mine. Although there are also risks involved in developing and producing resources, the risks are of a different character to those faced in exploration. In addition, the benefits of those activities are more readily retained by the businesses undertaking the activity.

2.2 WHAT IS THE CONCERN?

9. In 2001, the current section 40-80 of the *Income Tax Assessment Act 1997* (ITAA 1997) was legislated. While it maintained the longstanding immediate deduction for the costs of depreciating assets first used for exploration, it also extended the immediate deduction to mining, quarrying and prospecting rights and information. This was intended to simplify the tax treatment of these assets.

10. The extension of the concession in this way has opened up opportunities for taxpayers to claim a deduction for a cost relating, in substance, to the cost of gaining access to known resources for subsequent use in development and production. This is because the value of the rights and information will reflect the value of the minerals or petroleum that they are expected to provide access to (discounted for time and risk). As exploration proceeds and the prospectivity of an area is better understood, the value of the rights and information may increase accordingly.

11. Allowing a concession for what is essentially the cost of acquiring access to natural resources is outside the policy intent of the provision. While the development and production stages may involve considerable risk, this is different in nature to the risk involved in searching and appraising an area for resources that may or may not be present.

12. At one extreme, the Government has become aware of a number of cases involving individual claims to deduct the costs of mining, quarrying or prospecting rights and information worth hundreds of millions dollars (and in some cases billions of dollars). The mining, quarrying or prospecting rights and information were sold in the late stage of exploration. The acquisition of the rights and information, either directly or indirectly, is essential before resources development and production is possible. The high prices in these cases suggest that there is a high probability that resources exist in circumstances where development and production is likely on the tenement covered by the right. When the right is transferred, some further (often minor or 'confirmatory') exploration activity is undertaken to enable an immediate deduction for the full cost of the right and information to be claimed. An illustrative example of this conduct is provided in the Appendix.

13. The Government considers that these transactions are clearly outside of the policy intent of the immediate deduction for depreciating assets first used for exploration, and represent an integrity concern and an erosion of the corporate tax base. The acquisitions are better characterised as the acquisition of a natural resource for development and production and should be treated accordingly.

14. To ensure that genuine exploration activity continues to benefit from the immediate deduction, the Government has targeted the measure so that the costs of depreciating assets clearly involved in genuine exploration activity continue to be immediately deductible.

3. PROPOSAL

3.1 CHANGED TREATMENT FOR THE COSTS OF RIGHTS OR INFORMATION

15. It is proposed that the immediate deduction under section 40-80 of the ITAA 1997 for the cost of a depreciating asset first used for exploration or prospecting exclude the cost of mining, quarrying or prospecting rights or information, except as set out in paragraphs 19 and 20 below.

3.2 PERIOD OVER WHICH DEDUCTION FOR THE COST OF RIGHTS OR INFORMATION CAN BE CLAIMED

16. The deduction for the cost of such an asset, if it is first used for exploration or prospecting in circumstances that would currently allow an immediate deduction under section 40-80, will instead be available over 15 years or its effective life, if that is shorter.

17. The effective life of a mining, quarrying or prospecting right will be the life of the mine, quarry or petroleum field that it leads to. If that life is not known at the time of acquisition of the right, a 15-year effective life would initially be used. The remaining amount could be re-assessed at a later time when it becomes possible to work out a life of the mine, quarry or petroleum field.

18. The effective life of mining, quarrying, or prospecting information will be the life of the mine, quarry or petroleum field that the information is associated with. If the information is associated with more than one mine, quarry or petroleum field, the effective life would be that of the longest lasting venture. As with mining, quarrying or prospecting rights, a 15 year effective life would initially be used if the life of the mine, quarry or petroleum field with which the information is associated is not known at the time of acquisition of the information. This could be re-assessed at a later time when it becomes possible to work out a life of the mine, quarry, or petroleum field. If the information is not associated with any mine, quarry or petroleum field (or any such potential venture), the effective life would need to be estimated under normal principles. This would generally be the period over which the information could be used by any entity for a taxable purpose.

