A REVIEW OF SOME ASPECTS OF THE ORGANISATION AND FINANCING OF MINERAL RESOURCE VENTURES—PART II

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In this article—the second part of an article published in Volume One of this Journal*—the author considers the taxation implications of some mineral resource venture financing structures; overriding royalty interests, production payment interests, overriding royalties in cash or in kind, production payments in cash or in kind, carried interests and net profits interests. These expectancies are considered at various stages and from the point of view of both the holder of the expectancy and the working interest owner. Different methods of structuring mineral resource ventures will result in different taxation implications.*

In an earlier article[1] the writer analysed the Australian adaptation of certain arrangements, of North American origin, for the organisation and financing of mineral resource ventures. This article looks at some of the tax implications of those arrangements. The two articles should be read together.

I OVERRIDING ROYALTY INTERESTS—ON CREATION

In the creation of an overriding royalty interest by reservation,[2] A (the holder of the mineral concession) will either assign an undivided beneficial interest to B, or sublease jointly to A and B, thus retaining the right to extraction of minerals in common with B. On either basis B will bear the entire cost of exploration, development and mining. Obviously, when relevant minerals are actually produced and sold, the royalty holder will then derive assessable income either under section 25(1) of the Income Tax Assessment Act 1936 (Cth), as amended, or by virtue of a specific provision such as section 26(f).[3] The question is

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[1] Nicholls, "A Review of Some Aspects of the Organization and Financing of Mineral Resource Ventures" (1976) 1 *U.N.S.W.L.J.* 271. The expressions "overriding royalty interests", "production payment interests", and other related expressions here used, are there explained and defined.

[2] In a "reservation" situation the holder of a mineral concession assigns or subleases it to a working interest owner, reserving to himself an overriding royalty or other interest. In the converse "carve-out" situation, the holder of the concession himself continues as the working interest owner, granting an overriding royalty or other interest to some other party.

[3] See *Stanton* v. *Federal Commissioner of Taxation* (1955) 92 C.L.R. 630; *Federal Commissioner of Taxation* v. *Sherritt Gordon Mines Ltd* (1977) 17 A.L.R. 607; *Minister of National Revenue* v. *Wain-Town Gas & Oil Co. Ltd* [1952] 2 S.C.R. 377.

whether there is any immediate derivation of "income" at the time of the initial transaction.

An affirmative answer must assume that there has been an exchange of assets for consideration having[4] or convertible to[5] a money value: namely, the capitalised present value of the anticipated proceeds. The persuasiveness of this assumption would seem to depend on the likelihood of actual proceeds. A royalty for "wild cat acreage" might not be realisable at all, or only at a nominal value; a royalty for a mineral concession already producing minerals to meet existing sales contracts might lie at the other extreme.[6]

Once it is shown that the royalty has or is convertible to a money value, the question of derivation of income may be approached in several ways.

First, one must consider whether there has been a gain arising in the course of a business, as distinct from a disposal of part of its profit-yielding structure.[7] Assuming that there is a relevant "business",[8] the question usually framed is whether the asset disposed of is a "revenue asset" (giving rise to income) or "part of the profit-yielding structure" (in which case the gain is not income). If this formulation be adopted, then a mineral concession held by a mining company would prima facie be a structural asset;[9] and disposal of a significant interest in it would not, of itself, give rise to assessable income at that time.

There is, however, a more appropriate question. Does the transaction involve a realisation of the asset in the course of carrying on the

[4] Income Tax Assessment Act 1936 (Cth), as amended, s. 21.

[5] *Tennant* v. *Smith (Inspector of Taxes)* [1892] A.C. 150; *Abbott* v. *Philbin (Surveyor of Taxes)* [1961] A.C. 352. *Cf. Reed* v. *Cattermole (Inspector of Taxes)* [1937] 1 K.B. 613.

[6] *Cf.* the emphasis on the need for an ascertainable market value by Dixon C.J. (dissenting on other grounds) in *Federal Commissioner of Taxation* v. *W.E. Fuller Pty Ltd* (1959) 101 C.L.R. 403, 408, and by Pitney J. in *Eisner* v. *Macomber* (1920) 252 U.S. 189, 207. See also *Commissioner of Internal Revenue* v. *P.G. Lake Inc.* (1958) 356 U.S. 260; Exley and Maynes, "Taxation and Rating—Practical Problems", in 1 *Proceedings of the Petroleum Law Seminar* (Committee "O", International Bar Association, Cambridge, 1978), esp. Part 2(a).

[7] *Australasian Catholic Assurance Co. Ltd* v. *Federal Commissioner of Taxation* (1959) 100 C.L.R. 502. It is only the gain (as opposed to gross "proceeds") which will be regarded as income.

[8] "Generally, it would seem that existence of a business is an objective inference from the facts though some of the cases do not entirely exclude the subjective intention of the taxpayer as a relevant consideration". Parsons and Kenneally, *Principles of Income Tax Law in Australia* (1969) Vol. I, Ch. III.

