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Despite their widespread use in the resources industry, there has long been uncertainty over the income tax treatment of farmout arrangements. Accordingly, the release of two taxation rulings dealing with the income tax and GST consequences of farmout arrangements, MT 2012/1 and MT 2012/2 (the farmout rulings), is to be welcomed for the added certainty that they may bring. This article examines two questions raised by these rulings. First, in seeking a pragmatic outcome, has the Commissioner adopted a technically correct income tax treatment? That is, does the farmee provide benefits to the farmor for the assets farmed out, within the cost and balancing adjustment event provisions of the uniform capital allowance regime? Secondly, even if the key income tax thesis is correct, do the farmout rulings leave unresolved income tax issues, so continuing the uncertainty?

Long is the way

And hard, that out of hell leads up to light.¹

INTRODUCTION

Despite their widespread use in the resources industry, there has long been uncertainty over the income tax treatment of farmout arrangements. In general terms, a farmout involves an agreement between a person who holds an interest in a resource tenement (farmor) and another person (farmee), under which the farmee agrees to incur expenditure or undertake exploration in relation to the tenement, in return for which the farmor agrees to transfer part, but not all, of its interest. Much of the uncertainty arises because the income tax legislation does not contain specific provisions for farmouts and hence leaves a number of questions unanswered. Should the farmor recognise income or a gain from the part disposal of its interest in assets? What tax cost or deduction should the farmee be entitled to? The position is complicated by the tension between the perspective that a farmor does not receive benefits when the farmee conducts exploration activities – other than a reduction in risk and the attraction of additional capital to the exploration effort – and the concern that farmout arrangements may be used to achieve tax advantaged disposals of resources assets.²

In the absence of relevant case law, the release of two taxation rulings dealing with the income tax and GST consequences of farmout arrangements, Miscellaneous Taxation Ruling MT 2012/1 and Miscellaneous Taxation Ruling MT 2012/2 (the farmout rulings),³ is to be welcomed for the added certainty that they may bring. That is particularly so because the farmout rulings address the tension identified above by adopting a relatively pragmatic approach. Timing differences aside, they conclude

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¹ Milton J, "Paradise Lost" in Bush D (ed), *The Complete Poetical Works of John Milton* (Houghton Mifflin Company, 1965) p 241 (book II, lines 432-433).

² See Australian Taxation Office (ATO), *Miscellaneous Taxes: Application of the Income Tax and GST Laws to Deferred Transfer Farm-out Arrangements*, Draft Miscellaneous Taxation Ruling MT 2011/D1 at [132]-[141]; Heggart N, *Resources Update*, Paper presented at the Taxation Institute of Australia Western Australian State Convention (Busselton, 9-11 August 2007) p 6; ATO, Ruling Compendium MT 2012/1EC, Item 1; ATO, Ruling Compendium MT 2012/2EC, Item 1.

³ ATO, *Miscellaneous Taxes: Application of the Income Tax and GST Laws to Immediate Transfer Farm-out Arrangements*, Miscellaneous Tax Ruling MT 2012/1 (MT 2012/1); ATO, *Miscellaneous Taxes: Application of the Income Tax and GST Laws to Deferred Transfer Farm-out Arrangements*, Miscellaneous Tax Ruling MT 2012/2 (MT 2012/2).

for income tax purposes that the applicable farmout arrangements should result in no net taxable gain for the farmor (in the absence of cash consideration), but should still potentially permit the farmee to obtain a deduction for the full amount of its exploration expenditure. If monetary consideration is provided, a net taxable gain would generally result for the farmor.

This article examines two questions raised by the farmout rulings. First, in seeking a pragmatic outcome, has the Commissioner of Taxation adopted a technically correct income tax treatment?⁴ That is, does the farmee provide benefits to the farmor for the assets farmed out, within the cost and balancing adjustment event provisions of the uniform capital allowance (UCA) regime? Secondly, even if the key income tax thesis is correct, do the farmout rulings leave unresolved income tax issues?

Parts 1 and 2 outline, respectively, the legal mechanics of farmout arrangements; and the income tax treatment of farmouts, including a summary of the approach adopted in the farmout rulings.

Part 3 tests and validates the Commissioner's assertion that benefits are provided and received for the farmed-out assets under the UCA regime. However, the article questions whether the farmout rulings adequately specify the benefits likely to be received by the farmor and provided by the farmee. In particular, it demonstrates that, for immediate farmouts, the benefit provided or received would typically be contractual rights, which raises the issue of the separate asset analysis employed by the Commissioner for earnouts in draft Taxation Ruling TR 2007/D10 (draft earnout ruling).

Part 4 discusses the continued uncertainty caused by the failure to particularise the benefits provided and received. In particular, this Part examines the potential consequences for the farmor and farmee from the cross-over of the UCA and capital gains tax (CGT) regimes if a separate asset approach is taken to the contractual rights provided/received under an immediate farmout. For instance, might this result in unanticipated gains or losses where amounts or services ultimately delivered differ from the initial estimate? As part of the analysis, the article considers whether the problem can be resolved by adopting a single asset or look-through approach.

Part 5 considers the implications of the ambiguity raised in Part 4 in a specific context which is common for oil and gas farmouts and also potentially relevant for hard rock mining.⁵ That is, a farmout arrangement where the farmee's commitments require the farmee to meet cash calls made by the operator of a joint venture. For farmees who cannot rely on the farmout rulings, this raises the question of whether the partial solution adopted by MT 2012/1 to the UCA/CGT overlap issues of permitting the farmee deductions for free-carry payments is actually available. The article argues that it is not, and proposes an alternative solution.

PART 1: LEGAL MECHANICS OF FARMOUT ARRANGEMENTS

Although it has no set legal meaning, in the resources context, a farmout typically involves an agreement between the holder of an interest in a mineral or petroleum title (the farmor) and another person (the farmee) under which:⁶

- the farmee agrees to incur expenditure or carry out work in relation to the title;

⁴The income tax focus accords with the Australian Petroleum Production & Exploration Association's assessment of the primary importance of income tax for petroleum producers: Australian Petroleum Production & Exploration Association, *Submission to Australia's Future Tax System Review* (2008) p 25, http://taxreview.treasury.gov.au/content/submissions/pre_14_november_2008/APPEA.pdf viewed 22 September 2012.

⁵ Association of Mining and Exploration Companies and Minerals Council of Australia, *Submission to Australian Taxation Office: Draft Miscellaneous Taxation Ruling MT 2011/D2* (11 October 2011) p 5.

⁶ See, for example, Wilkinson J, *Introduction to Oil & Gas Joint Ventures* (Oilfield Publications, 1997) p 172; Martyn D, "Exploration, Appraisal and Development Farmout Agreements" in Martyn D (ed), *Upstream Oil and Gas Agreements* (Sweet & Maxwell, 1996) p 33; Birch C, "Choosing the Right Joint Venture Structure for a Farmin or Farmout" (2002) 5(1) *Journal of Australian Taxation* 60 at 61, 64-65; Maxwell R, Martin P and Kramer B, *The Law of Oil and Gas: Cases and Materials* (8th ed, Foundation Press, 2007) pp 757-758.

- in return for the farmee's expenditure, the farmor agrees to transfer part of its interest in the title and associated assets;⁷ and
- the farmor retains an interest in the title and associated assets.

Sometimes, a farmout agreement may expressly provide for additional consideration, such as a cash payment.⁸ However, the nature of the farmee's obligations and the retention of part of the farmor's interest in the title and associated assets are the chief characteristics distinguishing a farmout from the straight sale of assets. Accordingly, at least to the extent that the farmout arrangement concerns these matters rather than providing for additional consideration, the commercial reality is that the farmor is not attempting to "recoup" their investment in the assets, but rather to retain an interest in the potential benefits that may flow from those assets and to improve the value of those assets by securing additional exploration.⁹ Indeed, while there are various reasons for entering into farmouts, key concerns are usually to permit the farmor to share the costs and risks of exploration or development of the tenement.¹⁰

The assets to which a farmout may apply include: petroleum or mineral titles (such as petroleum exploration permits, petroleum retention leases, petroleum production licences and their hard rock equivalents), information, plant, infrastructure and joint operating/venture agreement rights where the farmor is already a participant in a joint venture. This article focuses on farmouts relating to projects in the exploration phase.

In terms of the legal mechanics, there are two broad types of farmout:

- "Immediate" farmout. Under these arrangements, the farmee acquires an up-front transfer of an interest in the petroleum title and related assets in return for agreeing to meet its percentage share of future expenditure, and to also meet a set quantum of the farmor's expenditure obligations or to carry out set work commitments.¹¹ Work commitments might include drilling a well or conducting seismic surveys. The agreement would typically include a defeasance condition or a mechanism for reconveyance of the interest if the farmee fails to meet its obligations.¹²
- "Deferred" farmout. Under these arrangements, the farmee does not obtain an upfront transfer of an interest in the title and related assets¹³ but instead obtains an interest (conditional deferred), or an option to acquire the interest (optional deferred),¹⁴ if the farmee incurs an agreed quantum of expenditure or carries out agreed work commitments.¹⁵

Upon transfer of the interest farmed out, the parties would typically enter into a joint venture or joint operating agreement.¹⁶ Under this agreement it is usual for one of the parties, or for another entity, to adopt the role of "operator" of the joint venture, comprising activities such as conducting negotiations

⁷ In some cases, an alternative interest, such as a "royalty" or production payment right may be provided: Birch, n 6 at 73.

⁸ Young D, *Contract Rights and Agreements: Tips and Tricks*, Paper presented at the Taxation Institute of Australia seminar Hot Tax Issues for Resource Companies (Perth, 3 August 2006) p 4; Herd P, "Capital Gains – Some Practical Problems" (1988) 23(5) *Taxation in Australia* 291 at 293.

⁹ Thompson A, "Oil and Gas Farmin and Farmout Agreements: Issues and Approaches from the Farmor's Perspective" (2005) *AMPLA Yearbook* 241 at 248-250.

¹⁰ See, for example, Taxation Ruling IT 2378 at [4]; Martyn, n 6, p 33; Birch, n 6 at 65-67; Gately D, "Farmouts and Capital Gains: The Cost of Doing Business" (1987) 6(2) *AMPLA Bulletin* 58 at 58.

¹¹ Young, n 8, p 11; Martyn, n 6, p 38.

¹² Frecker D, *Oil and Gas Farmin and Farmout Agreements: Issues and Approaches from the Farmee's Perspective*, Paper presented at the AMPLA 29th Annual Conference (Sydney, 24-27 August 2005) pp 5-6; Martyn, n 6, p 38.

¹³ Although a farmout agreement would often provide a farmee with a licence to access and use information about the tenement obtained before and after entry into the agreement: Martyn, n 6, p 38.

¹⁴ The option might involve a separate exercise step or be exercised on satisfying the expenditure requirements as in *Amoco Minerals Australia Co v Commissioner of State Taxation (WA)* (1978) 8 ATR 719 at 721 (Jones J).

¹⁵ Young, n 8, p 11; Martyn, n 6, p 38; Birch, n 6 at 67; *Petroleum Financial Corp v Cockburn* 241 F 2d (5th Cir, 1957) 312 at 313-314.

¹⁶ See, for example, Association of International Petroleum Negotiators (AIPN), *International Model Farmout Agreement* (2004) (AIPN Agreement), Arts 2.2, 5.1.

with third parties like governments and financiers, engaging and co-ordinating staff, and overseeing the “internal relationship of the joint venture” between the operator and the parties.¹⁷

PART 2: INCOME TAX TREATMENT OF FARMOUTS

Context

The Income Tax Assessment Acts do not contain specific provisions for farmouts, which has resulted in much uncertainty for the taxation of farmout arrangements.¹⁸ The farmout rulings address the UCA provisions, CGT regime, ordinary income rules, general deduction provision and specific items of statutory income, such as amounts received for providing mining information in relation to farmouts. The key provisions for most farmouts involving petroleum or mining assets that started to be held from 1 July 2001,¹⁹ and the prime focus of the farmout rulings, are the UCA rules.

The UCA regime permits taxpayers to deduct the statutory decline in value of “depreciating assets” held during an income year if certain conditions are satisfied.²⁰ If they started to be held from 1 July 2001, most of the petroleum or mining assets discussed above, including the tenements, would be depreciating assets.²¹

Since the deductions are based on a statutory formula, the amount a taxpayer receives for stopping to hold a depreciating asset may differ from its depreciated value. The UCA regime therefore contains “balancing adjustment” provisions.²² For the farmor, entry into a farmout will potentially result in a “balancing adjustment event”. Such an event will occur when the farmor stops “holding” a part of its interest in a petroleum asset that is a depreciating asset; for instance, because the farmor has transferred part of its interest.²³

Under a balancing adjustment event, the farmor must include an amount in assessable income if the “termination value” for the depreciating asset is more than its “adjustable value” (broadly, for a tenement, the amounts paid for the interest in the tenement, less the decline in value deductions allowed). Conversely the farmor is entitled to a deduction if the “termination value” is less than the “adjustable value”.²⁴ Where a project is at the exploration stage, the adjustable value of the farmor’s depreciating assets is likely to be nil, due to the potential availability of an upfront deduction where an asset is first used for exploration or prospecting.²⁵ Therefore, if the depreciating assets have any termination value, the farmor is likely to have an amount of assessable income.