19. If exploration is unsuccessful, the remaining value of the right, and associated information, will be written off when this is established.

Consultation questions

Q1: Views are sought on whether the methodology used to determine the life of the mine; quarry or petroleum field for the purpose of this measure could be made clearer or simpler.

Q2: Views are sought on the whether the method used to demonstrate that the effective life of a mining, quarrying or prospecting right has come to an end in a period of less than 15 years could be made clearer or simpler.

3.3 CASES WHERE COSTS OF A RIGHT WILL CONTINUE TO BE IMMEDIATELY DEDUCTIBLE

20. Costs of a mining, quarrying or prospecting right will continue to be immediately deductible to a taxpayer under section 40-80 if the existing requirements of section 40-80 are met and either:

20.1. the right is directly acquired by the taxpayer from an issuing authority of the Commonwealth, a State or a Territory and the costs are for that acquisition; or

20.2. the right is acquired by the taxpayer as a farmee under a 'farm-in, farm-out' arrangement, as described in public taxation rulings MT 2012/1 and MT 2012/2, to the extent that the cost is the non-cash exploration benefit provided by the farmee to the farmor under such an arrangement.

Consultation question

The measure will codify the tax outcomes that are currently delivered through the Australian Taxation Office's tax rulings MT 2012/1 and MT 2012/2 in relation to farm-in/farm-out arrangements.

Q3: Views are sought on ways in which this codification exercise could make the application of tax law more straightforward and/or improve support for genuine exploration without introducing integrity concerns.

3.4 CASES WHERE COSTS OF INFORMATION WILL CONTINUE TO BE IMMEDIATELY DEDUCTIBLE

21. Costs of mining, quarrying, or prospecting information will continue to be immediately deductible to a taxpayer under section 40-80 if the existing requirements of section 40-80 are met and either:

21.1. the costs are for the acquisition by the taxpayer of mining, quarrying or prospecting information from a Commonwealth, State or Territory authority whose functions include making such information available for exploration purposes, for example, Geoscience Australia; or

21.2. the costs are incurred by the taxpayer to create the information through activity that qualifies as 'exploration or prospecting' (under the current income tax definition in section 40-730 of the ITAA 1997), rather than being costs of acquiring information that has already been created.

21.2.1. Examples of costs of creating information would be expenditure, such as salaries and wages, contractors' fees, travel and accommodation, fuels and consumables, incurred in creating the information through exploration or prospecting activity.

3.5 DATE OF EFFECT

22. The changes apply to taxpayers who start to hold the mining, quarrying, prospecting right, or information after the time of announcement unless: the taxpayer has committed to the acquisition

of the right or information (either directly or through the acquisition of an entity holding the asset) before the announcement; or they are taken by tax law to already hold the right or information before the announcement. Any commitment will need to be objectively verifiable.

22.1. A taxpayer may have committed to the acquisition of the mining, quarrying or prospecting right or information if they have, for example, made an ASX announcement announcing such a commitment, executed contracts that identify the sale of the right or information and the consideration to be paid for them, or where there is objective evidence of a firm intention of the board to acquire the right or information.

3.6 RELATED ISSUES

3.6.1 Interest realignments and tenement swaps

23. Where a taxpayer acquires a mining, quarrying or prospecting right through an interest realignment or a tenement swap, the taxpayer will be entitled to a deduction equivalent to the annual decline in value of the right, given its effective life.

24. The Government understands that there are a range of industry practices around the acquisition of interests in mining rights through an exchange of interests, and that these transactions can be an important step in bringing a project from the exploration to the development stage. It is recognised that there may be some circumstances in which this type of transaction should receive a concessional tax treatment, because the transaction does not give rise to integrity concerns.

25. However, these types of transactions could involve exchanges of interests in natural resources worth hundreds of millions of dollars. A blanket extension of the immediate deduction to cover all interests acquired in this way would reopen the integrity risk, that is, that a concession that is intended to support exploration could be claimed in relation to the cost of acquiring natural resources for subsequent development and production.