[9] *Hughes (Inspector of Taxes)* v. *British Burmah Petroleum Co. Ltd* (1932) 17 Tax Cas. 286, 295; *Coltness Iron Co.* v. *Black (Assessor of Taxes)* (1881) 6 App. Cas. 315; *Alianza Co. Ltd* v. *Bell* [1906] A.C. 18; *Commissioners of Inland Revenue* v. *Newcastle Breweries Ltd* (1927) 12 Tax Cas. 927, 942. See also *Calgary & Edmonton Corporation Ltd* v. *Minister of National Revenue* [1955] Canada Tax Cases 161; *Admin Exploration Pty Ltd (In Liquidation)* v. *Federal Commissioner of Taxation* [1972] A.T.C. 4253; *Stow Bardolph Gravel Co. Ltd* v. *Poole (Inspector of Taxes)* [1954] 1 W.L.R. 1503; *H.J. Rorke Ltd* v. *Inland Revenue Commissioners* [1960] 1 W.L.R. 1132.

business? Or does it involve a termination of the business, a reduction in its scope or a change in its direction, or withdrawal from or abandonment of a substantial sphere of activity?[10] By this test, the reservation of an overriding royalty interest could be treated as *not* giving rise to income only if the mineral concession involved was the taxpayer's sole concession (or one of a very few concessions).

In a reservation on assignment, the retention of an overriding royalty interest might suggest that there has been no realisation of an asset. But whatever interest is assigned for the future to the working interest owner *has* been realised. (The consideration is the assurance that the holder of the overriding royalty interest is relieved from further contributions to exploration and exploitation costs.) Indeed, the reservation of an overriding royalty in cash or in kind will usually involve a realisation of the whole mineral concession.

In all these cases, however, I would argue that there is no relevant "gain", and no receipt to be taken into the calculation of a gain, until there is an actual receipt by the overriding royalty holder of either production or cash.

Secondly, one must consider whether the transaction is caught by section 26(a) of the Act. A sublease arrangement may not be a "sale" within the meaning of the first limb of section 26(a); but the second limb may well apply to both sublease and assignment situations. Again, however, as with "gain in the course of a business", the essential argument would be that there have been no proceeds of the realisation until production or cash is received.

Finally, one must consider whether the royalty arrangement operates as "compensation" for what would otherwise have been a revenue asset (namely, the mineral concession)[11] or a source of anticipated income receipts (namely, the proceeds of sale of mineral production from the concession). On the latter approach, since the proceeds of sale would be income,[12] the compensation itself would be income.

If, however, the mineral concession was treated not as a revenue asset but as part of the profit-yielding structure,[13] neither analysis

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[10] *Van den Berghs Ltd* v. *Clark (Inspector of Taxes)* [1935] A.C. 431; *Edgerton Fuels Ltd* v. *Minister of National Revenue* [1970] Canada Tax Cases 202; *Dickenson* v. *Federal Commissioner of Taxation* (1958) 98 C.L.R. 460; *Evans Medical Supplies Ltd* v. *Moriarty (Inspector of Taxes)* [1957] 1 W.L.R. 288; *Murray (Inspector of Taxes)* v. *Imperial Chemical Industries Ltd* [1967] Ch. 1038; *British-Borneo Petroleum Syndicate Ltd* v. *Cropper (Inspector of Taxes)* [1968] 1 W.L.R. 1701. *Cf. Rolls-Royce Ltd* v. *Jeffrey (Inspector of Taxes)* [1962] 1 W.L.R. 425; *Musker (Inspector of Taxes)* v. *English Electric Co. Ltd* (1964) 41 Tax Cas. 556.

[11] *British-Borneo Petroleum* case, note 10 *supra*.

[12] *Newcastle Breweries* case, note 9 *supra*, 943-944; *Waterloo Main Colliery Co. Ltd* v. *Commissioners of Inland Revenue* (1947) 29 Tax Cas. 235, 242.

[13] *Van den Berghs* case, note 10 *supra; Glenboig Union Fireclay Co. Ltd* v. *Commissioners of Inland Revenue* (1922) 12 Tax Cas. 427. *Cf.* the *Stow Bardolph* and *H.J. Rorke* cases, both note 9 *supra*.

would seem to be tenable. The mere fact that the future income was taken into account in determining the *amount* of the overriding royalty could hardly be decisive: "the measure that is used for the purpose of calculating a particular result" cannot dictate "the quality of the figure . . . arrived at by means of the test".[14]

In any event, the substance of the transaction is clearly not compensatory. If it is to have any revenue aspect, it should be as either the realisation or the utilisation of an asset. The argument in terms of compensation should fail.