¹⁷ Hewitt I, *Hewitt on Joint Ventures* (5th ed, Sweet & Maxwell, 2011) pp 87-88. See also *Energy and Resources Law in Australia* (LexisNexis looseleaf service) at [222.570] viewed 18 January 2012.

¹⁸ See, for example, Bryant S and Willment R, *Lifecycle of a Resources Project*, Paper presented at the Taxation Institute of Australia South Australian Division Conference (Adelaide, 26 November 2008) p 6; Kelly J, *Capital Allowances*, Paper presented at the Taxation Institute of Australia National Resources Tax Conference (Perth, 14-15 October 2009) p 17; Birch, n 6 at 61. Other pieces of tax legislation do include farmout specific provisions. See *Minerals Resource Rent Tax Act 2012* (Cth), s 70-35(7) (and see also s 35-35 and Div 195); Explanatory Memorandum to the *Minerals Resource Rent Tax Bill 2011* (Cth) pp 106-107, 239.

¹⁹ *Income Tax Assessment Act 1997* (Cth) (ITAA 1997), Div 40. As to the date of application of the UCA regime, see *New Business Tax System (Capital Allowances) Act 2001* (Cth), Sch 1, Item 2.

²⁰ ITAA 1997, s 40-25(1).

²¹ Provided they are not held as trading stock: ITAA 1997, ss 40-30(1)(b), 40-30(2).

²² Similar adjustment provisions apply in relation to any project pool deductions a farmor may have under ITAA 1997, Subdiv 40-I for specified expenditure which does not form part of the cost of a depreciating asset.

²³ ITAA 1997, s 40-295(1)(a). See also s 40-115 in respect of splitting a depreciating asset.

²⁴ See ITAA 1997, s 40-285(1)-(2).

²⁵ ITAA 1997, s 40-80(1). The statutory decline in value of a depreciating asset is equal to its cost in the year that a taxpayer starts to hold it where: the asset is first used for exploration or prospecting for minerals (including petroleum) obtainable by mining operations; the asset is not first used for development drilling for petroleum or operations in the course of working a mining property or petroleum field; and the taxpayer carries on mining operations, it would be reasonable to conclude that the taxpayer proposes to do so or the taxpayer carries on a business of exploration or prospecting for minerals obtainable by such operations and the expenditure on the asset was necessarily incurred in carrying on that business.

The farmee will be interested in its ability to deduct the decline in value of depreciating assets that it starts to hold as a result of the farmout arrangement. The decline in value is based on the cost of the depreciating asset, which would typically include amounts which mirror those included in the termination value for the farmor, and could potentially result in an upfront deduction where the test of first use for exploration or prospecting and other requirements are met.²⁶ In addition, exploration or prospecting expenditure incurred by the farmee which does not form part of the cost of a depreciating asset, may be deductible under s 40-730(1) of the *Income Tax Assessment Act 1997* (Cth) (ITAA 1997).

Farmout rulings

Uncertainty for farmouts under the UCA regime has been exacerbated by over 10 years' delay between the commencement of the UCA rules and the release of the farmout rulings. That uncertainty has now been partially resolved although it is not assisted by the fact that both farmout rulings apply from the date of issue of the relevant earlier draft ruling,²⁷ rather than from 1 July 2001.²⁸ MT 2012/1 concerns immediate farmouts, while MT 2012/2 concerns deferred farmouts. Both adopt a relatively pragmatic approach for income tax purposes, concluding that the relevant farmout arrangements (leaving timing differences aside):

- should result in no net taxable gain for the farmor (in the absence of cash consideration) should result in a net taxable gain for the farmor if cash consideration is provided; and
- should potentially permit the farmee to obtain a deduction for the full amount of its exploration expenditure (which may include, for instance, free-carry payments).

The following table explains, in abbreviated form, how the rulings reach this result. As can be seen from the table, central to each ruling is the analysis that the farmee is providing “exploration benefits” (consisting of services, or rights to services)²⁹ and, potentially, monetary consideration or rights to monetary consideration, to the farmor in return for the assets farmed out.³⁰

Event	Immediate		Deferred	
	Farmor	Farmee	Farmor	Farmee
Farmor grants option to farmee to acquire farmout assets on terms of farmout agreement for no/cash payment.	N/A	N/A	Assuming the grant is on capital account, potential capital gain (from CGT event D2) based on the cash payment (if any) less the expenditure incurred in granting the option. See MT 2012/2 at [39]-[40], [117], [127]. A capital loss might also be made. <i>Subsequently disregarded if option exercised.</i> See MT 2012/2 at [57], [117], [127].	Assuming acquisition on capital account, cost base acquired in the option will include the cash payment (if any). See MT 2012/2 at [41], [117], [127]. The Commissioner considers that on exercise of the option the farmee will make a capital loss equal to its cost base in the right (under CGT event C2). See MT 2012/2 at [42], [117], [127].*

²⁶ ITAA 1997, ss 40-25(1), 40-80(1), 40-185(1)(b).

²⁷ That is, after 27 July 2011 for MT 2012/1; and after 24 August 2011 for MT 2012/2.

²⁸ MT 2012/1 at [80]; MT 2012/2 at [123]. This has also been confirmed in the relevant ruling compendiums in which the Commissioner responded to comments on the draft farmout rulings: Ruling Compendium MT 2012/1EC, Item 4; Ruling Compendium MT 2012/2EC, Item 8.

²⁹ MT 2012/1 at [92]; MT 2012/2 at [29], [135].

³⁰ MT 2012/1 at [15]-[16]; MT 2012/2 at [20], [29].

Event	Immediate		Deferred	
	Farmor	Farmee	Farmor	Farmee
Farmor grants use and access rights to farmee for no/cash payment.	N/A	N/A	Cash payment (if any) is ordinary income for the farmor and assessable under the ITAA 1997, s 6-5. See MT 2012/2 at [43]-[45], [117], [127].	Cash payment (if any) likely immediately deductible to the extent on revenue account (ITAA 1997, s 8-1) and to the extent otherwise, will be a capital loss when the rights end (CGT event C2). See MT 2012/2 at [46]-[47], [117], [127].
Farmee provides no/cash payment and exploration services for farmed-out assets / to satisfy option conditions so that option can be exercised to acquire farmed-out assets	<p>(1) Cash payment or market value[#] of right to cash payment (if any) and market value of exploration services included in the termination value of UCA assets for balancing adjustment event purposes. See MT 2012/1 at [15]-[16], [24]-[27], [77], [83].</p> <p>(2) Farmor obtains a deduction equal to the extent of the market value of the farmed-out assets which are provided for exploration services (deemed equal to the market value of the exploration services), on the basis that the transfer is expenditure for exploration or prospecting by the farmor. See MT 2012/1 at [28]-[30], [73], [110]-[121]], on the basis that ITAA 1997, s 40-730(1) applies.</p>	<p>(1) Cash payment or market value of right to cash payment (if any) and market value of exploration services are likely deductible in full. This is on the basis that these items comprise the cost of the farmed-out assets for UCA purposes and that the farmee can deduct a decline in value equal to their cost (likely, if first used for exploration or prospecting). See MT 2012/1 at [40]-[43], [71]-[73], [84].</p> <p>(2) Farmee receives assessable income equal to the extent of the market value of the farmed-out assets which are provided for exploration services (deemed equal to the market value of the exploration services), on the basis that the farmee is providing services for reward on revenue account or to which s 15-2 ITAA 1997 applies. See MT 2012/1 at [55], [73], [132]-[134], on the basis that ITAA 1997, s 6-5 or s 15-2 apply. <i>If no cash/right to cash, (1) and (2) potentially net out.</i></p>	<p>(1) Cash payment (if any), market value of exploration services and capital proceeds for grant of the option (if any) are included in the termination value of UCA assets for balancing adjustment event purposes. See MT 2012/2 at [48]-[51], [115]-[117], [269].</p> <p>Assuming the adjustable value (broadly, the cost of the asset less its decline in value) is likely to be nil for exploration or prospecting stage assets (see ITAA 1997, s 40-80(1)), a balancing adjustment amount is included in assessable income, equal to the difference between the termination value and the adjustable value. See MT 2012/2 at [49]-[50], [115]-[117].</p> <p>(2) Deduction as for immediate farmout. See MT 2012/2 at [52]-[56], [162]-[163], on the basis that ITAA 1997, s 40-730(1) applies. <i>If no cash, (1) and (2) potentially net out.</i></p>	<p>(1) Cash payment (if any), market value of exploration services and cash payment for the grant of the option (if any) are likely deductible in full. This is on the basis that these items comprise the cost of the farmed-out assets for UCA purposes and that the farmee can deduct a decline in value equal to their cost (likely, if first used for exploration or prospecting). See MT 2012/2 at [64]-[67], [115]-[117].</p> <p>(2) Assessable income as for immediate farmout. See MT 2012/2, [70]-[71], [173]-[175], on the basis that ITAA 1997, s 6-5 or s 15-2 apply. <i>If no cash, (1) and (2) potentially net out.</i></p>

Event	Immediate		Deferred	
	Farmor	Farmee	Farmor	Farmee
Farmee incurs expenditure on exploration activities in meeting its farmout commitments.		Farmee potentially obtains a deduction for the amount of the expenditure under s 40-730 (exploration or prospecting expenditure not forming part of the cost of a depreciating asset) or s 8-1 (general deduction) of the ITAA 1997. See MT 2012/1 at [44], [57], [71]-[73].		Deduction as for immediate farmout. See MT 2012/2 at [69], [72], [115]-[117].
Net amount (if no cash payments)	Nil	Exploration expenditure potentially deductible.	Nil	Exploration expenditure potentially deductible.
<p>*The Commissioner appears to ignore ITAA 1997, s 134-1(1), Item 1, which would have the effect that the amount paid for the grant of the option is included in the cost base or reduced cost base of the CGT assets acquired. The Commissioner also does not appear to consider s 134-1(4), which provides that a capital gain or loss made from exercising the option is disregarded.</p> <p># All values referred to in the table are GST exclusive.</p>				

The summary set out above, however, masks significant timing differences that are likely to arise for farmouts extending over more than one income year. This article does not explore the timing issues because its focus is the underlying treatment of the farmout arrangement.³¹

The farmout rulings also address a number of other matters, such as the provision of access to mining information by the farmor to the farmee;³² the existence of rights to reassign a farmed-out interest;³³ and the provision of exploration services without any transfer to the farmee.³⁴

Finally, the farmout rulings only apply to certain specified arrangements,³⁵ which means it will be critical for parties to ensure that the manner in which they implement their farmout is consistent with those requirements.

PART 3: ARE BENEFITS PROVIDED/RECEIVED FOR THE FARMED-OUT ASSETS?

As discussed above, the key reasoning supporting the farmout rulings' income tax treatment is that the farmee is providing exploration benefits, with or without monetary consideration, to the farmor for the assets farmed out. This analysis is critical to the chief UCA issues identified in Part 2:

- for the farmor, whether the farmor receives, in respect of the farmed-out assets, something of value under a balancing adjustment event for the depreciating assets; and
- for the farmee, whether the farmee is able to obtain a deduction in providing exploration benefits for the farmed-out assets.

However, the analysis is not fully developed in the farmout rulings. The significance of testing this reasoning is highlighted by the fact that it appears inconsistent with the approach in Taxation Ruling IT 2378,³⁶ which continues to apply for CGT.

³¹ For a discussion of timing issues see Heggart N, *Tax Certainty for Farm-outs?*, Paper presented at the Taxation Institute of Australia WA Division Seminar (Perth, 26 August 2011).

³² See, for example, MT 2012/1 at [18]-[19], [45], [53]-[54], [129]-[131]; MT 2012/2 at [32]-[34], [80]-[82], [170]-[172].

³³ See MT 2012/1 at [47], [51].

³⁴ MT 2012/2 at [74]-[79].

³⁵ MT 2012/1 at [12]; MT 2012/2 at [13].

³⁶ The market value substitution rule adopted in Taxation Ruling IT 2378 only applied (for arm's-length dealings) where the taxpayer received no consideration in respect of the disposal or that consideration could not be valued. It appears the Commissioner relied on the former ground: at [7].

The rules for determining the “termination value” (for the farmor) and the “cost” of a depreciating asset (for the farmee) set out the requirements for determining these two issues and are further explored below. Each element of the requirements is then applied, leading to the conclusion that the Commissioner should generally be correct that a farmor does receive a benefit from the farmee for the assets farmed out under the UCA regime.

UCA requirements

As identified in the farmout rulings, the relevant components for the “termination value” and “cost” are generally likely to be, first (benefit/liability requirement):³⁷

- any “amount” “received” by the farmor under the farmout, or the “amount” of a “right to receive an amount” when it is granted to the farmor, except to the extent that the right has already been satisfied (for the farmee, any “amount” “pa[id]”, or the “amount” of a “liability to pay an amount”); and
- the market value of any “non-cash benefit” or “right to receive a non-cash benefit” “received” by the farmor under the farmout (or the market value of a “non-cash benefit” “provided” or for which a “liability to provide a non-cash benefit” has been “incurred”).

Two further requirements apply, which are not properly explored in the farmout rulings:

- secondly (received/incurred requirement), the amount, non-cash benefit, or right to receive/liability to provide the amount or non-cash benefit, must have been received by the farmor or paid, provided or incurred by the farmee; and
- thirdly (nexus requirement), a sufficient nexus must exist between that receipt or the incurring and the farmor ceasing to hold/the farmee starting to hold the relevant interest under the farmout.