Consultation question

Q4: Views are sought about any circumstance in which an interest acquired through an exchange of mining rights should receive a concessional tax treatment because the transaction does not give rise to the integrity concerns that this proposal is intended to address. It would be particularly useful if submissions could identify practical examples of such transactions and comment on their prevalence at the exploration stage of a project.

3.6.2 Geothermal energy

26. The Government has introduced legislation to extend the same tax treatment of exploration to geothermal energy as applies to mining and petroleum exploration. Consistent with this policy to provide equal treatment, this proposal will also apply to exploration for geothermal energy.

3.6.3 ATO ruling on the scope of exploration activity

27. The ATO is currently reconsidering — for various reasons — its interpretation of the scope of the definition of exploration used in the tax legislation. While this would mainly affect the petroleum resource rent tax, it could also affect the scope of exploration for income tax purposes. The ATO is

consulting on the ruling. The ATO plan to progress their rulings on exploration in the second half of 2013.

3.6.4 No change for rights that are not first used in exploration

28. The proposal will not change the effective life of mining rights that do not satisfy the requirements of section 40-80 ITAA 1997. In these cases, the effective life is the life of the mine, quarry or petroleum field to which the right relates (subsection 40-95(10) ITAA 1997).

3.7 COMPARISON OF CURRENT AND PROPOSED TREATMENT

Table 1: Examples of expenditure on exploration and prospecting: current and proposed treatment

Expenditure	Current treatment	Proposed treatment
<i>Tangible depreciating assets</i>		
Offshore and onshore drilling rigs, integrated geophysical survey aircraft, seismic survey assets, hydrophones, global positioning systems, ground penetrating radar systems, cabling, messing and sleeping huts, etc.	Immediately deductible if it satisfies s40-80	Immediately deductible if it satisfies the current s40-80
<i>Intangible depreciating assets</i>		
Mining, quarrying or prospecting rights issued or awarded by a relevant Commonwealth, State or Territory authority	Immediately deductible if it satisfies s40-80	Immediately deductible if it satisfies the current s40-80
Mining, quarrying or prospecting rights acquired as part of an eligible farm-out arrangement	Immediately deductible if it satisfies s40-80	Immediately deductible if it satisfies the current s40-80, to the extent that the cost is the non-cash exploration benefit provided by the farmee to the farmor

Table 1: Examples of expenditure on exploration and prospecting: current and proposed treatment (continued)

Expenditure	Current treatment	Proposed treatment
Mining, quarrying or prospecting right acquired from another entity	<p>If it satisfies s40-80 – immediately deductible.</p> <p>Otherwise – deductible over the life of the mine, quarry or petroleum field (as per s40-95(10))</p>	<p>If it satisfies the current s40-80 – deductible over the shorter of 15 years or effective life of the mine, quarry or petroleum field to which it relates. If exploration is unsuccessful, the remaining value will be written off when this is established.</p> <p>Otherwise – deductible over the life of the mine, quarry or petroleum field (as per s40-95(10))</p>
Geoscience survey data acquired from a relevant Commonwealth, State or Territory authority (for example, Geoscience Australia)	Immediately deductible if it satisfies s40-80	Immediately deductible if it satisfies the current s40-80
Taxpayer expenditure on creating mining, quarrying or prospecting information	Immediately deductible if it satisfies s40-80	Immediately deductible if it satisfies the current s40-80

Table 1: Examples of expenditure on exploration and prospecting: current and proposed treatment (continued)

Expenditure	Current treatment	Proposed treatment
Mining, quarrying or prospecting information acquired from another entity	<p>If it satisfies s40-80 – immediately deductible.</p> <p>Otherwise – deductible over its effective life.</p>	<p>If it satisfies the current s40-80 and relates to a mine, quarry or petroleum field – deductible over the shorter of 15 years or effective life of the mine, quarry or petroleum field. If exploration is unsuccessful, the remaining value will be written off when this is established.</p> <p>If it does not satisfy the current s40-80 and relates to a mine, quarry or petroleum field – deductible over the life of the mine, quarry or petroleum field</p> <p>Otherwise – deductible over its effective life</p>
<i>Other capital expenses</i>		
For example, wages, contractor’s fees, administration, accommodation and transport costs	Immediately deductible if satisfy s40-730	Immediately deductible if satisfy s40-730