If the transaction were held to involve a derivation of assessable income, the royalty holder would presumably seek to take into account, in determining the amount of assessable income, his prior costs of acquiring and maintaining the mineral concession. In the case of assessment under section 26(a), or under section 25(1) if only the gain was brought into account,[15] he might be able to do so. If, however, he had to rely on section 51(1) to obtain a deduction for the past costs, there would be obvious difficulties. First, he would be faced with the argument that the maintenance costs were incurred prior to the commencement of the business.[16] Second, the acquisition costs, and perhaps the maintenance costs as well, would probably be regarded as capital costs.[17]

As for the case where the overriding royalty interest is "carved out" rather than reserved,[18] so that the original concession holder continues to hold the working interest subject to the newly created royalty, the position appears to depend on the purpose of such an arrangement. If the purpose were to *sell* the royalty (either by actually assigning it for cash, or by obtaining a cash premium through a subleasing arrangement whereby the concession holder granted a sublease to himself and the overriding royalty holder), then the principles already considered would apply *mutatis mutandis*. Again, the question would be whether the present capitalised value of an overriding royalty could be regarded as "income" at the time of its creation; and only a net gain could be included. But, of course, the concession holder could not argue that he had not received any gain.

On the other hand, if the purpose were to *use* the royalty as security for the raising of debt finance (for example, by creating the overriding royalty interest in favour of a trustee, and then mortgaging the resulting equity to a financier), there could be no question of "income". For this would involve a *use* of the taxpayer's assets, not their realisation.

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[14] Lord Buckmaster in the *Glenboig* case, note 13 *supra*, 464; quoted by Lord Macmillan in the *Van den Berghs* case, note 10 *supra*, 442.

[15] See note 7 *supra*.

[16] *White* v. *Federal Commissioner of Taxation* (1968) 120 C.L.R. 191.

[17] *Id.*, 210-211; and see citations in note 9 *supra*.

[18] See note 2 *supra*.

Generally, the principles here outlined for overriding royalty interests are applicable also to the creation of other types of expectancy—overriding royalties in cash and in kind, production payment interests, and production payments in cash and in kind. The creation of these other expectancies therefore need not be examined in detail.

II OVERRIDING ROYALTY INTERESTS AND PRODUCTION PAYMENT INTERESTS—AFTER CREATION

1. *The Position of the Holder of the Expectancy*

The holder's share of minerals attributable to the overriding royalty interest or production payment interest becomes his when severed from the ground. Income from the sale of such minerals is therefore clearly included in his assessable income under section 25(1). However, it will not be income from the carrying on of a mining business for the purposes of Division 10,[19] or income from the carrying on of prescribed petroleum mining operations[20] for the purposes of Division 10AA, unless there is a joint venture arrangement between the holders of the expectancy and of the working interest. A mere passive role will not suffice; the expectancy holder must be actively engaged (or, at the least, actively represented) in the mining operation.

In the absence of a joint venture agreement, only the working interest owner carries on mining operations. In doing so he produces not only the minerals to which he is entitled, but also those to which the expectancy holder is entitled. Those minerals are the property of the latter, subject only (apart from explicit agreement to the contrary) to the working interest owner being reimbursed for his costs.[21]

I shall now consider what costs and expenses may be offset by the expectancy holder against the income derived from the sale of his share of the minerals. Obviously, any expenses of the actual sale would be deductible.

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[19] Under Division 10, exploration and prospecting expenditures are only deductible from assessable income from a mining business carried on by the taxpayer and activities associated directly therewith (other than a business of mining for petroleum). Other expenditures which are allowable capital expenditures for the purposes of Division 10, and are included in the taxpayer's residual capital expenditure, are deductible from income from any source to the extent therein specified. Under Division 10AA, exploration and prospecting expenditures and other expenditures which are allowable capital expenditures for the purposes of that Division, and which were incurred on or before 17 August, 1976, can only be offset against "assessable income from petroleum" as defined in s. 6. See generally Oser and Nicholls, "The Structure of Mineral Resource Ventures I: Tax Aspects", in *Mining Resources Development in Australia* (1977) (Seminar proceedings, University of Sydney Law School).

[20] As defined by s. 124.

[21] Olisa, "Legal Problems Arising out of Co-Ownership of Oil and Gas Leasehold Estate and Facilities" (1970) 8 *Alberta L. Rev.* 177, 178-182, discussing *Henderson* v. *Eason* (1851) 17 Q.B. 701, 117 E.R. 1451, as followed in *Spelman* v. *Spelman* [1944] 2 D.L.R. 74.

The expectancy holder would have incurred no expenditure on exploration, development or production, unless he had done so before the creation of the expectancy. Apart from section 26(a) (to be considered presently), such *prior* expenditure would not be deductible—either because it arose before the relevant business commenced, and hence not in the gaining or producing of assessable income, or because it was expenditure of a capital nature (for instance, the cost of acquisition).

It would also be difficult to obtain a deduction under section 51(1) for maintenance expenses. The argument would be that such expenses related not to the gaining or producing of the assessable income derived from the sale of the minerals, but rather to the maintenance of the right to extract the minerals, that right being of a capital nature.