Each of these requirements is applied below to three broad types of benefits that might be received or provided under a farmout: a specified sum of money paid to, or for the benefit of, the farmor; the incurring of expenditure on the tenement or satisfaction of work commitments in the farmee’s own right (that is, exploration services); and an obligation to pay an unascertainable (at the time of entry into the farmout arrangement) sum of money to, or for the benefit of, the farmor.

Benefit/liability requirement

Specified sum

The term “amount” implies a monetary sum.³⁸ Where the farmee is obliged to pay a specified sum, whether to the farmor or a third party (such as a joint venture operator), consistently with the farmout rulings,³⁹ this is likely to be an “amount” or right to receive/liability to pay an “amount”.⁴⁰ In the case of an immediate farmout, it is the grant of the right to receive an amount that is likely to be relevant, whereas for a deferred farmout, the amount would generally have been received by the time of the balancing adjustment event so that the right/liability is disregarded.⁴¹

Services

In this case, as noted in the farmout rulings,⁴² the farmor may receive a “non-cash benefit” or right to receive a “non-cash benefit”.⁴³ The phrase is defined in s 995-1(1) of the ITAA 1997 as:

property or services in any form except money. If a non-cash benefit is dealt with on behalf of an entity, or is provided or dealt with as an entity directs, the benefit is taken to be provided to the entity.

³⁷ ITAA 1997, s 40-305(1)(b), Items 1, 3, 4, 6; s 40-185(1), Items 1, 2, 4, 5. See also MT 2012/1 at [27]; MT 2012/2 at [51]. Assuming that entry into the farmout does not result in a general-law or tax-law partnership being formed and that the farmor and farmee are dealing at arm’s length.

³⁸ *EMI Australia Ltd v FCT* (1971) 2 ATR 325 at 332. Although an amount may be a nil amount: ITAA 1997, s 995-1(1).

³⁹ MT 2012/1 at [27], [75]-[77]; MT 2012/2 at [51], [115]-[117].

⁴⁰ This would be consistent with the approach taken, in the stamp duty context, in *Chief Commissioner of State Revenue v Dick Smith Electronics* (2005) 221 CLR 496 at [77].

⁴¹ ITAA 1997, ss 40-185(2), 40-305(2).

⁴² MT 2012/1 at [27], [71]-[73]; MT 2012/2 at [51], [115]-[117].

⁴³ See, for example, Bryant and Willment, n 18, p 6.

The Commissioner treats the exploration benefits as the provision of a service or the right to a service rather than a separate piece of property in the farmout rulings.⁴⁴ However, in accordance with several commentators' assertions on the draft farmout rulings, in the context of an immediate farmout, where the contract is not executory, the rights created are likely to constitute property of the farmor unless the agreement makes the identity of the farmor critical to the farmee, so that the rights are personal – for instance, by preventing assignment.⁴⁵ In any event, whether it is characterised as “property” or a “right to receive a non-cash benefit”/“liability to provide a non-cash benefit”, the same value will be included in the “termination value” or “cost” and the point is that separate contractual rights are likely to have been created, which has broader UCA/CGT implications (discussed below).

A deferred farmout agreement would be an executory contract for the farmor so the farmor's rights are unlikely to amount to property.⁴⁶ In addition, if structured as an optional deferred farmout, the farmor would not have any contractual right to require the farmee to undertake work commitments. Nevertheless, in accordance with MT 2012/2, it is likely that the farmee provides “services”. The *Macquarie Dictionary* definition of “services” is: “the performance of any duties or work for another; helpful activity”.⁴⁷ Accordingly, the farmee agreeing to undertake work commitments (including to expend a certain amount), such as drilling a well or carrying out seismic surveys, should constitute services. This approach would also correspond with that taken in *Pancontinental Mining Ltd v Commissioner of Stamp Duties (Qld)*, where the provision of mining information was characterised as the provision of a service.⁴⁸

Unascertainable amount

The result is not as clear for unascertainable amounts. For instance, the amount of a carry provided to the farmor for a set period or until a set event, would be contingent on the making of, and extent of, cash calls by the joint venture operator.

Known amounts will have been paid/received for a deferred farmout. However, for an immediate farmout, the issue is whether the arrangement results in a liability to pay an amount/right to receive an amount, or a non-cash benefit, being proprietary contractual rights. The Commissioner treats such rights to contingent or unascertainable amounts as non-cash benefits in the form of property.⁴⁹ Nevertheless, the *Macquarie Dictionary* defines a “liability” as: “an obligation, especially for payment; debt or pecuniary obligations (opposed to *asset*)”.⁵⁰ A carry would create a present obligation, but with the possibility of payment and the extent of the amount subject to contingencies. That may prevent the obligation amounting to a “debt” on the basis that it is contingent and not a liquidated sum.⁵¹ However, as its definition shows, the term “liability” is broader than “debt” and:

⁴⁴ MT 2012/1 at [83], [87]-[92]; MT 2012/2 at [130]-[135].

⁴⁵ *Hepples v FCT* (1990) 22 FCR 1 at 21-22; 21 ATR 42. This would be consistent with *Allgas Energy Ltd v Commissioner of Stamp Duties (Qld)* (1979) 10 ATR 593 at 597 – the court assumed that an immediate assignment of an interest in farmed-out assets had occurred. In some circumstances contractual rights may still constitute property even if they are not assignable: *FCT v Orica Ltd* (1998) 194 CLR 500 at [90]-[91], [108]-[110], [187]; 39 ATR 66. As to comments on Draft MT 2011/D1, see Ruling Compendium MT 2012/1EC, Item 1. As discussed in this article, the Commissioner's response that the farmor receives a benefit appears correct, but the issue is whether that benefit consists of property or services.

⁴⁶ The right to performance of an executory contract (particularly if a personal contract) would not typically be characterised as “property”: *Commissioner of Stamp Duties v Yeend* (1929) 43 CLR 235 at 241, 245-247. See also Birch, n 6 at 68. Compare *Austell Pty Ltd v Commissioner of State Taxation (WA)* (1991) 4 WAR 235; 20 ATR 1139.

⁴⁷ Yallop C et al (eds), *Macquarie Dictionary* (4th ed, Macquarie Library Pty Ltd, 2005).

⁴⁸ *Pancontinental Mining Ltd v Commissioner of Stamp Duties (Qld)* [1989] 1 Qd R 310 at 312 – it could not be treated as the transfer of property. Compare *CSR (WA) v Nischu Pty Ltd* (1991) 4 WAR 4371 at 446; 21 ATR 1557, which indicated that information may form part of property items such as the chattels containing the information.

⁴⁹ MT 2012/1 at [27], [75]-[77]. MT 2012/2 expressly does not apply to free-carry payments, which provide a typical example of rights to unascertainable amounts.

⁵⁰ *Macquarie Dictionary*, n 47.

⁵¹ *Bluebottle UK Ltd v DFCT* (2007) 232 CLR 598 at [53]; 67 ATR 1; *Geo Thompson (Aust) Pty Ltd v Vittadello* [1978] VR 199 at 224, cf at 211-212; *Bakewell v DFCT* (1937) 58 CLR 743 at 754; ATO, *Income Tax: Deductibility of Payments Incurred on*

- both the definition of the term “amount”, which includes a “nil amount”,⁵² and several authorities suggest it is arguable that if there is a present obligation, it should not matter that the making of a payment is subject to a contingency,⁵³ for instance, the making of a call by the directors of a company while it is a going concern for the unpaid capital on a share or by the liquidators on a winding up,⁵⁴ which bears some analogy to a cash call by an operator; and
- although the term “amount” indicates that the liability must relate to money, there would seem to be no rationale for requiring a liquidated sum. In any event, even for a debt, it is accepted that a liquidated sum will include one where the sum is ascertainable by a calculation,⁵⁵ with some accepted calculation provisions operating on the basis of prospective contingencies – the debt admittedly being found to exist once those contingencies had occurred.⁵⁶

The definition of right (“a just claim or title, whether legal, prescriptive, or moral”),⁵⁷ should at least include a proprietary contractual right to an unliquidated amount, especially since the purpose of the UCA balancing adjustment provisions appears to be to bring all items of value received into account when determining the termination value so that the statutory decline in value can be matched to the actual value of the depreciating asset.⁵⁸ Further, it is accepted that a breach of contract may give rise to a “right to damages”, even though the amount is not a liquidated sum.⁵⁹ However, as for a contingent obligation, it is harder to describe a contingent entitlement to an amount as a “right” to the amount.

In terms of the effect of any contingency, farmout cash consideration clauses typically provide for a specified amount in respect of the farmor’s historical expenditure in addition to the carry.⁶⁰ It may therefore be possible to characterise the right/obligation as a right/obligation in respect of an amount, with the extent of the amount depending on the occurrence of contingencies – such that there is only one right/obligation and no separate recognition of the right to the unascertained amount as a non-cash benefit.

If the obligation to provide/entitlement to receive the unascertained amount does not constitute a liability or a right to an amount, then it will nevertheless generally be characterised as a non-cash benefit and so brought to account in this form. This is likely based on the received/incurred requirement discussed below and is consistent with the approach taken in MT 2012/1.

Received/incurred requirement

The farmor must “receive” and/or be granted or provided the amounts, rights, or non-cash benefits identified above before they must be recognised for UCA purposes. A “receipt” has been described in

Moneys Raised Through the Issue of Perpetual Notes, Taxation Ruling TR 2002/15 at [53]-[74]. Rights to an unascertained amount based on the price at which sale shares traded after a future float (if a float occurred) have been held not to constitute a “debt”: *Marren (Inspector of Taxes) v Ingles* [1980] 1 WLR 983 at 986-987, 990.

⁵² ITAA 1997, s 995-1(1).

⁵³ *FCT v The Midland Railway Company of Western Australia Ltd* (1951) 85 CLR 306 at 314. As to contingent obligations being accepted as debts, see *Humes Ltd v Comptroller of Stamps (Vic)* (1989) 20 ATR 860; *Powell v Fryer* (2001) 37 ACSR 589 at [62].

⁵⁴ *Re Peter Lalor Home Building Cooperative Society Ltd* [1958] VR 165 at 185-186. The liability was referred to as a single liability.

⁵⁵ *Spain v The Union Steamship Co of New Zealand Ltd* (1923) 32 CLR 138 at 142, 158.

⁵⁶ The relevant calculation clause provided “The employer shall pay any reasonable expenses of an employee incurred in the service or in the interests of the employer. (a) This provision shall apply to (amongst other matters) inquiries as to casualties”: *Spain v The Union Steamship Co of New Zealand Ltd* (1923) 32 CLR 138 at 142.

⁵⁷ *Macquarie Dictionary*, n 47.

⁵⁸ The guide to the balancing adjustment provisions states that the balancing adjustment is “generally based on the difference between the actual value of the asset when you stop holding it and its adjustable value”: ITAA 1997, s 40-280. See also Revised Explanatory Memorandum to the *New Business Tax System (Capital Allowances) Bill 2001* (Cth) at [3.33].

⁵⁹ *Carter on Contract* (LexisNexis looseleaf service) at [41-001] viewed 20 February 2012.

⁶⁰ AIPN Agreement, n 16, cll 4.1(a), 4.1(c) (alt 2).

the following terms:⁶¹

to constitute a receipt of anything there must be a person to receive and a person from whom he receives, and something received by the former from the latter ...

The ordinary meaning of the term “grant” is: “to bestow or confer, especially by a formal act; to grant a right”.⁶²

Specified sum

Specified amounts paid (for a deferred farmout) or to be paid (for an immediate farmout) directly to the farmor would generally be received by, or the rights to the amounts granted to, the farmor as they are given directly to or are created by the farmee for the benefit of the farmor and are “something”, being money or property.⁶³ If the farmee has actually paid, or (by analogy with the approach under s 8-1 of the ITAA 1997) created a presently existing liability to pay an ascertainable sum, the amount will have been “paid” or the liability “incurred”.

Although not as certain, it is also likely that specified “amounts” paid or to be paid to third parties by the farmee for the benefit of the farmor are “received”, or are to be paid pursuant to a “right to receive an amount”, by the farmor. Both the legislation⁶⁴ and the authorities⁶⁵ recognise that amounts which are “applied or dealt with in any way on [a taxpayer’s] behalf or as [a taxpayer] direct[s]” are received by the taxpayer (the definition of non-cash benefit contains a similar deeming provision). In *Perrott v DCT (NSW)*, Ferguson J noted that such provisions are aimed at:

the case where the taxpayer, though he has not received the money itself, has had the benefit of it, or of something which is substantially equivalent to it.⁶⁶

However, despite the different context of the UCA provisions, for a constructive receipt to occur, it is likely that the constructive recipient must have a pre-existing right to receive an amount, before it is dealt with on the taxpayer’s behalf.⁶⁷

If a farmee agrees to meet specific amounts of a farmor’s cash call obligations to a joint venture operator, even though such amounts would be paid to the operator, they would typically be paid so as to satisfy a pre-existing obligation of the farmor. The farmee could be characterised as acting as agent of the farmor in making the payment to the operator and, in doing so, applying the farmor’s entitlement to receive payment from the farmee against the debt that becomes due from the farmor to the farmee for the payment to the operator.⁶⁸ Alternatively, it seems that an agreement entered into with another party (debtor) which both creates a right to a receivable in the future and includes an “irrevocable consent” by the taxpayer to the debtor applying the receivable in a specified way before the receivable arises, should still amount to a derivation of “the value of any benefit or property

⁶¹ *Gresham Life Assurance Society Ltd v Bishop* [1902] AC 287 at 296 (Lord Lindley).