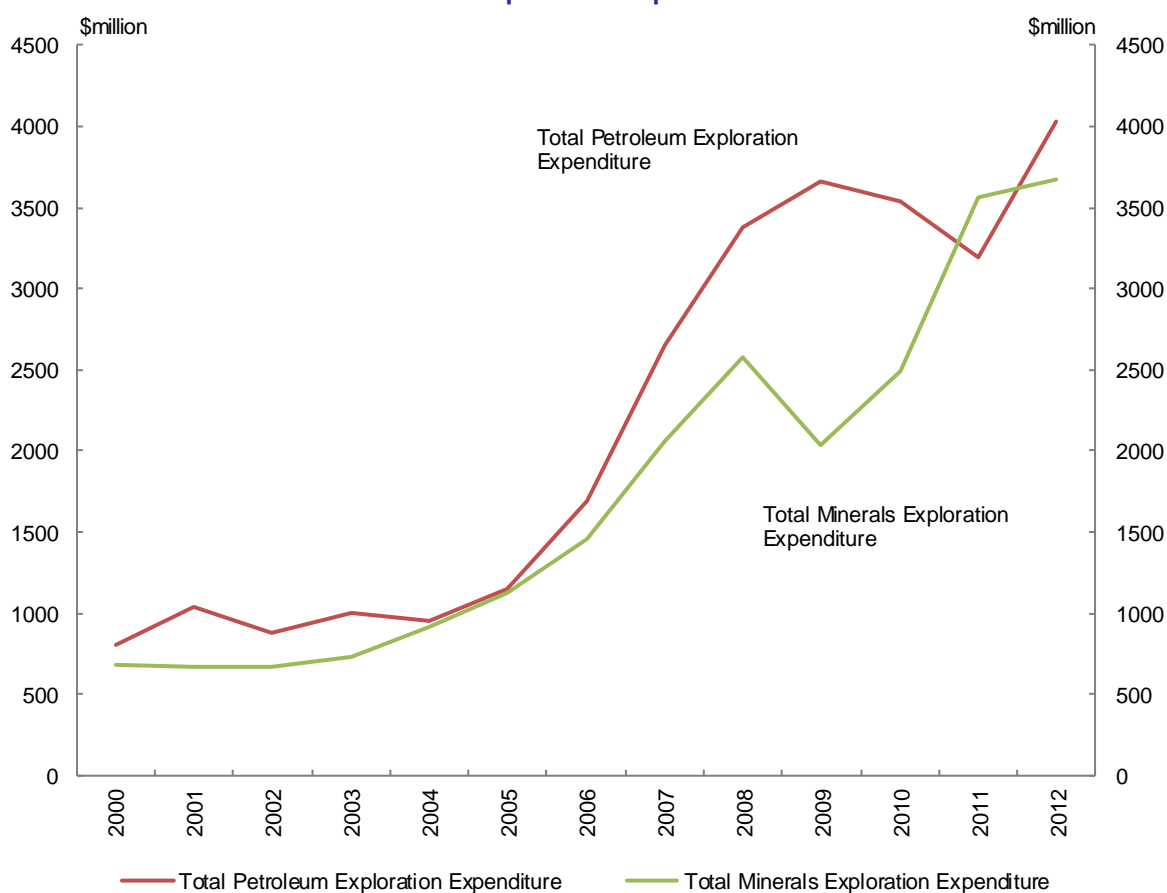
4. BACKGROUND

4.1 RESOURCE EXPLORATION IN AUSTRALIA

29. The resources exploration sector is critical to the prosperity of Australia's resource industry. The sector identifies and assesses the quality of deposits that are then able to be developed into production. This production helps support Australia's economic growth into the future.