If assessment were under section 26(a), the expectancy holder might claim to be assessed only on a "profit emerging" basis. Assuming that this claim were accepted, there would be difficult questions as to the proper basis for calculation of the emerging profit. Should the costs prior to reservation or carve-out be amortised on some basis over the expected term of the royalty stream, or written off against the first income derived? The principles adopted in *Federal Commissioner of Taxation* v. *Thorogood*[22] are an inadequate guide to the problem, since that case involved the allocation of costs in a land subdivision—a different and essentially an easier problem.

In a carve-out situation, quite apart from section 26(a), the expectancy holder might argue that the annuity purchase cases[23] should be applied by analogy, so that each amount of the proceeds of sale would to some extent be regarded as a return of capital.

2. *The Position of the Working Interest Owner*

The holder of an overriding royalty or production payment interest is entitled to a share of the minerals corresponding to his stipulated royalty or production payment percentage. It follows that the working interest owner—the party "paying" the royalty—cannot be held assessable in respect of the proceeds of sale of that share. Yet he has

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[22] (1927) 40 C.L.R. 454.

[23] See Hannan and Farnsworth, *The Principles of Income Taxation* (1952) 76. *Just* v. *Federal Commissioner of Taxation* (1949) 23 A.L.J. 47, and *Egerton-Warburton* v. *Deputy Federal Commissioner of Taxation* (1934) 51 C.L.R. 568, both assume that annuities need not be of fixed amounts. See also 17 C.T.B.R. (N.S.) Case 101; *Re Fitch's Will Trusts; Public Trustee* v. *Nives* (1928) 139 L.T. 556. However, the annuity provisions of s. 26AA(2)(a) appear to apply only to annuities payable to individuals. A corporate expectancy holder would therefore have to rely on s. 26AA(2)(b); and for that purpose the expectancy would need to be for a fixed term. The argument would be more difficult on a reservation than in a carve-out situation, since the holder of an expectancy by reservation might be hard pressed to show that there had been a "purchase" within the meaning of s. 26AA, and to specify the amount of the purchase price.

had to bear *all* the costs and expenses of exploration, development and production. Can he therefore obtain deductions[24] in respect of so much of the costs and expenses as is attributable to the expectancy holder's share?

(a) *Section 51(1) Deductions*

The working interest owner could have problems with the first limb of section 51(1). It could be argued that only the working interest percentage of the expenditure was attributable to the gaining or producing of *his* assessable income, the remainder being attributable to the production of assessable income of another person, the expectancy holder. Indeed, one need not go so far. It is enough that there is some portion of the working interest owner's expenditure which cannot be said to relate to the gaining of *his* assessable income.

As to that portion, it may be possible to secure deductibility on the basis of the Privy Council's decision in *Europa Oil (N.Z.) Ltd* v. *Inland Revenue Commissioner*.[25] The argument would be that the working interest owner's *total* outgoings were necessarily expended to receive his share of production. The fact that such expenditure gave rise to economic advantages for another party would not affect its revenue character so far as the working interest owner himself was concerned.

If that argument failed, the question of apportionment would arise. Would the working interest owner's claim to deduction in respect of the *whole* cost of exploration and exploitation simply be reduced to the percentage attributable to his working interest? Or would such apportionment not be allowed, with the result that the whole of his claim to deduction would be rejected?

In *Ronpibon Tin No Liability* v. *Federal Commissioner of Taxation*,[26] it was expressly recognised that section 51(1) allows "the dissection and even apportionment of losses and outgoings":

> [T]he problem is to apportion outgoings which have a double aspect, outgoings that are in part attributable to the gaining of assessable income and in part to some other end or activity. . . . [A]t least two kinds of items of expenditure . . . require apportionment. One kind consists in undivided items of expenditure in respect of things or services of which distinct and severable parts are devoted to gaining or producing assessable income and distinct and severable parts to some other cause. . . . The other kind . . . consists in those [items] involving a single outlay or charge which

[24] To the extent only, of course, that such costs and expenses would otherwise be deductible if the working interest owner held 100% of the mineral concession. Special investment allowance deductions under ss. 82AA-82AQ (Division 3, Subdivision B) are outside the scope of this article. See Oser and Nicholls, note 19 *supra*, 71-72.

[25] [1976] 1 W.L.R. 464.

[26] (1949) 78 C.L.R. 47, 55.

> serves both objects indifferently. . . . With the latter kind there must be some fair and reasonable assessment of the extent of the relation of the outlay to assessable income.[27]

The *Ronpibon* case was mainly concerned with the first and second limbs of section 51(1), not with the question of whether expenditure was of a capital nature. It was in the latter context that Walsh J., in *Poole* v. *Federal Commissioner of Taxation*,[28] refused to make an apportionment. Insofar as his Honour's observations suggest, as a matter of principle, that in order for apportionment to be appropriate there must be "evidence . . . which could provide a formula for such a division", such a suggestion seems clearly inconsistent with the *Ronpibon* case.