⁶² *Macquarie Dictionary*, n 47.

⁶³ The ATO considers that contractual rights to receive future payments are “received” by the party in whose benefit they are created: ATO, *Income Tax: Capital Gains: Capital Gains Tax Consequences of Earnout Arrangements*, Draft Taxation Ruling TR 2007/D10 (Draft TR 2007/D10) at [12].

⁶⁴ ITAA 1997, s 6-10(3).

⁶⁵ Woellner RH et al, *Australian Taxation Law* (22nd ed, CCH Australia, 2011) p 800, with particular reference to *Case T44* (1986) 86 ATC 366.

⁶⁶ *Perrott v DCT (NSW)* (1923) 23 SR (NSW) 118 at 124. See also *Permanent Trustee Co (NSW) Ltd v FCT* [1940] 2 AITR 109 at 110-111.

⁶⁷ In the context of CGT, where the focus is on money or property received or entitled to be received in respect of a CGT event and the flipside (for cost base) of money or property paid or given or required to be paid or given, in respect of acquiring a CGT asset, *Dingwall v FCT* suggests that there must be a payment or giving, or a presently existing obligation to pay an ascertained amount at a future date: *Dingwall v FCT* (1995) 57 FCR 274 at 282; 30 ATR 498. See also *Gair v FCT* (1944) 71 CLR 388 at 396 in the context of “derivation” of ordinary income; Gilders F et al, *Understanding Taxation Law* (5th ed, LexisNexis Butterworths, 2011) at [6.90].

⁶⁸ Compare the appropriation example discussed in Parsons R, *Income Taxation in Australia* (University of Sydney, 1985) at [11.136]. See also *FCT v Orica Ltd* (1988) 194 CLR 500 at [22], [67]-[68]; 39 ATR 66.

received as a result of the application of the money”,⁶⁹ which would be the value of the satisfied obligation for the farmor. If the relevant farmout agreement cannot be characterised in either way, it is arguable that the farmor does not receive the amount.⁷⁰

The same third party payment difficulty does not arise for the farmee, where what is required is a payment of an amount or an incurring of a liability by the farmee.

Services

Several comments in the relevant ruling compendiums question whether exploration benefits are provided by the farmee to the farmor.⁷¹ However, as for rights to specified sums, proprietary contractual rights would clearly be “received” by or “granted” to the farmor as they are created by the farmee for the benefit of the farmor and are “something”, being property. Similarly, the farmee must “provide” such non-cash benefits. The ordinary meaning of provide,⁷² when used in the context of providing a “non-cash benefit” which includes “services”, must include the creation of things which do not pre-exist.⁷³ Accordingly, non-cash benefits would be received under an immediate farmout.

In addition, where activities or expenditure are directly carried out by the farmee, while the services may not amount to property (such that it is difficult to say that “something” has been received), they might well involve the provision of items of property which themselves contain information, or the transfer of an interest in mining plant and equipment which is used or constructed in providing the service. In addition, the definition of “non-cash benefit” expressly contemplates that services, as distinct from property, can be “received”. Where activities are carried out in relation to property (such as a tenement) held by the farmor, the work (being the services) should appropriately be characterised as being “received” by the farmor. Accordingly, it is likely that even for a deferred farmout the farmor will receive something.

Unascertainable amount

It is unlikely that obligations to pay unascertainable amounts constitute rights, for the farmor, to “receive an amount” or, for the farmee, the “incurring” of a liability to pay an amount. By analogy with the approach to derivation for an accruals basis taxpayer,⁷⁴ for a right to receive an amount to exist, it is likely that it must be possible to quantify the amount.⁷⁵ In addition, if the right to the amount can itself be described as contingent, the amount is unlikely to be treated as derived on an accruals basis, and, by comparison, may not be a right to receive an amount under the UCA rules.⁷⁶

For a liability to pay an amount to be “incurred”, looking to authorities on the ITAA 1997 general deduction provision, the critical requirement is that the taxpayer must be “definitively committed” and “completely subjected” to the outgoing.⁷⁷ This generally requires a presently existing “pecuniary liability”.⁷⁸ It is accepted that an outgoing can be incurred, even if it is not payable until a later time and even if it is subject to a “theoretical contingency”, although a contingency which must be satisfied

⁶⁹ Parsons, n 68 at [11.143], [11.146]. See also *Federal Coke Co Pty Ltd v FCT* (1977) 7 ATR 519 at 526, 538.

⁷⁰ Parsons, n 68 at [13.65].

⁷¹ Ruling Compendium MT 2012/1EC, Item 1; Ruling Compendium MT 2012/2EC, Item 1.

⁷² To “furnish or supply”, “afford or yield”: *Macquarie Dictionary*, n 47.

⁷³ This would be consistent with (arguably, with more justification) the interpretation adopted by the Commissioner for the term “give” under the CGT cost base provisions: Draft TR 2007/D10 at [129]-[136].

⁷⁴ Which appears justified, since the farmor is obliged to include the amount of the right in the termination value of the depreciating asset and, hence, potentially in assessable income.

⁷⁵ *Barratt v FCT* (1992) 23 ATR 339 at 346. See also *Henderson v FCT* (1970) 1 ATR 596 at 601; Parsons, n 68 at [11.51].

⁷⁶ The Commissioner considers that there must generally be a recoverable debt before income is derived on an accruals basis: ATO, *Income Tax: Determination of Income; Receipts Versus Earnings*, Taxation Ruling TR 98/1 at [9]-[10]. See also: *Barratt v FCT* (1992) 23 ATR 339 at 346; *Gasparin v FCT* (1994) 50 FCR 73 at 81-82; 28 ATR 130; Parsons, n 68 at [11.49].

⁷⁷ *FCT v James Flood Pty Ltd* (1953) 88 CLR 492 at 506, 508. See also *FCT v Citylink Melbourne Ltd* (2006) 228 CLR 1 at [137]; 62 ATR 648.

⁷⁸ *FCT v Malouf* (2009) 174 FCR 581 at [43]; 75 ATR 335.

before the obligation to pay an amount arises will not be generally be “theoretical”.⁷⁹ Moreover, for an amount to be incurred under s 8-1 of the ITAA 1997, “incurred” has been construed as at least requiring that an outgoing be “capable of approximate calculation based on probabilities”.⁸⁰

Accordingly, even though an immediate farmout agreement would not be executory for the farmor,⁸¹ such that an obligation to pay an unascertainable amount would arise, the better view is that there is no right to receive an amount, or an incurring of a liability to pay an amount, until that particular amount is subject only to a contingency as to timing of payment and until it is quantifiable, or, perhaps, capable of approximate calculation.⁸² This would be consistent with the approach in *Dingwall v FCT*⁸³ as to whether a taxpayer is “required to pay an amount” of uncalled capital on a share under the precursor CGT cost base provisions.

Accordingly, in the case of a right to receive/liability to pay an unascertainable amount, what is received and provided is a non-cash benefit, being the contractual right itself.

Nexus requirement

Finally, there must be a sufficient nexus between the provision of the amount, the non-cash benefit, or the right to the amount or non-cash benefit and the farmor ceasing to hold part of its interest for the farmor to be characterised as having received them “under”⁸⁴ a balancing adjustment event “for”⁸⁵ the depreciating asset. A broader nexus applies to the farmee such that a payment, provision or incurring of a liability must be “to hold” or “in relation to starting to hold” an asset,⁸⁶ the nexus having been intentionally expanded from an earlier requirement that costs be incurred “to hold” or “for holding” the relevant asset.⁸⁷

Example 3.3 in the Revised Explanatory Memorandum to the Bill which introduced the UCA regime provides:

Andrew sells a panel-van (a depreciating asset) to Fiona, a house painter, in exchange for Fiona:

- painting Andrews[sic] home, the painting services are a non-cash benefit with a market value of \$4,000; ...
- undertaking to re-paint Andrews home again in 10 years, the painting services are a non-cash benefit with a market value of \$1,500; and⁸⁸

Arguably, if the panel-van was an interest in a mining or petroleum title and the painting services were work commitments, a farmee could be described as being in a similar position to Fiona, except that the farmee is likely to pay a third party to carry out the work commitments and the farmor retains an interest in the mining or petroleum title/panel-van. The approach in *CCSR (NSW) v Dick Smith*

⁷⁹ *FCT v Citylink Melbourne Ltd* (2006) 228 CLR 1 at [125], [136]-[137]; 62 ATR 648. For instance, an obligation to pay interest on debentures in years in which a company earns “net income” would not result in an amount being incurred other than in years in which the company earns net income: at [134], citing *Emu Bay Railway Co Ltd v FCT* (1944) 71 CLR 596.

⁸⁰ *Commonwealth Aluminium Corporation Ltd v FCT* (1977) 7 ATR 376 at 386.

⁸¹ As it was for the purchaser in *FCT v Malouf* (2009) 174 FCR 581 at [48]-[49]; 75 ATR 335.

⁸² This would be consistent with Lord Fraser’s comments as to the effect of the word “incurred” in a different legislative context when considering the contingent right to an unascertainable amount in *Marren (Inspector of Taxes) v Ingles* [1980] 1 WLR 983 at 990.

⁸³ *Dingwall v FCT* (1995) 57 FCR 274 at 282; 30 ATR 498.

⁸⁴ ITAA 1997, s 40-305(1).

⁸⁵ ITAA 1997, s 40-300(1)(b) provides that the termination value of a depreciating asset is “the amount you are taken to have received under section 40-305 for the asset” (emphasis added).

⁸⁶ ITAA 1997, ss 40-180(1)(b), 40-180(3), 40-185(1)(b).

⁸⁷ Explanatory Memorandum to the *Tax Laws Amendment (2006 Measures No 1) Bill 2006* (Cth) at [2.8], [2.124]-[2.128].

⁸⁸ Revised Explanatory Memorandum to the *New Business Tax System (Capital Allowances) Bill 2001* (Cth) at [3.41].

*Electronics*⁸⁹ to the nexus question for transfer duty purposes also provides support, with the majority looking to “what was received by the Vendors so as to move the transfers”.

Specified sum

The amounts paid or agreed to be paid by the farmee are what “move”, in conjunction with any further consideration, the transfer of an interest by the farmor in its mining or petroleum assets (provided, for an Optional Deferred farmout, that they are not appropriately characterised as being given for the grant of the option). It cannot be argued that these are pre-existing rights held by the farmor,⁹⁰ nor that they are provided for the use of the petroleum assets.⁹¹ Accordingly, the required nexus should exist for both the farmee and farmor.

Services or unascertainable amounts

It should likewise be possible to characterise the provision of services and unascertainable amounts under a farmout arrangement as forming part of the consideration that “moves” the transfer of an interest in the farmed-out assets.

The real controversy is whether, for an immediate farmout, it is the underlying rights to receive/provide the services or the unascertainable amounts, or the services/amounts themselves that are received/provided for the farmed-out assets. The analysis above indicates that the focus must be placed on the rights. However, the discussion below considers whether a concessional approach could be adopted.

CONTINUED UNCERTAINTY

The analysis above demonstrates that, for immediate farmouts, the benefit received for the farmed-out assets would typically be a contractual right to services or to receive the benefit of ascertained or unascertained monetary amounts. While an improvement on the draft ruling, MT 2012/1 does not adequately explore the interaction with the CGT provisions which this analysis necessitates if the “separate asset” approach adopted by the Commissioner in the draft earnout ruling is applied. Under that approach, the right to an unascertained amount or the right to services would be treated separately from the disposal of the farmed-out assets, giving rise to separate CGT events.⁹² For farmed-out mining or petroleum assets which are depreciating assets, the CGT anti-overlap provisions would generally result in any capital gain or loss from CGT event A1 on a disposal of those assets being disregarded.⁹³ However, the UCA anti-overlap provisions would not, on their face, apply to the creation of a right to receive payments or services (CGT event D1 for the farmee) or the ending of that right once the services or payments have been provided (CGT event C2 for the farmor).⁹⁴

Since MT 2012/1 only recognises this issue in relation to free-carry rights to unascertainable amounts,⁹⁵ a degree of uncertainty remains. For instance, what about rights to receive services? More significantly, MT 2012/1 fails to explore the implications where the amounts or services ultimately

⁸⁹ *Chief Commissioner of State Revenue v Dick Smith Electronics* (2005) 221 CLR 496 at [72], [22]-[29]. Although disagreeing in the result, the minority in *Dick Smith* adopted a broadly similar approach to identifying the consideration for the dutiable transaction and were willing to accept that if a provision of the sale agreement had obliged the purchaser to loan an amount to a third party, the incurring of that obligation would be non-monetary consideration for the share transfer: at [40]-[41].

⁹⁰ As was the case in *Lend Lease Custodian Pty Ltd v FTC* (2006) 65 ATR 455.

⁹¹ In the UCA context, the Commissioner has previously accepted that amounts paid for the use of an asset are not characterised as being received for the grant of a lease or licence to use the asset: see, for example, ATO, *Capital Allowances: Termination Value on the Granting of a Licence to Exploit a Patented Invention*, ID 2006/167.

⁹² See ATO ID 2006/167, n 91.

⁹³ Assuming that the relevant depreciating assets were used wholly for taxable purposes by the farmor: ITAA 1997, s 118-24.