30. Expenditure in the resource exploration sector has been particularly high over the last decade, driven in part by increasing costs.

Chart 1: Resources exploration expenditure in Australia



Source: ABS, 8412.0 Mineral and Petroleum Exploration.

4.2 TAX TREATMENT OF EXPENDITURE FOR RESOURCE EXPLORATION

31. Australia's income tax law has long allowed an immediate deduction for some expenditure on assets used in relation to exploration and prospecting activities.

32. The income tax law defines exploration and prospecting to include a number of activities ordinarily carried out for exploration purposes, including geological mapping, geophysical surveys, exploratory drilling and studies to evaluate the economic feasibility of mining or quarrying (section 40-730 ITAA 1997).

33. Exploration does not, however, include expenditure on developing or operating a mine, quarry or petroleum field.

34. The tax law currently provides that the cost of any depreciating asset that is first used for exploration or prospecting is immediately and fully deductible under the capital allowance provisions, provided one of three tests is satisfied:

34.1. the taxpayer carried on general mining operations, petroleum mining operations or quarrying operations;

34.2. it would be reasonable to conclude that the taxpayer proposed to carry on such operations; or

34.3. the taxpayer carried on a business of, or a business that included, exploration or prospecting for minerals (including petroleum) or quarry materials obtainable by such operations and the expenditure was necessarily incurred in carrying on that business (section 40-80 ITAA 1997).

35. Depreciating assets are those assets that have a limited effective life and that are reasonably expected to decline in value over time as the asset is used. Land and trading stock are specifically excluded. Since 2001, mining, quarrying or prospecting rights and information have been specifically included as depreciating assets, along with selected other intangible assets (section 40-30 ITAA 1997). (Prior to this time there was some scope, subject to conditions, to depreciate the cost of a mining right over the life of the mine or 10 years. There was no specific provision for information.)

36. Where a mining, quarrying, or prospecting right is not first used for exploration, or the taxpayer does not satisfy the activity tests, the cost of the right must be depreciated over the life of the mine, petroleum field or quarry to which it relates, or any potential mine, petroleum field or quarry (subsections 40-95(10) and (11) ITAA 1997). A mine may have a life of many decades.

37. Expenditure on exploration or prospecting for minerals, petroleum, or quarry materials that is not the cost of a depreciating asset is fully deductible in the year in which it is incurred (section 40-730 ITAA 1997).

38. No deduction is available under either section 40-80 or 40-730 if the asset is used for, or the expenditure is on, development drilling for petroleum or operations in the course of working a mining or quarrying property or petroleum field.

39. The expense related to carrying out some exploration activities may have a revenue character and be deductible under the general deduction provision in section 8-1 of the ITAA 1997.

40. Capital expenses that are not otherwise deductible as the cost of a depreciating asset or under section 40-730 may be deductible through a mining or infrastructure project pool over the life of the project (sections 40-830 to 40-860 ITAA 1997), as 'black hole' expenditure (section 40-880 ITAA 1997), or result in a change in an asset's capital gains tax cost base.

4.3 FARM-IN, FARM-OUT ARRANGEMENTS

41. Under a 'farm-in, farm-out' arrangement, a mining tenement holder (the farmor) agrees to provide another party (the farmee) with an interest in its mining tenement, generally in return for

the farmee carrying out certain exploration commitments. The farmor is often a small explorer and the farmee a larger miner.

42. There are typically two classes of farm-out arrangement, an immediate transfer farm-out arrangement and a deferred transfer farm-out arrangement (specified in the Australian Taxation Office’s Miscellaneous Tax Rulings MT 2012/1 and MT 2012/2).

4.3.1 Immediate transfer farm-out arrangements

43. Under an immediate transfer farm-out arrangement, an obligation to transfer a percentage interest in a mining tenement from a farmor to a farmee arises for the farmor upon entry into the agreement. Typically, the farmor and farmee will also establish a joint venture or, if a joint venture is already in existence, the farmee will become a joint venturer along with the other parties to the joint venture arrangement.