For our purposes, if the expenses attributable to the expectancy holder's share of production were held not to be deductible in full under section 51(1), this would seem to be a case in which apportionment should and would be allowed.[29]

(b) *Depreciation*

The first problem is whether section 54 would apply at all in a case where the taxpayer (in this instance the working interest owner) has only an undivided interest as tenant in common in the plant or other property fixtures for which depreciation is claimed.[30] Even if the section applied, the taxpayer could only obtain a deduction in respect of so much of the property as was owned by him.

The next problem is section 61, enabling the Commissioner to allow only a partial deduction where the use of property is "only partly for the purpose of producing assessable income". Even if the working interest owner owned the whole of the plant and fixtures, he would still be using them "only partly for the purpose of producing [his] assessable income". Accordingly, he would not be entitled to a depreciation deduction in respect of expenses attributable to the expectancy. But, by the same token, his claim to apportionment should face no such problems as *Poole's* case might raise in relation to section 51(1).

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[27] *Id.*, 59.

[28] (1970) 122 C.L.R. 427, 440. *Cf. Roseberry-Surprise Mining Co.* v. *R.* [1924] S.C.R. 445.

[29] The second limb of s. 51(1) might perhaps be relied on, either on the ground that the words "to the extent" are not there applicable (but see the *Ronpibon* case, note 26 *supra*, 55); or on the ground that despite those words, it suffices that the expenditure was necessarily incurred in the carrying on of a business for the purposes of producing assessable income. The working interest owner could argue that *his* minerals could not be extracted unless the *whole* of the expenditure was incurred.

[30] In practice, in assessing joint venture arrangements for mineral resource projects, the Commissioner appears to allow each joint venturer to claim separately for depreciation deductions in respect of his expenditure on plant and fixtures in which he holds only an undivided interest as tenant in common. See Oser and Nicholls, note 19 *supra*, 10-17.

(c) *Amortisation under Division 10 (General Mining)*

Would the working interest owner obtain a deduction (if otherwise allowable under Division 10) for the share of exploration and development costs attributable to the expectancy? Insofar as such costs were allowable capital expenditure under Division 10,[31] it might be argued that all of them, including those attributable to the expectancy holder's share of production, were expenditure incurred by the taxpayer in carrying on prescribed mining operations. Section 122A(1) refers simply to "expenditure of a capital nature incurred by the taxpayer", including "(a) expenditure in carrying on prescribed mining operations"; and section 122 defines these as "mining operations . . . carried on for the purpose of gaining or producing assessable income". To restrict the allowance proportionately to so much of the expenditure as was referable to the income-producing phase of the operations would read in words that are not there. On this argument, one only needs to have *some* assessable income, actual or prospective, in order to make *all* the expenditure qualify for inclusion. It would be irrelevant that some of the expenditure goes to the mining of minerals which will be owned by the expectancy holder, and is therefore for the purpose of enabling *him* to produce assessable income.

This reasoning, however, may not be applicable to section 122A(1)(b), which refers to expenditure on plant "for use primarily and principally in the treatment of minerals obtained from the carrying on by the taxpayer of prescribed mining operations"; for this *may* be read as applicable only where the minerals treated are primarily the taxpayer's own. If an overriding royalty interest affects only a small percentage of minerals, this should cause no problem. But where the percentage of minerals processed for others is substantial (for example, in the case of a production payment interest relating to fifty per cent of production), it may be that the plant is not used "primarily and principally" for the treatment of the minerals of the working interest owner.

As to exploration and prospecting expenditures incurred by the working interest owner but attributable to the expectancy holder's share of production, these would appear to fall within the language of section 122J. They would, therefore, be available as deductions to the working interest owner in the same way as his own exploration and prospecting

[31] By no means all expenditures commercially related to development are so allowable. See, *e.g.*, the extensive reports and surveys for the "Deepdale Development Proposal", discussed by Kitto J. in *Federal Commissioner of Taxation* v. *Broken Hill Pty Co. Ltd* (1969) 120 C.L.R. 240, 257-260. Such expenditures may also not be exploration or prospecting expenditures for the purposes of Division 10 and Division 10AA. See ss. 122J(6) and 124AH(7). And see Hanson, "The Time of Commencement of a Business" (1974) 3 *Australian Tax Rev.* 183, 186; *Bowater Power Co. Ltd* v. *Minister of National Revenue* [1971] Canada Tax Cases 818; *Falconbridge Nickel Mines Ltd* v. *Minister of National Revenue* [1965] Canada Tax Cases 82, 90-93.

expenditures. If anything, the argument here seems more promising than that in relation to section 122A.