⁹⁴ Other CGT events could also conceivably occur. In the context of earnout rights, see, for example, Evans C, “Yearning for Earnout Certainty” (2008) 11(5) *The Tax Specialist* 294 at 297.

⁹⁵ MT 2012/1 at [48]-[49], [52], [77].

delivered differ from the value of the rights initially created,⁹⁶ which is relevant to determining whether the combined UCA and CGT outcome is commercially appropriate. In this regard, MT 2012/1 neglects to consider whether the outcome might be improved by adopting a single asset or look-through approach.

These issues are separately explored below from the farmor’s and farmee’s perspectives. However, by way of overview, the effect of applying a separate asset, versus a single asset or look-through approach for CGT purposes, can result in differing advantages and disadvantages for the farmor and farmee.

Consideration	Separate asset		Single asset or look-through	
	Farmor	Farmee	Farmor	Farmee
Right to services.	In the balancing adjustment event income year, the market value of right to services must be included in termination value, but potentially nets out with a deduction equal to the market value of the assets farmed-out for the exploration services. Depending on whether value of property received when services are delivered exceeds cost base or is less than reduced cost base, a capital gain or loss could subsequently result.	Initially, market value of exploration services likely to be deductible in full, netting off with an equal amount of assessable income for agreeing to provide the exploration services. Risk to cashflow due to capital gain from CGT event D1, which will only be retrospectively eliminated under an anti-overlap provision over several years. Subsequent expenditure on exploration activities potentially deductible.	In the balancing adjustment event income year, the market value of right to services must be included in termination value, but potentially nets out with a deduction equal to the market value of the assets farmed-out for the exploration services.	Initially, market value of exploration services likely to be deductible in full, netting off with an equal amount of assessable income for agreeing to provide the exploration services. Subsequent expenditure on exploration activities potentially deductible.
Right to specified amount.	In the balancing adjustment event income year, the amount must be included in termination value (and potentially in assessable income). Subsequent (equal) deduction potentially available if amount used for exploration activities. May be no income against which the deductions can be utilised.	Initially, amount likely to be deductible in full.	As for separate asset approach.	As for separate asset approach.

⁹⁶The “services” received by the farmor will not generally be the same as the exploration or prospecting activities carried out by the farmee, since the farmee to some extent carries out those activities for its own benefit: MT 2012/1 at [94].

Consideration	Separate asset		Single asset or look-through	
	Farmor	Farmee	Farmor	Farmee
Right to unascertainable amount.	In the balancing adjustment event income year, the market value of the right must be included in termination value (and potentially in assessable income). Potentially nominal value if farmed-out assets given for the right have nominal value because the tenement is at the “wildcat” exploration stage. Capital gain/s made as subsequent payments are made and exceed the cost base of the right, but with subsequent deductions potentially available if the amounts are used for exploration activities. Could permit netting out in each relevant income year. Risk of capital loss which cannot be set off against UCA revenue gain if payments are lower than value of right.	Initially, market value of right likely to be deductible in full. However, if right has nominal value, only nominal deduction is obtained. Additionally, risk that the (likely equivalent) value of the farmed-out assets received for the right will be capital proceeds under CGT event D1. Real risk that no deductions can be obtained for subsequent payments in satisfaction of right, although MT 2012/1 provides concessional treatment that would permit deductions.	In the balancing adjustment event income year, the market value of the right must be included in termination value (and potentially in assessable income). Potentially nominal value. Risk, but no clear inclusion in assessable income of subsequent payments unless look-through approach is also applied for UCA purposes. Subsequent deductions potentially available if the amounts are used for exploration activities (although farmor may not have income against which the deductions can be utilised).	Initially, market value of right likely to be deductible in full. However, if right has nominal value, only nominal deduction is obtained. Potential, but no clear deduction for subsequent payments unless look-through approach is also applied for UCA purposes.

The application of the taxation of financial arrangements provisions (TOFA) in Div 230 of the ITAA 1997 has not been considered below. However, there is a risk that a farmout arrangement may give rise to a financial arrangement, especially in circumstances where the farmee incurs an obligation to pay an unascertained amount, rather than to provide services.⁹⁷ Accordingly, TOFA may be relevant for some farmouts, particularly where an entity’s aggregated turnover for the relevant income year is more than \$100 million, the value of its financial assets for the relevant income year is more than \$100 million, or the value of the entity’s assets for the relevant income year is more than \$300 million.⁹⁸

⁹⁷ See ITAA 1997, s 230-45.

⁹⁸ ITAA 1997, s 230-455(1)(a)(iv). If it is to end more than 12 months after it starts, the farmout arrangement must also not be a qualifying security. Farmout arrangements are generally unlikely to constitute or result in the creation of a “qualifying security” (*Income Tax Assessment Act 1936* (Cth), s 159GP(1)) either because the farmout arrangement would not be characterised as a “debt like obligation” (given the Commissioner’s approach in the draft earnout ruling, this ground is more likely to be relevant for farmouts where only services are to be provided by the farmee) and so should not generally be treated by the Commissioner as a “security” (see Taxation Ruling TR 96/14 at [4]; Taxation Determination TD 2008/21 at [20]), or would not be a “qualifying” security on the basis that it could not be said that it would be reasonably likely, having regard to the terms of the farmout arrangement, that the sum of payments under the farmout arrangement would exceed the issue price of the farmout arrangement.

Farmor's perspective

For the farmor, the provision of services or payments by a farmee would result in the discharge of the rights held by the farmor to receive a service or payment.⁹⁹ CGT event C2 would occur each time a right or part of a right is satisfied.¹⁰⁰ Accordingly, the farmor would make a capital gain from each occurrence if the “capital proceeds” (which would likely include the payments made by the farmee, but may not include the full market value of the services provided)¹⁰¹ from the ending of the right are more than the right's “cost base” and will make a capital loss if those capital proceeds are less than the “reduced cost base”.¹⁰² Adopting an approach consistent with that in MT 2012/1 in relation to rights to free-carry payments,¹⁰³ the cost base is likely to be determined by the market value of the farmed-out assets, to the extent that they are given to acquire the rights.¹⁰⁴ This amount is likely to differ from the final value of the amounts, or property in respect of services, received, resulting in either a capital gain or capital loss, over which the farmor has little control.

MT 2012/1 does not explore the consequences of a capital gain or loss,¹⁰⁵ which could be significant, particularly in circumstances where the farmor is unable to utilise any capital loss which is generated. Further, to the extent that the assets initially farmed-out are not “money” or “property”, some of the value inherent in the farmed-out assets may not be included in the cost base or reduced cost base,¹⁰⁶ increasing the farmor's risk of an additional capital gain.

This “risk” is likely to be ameliorated by the fact that the farmor can potentially obtain a deduction to the extent it applies moneys received for exploration or prospecting expenditure,¹⁰⁷ as accepted in MT 2012/1 for free-carry payments.¹⁰⁸ Further, to the extent that services are received by the farmor, there may be no capital proceeds, since the services may not amount to “money” or “property”.¹⁰⁹ Nevertheless, care would be required, since the services might involve the provision of items of property which themselves contain information, or the transfer of an interest in property used or constructed in providing the service.

Based on the Commissioner's approach in the draft earnout ruling, CGT event C2 should only occur in relation to rights to services or to unascertained amounts, not rights to ascertainable amounts.¹¹⁰ This appears consistent with the Commissioner's approach in MT 2012/1, which is silent in relation to CGT event C2 for free-carry rights to ascertainable amounts.

⁹⁹ *FCT v Orica Ltd* (1998) 194 CLR 500 at [39], [94]-[100]; 39 ATR 66. Whether it is part of a right or separate rights that are discharged will depend on the characterisation of the contractual obligations.

¹⁰⁰ CGT event C2 occurs if a taxpayer's ownership of an intangible CGT asset (such as contractual rights) ends by the asset being, amongst others, discharged or satisfied: ITAA 1997, s 104-25(1)(b). See also Draft TR 2007/D10 at [17]-[22].

¹⁰¹ In particular, due to the constructive receipt provisions: ITAA 1997, s 103-10.

¹⁰² ITAA 1997, s 104-25(3).

¹⁰³ MT 2012/1 at [48].

¹⁰⁴ ITAA 1997, s 110-25(2)(b). Certain incidental and other costs may be included in further elements of the cost base. See also *Rabelais Pty Ltd v Cameron* (1995) 95 ATC 4552 at 4553.

¹⁰⁵ MT 2012/1 at [49].

¹⁰⁶ For instance, mining information, as information is not generally characterised as “property”: *Nischu v Commissioner of State Taxation (WA)* (1990) 21 ATR 391 at 394. See also Birch, n 6 at 89. In addition, it may be arguable whether petroleum exploration permits are property: Alexander H, “Tax Aspects of Joint Ventures” in Duncan W (ed), *Joint Ventures Law in Australia* (Federation Press, 1994) p 192 at [7.8]. Although the Commissioner accepts in Draft TR 2007/D10 that the giving of property can include the creation of contractual rights (in the context of earnout rights) (at [129]-[136]), there is also a real risk that rights created by the farmor in the farmee would not amount to property given by the farmor to the farmee on the basis that to be given, the property must be pre-existing.

¹⁰⁷ Under ITAA 1997, s 40-730(1).

¹⁰⁸ MT 2012/1 at [31]-[33].

¹⁰⁹ ITAA 1997, ss 103-10(2), 116-20(1).

¹¹⁰ Draft TR 2007/D10 at [3]. See also Evans, n 94 at 295. This would be consistent with the approach taken by the Commissioner in ATO, *CGT: Acquisition of CGT Asset – Satisfaction of Rights to have Asset Transferred to Purchaser*, ID 2003/790.

Although not considered in MT 2012/1, there are several possible bases for extending this approach and asserting that no separate CGT event should be recognised for rights to services or unascertained amounts as well. This would mean that any subsequent services or payments are potentially received in respect of CGT event A1 and that the UCA anti-overlap provisions would stop a capital gain or loss from being recognised. Whether an amount might otherwise be included in the farmor's assessable income is considered below, along with the possible bases for replacing the separate asset approach.

Recognition of a separate asset

There is a real question whether the Commissioner is correct to recognise a separate asset, at least in relation to rights to unascertained amounts.¹¹¹ The separate asset approach is based largely on *Marren (Inspector of Taxes) v Ingles*.¹¹² *Marren* related to the creation, on a sale of shares, of contingent rights to payment of an unquantified amount if a float of the sale company subsequently occurred, the court accepting that the rights were received as consideration for the disposal of the shares with the subsequent payments in satisfaction of the rights being for a deemed disposal of the rights.¹¹³ There are also Australian authorities that have recognised that, for CGT purposes, compensation amounts may be in respect of separate rights to compensation rather than an underlying asset.¹¹⁴ However, the United Kingdom legislative provisions considered in *Marren* differ from the Australian CGT provisions in not expressly contemplating future payments, whereas the CGT capital proceeds provisions include money or property which the vendor has received or is entitled to receive without imposing any time limit.¹¹⁵

For the reasons articulated in Part 3, it is likely to be difficult to establish that a right to an amount, where the precise amount is contingent on the making of cash calls, is an entitlement to receive money at the time of the CGT event. Nevertheless, due to the absence of a time limit for CGT, it appears open – rather than treating the right to payment of an unascertainable amount as a separate asset – to view the farmout as giving rise to an entitlement to receive money which arises when the contingency is satisfied, or as resulting in the receipt of money when the payments are subsequently made.¹¹⁶ Support for this view is provided, as noted by Walrut, by authorities which emphasise that the purpose of the CGT provisions is to tax the “true gain”.¹¹⁷ It is also provided for CGT event A1, in particular, because the time of the event (entry into the disposal contract, if there is a contract) would typically occur before any payments are made under the contract and typically in the context of at least some conditions precedent to completion in the contract.¹¹⁸ Even if received at a later point in

¹¹¹ The CGT capital proceeds provisions refer to the receipt of, or entitlements to receive, “money” or “property” but not services, such that rights to services would likely be recognised as separate items of property: ITAA 1997, s 116-20(1); see also s 110-25(2) in relation to cost base.

¹¹² Draft TR 2007/D10 at [90], referring to *Marren (Inspector of Taxes) v Ingles* [1980] 1 WLR 983.

¹¹³ *Marren (Inspector of Taxes) v Ingles* [1980] 1 WLR 983 at 988-989. See also at 985 regarding the sale of shares for cash plus a right to an unascertained amount based on price at which the shares traded after a future float.

¹¹⁴ *Provan v HCL Real Estate Ltd* (1992) 92 ATC 4644 at 4652; 24 ATR 238. Rolfe J did not decide which right the compensatory amounts were received for, rather his Honour recognised the possibility of capital gains tax for the purposes of a damages award (even though the underlying asset was a pre-CGT asset).

¹¹⁵ ITAA 1997, s 116-20(1) (as to cost base, the corresponding provision is s 110-25(2)); emphasised by ss 103-10(2), 103-15. See also Walrut B, “Earnout Arrangements and Draft Taxation Ruling TR 2007/D10” (2009) 38 AT Rev 181 at 184-187, 190; Wood D, “M&A Transactions: What are the Issues; What are the Opportunities?” (2011) 14(5) *The Tax Specialist* 238 at 242.

¹¹⁶ In the earnout context, see, for example, Walrut, n 115 at 187.

¹¹⁷ Walrut, n 115 at 187, quoting Gummow J in *FCT v Orica Ltd* (1998) 194 CLR 500 at 545; 39 ATR 66.