Table 2: Characteristics of an immediate farm-out arrangement

<i>The farmor</i>	<i>The farmee</i>
<ul style="list-style-type: none"> • Transfers a percentage interest in the mining tenement to the farmee (leaving the farmor with a reduced percentage interest in that mining tenement); • May also share mining information with the farmee as part of that transfer. 	<p>Undertakes:</p> <ul style="list-style-type: none"> • exploration commitments which may be referable to: a period of time; an amount; a schedule of works; or a combination thereof; or • to make cash payments to the joint venture on behalf of the farmor to meet cash calls that the farmor would otherwise be obliged to meet in respect of the farmor’s retained interest in the mining tenement. • May also make cash payments to the farmor. These payments may, or may not, be referable to the exploration costs the farmor has incurred prior to the farm-out arrangement being entered into; • May also make cash payments to third parties to meet expenses incurred by the farmor thereby relieving the farmor from meeting those expenses.

44. Under the current law, due to the interaction between sections 40-80, 40-730 and other provisions of the tax law, immediate transfer farm-out arrangements have no tax consequences for farmors and farmees to the extent that they do not involve payments of cash between the parties.

45. In a simple case, the lack of tax consequences under the current law is because:

45.1. The farmor is assessed on the consideration (that is, the exploration benefit) it receives in exchange for the tenement. Thus, the transfer of the interest in the mining tenement to the farmee is a balancing adjustment event, with the result that an amount is included in the farmor’s assessable income.

45.2. The farmor is also entitled to a matching deduction for its expense (that is, the interest in the mining tenement) used to acquire the exploration benefit. The deduction is claimed under section 40-730 ITAA 1997 for the value of the interest in the mining tenement, to the extent that it has been exchanged for the exploration benefit.

45.3. The farmee is assessed on the income (that is, the interest in the mining tenement) it earns in return for the provision of exploration services.

45.4. The farmee is also entitled to a deduction for its expense in providing the exploration services (section 40-730 or section 8-1 ITAA 1997). In addition, if the farmee's interest in the mining tenement is first used for exploration, it is entitled to an immediate deduction for its cost in acquiring the depreciating asset. (This cost is the value of exploration benefit provided to the farmee.)

46. Without a carve out for an immediate farm-out arrangement, the targeting of the immediate deduction for depreciating assets first used for exploration may, in some circumstances, result in the farmee not being able to offset income with an immediate deduction. Instead the farmee would be required to deduct the decline in value of the depreciating asset across a number of years.

4.3.2 Deferred transfer farm-out arrangements

47. Under a deferred transfer farm-out arrangement, the terms of the arrangement specify that the transfer of an interest in the mining tenement from the farmor to the farmee occurs only after the farmee has met all of the exploration commitments and any payment requirements to earn that interest (collectively referred to as the earn-in requirements) within a specified period of time (the earn-in period).

Table 3: Characteristics of a deferred farm-out arrangement

<i>The farmor</i>	<i>The farmee</i>
<ul style="list-style-type: none"> • Provides the farmee with a right (akin to an option) to acquire an interest in a mining tenement by satisfying the earn-in requirements over the earn-in period. • Provides the farmee with exclusive use and access rights (akin to a licence). • Transfers a percentage interest in the mining tenement to the farmee at the end of the earn-in period if the farmee exercises the right to acquire the interest in the mining tenement (and all necessary approvals are granted). This leaves the farmor with a reduced percentage interest in that mining tenement. • May also share mining information with the farmee. 	<ul style="list-style-type: none"> • Undertakes exploration commitments, which may be referable to a period of time, an amount(s), a schedule of works, or a combination thereof. Under the terms of the agreement, the exploration commitments may to some extent be mandatory but most, if not all, of the exploration commitments will be at the discretion of the farmee. • May also make cash payments to the farmor. These payments may, or may not, be referable to the exploration costs the farmor has incurred prior to entering into the deferred transfer farm-out arrangement. Payment(s) may also be made at the time of exercising the right to acquire, or upon transfer of, the interest in the mining tenement. • May also make cash payments to third parties to meet expenses incurred by the farmor thereby relieving the farmor from meeting those expenses.