The question of whether *all* the expenditure must be directed or related to the gaining or producing of assessable income by the working interest owner seems not to be affected by section 122S. That section appears to be concerned, not so much with the extent to which a particular expenditure is to give rise to a deduction, but rather with the extent to which a deduction which *is* allowed or allowable—that is, one for which the question of deductibility has already been answered in the affirmative—is to be treated as attributable to a particular expenditure which was taken into account in determining entitlement to that deduction. In other words, the section is designed to permit the Commissioner, once a deduction is allowed or becomes allowable, to review the component elements in the calculation.[32]

(d) *Amortisation under Division 10AA (Petroleum)*

Expenditure which would otherwise be included in allowable capital expenditure under Division 10AA will not, in my view, be excluded by reason only that it relates to the share of production attributable to an overriding royalty interest or production payment interest. Section 124AA(2) provides that allowable capital expenditure for the purposes of Division 10AA is "expenditure of a capital nature" incurred by the taxpayer *inter alia* in carrying on "prescribed petroleum operations", which section 124 defines as "mining operations in Australia for the purpose of obtaining petroleum". As in the case of Division 10, there does not appear to be any restriction of allowable capital expenditure to that related directly to the taxpayer's earning of assessable income from the mining operations.[33]

Section 124AH (as to petroleum exploration and prospecting expenditure) is likewise apparently not restricted to expenditures solely related to the interest of the working interest owner. Section 124AP corresponds to section 122S.

3. *Production Payment Interests at the End of the Payout Period*

Once the production payment interest has been "paid out", the entire interest in the mineral concession reverts to the working interest owner. The consequences must be considered in relation to depreciation, Division 10 and Division 10AA.

As to depreciation, section 59AA can have no application. If depreciation has been allowed, it can only have been allowed to the

[32] See Treasurer's Explanatory Memorandum on the Income Tax Assessment Bill (No. 2) 1974, p. 121.

[33] The allowable capital expenditure for accommodation and facilities for employees under s. 124AA(2)(c) and (d) is restricted to "employees of the taxpayer"; but this can be met by appropriate structuring of arrangements as to who employs the personnel on the site.

working interest owner in respect of his undivided interest in the property in question. If that interest has throughout been one of sole ownership, there will be no change of ownership attracting section 59AA. If the working interest owner had something less than sole ownership, then the interest of the expectancy holder could not have been property in respect of which depreciation was allowed or became allowable, since he could not have incurred any costs in respect of such property. All such costs would have been incurred by the working interest owner.

A similar line of argument would apply in relation to section 122R (Division 10) and section 124AO (Division 10AA).

III OVERRIDING ROYALTIES IN KIND AND PRODUCTION PAYMENTS IN KIND—AFTER CREATION

1. *General Principles*

If there is an overriding royalty in kind which does not amount to an overriding royalty interest, then the question arises whether one can speak of it as "reserved" in the sense applicable to overriding royalty interests. Apart from the special case in which minerals are privately owned one cannot, in Australia, sell minerals or petroleum *in situ*, since the holder of the mineral concession has no title to the minerals prior to severance, but only the right to extract them. Accordingly, it seems impossible to speak of the holder of an overriding royalty in kind as having "reserved" an interest in mineral production in the sense here used.

An overriding royalty in kind or production payment in kind will generally be regarded either as consideration for an assignment, or as rental for a sublease. It could, of course, also be created by the working interest owner "carving" it out of his interest and selling it; or transferring it in consideration for the performance of work; or using it as security for the raising of debt finance.

It may be that when the relevant minerals are severed from the ground they are initially the property of the working interest owner, who then delivers them to the expectancy holder in pursuance of what is merely a contractual obligation. However, there is another approach which suggests that (depending on how they are structured) these arrangements may vest beneficial ownership in the holder of the expectancy at the moment of severance. In *B. & B. Royalties Ltd* v. *Minister of National Revenue*,[34] it was held that the substance of the transaction was an irrevocable alienation of a stated percentage share of any production recovered, or the proceeds of that production—so that it could not be said that the working interest owner ever received any "net profits or gain" on the sale of that share.

[34] [1940-1941] Canada Tax Cases 65.

2. *The Position of the Holder of the Expectancy*

(a) *Derivation of Income*

In a *B. & B. Royalties* situation, it is arguable that the value of the expectancy holder's share of production is included in his assessable income at the moment of its severance from the ground. However, if at the moment of severance all minerals are the property of the working interest owner, who then has a contractual obligation to deliver the appropriate share to the holder of the expectancy, the point of time at which the latter may be said to derive assessable income is unclear. Does he derive income when the minerals are received by him, or only when they are sold by him?

On the basis of *Tennant* v. *Smith* and *Abbott* v. *Philbin*,[35] and of section 21 of the Act, any income would be derived at the time the minerals were received, the amount of the income being equal to the value of the minerals at that time. That value may well, of course, be different from the proceeds of sale. In determining the tax consequences of such a difference, the trading stock provisions would presumably apply.

In view of section 25(1) and the periodic receipts cases collected in the *I.C.I.* case,[36] the assumption that income is derived at the time of receipt of the minerals does not seem open to realistic challenge. Whatever the capital nature of the consideration would otherwise be, the periodic and recurring nature of the deliveries of shares of production would make them assessable income in the hands of the expectancy holder.

It should be noted that section 26(f) would not be applicable. That provision includes in assessable income only "any amount received as or by way of royalty"; and in the case of an overriding royalty in kind or production payment in kind, there is no "amount received". Nor would section 21 operate to affect this conclusion. That section, applying to "consideration . . . paid or given otherwise than in cash", provides that its "money value" shall be deemed to be paid or given. But this only deems the "money value" of the non-cash consideration to have been received; it does not deem the value so received to be an "amount received".