¹¹⁸ See ITAA 1997, s 104-10(3)(a). Compare *FCT v Sara Lee Household and Body Care (Australia) Pty Ltd* (2000) 201 CLR 520 at [40], [105]; 44 ATR 370.

time, it should still be possible to say that the money is received “in respect of” the disposal of the farmed-out assets, with the “in respect of” nexus being at least as wide as the nexus test for the UCA provisions.¹¹⁹

That is the approach taken by the Administrative Appeals Tribunal in *Re Taxpayer v FCT*.¹²⁰ The decision concerned the application of the precursor CGT provisions to a sale of shares in circumstances where the sale contract provided that the purchase price was a particular sum as adjusted for certain matters, including breaches of tax warranties. Senior Member Hunt accepted that the consideration for the sale was the amount specified in the contract, as adjusted in a later income year in accordance with the contract,¹²¹ and emphasised that:

I do not consider that any asset has been created in the present case by the indemnity provisions requiring repayments to the purchaser in the event of liabilities being discovered after the date of disposal of the shares.¹²²

Senior Member Hunt appears to have treated the right as an entitlement to money from the time of entry into the contract, although the construction of the CGT provisions set out immediately above seems preferable where there is no right to a set sum of money (even if defeasible) specified in the contract. Callinan J, in *FCT v Sara Lee Household and Body Care (Australia) Pty Ltd*, also makes several comments which provide support for a single asset approach.¹²³

Look-through approach

A second basis, could be to adopt a “look-through” approach to CGT event C2. In the context of amounts received in respect of “a right to seek compensation or a cause of action”, the Commissioner accepts that a look-through approach is appropriate in some circumstances.¹²⁴ Under the look-through approach, an amount received is treated as being in respect of an “underlying asset” (for instance, which has been assigned or damaged), rather than for the compensation right.¹²⁵

If the look-through approach was to be applied to payments or services received by a farmor, CGT event C2 would be ignored and CGT event A1 would apply, enlivening the anti-overlap provision discussed above.

The test applied by the Commissioner is to examine the “reality of the matter” and to identify whether there is “a direct and substantial link with the underlying asset”.¹²⁶ The Commissioner justifies this approach primarily by reference to *Zim Properties Ltd v Procter (Inspector of Taxes)*,¹²⁷ as well as several Australian authorities.¹²⁸ However, *Zim Properties* concerned differently worded

¹¹⁹ See *State Government Insurance Office (Qld) v Crittenden* (1966) 117 CLR 412 at 416-417. See also *Moneywood Pty Ltd v Salamon Nominees Pty Ltd* (2001) 202 CLR 351 at [96], [151]; [172]; *Lend Lease Custodian Pty Ltd v DCT* (2006) 65 ATR 455.

¹²⁰ *Re Taxpayer v FCT* (2006) 62 ATR 1043. The case concerned the precursor CGT provisions in the *Income Tax Assessment Act 1936* (Cth).

¹²¹ See especially *Re Taxpayer v FCT* (2006) 62 ATR 1043 at [24], [27].

¹²² *Re Taxpayer v FCT* (2006) 62 ATR 1043 at [20].

¹²³ *FCT v Sara Lee Household and Body Care (Australia) Pty Ltd* (2000) 201 CLR 520 at [105]; 44 ATR 370: “[T]he disposition in this case must be taken to have occurred on the making of the May agreement ... On that date the respondent executed an agreement and entered into a transaction for the disposal of assets and became entitled (subject to the fulfilment of conditions precedent) to receive consideration which included a component of capital gain.” See also *Kiwi Brands Pty Ltd v FCT* (1998) 90 FCR 64 at 72-73; 40 ATR 477 (the decision was successfully appealed in *Sara Lee*, but this point was not questioned); *Lend Lease Custodian Pty Ltd v DCT* (2006) 65 ATR 455 at [88]-[89].

¹²⁴ ATO, *Income Tax: Capital Gains: Treatment of Compensation Receipts*, Taxation Ruling TR 95/35 at [3].

¹²⁵ TR 95/35, n 124 at [3]-[4], [6].

¹²⁶ TR 95/35, n 124 at [71], [82].

¹²⁷ TR 95/35, n 124 at [70]-[73]; Draft TR 2007/D10 at [84]-[87]. *Zim Properties Ltd v Procter (Inspector of Taxes)* [1985] STC 90 concerned a payment to settle a cause of action against solicitors for a failed sale of property.

¹²⁸ TR 95/35, n 124 at [74], [78]-[80]. See *Tuite v Exelby* (1993) 93 ATC 4293 at 4300-4301; (1992) 25 ATR 81 (amount received by purchasers of shares under damages claims for breach of restrictive covenant and fiduciary duties treated as being in relation to an event – the breaches of the restrictive covenant and fiduciary duties – affecting the shares purchased);

chargeable gains provisions under the *Finance Act 1965* (UK), which expressly contemplated that amounts of compensation for damage to assets could be “capital sums” derived from those assets.¹²⁹ The support provided by the Australian authorities is also somewhat limited since they concern whether a plaintiff should be able to recover an additional amount in respect of potential capital gains liabilities when seeking damages from a defendant.¹³⁰ That increases the importance of obtaining a binding ruling confirming the availability of the look-through approach, if it is to be relied on.

If the look-through principle is available, the issue is whether it can apply to all immediate farmouts. This is unlikely, based on the Commissioner’s approach in TR 2007/D10. There, “the Commissioner found that the earnout right, not the sale assets, was the asset to which the earnout payments most directly related”,¹³¹ noting:

[T]he “reality of the matter” ... is that the parties have entered into a financial arrangement that is independent of the sale transaction from which it arises ... The deferred payments are not, as a matter of substance, made in respect of the acquisition of those assets. They are paid in respect of a separate obligation under which the seller stands to make a financial gain depending on the economic performance of an asset which the seller has ceased to own.¹³²

As a usual reason for entering into a farmout is that the farmor wants to share the economic risk of exploration activities,¹³³ a work commitment or unlimited carry obligation may well entail a degree of risk, such that it could be described as a separate “financial arrangement”. A minimum exploration expenditure obligation is less likely to amount to an independent obligation.

However, as noted by Evans, there is a “strong case” that the look-through approach should apply as the “reality of the matter” is that earnout arrangements are “part of a continuum of events that begins with the negotiations for the sale of the original assets and ends when all consideration (ascertained and unascertained at the time of that original disposal) has been settled”.¹³⁴

The commercial reality for work commitments or obligations to pay unascertained amounts provided under a farmout could be similarly described and the look-through principle adopted on the same basis.

Tax treatment of payments or services received

If a single asset or look-through approach is used for CGT, how are subsequent payments or services received by the farmor to be treated? One option would be to apply a similar approach for UCA purposes, so that any amounts or services received which are greater or less than the rights received at the time of the balancing adjustment event would be treated as an adjustment to the termination value and implemented by amending the relevant income tax assessment. However, the UCA provisions do not expressly refer to amounts being paid or received at “a later time”.¹³⁵ Indeed, the UCA balancing adjustment provisions contemplate the inclusion in an asset’s termination value of the amount or market value of certain rights at the time they are granted and the explanatory materials indicate that

Carborundum Realty Pty Ltd v RAlA Archicentre Pty Ltd (1993) 25 ATR 192 at 195-196, 200 (Harper J) (in the context of payments under a court judgment in satisfaction of a chose in action or judgment debt – whether such payments are in respect of the disposal of an underlying asset). See also Datt K, “Sons of Gwalia – a Taxing Decision” (2008) 37 AT Rev 104 at 110.

¹²⁹ *Zim Properties Ltd v Procter (Inspector of Taxes)* [1985] STC 90 at 103.

¹³⁰ Also as the comments in *Carborundum Realty Pty Ltd v RAlA Archicentre Pty Ltd* have been questioned: *Rabelais Pty Ltd v Cameron* (1995) 95 ATC 4552 at 4553.

¹³¹ Draft TR 2007/D10 at [12]-[15], [83], [86]-[87]. The federal government announced in 2010 that it would introduce legislation to achieve a look-through CGT approach for earnout rights as a result of complications caused by the draft ruling: Sherry N, Assistant Treasurer, *Look-through Treatment for Earnout Arrangements to Simplify Sale of Business Assets*, Press Release No 98 (12 May 2010). The legislation has not yet been introduced into Federal Parliament.

¹³² Draft TR 2007/D10 at [88]-[89].

¹³³ See, for example, Martyn, n 6, p 33; Gately, n 10 at 58. See also Birch, n 6 at 65-67.

¹³⁴ Evans, n 94 at 301. See also Wood, n 115 at 242 (describing the Commissioner’s approach as “contrived”).

¹³⁵ ITAA 1997, ss 103-10(2), 103-15.

the termination value must be determined at the time of the balancing adjustment event with rights to amounts or to non-cash benefits being included to the extent they have not been satisfied at that time.¹³⁶

Accordingly, to adopt a single asset approach it would be necessary to treat rights to services or unascertainable amounts as rights to receive “an amount” or a “non-cash benefit”, under the UCA termination value provisions, with the precise amount or non-cash benefit determined subsequently in accordance with the “formula” set out by the provisions of the farmout agreement. As discussed in Part 3, the better view appears to be that rights to unascertainable amounts would not come within this meaning, although there is a remotely feasible argument, so that a binding ruling would be required for taxpayers to have certainty.

If the approach set out above cannot be applied, subject to shoehorning the increase or reduction under another provision, the farmor may make a windfall gain or an unrecognised loss.

Farmee’s perspective

From the farmee’s perspective, CGT event D1 could apply to the creation of a right in the farmor,¹³⁷ with the farmee making an upfront capital gain if the capital proceeds from creating the right (likely to be the market value of the property given by the farmor)¹³⁸ exceed the farmee’s incidental costs (such as solicitor’s fees),¹³⁹ which would often be the case. MT 2012/1 acknowledges this issue as regards rights to payment of unascertainable free-carry amounts, but does not explore the consequences or potential solutions, nor the implications for rights to services.¹⁴⁰ This could mean, for rights to services, that the farmee’s deduction under the UCA provisions for the market value of the exploration services is used up against an equal amount of assessable income recognised by the farmee for the provision of exploration services, leaving the farmee with a capital gain as a result of CGT event D1.¹⁴¹

Nevertheless, there does appear to be a partial solution. MT 2012/1 treats the farmee as receiving ordinary income under s 6-5 of the ITAA 1997 for the provision of rights to exploration services (or statutory income under s 15-2), with the amount of assessable income being equal to the market value of the assets farmed out by the farmor in respect of the exploration services.¹⁴² An alternative CGT anti-overlap provision should therefore apply, subject to cashflow problems caused by timing difficulties,¹⁴³ to eliminate any capital gain from CGT event D1 to the extent that the right relates to exploration services.¹⁴⁴

However, to the extent that the farmee provides a right to an unascertained amount of expenditure (such as an unquantified carry), there is no clear anti-overlap provision. This is potentially a perverse outcome, since the capital gain from CGT event D1 is likely to equal the deduction available to the farmee under the UCA provisions in respect of that part of the cost of the farmed-out UCA assets for

¹³⁶ ITAA 1997, s 40-305(1)(b), Items 3, 6; Revised Explanatory Memorandum to the *New Business Tax System (Capital Allowances) Bill 2001* (Cth) at [3.37], [3.40].

¹³⁷ The time of the CGT event is when the farmee enters into the farmout agreement: ITAA 1997, s 104-35(2).

¹³⁸ ITAA 1997, s 116-20(1)(b).

¹³⁹ ITAA 1997, s 104-35(3).

¹⁴⁰ MT 2012/1 at [52].

¹⁴¹ As noted in Part 2 above, the farmee would, separately, potentially be entitled to a deduction for the expenditure on exploration services.

¹⁴² MT 2012/1 at [55]-[56], [132]-[134].

¹⁴³ Since MT 2012/1 records the Commissioner’s intention to include the market value of the farmed-out assets in the farmee’s income over time on the basis that the income is only derived as the services are provided: MT 2012/1 at [56], [134].

¹⁴⁴ ITAA 1997, s 118-20(1). To the extent that a deduction would otherwise be obtained for incidental costs such as solicitor’s fees, these amounts would also be excluded from being included in the incidental costs, therefore preventing an additional capital loss for the farmee: ITAA 1997, s 110-45(1B).

which the right is provided;¹⁴⁵ yet there is no clear basis for the farmee to obtain tax recognition for the payments in satisfaction of the right (discussed further below). The Commissioner avoids a similar outcome under the draft earnout ruling as a result of CGT event D1 by treating the buyer as “borrowing money or obtaining credit from” the seller as a result of the right, so falling within an exception to CGT event D1.¹⁴⁶ This is a very strained construction,¹⁴⁷ so it is not surprising that it is not employed in MT 2012/1.

In addition to whether CGT event D1 occurs, there is the further question whether recognising the creation of a separate obligation on the part of the farmee at the time of the farmout might impact on the farmee’s ability to claim deductions under the UCA regime for expenditure actually incurred or the actual cost of services provided. It is the combined position that is relevant for testing the commercial outcome for farmees. MT 2012/1 accepts that the farmee can potentially obtain deductions for expenditure on exploration and prospecting activities under the UCA regime or under the general deduction provision, s 8-1 of the ITAA 1997. This means that any difference in scope between the obligation to provide services and the services actually provided is unlikely to be relevant for the farmee.