48. There are a wider variety of arrangements covered under the deferred transfer farm-out ruling than under the immediate transfer farm-out ruling, including:

48.1. the granting of the right to acquire an interest in a mining tenement;

48.2. the granting of exclusive use and access rights;

48.3. the provision of exploration benefits by the farmee but no transfer of any interest in the mining tenement; and

48.4. the sharing of mining information.

These variations do not engage areas of tax law subject to change as a result of this proposal and thus are not discussed further.

49. The deferred transfer farm-out arrangements also include the provision of an exploration benefit by the farmee and the transfer of an interest in the mining tenement by the farmor. The tax consequences of these actions will be very similar to the tax consequences noted above for immediate transfer farm-out arrangements. The key difference is that the farmor will usually only transfer the interest in the mining tenement once the exploration benefit has been provided in full. As a result, the relevant tax consequences will flow at the end of the arrangement rather than at the start.

50. The farm-out arrangements recognised in the Australian Taxation Office rulings are arrangements used in the resources industry which do not generally give rise to integrity concerns. This is, in part, because there are inherent limitations on the consideration (that is, the exploration benefit) that is able to be provided in exchange for the tenement under any particular arrangement.

51. If farm-out arrangements did not result in a zero tax outcome for the parties involved, they may not be used to carry out exploration.

4.4 INTEREST REALIGNMENTS AND TENEMENT SWAPS

52. The Government is aware of two broad categories of industry practice relating to the exchange of various types of mining, quarrying or prospecting rights — ‘interest realignments’ and ‘tenement swaps’.

53. The first is where interests in rights used in a resources joint venture are realigned between the parties to the venture but the overall ownership interests in the joint venture do not change in any substantial way. The second includes other situations where rights are swapped in the course of a transaction, and there is a substantial change in overall ownership.

4.4.1 Interest realignments

54. Interest realignments are situations where the parties to a joint venture exchange interests in mining rights, with a view to aligning the ownership of individual rights with the ownership of the overall venture. Importantly, no substantial change in the overall ownership of the joint venture arises out of the transactions.

54.1. For example, if a joint venture is owned by two parties each having a 50 per cent interest, then there would be an exchange of interests in each underlying permit to ensure that both parties have 50 per cent ownership of every permit.

4.4.2 Tenement swaps

55. Tenement swaps are situations where a party acquires an interest in a mining right, in exchange for an interest in a separate mining right. In these cases, there is a substantial change in the ownership of the project. This might occur because the parties to a joint venture wish to bring in a

partner with new expertise, or because the parties wish to consolidate interests to expedite development.

55.1. For example, if a joint venture is owned by two parties each having a 50 per cent interest, and one party wishes to exit the joint venture then it could swap its interest with a party that wishes to join the joint venture, in exchange for an interest of similar value in completely unrelated resources.