(b) *Division 10 and Division 10AA*

It would seem that the assessable income derived on receipt of the minerals is neither income from the carrying on of a mining business for the purposes of Division 10, nor income from petroleum for the purposes of Division 10AA.[37]

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[35] Both cited in note 5 *supra*.

[36] *Murray (Inspector of Taxes)* v. *Imperial Chemical Industries Ltd*, note 10 *supra*, esp. 1051-1052 *per* Lord Denning M.R.

[37] See note 19 *supra*.

Nor, in the case of petroleum, would section 124AJ(2)[38] apply. What the holder of the expectancy receives is not "a share of the income" derived by the working interest owner from the sale of petroleum obtained from mining operations carried on by him. What is delivered is a share of petroleum from mining operations carried on by the working interest owner. Even if (as in *B. & B. Royalties*) the petroleum is the property of the expectancy holder at the moment of severance, it cannot be said that it is "petroleum obtained from mining operations carried on by him".

(c) *Offsetting of Costs and Expenses*

It follows from (b) above that the holder of an overriding royalty in kind or production payment in kind would not be able to offset against income derived from his expectancy any pre-reservation exploration and prospecting expenditure which he may have incurred.

As to pre-reservation expenses of acquisition or maintenance, the holder of the expectancy in a carve-out situation could obtain a deduction only if he could apply section 26(a) to the exclusion of section 25(1).[39] (He might also seek to rely on the annuity purchase cases, but with little chance of success.)[40] In a reservation situation, too, there might be a possibility of applying section 26(a), and of taking the costs of acquisition or maintenance into account in the calculation of a "profit emerging".[41] Any attempt to obtain a deduction under section 51(1) would, however, be unsuccessful—either because the expenditure was of a capital nature, or because (as in *White's* case)[42] it was incurred before there was a business.

3. *The Position of the Working Interest Owner*

(a) *On the Basis of Mere Contractual Obligation*

If the share of production attributable to the relevant expectancy belongs to the working interest owner at the moment of severance, with only a contractual obligation to deliver it to the expectancy holder, it could be argued that he has derived assessable income because he is using one of his revenue assets[43]—namely, the share of production attributable to the expectancy—to discharge a liability in respect of the expectancy, this discharge of liability involving a derivation of income

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[38] See Oser and Nicholls, note 19 *supra*, 27-32.

[39] As to the scope of the former section see *White's* case, note 16 *supra*, 212 *per* Windeyer J.

[40] See note 23 *supra*.

[41] See § II(1) *supra*.

[42] Note 16 *supra*.

[43] Although the mineral *concession* is almost certainly a capital asset, it seems clear that the mineral *production* is a revenue asset. See, *e.g.*, the *Stow Bardolph* case, note 9 *supra*.

on the basis of *Sharkey* v. *Wernher*.[44] Any such "imputed" income would be income from carrying on a mining business,[45] and therefore available for offsetting by the working interest owner against mineral exploration and prospecting expenses under section 122J. It would not, however, be assessable income from petroleum for the purposes of sections 124AD, 124AF and 124AH, unless the delivery to the expectancy holder could be regarded as a sale. (If it were assessable income from petroleum, section 124AJ(2) might apply.)[46]

Assuming that the working interest owner has thus derived assessable income, could he obtain a deduction for the value of the share of production delivered to the expectancy holder? In the case of an overriding royalty in kind created by reservation in a sublease arrangement, he could presumably do so, since delivery of a share of production would, in effect, be a payment of rental under the sublease. If, however, assignment rather than sublease were involved, the delivery would be expenditure of a capital nature, and no deduction would be obtained.[47] There would be less chance of a deduction in the case of a production payment in kind, since (whether sublease or assignment were used) the limitation on the amount or value recoverable under such an arrangement would give it more of the flavour of an outgoing of a capital nature.

In a carve-out situation, where the carved-out expectancy had been sold for cash or equivalent, it could be argued that the delivery of the share of production was in effect an outgoing of a capital nature, being at least in part repayment of capital provided by the expectancy holder.[48] Subject to that possibility, which I would not lightly dismiss, the working interest owner should be able to obtain a deduction.

(b) *Immediate Beneficial Ownership of the Expectancy Holder*

If one were to adopt the approach of Windeyer J. in *Norman* v. *Federal Commissioner of Taxation*,[49] the above remarks would apply to

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[44] *Sharkey (Inspector of Taxes)* v. *Wernher* [1956] A.C. 58. In that case, however, the racing stables and the stud farm were owned by a single person, whereas in the situations now relevant the expectancy holder and the working interest owner are separate parties. In *Jacgilden (Weston Hall) Ltd* v. *Castle (Inspector of Taxes)* [1971] Ch. 408 this distinction favoured the taxpayer; in our context it would appear rather to assist the Commissioner. *Cf. Skinner (Inspector of Taxes)* v. *Berry Head Lands Ltd* [1971] 1 All E.R. 222; *Petrotim Securities Ltd* v. *Ayres (Inspector of Taxes)* [1964] 1 W.L.R. 190.