Further, no issue will arise where the right is to an ascertained amount. For payments made in satisfaction of rights to unascertainable amounts, MT 2012/1 proceeds on the basis that the capital gain from CGT event D1 is likely to net out with the UCA deduction,¹⁴⁸ but then avoids the perverse outcome described above by providing a significant concession to the farmee by accepting that the farmee can qualify for a deduction for payments in satisfaction of the right, at the same time as permitting the farmor a deduction for the same payments.¹⁴⁹ This concession is based merely on a reference to ss 40-730 and 8-1 of the ITAA 1997. This is apparently on the basis that this expenditure is “expenditure incurred on exploration or prospecting” or “[e]xpenditure by the farmee that relates to exploration by the farmee”.¹⁵⁰ Although it may reflect much current practice, the legal justification for this approach seems weak, particularly in relation to s 40-730, if the farmee is acting as agent of the farmor in making such payments, as appears to be assumed in MT 2012/1, which refers to such payments being made “on behalf of”, or “constructively receive[d]” by, the farmor.¹⁵¹ It is unclear how the agent, rather than (or, as well as) the principal, incurs expenditure on exploration or prospecting in these circumstances.

Looking to the alternative ground of s 8-1, the key issues are likely to be whether the expenditure satisfies the “nexus” requirement under either the first or second limb of s 8-1 and the possibility that the expenditure might be excluded from deductibility as being on capital account. The capital/revenue distinction appears the most difficult question. The answer lies in whether the payments relate to the farmee’s business structure or to its operation and is typically found by looking to the character of the advantage sought by the payments, the manner in which the advantage is to be used and the means adopted to obtain it.¹⁵² The second and third factors, however, are likely to be very dependent on the particular circumstances. For instance, if the farmee habitually farms into and out of interests in

¹⁴⁵ Subject to any incidental costs of the farmee.

¹⁴⁶ Draft TR 2007/D10 at [26], [142]-[147].

¹⁴⁷ See Walrut, n 115 at 185; Evans, n 94 at 300.

¹⁴⁸ MT 2012/1 at [75]-[77].

¹⁴⁹ MT 2012/1 at [31]-[33], [75]-[77].

¹⁵⁰ MT 2012/1 at [44], [57], [75]-[77].

¹⁵¹ MT 2012/1 at [10], [15]-[16], [75]. See also at [27].

¹⁵² *Sun Newspapers Ltd v FCT* (1938) 61 CLR 337 at 363; *FCT v Citylink Melbourne Ltd* (2006) 228 CLR 1 at [147]; 62 ATR 648.

tenements, this may support a revenue characterisation based on manner of use; while a series of free-carry payments required to earn an interest in a tenement might also be more likely to be viewed as on revenue account than a single payment.¹⁵³

However, the first factor is often the most influential,¹⁵⁴ and is likely to prove the greatest obstacle. In considering what “advantage” is sought by the payment, it is worth considering how the payments might be treated for CGT and UCA purposes. Under the draft earnout ruling, the Commissioner contends that subsequent payments under earnout rights are not in respect of the acquisition of an asset for CGT purposes.¹⁵⁵ This suggests that such payments are also not paid to hold a depreciating asset, but made “to discharge a liability that is independent of an obligation to pay the purchase price of the original asset”,¹⁵⁶ and so not included in the cost of farmed-out assets for UCA purposes.¹⁵⁷ While an alternative interpretation is open,¹⁵⁸ the explanatory materials indicate that the first element of an asset’s cost must be determined at the time a taxpayer starts to hold it and that payments to satisfy a liability (which was created to acquire the asset) should not also be included because they are “paid to meet [the] liability, not to hold the asset”.¹⁵⁹ The legislative context also supports this construction, since the cost provisions expressly refer to the incurring of a liability to pay an amount.¹⁶⁰

The authorities suggest a similar approach may be adopted under the general deduction provisions in the sense that outgoings in discharge of a promise made to acquire a capital asset are not necessarily capital in nature. If free-carry payments are viewed as linked to the liability created by the farmout agreement and the operator’s cash calls, it is arguable that they relate to operation of the business structure acquired by the farmee (being the rights under the farmout agreement). The advantage sought is that the farmee will be able to continue to exercise its rights under the farmout agreement, will be able to obtain completion of the agreement, or has obtained a financial benefit in the form of use of an amount equal to the value of the farmee’s interest in the tenement, until the completion of the farmout arrangement.

*Cliffs International Inc v FCT*¹⁶¹ provides some support for such an outcome. In that decision, private override royalty payments made in satisfaction of a right granted as part consideration for the purchase of shares in a mining company, were accepted as revenue outgoings, being analogous to royalty payments for use of a patent¹⁶² or as akin to rental payments for the exercise of the right to mine.¹⁶³ Jacobs J asked whether the payments were “merely payment for the capital asset, the shares, already wholly acquired, and which are to be paid for over a period? Or is the purpose of the payment from the practical and business point of view to pay for the current mining operations?”.¹⁶⁴ His Honour found that the amounts were on revenue account as the payments were for the exercise of the right to mine, as they “were in respect of a depreciating asset, that they were recurrent over the life of

¹⁵³ *Cape Flattery Silica Mines Pty Ltd v FCT* (1997) 36 ATR 360 at 373. Although given the purpose of the payments, it may be difficult to describe such payments as periodic payments for a period of use commensurate with the payment: *FCT v Citylink Melbourne Ltd* (2006) 228 CLR 1 at [153]-[155]; 62 ATR 648; *Sun Newspapers Ltd v FCT* (1938) 61 CLR 337 at 363.

¹⁵⁴ *FCT v Citylink Melbourne Ltd* (2006) 228 CLR 1 at [148]; 62 ATR 648.

¹⁵⁵ Draft TR 2007/D10 at [24]-[25], [137]-[141].

¹⁵⁶ Draft TR 2007/D10 at [139].

¹⁵⁷ ITAA 1997, s 40-185(1)(b).

¹⁵⁸ Especially since ITAA 1997, s 40-185(2) expressly prevents double counting of a liability to pay an amount or provide services to the extent that the liability has been satisfied.

¹⁵⁹ Revised Explanatory Memorandum to the *New Business Tax System (Capital Allowances) Bill 2001* (Cth) at [2.14], [2.21]-[2.22].

¹⁶⁰ ITAA 1997, s 40-185(1)(b), Item 2.

¹⁶¹ *Cliffs International Inc v FCT* (1979) 142 CLR 140; 9 ATR 507.

¹⁶² *Cliffs International Inc v FCT* (1979) 142 CLR 140 at 151; 9 ATR 507.

¹⁶³ *Cliffs International Inc v FCT* (1979) 142 CLR 140 at 176; 9 ATR 507.

¹⁶⁴ *Cliffs International Inc v FCT* (1979) 142 CLR 140 at 172; 9 ATR 507.

the asset if the asset was used throughout its life and that the amount of the payments were proportioned to the use made of the asset".¹⁶⁵ Seen as payments to enable the continued exercise of rights under a farmout agreement, the payments also bear some resemblance to the deductible concession fees in *FCT v Citylink Melbourne Ltd*,¹⁶⁶ or, if viewed as being made to obtain a financial benefit, as payments akin to interest¹⁶⁷ that secure the use of the tenement during the period before completion of the farmout agreement.¹⁶⁸

Nevertheless, this seems a highly artificial way of viewing the payments. From a "practical and business point of view",¹⁶⁹ the payments must be made to entitle the farmee to retain an interest in the farmout assets and can therefore be viewed as part payment for the farmout assets.¹⁷⁰ Since they are not linked to the extent of use made by the farmee of the farmed-out assets or rights under the farmout agreement, it appears hard to adopt the approach in *Cliffs International*. From this perspective, the advantage appears capital in nature, forming part of the farmee's business structure.

The nexus condition is that the expenditure is:

- "incurred in gaining or producing" assessable income (first limb); or
- "necessarily incurred in carrying on a business for the purpose of gaining or producing" assessable income (second limb).

To satisfy this nexus test, there must be a sufficient connection between the expenditure incurred and the activities or operations which are productive of assessable income (first limb), or which relate to the business (second limb).¹⁷¹ It is arguable that free-carry payments arise as an incident of the farmee's activities in generating assessable income or carrying on its business in the sense that they are caused by entry into the farmout arrangements and the farmee's implementation of those arrangements.¹⁷² Further, if one looks to the benefits or rights obtained by free-carry payments, making the payments permits the farmee to obtain an interest in the tenement and associated assets and, indirectly, finances exploration on the tenement – which seems at least as close as the head office administrative expenses in *Ronpibon Tin NL v FCT*¹⁷³ incurred to support investment operations, or of *W Nevill & Co Ltd* paying a joint managing director to induce him to resign so as to improve the company's efficiency.¹⁷⁴ This would also be consistent with the approach in *Egerton-Warburton v DFCT*¹⁷⁵ in relation to annuity payments pursuant to an obligation incurred in order to acquire land.

¹⁶⁵ *Cliffs International Inc v FCT* (1979) 142 CLR 140 at 175; 9 ATR 507.

¹⁶⁶ *FCT v Citylink Melbourne Ltd* (2006) 228 CLR 1; 62 ATR 648.

¹⁶⁷ Even though unlikely to be interest as there is no obligation to repay principal: *Macquarie Finance Ltd v FCT* (2004) 210 ALR 508 at [47].

¹⁶⁸ In relation to the deductibility of interest, see *Steele v DFCT* (1999) 197 CLR 459 at [29]; 41 ATR 139: "[I]nterest is ordinarily a recurrent or periodic payment which secures, not an enduring advantage, but, rather, the use of borrowed money during the term of the loan". See also *Robe River Mining Co Pty Ltd v FCT* (1989) 21 FCR 1 at 10; 20 ATR 768, where it appears the parties accepted that interest payments to secure funds to conduct mining activities were deductible.

¹⁶⁹ *Hallstroms Pty Ltd v FCT* (1946) 72 CLR 634 at 648; *Cliffs International Inc v FCT* (1979) 142 CLR 140 at 171-172, 176; 9 ATR 507.

¹⁷⁰ As to the capital nature of "use" payments, such as lease payments, which are linked to the price of an underlying asset, see, for example, *Macquarie Finance Ltd v FCT* (2004) 210 ALR 508 at [47]; *Steele v DFCT* (1999) 197 CLR 459 at [29]; 41 ATR 139; cf *FCT v South Australian Battery Makers* (1978) 140 CLR 645; 8 ATR 879.

¹⁷¹ *FCT v Day* (2008) 236 CLR 163 at [30]-[33]; 70 ATR 14; *Spriggs v FCT* (2009) 239 CLR 1 at [55]-[58]; 72 ATR 148; *Ronpibon Tin NL v FCT* (1949) 78 CLR 47 at 56-57; *FCT v Anstis* (2010) 241 CLR 443 at [27]-[30]; 76 ATR 735.

¹⁷² Just as much as the defamation settlement and legal costs followed on from newspaper publication activities in *Herald & Weekly Times Ltd v FCT* (1932) 48 CLR 113 or the legal costs in *FCT v Day* flowed from Day's obligation not to undertake certain conduct as a public officer: (2008) 236 CLR 163 at [37]; 70 ATR 14.

¹⁷³ *Ronpibon Tin NL v FCT* (1949) 78 CLR 47 at 58-60. The expenses were also incurred in relation to preparations for resuming foreign mining operations, which would be capital outgoings and so not deductible on that basis.

¹⁷⁴ *W Nevill & Co Ltd v FCT* (1937) 56 CLR 290.

¹⁷⁵ *Egerton-Warburton v DFCT* (1934) 51 CLR 568 at 580-581.

Again, one solution would be to apply a single asset approach and such an approach has been applied previously in relation to the purchaser of assets.¹⁷⁶ However, as noted above, the UCA provisions do not expressly refer to amounts being paid or received at “a later time”, as do the CGT provisions,¹⁷⁷ and (unlike the position for a balancing adjustment event) the amount of a depreciating asset’s cost is used for the purposes of calculating its decline in value from the time that the taxpayer first holds the asset and uses it or has it installed ready for use, potentially necessitating amendment of more than one income year’s assessment if the cost is subsequently amended. Treating the creation of an obligation to pay an unascertainable amount as the incurring of a “liability to pay an amount” with the quantum of the amount being determined over subsequent years is also inconsistent with the analysis in Part 3 above. However, it is an argument that is theoretically possible so inclusion in a binding ruling could provide a level of certainty, although given the weak argument, this is not necessarily preferable to the approach existing under the current MT 2012/1.

In addition, as suggested by Evans in the context of earnouts,¹⁷⁸ to the extent this approach is not accepted by the Commissioner, it may be possible for the farmee to obtain a deduction for the excess, if the Commissioner characterises an obligation to pay an unascertainable amount as a loan, in part as a borrowing expense.¹⁷⁹ The business black hole expenditure deduction provision would also potentially be available.¹⁸⁰ Likewise, Eggleston and Cooper’s comments in relation to earnout rights suggest there may be some risk for the farmee that if the payments which extinguish its obligation are less than the amount “borrowed”, there could be an assessable gain.¹⁸¹

UNCERTAINTY IN CONTEXT – JOINT VENTURE OPERATOR

A significant change from the earlier draft rulings is that MT 2012/1 does¹⁸² explicitly discuss the tax result where an operator is interposed between the farmee and third party service providers, as would be common where the farmout concerns an interest in an existing joint venture. This is a welcome development, as often the farmee will agree to meet past or future cash calls made by the joint venture operator,¹⁸³ and it appears from Ruling Compendium MT 2012/1EC to have been prompted by concerns that the draft ruling would only have applied where the farmee undertook exploration itself or through contractors acting on its behalf.¹⁸⁴ Applying the analysis in Parts 3 and 4 and comparing the position under the farmout rulings, this section of the article demonstrates that some uncertainty remains, although the concession of a deduction to the farmee for free-carry payments provides a practical solution to one of the more significant issues, where MT 2012/1 applies. However, for farmees who cannot rely on the farmout rulings the partial solution adopted by MT 2012/1 to the UCA/CGT overlap issues of permitting the farmee deductions for free-carry payments appears technically unsound. Accordingly, an alternative involving disproportionate cash contributions under joint venture agreements, is posed for consideration.