4.4.3 Current treatment

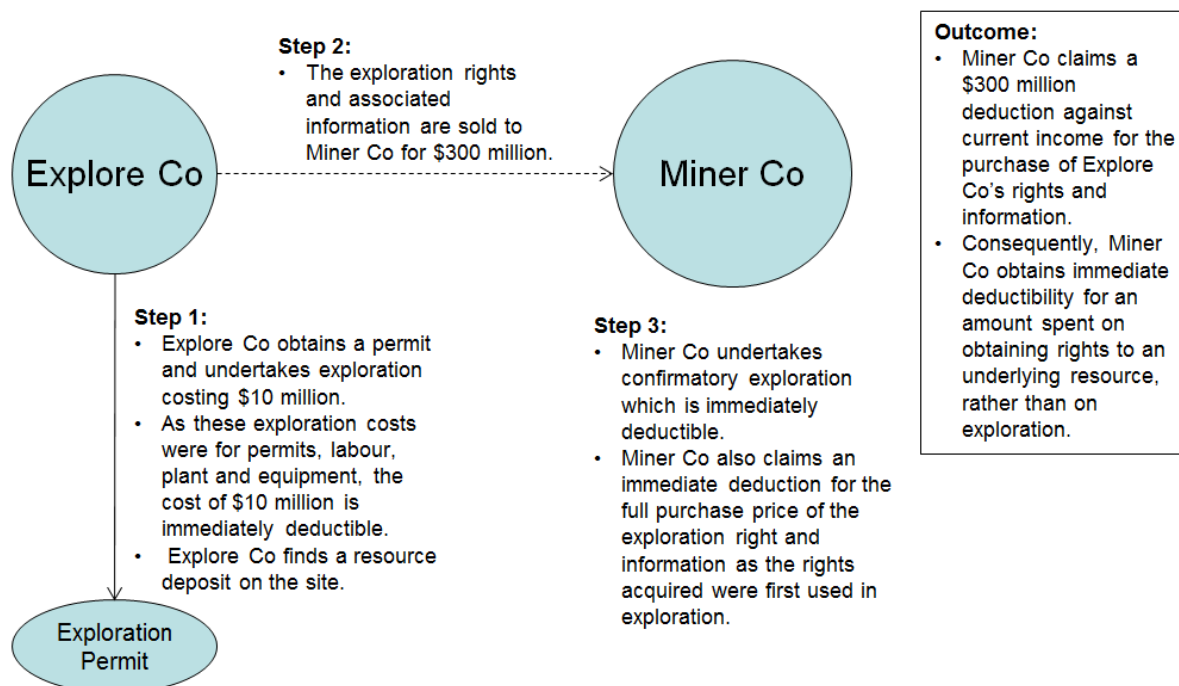
56. As discussed above, the usual tax treatment for a depreciating asset used for taxable purposes is that a taxpayer is entitled to a deduction equivalent to the annual decline in value of the asset, given its effective life. The decline in value of a depreciating asset is calculated on the basis of the cost of the asset to the taxpayer.

57. Generally, where an asset has been acquired for non-cash consideration, the first element of the asset's cost is taken to be the market value of that non-cash consideration.

58. This means that in these 'swap' transactions the first element of the cost base of the acquired asset is the market value of the mining right that is transferred to the counterparty.

59. If the taxpayer satisfies the conditions of section 40-80 ITAA 1997, the cost of a mining right acquired through a swap transaction would be immediately deductible. In other cases, the taxpayer would be entitled to a deduction equivalent to the annual decline in value of the mining right, given its effective life.

5. APPENDIX



Issue: Obtaining an immediate deduction for amounts that are not in substance expenditure on 'exploration'.

Outcome: This example illustrates the scope for mining companies to claim an immediate deduction for depreciating assets first used in exploration for what is in substance the cost of gaining access to natural resources for production and development. This can include treating the cost of acquiring mining or prospecting rights as exploration expenditure notwithstanding these costs essentially reflect the gain that is expected from exploiting the underlying resources.

Scenario: As illustrated in the diagram above, a mining company (Miner Co) acquires a prospecting right from an exploration company (Explore Co) for \$300 million.

Explore Co had conducted considerable exploration activity in the area covered by the right and had appropriately obtained immediate tax deductions for expenditure on those activities. Assume these costs were \$10 million.

Explore Co's work revealed resources with considerable potential for commercial exploitation.

The \$300 million price Miner Co pays for the prospecting right reflects not only the value of the exploration work previously undertaken but also the likely value of the resources discovered. The exploration right in this circumstance represents an enduring asset whose cost should be allowable as a deduction as its economic benefits are realised over its useful life.

Miner Co contends that it is entitled to an immediate deduction for the \$300 million on the basis that first use of the right is (in its hands) 'for exploration'. Miner Co may undertake some minor 'confirmatory' exploration work in relation to matters previously considered by Explore Co, and, perhaps, some additional, but minor, commercial feasibility analysis.