For a deferred farmout, payments would have been made to meet the farmor’s liabilities at the time of the balancing adjustment event, so these should be “amounts” which are included in the termination value of the farmed-out assets.

In the case of an immediate farmout, for ascertained amounts (such as cash calls which have already been made, but are not yet due) the farmee will have incurred the requisite liability and the

¹⁷⁶ See Evans, n 94 at 299-301.

¹⁷⁷ ITAA 1997, ss 103-10(2), 103-15.

¹⁷⁸ Evans, n 94 at 300. See also Eggleston T and Cooper G, “New Draft Ruling on the Taxation of Earn Out Arrangements” (2007) 46 *Weekly Tax Bulletin* [2041].

¹⁷⁹ ITAA 1997, s 25-25(1).

¹⁸⁰ ITAA 1997, s 40-880; see also Evans, n 94 at 300.

¹⁸¹ Eggleston and Cooper, n 178; see also Evans, n 94 at 300.

¹⁸² Although MT 2012/2 expressly does not do so (at [16]).

¹⁸³ See, for example, AIPN Agreement, n 16, cll 4.1(b) (alt 2), 4.1(c) (alt 2). See also Heggart, n 31, pp 16-17.

¹⁸⁴ Which the farmee would not be doing if acting as agent for the farmor in making free-carry payments to the joint venture operator. See, for example, Ruling Compendium MT 2012/1EC, Item 2.

farmor should hold a corresponding right to receive an amount so that it is the amount of the right which is incorporated in the termination value. If the amount of the carry is unascertainable, the better view is that no such right to receive an amount has been created. Therefore, it is the market value, which may be nominal, of the right which would be included in the termination value. This accords with the position under MT 2012/1.¹⁸⁵ Further, as acknowledged in MT 2012/1,¹⁸⁶ as payments are subsequently received, CGT event C2 would occur, requiring the farmor to recognise the excess of the payments over the cost base of the right as capital gains. Alternatively, although not considered in MT 2012/1, if the single asset or look-through approaches are adopted for CGT and, potentially, UCA purposes, the farmor will need to progressively seek amended assessments to recognise the full amount of payments received in the income year of the farmout.

However, as apparently assumed in MT 2012/1,¹⁸⁷ provided the operator is acting as agent for the joint venturers in incurring exploration expenditure,¹⁸⁸ the farmor would potentially be entitled to corresponding exploration expenditure deductions as expenditure is incurred by the operator.¹⁸⁹ Further, even if the operator is not acting as agent,¹⁹⁰ it may be possible for the farmor to come within s 40-730 of the ITAA 1997 on the basis that the payment (by the farmee as its agent) of cash call amounts to the operator is expenditure incurred on exploration or prospecting, since exploration activities are purchased from the operator.

For the farmee, consistently with MT 2012/1,¹⁹¹ a payment or obligation to pay an ascertained amount should be an “amount” or “liability to pay an amount” and should therefore be included in the cost of the depreciating assets which the farmee starts to hold as a result of the farmout. This would potentially permit an immediate deduction of the amount, or amount of the liability, from the time that the farmee holds the assets and has used them or installed them ready for use.¹⁹²

Obligations to pay unascertained amounts under an immediate farmout should result in the market value of the obligation being included in the cost of the farmed-out assets, with a risk that the farmee would have to recognise a corresponding amount as a result of CGT event D1. This is the course adopted by the Commissioner in MT 2012/1.¹⁹³ On a separate asset approach, no clear deduction would exist for subsequent payments to satisfy the obligation to pay an unascertainable amount since the farmee is likely to be characterised as the agent of the farmor for the purposes of making payment of the cash calls to the operator. However, as demonstrated in Example 2 contained in MT 2012/1, the Commissioner concedes a deduction to the farmee for the free-carry component of payments to the joint venture operator.¹⁹⁴ This has the effect that the farmee, in the example, obtains a \$1,000

¹⁸⁵ MT 2012/1 at [27], [75]-[77].

¹⁸⁶ MT 2012/1 at [48]-[49], [75]-[77].

¹⁸⁷ MT 2012/1 at [32], [75]-[77], [122].

¹⁸⁸ Styles S, “Joint Operating Agreements” in Gordon G, Paterson J and Ünmez E (eds), *Oil and Gas Law – Current Practice and Emerging Trends* (2nd ed, Dundee University Press, 2011) p 382; *Energy and Resources Law*, n 17 at [222.570], [222.610]; McMurtrie L and Feely R, “Fiduciary Obligations in Resource Joint Ventures” (2010) 29(3) ARELJ 337 at 340. Including where authority is provided to the operator by approval of a work program or budget: Taylor M and Winsor T, *The Joint Operating Agreement: Oil and Gas Law* (Longman, 1989) p 27.

¹⁸⁹ Under ITAA 1997, s 40-730(1). See also Heggart, n 31, p 16.

¹⁹⁰ The Commissioner accepts that the operator may, in some circumstances, be acting in its own capacity rather than as agent: ATO, *Petroleum Resource Rent Tax: Deductibility of Expenditure to Procure the Carrying on or Providing of Operations, Facilities or other Things by another Person in Relation to a Petroleum Project*, Draft Taxation Ruling TR 2010/D6 at [47], [127] (the draft ruling has been withdrawn as a result of *Esso Australia Resources Pty Ltd v FCT* (2012) 200 FCR 100, a decision which does not affect this analysis). See also O’Rourke S, “Corporate Developments: Joint Venture Governance” [2005] *AMPLA Yearbook* 112 at 115; *Energy and Resources Law*, n 17 at [222.570], [222.610]; Taylor and Winsor, n 188, p 24.

¹⁹¹ MT 2012/1 at [40]-[43], [75]-[77].

¹⁹² Provided the requirements of ITAA 1997, s 40-80(1) are satisfied, including first use for exploration or prospecting. See also ITAA 1997, ss 40-25(1), 40-60(1).

¹⁹³ MT 2012/1 at [52], [75]-[77].

¹⁹⁴ MT 2012/1 at [75]-[77].

deduction (under the UCA regime) for the creation of the free-carry right to an unascertainable amount, which nets off with a \$1,000 capital gain under the CGT regime, but later makes a \$20,000 free-carry payment in satisfaction of the right, for which a further deduction is obtained by the farmee (and the farmor).

Alternatively, if the single asset and look-through approaches were adopted for CGT and UCA, the farmee should be entitled to progressively seek amended assessments to include the full amount of payments in the assets' costs in the income year of the farmout.

This means that, for an immediate farmout, the farmor may only need to include a nominal amount in assessable income when the farmout occurs (if the value of the carry right can be determined by reference to a nominal value for "wildcat" stage assets received under the farmout), with subsequent capital gains and potentially matching deductions over time. This could be a useful outcome for the farmor. For the farmee, the deduction for the market value of the right is likely to be eliminated by a corresponding capital gain, although under MT 2012/1 the farmee would also obtain a deduction for the subsequent payments. However, the lack of a clear basis for this deduction presents a significant disadvantage for farmees who choose not to, or are unable to, rely on MT 2012/1. If a single asset and look-through approach is used, the farmor must potentially include the full value of the payments from the start of the arrangement, with cancelling deductions spread over time,¹⁹⁵ a disadvantage for the farmor. The farmee, however, will obtain the potential benefit of an immediate deduction for the full amount of the payments (once the relevant assessment is amended), while its actual expenditure is then incurred after this point.¹⁹⁶

The reverse would apply for a deferred farmout, with the farmor having the ability to obtain deductions before the balancing adjustment event occurs and the farmee not being able to deduct the cost of the farmed-out assets until the completion of the farmout arrangement, despite making earlier payments to the farmor.¹⁹⁷

The timing problems and, where relevant, risk of loss of deductions for the farmee could be ameliorated if a progressive farmout is commercially acceptable. A progressive farmout could be structured to match, as far as possible, the payments for an income year with the transfer of a corresponding proportion of a depreciating asset. However, such an arrangement would increase the administrative time and costs under a farmout, particularly because multiple registrations for each portion of the tenement transferred would likely be required with the relevant authorities.

An alternative which addresses a number of risks for immediate farmouts and which seems to provide a stronger basis for obtaining exploration deductions, might be to incorporate a concept of disproportionate contributions in joint venture agreements to which a potential farmor is party. Such a provision would permit a joint venture participant to make an election for a certain period of time to reduce the participant's percentage cash call obligations by increasing that of a prospective transferee by an equal amount. Provided the joint venture agreement does not create a liability for a cash call amount until the operator has made a cash call, it should be possible for the farmor to ensure, in this way, that the farmor has no liability to the operator which is met by the farmee. Rather, the farmee would acquire contractual rights under the joint venture agreement of lesser value than might otherwise be the case, since the farmee would be required to assume a disproportionate spend obligation, owed by the farmee under the joint venture agreement rather than under the farmout agreement to the farmor. In making payments to satisfy the obligation, the farmee could potentially obtain exploration or prospecting expenditure deductions.

Typically, where a joint venture agreement is already in existence, the farmee would agree under the farmout arrangements to enter into the joint operating agreement and to ratify its terms, which would include an assumption of the obligations from which the farmor is released and would therefore

¹⁹⁵ The deductions may not precisely equal the market value of the right. See Part 4.

¹⁹⁶ See further Heggart, n 31, p 16.

¹⁹⁷ In addition, the farmee bears an additional risk that the project may move beyond the exploration stage before the transfer occurs, so that deductions are only available over time, rather than immediately upon starting to hold the depreciating assets. See, for example, Ruling Compendium MT 2012/2EC, Item 3.

include an obligation to make disproportionate contributions.¹⁹⁸ The contractual right created in the farmor may well amount to a non-cash benefit and so be included in the termination value of the farmed-out assets. However, the right concerns the entry of the farmee into an agreement that will provide it with a mix of rights and obligations. To the extent that the assets farmed-out have only a nominal value, there should be a reasonable argument that the right to have the farmee enter into the joint venture agreement also has only a nominal value.

These contractual arrangements would assist in ensuring that the farmor does not have to recognise the disproportionate contribution payments made by the farmee and that the farmee is potentially able to obtain a deduction for such payments. It should not matter whether the separate asset or the single asset and look-through approaches are applied.

CONCLUSION

The farmout rulings should be welcomed as a major step toward resolution of the position. The Commissioner appears correct to treat the farmor as receiving a benefit from the farmee “for” the assets farmed-out under the UCA regime. However, the rulings arguably do not sufficiently identify what benefits are received or provided by the farmor and farmee for the farmed-out assets. This is particularly relevant for immediate farmouts because the benefits would typically include rights to amounts, services and non-cash benefits in the form of contractual rights. This raises the question whether the separate asset approach proposed for earnouts in the draft earnout ruling should apply to farmouts.

MT 2012/1 is a significant improvement on the draft rulings because it recognises that the separate asset analysis will apply in relation to the grant of free-carry rights to unascertainable amounts. However, it fails to consider the issue for rights to services and does not adequately discuss the implications where the amounts or services ultimately delivered differ from the value of the rights initially created. These implications could well determine whether the farmout rulings result in a revenue Nirvana or Hades for farmors and farmees – thus leaving a degree of uncertainty in place. More significantly, for the farmee, MT 2012/1 accepts that subsequent payments in satisfaction of a right are potentially deductible. This is a major concession when compared with the draft rulings, which appears to have no clear basis other than practice. However, a significant risk remains for farmees who are unable to rely on the ruling, or for whom the status of activities on the farmed-out tenements moves beyond exploration between the time of the farmout and the time for payment of free-carry amounts.¹⁹⁹

Accordingly, single asset and look-through approaches have also been explored for CGT (and UCA) on the basis that they could produce an equally commercially acceptable outcome. Unfortunately, the legal basis for such approaches, particularly for UCA purposes, is likely weak such that they could only provide certainty if the Commissioner includes them in a revised form of the farmout rulings or if they are incorporated by legislative amendment.

This article has demonstrated the potential uncertainty in the context of free-carry payments to a joint venture operator, including the surprising level of risk for the farmee in circumstances where MT 2012/1 cannot be relied upon for a deduction in respect of free-carry payments. However, in this context, it is submitted that optional disproportionate contribution provisions in joint venture agreements may assist in providing a stronger basis for reducing the termination value for the farmor and in ensuring exploration expenditure deductions for the farmee.

¹⁹⁸ See AIPN Agreement, n 16, Arts 2.2, 5.1, 12.2(D)(1).

¹⁹⁹ Which would preclude deductions under ITAA 1997, s 40-730. The difficulties in relying on the main alternative path to a deduction (ITAA 1997, s 8-1) are discussed above.