[45] The two cases last cited (note 44 *supra*) might suggest a contrary argument: that, in handing over to the expectancy holder his share of production, the working interest owner is "not acting in the course of its own trade [the mining business] . . . but out of that course" (*per* Ungoed-Thomas J. at first instance in the *Petrotim* case, (1962) 41 Tax Cas. 389, 400).

[46] See Oser and Nicholls, note 19 *supra*, 30-32.

[47] *Federal Commissioner of Taxation* v. *Cliffs International Inc.* (1977) 16 A.L.R. 681.

[48] *Cf.* § IV(2)(b) *infra*.

[49] (1963) 109 C.L.R. 9, 24-25.

all the arrangements here under review. If, however, that approach is not followed (as I submit it should not be),[50] it may be possible to create an arrangement whereby the expectancy holder has the beneficial ownership of his share of production at the moment of severance, as in the *B. & B. Royalties* case.[51] The taxation results would then be different; nothing representing the expectancy holder's share of production would ever be brought into the assessable income of the working interest owner. It is clear, however, that this would depend on the precise arrangement adopted.[52]

(c) *Deductions for Exploration and Development Costs*

To what extent may the working interest owner obtain deductions in respect of that share of the costs and expenses of exploration and exploitation attributable to the expectancy holder's share of the minerals? For an overriding royalty interest, this question has already been considered.[53] For an overriding royalty in kind or production payment in kind, the same considerations would seem to apply, but with one important proviso. If the value of the expectancy holder's share of production is included in the assessable income of the working interest owner, then *all* the expenses of exploration, development and production, including those attributable to the expectancy holder's share, will be expenses directly related to the derivation of income by the working interest owner.

4. *Production Payments in Kind at the End of the Payout Period*

At the end of the payout period sections 59AA, 122R and 124AO would have no operation, since there would be no change in the owner-

[50] It was rejected by the Board of Review in 18 C.T.B.R. (N.S.) Case 18 and by Maclean J. in the *B. & B. Royalties* case, note 34 *supra*, 76-77; and is inconsistent with the reasoning in *In re Lind; Industrials Finance Syndicate Ltd* v. *Lind* [1915] 2 Ch. 345, approved by Dixon J. in *Palette Shoes Pty Ltd (In liquidation)* v. *Krohn* (1937) 58 C.L.R. 1, 27—though in *Norman's* case Windeyer J., 24-25, dismissed these cases as "beside the point". In any event, the expectancy arrangement could be structured to avoid such an approach.

[51] Note 34 *supra*.

[52] Thus in the *Calgary & Edmonton* case, note 9 *supra*, two sisters who had transferred their rights to mine hydrocarbons under certain lands in consideration of $75,000 in cash and the payment of 10% of gross proceeds of the sale of production until a further sum of $75,000 had been paid, were held (167) to have "reserved no right in the production of the petroleum. They only agreed that they would be entitled to a further sum of $75,000 if the lands were productive of oil". The percentage clause was inserted "not to give the sisters a right or title to a share in the proceeds of the production, but merely to indicate how, when and where the sum of $75,000 would be paid". So, too, in *Pine Pass Oil & Gas Ltd* v. *Pacific Petroleums Ltd* (1968) 70 D.L.R. (2d) 196, 204-205, the placing of certain permits in trust as to an undivided 7½% net carried interest (as there defined) in the proceeds of sale of production was held to leave the working interest owner "completely free to exploit those permits as it may wish. It is only if [it] elects to develop the permits and receives some proceeds therefrom, that any duty to account for a portion of the sale of those proceeds does arise". Clearly, such arrangements as these would not vest the ownership of minerals at the instant of severance in the expectancy holder.

[53] § II(2) *supra*.

ship of any property in respect of which any relevant deductions had been allowed or become allowable.

IV OVERRIDING ROYALTIES IN CASH AND PRODUCTION PAYMENTS IN CASH—AFTER CREATION

1. *The Position of the Holder of the Expectancy*

(a) *Derivation of Income*

The amounts received by the expectancy holder under an overriding royalty in cash or production payment in cash might be included in his assessable income

(i) as rent;
(ii) as compensation for income or for a revenue asset;
(iii) as periodic payments;[54]
(iv) as receipts "as or by way of royalty" under section 26(f);
(v) as an annuity under section 26AA; or
(vi) as a component of profit arising under section 26(a).

For a reservation on sublease, all six of these headings would apply. For a reservation on assignment heads (ii) to (vi) might be relevant; and for a carve-out, heads (iii) to (vi).

In the case of a production payment in cash, effected (by reservation) on assignment of the working interest or (by carve-out) on assignment of the right to receive the production payments, it might be argued that in view of their limited amount the payments should be treated as instalments of capital. But the argument is a dubious one.[55]

(b) *Division 10 and Division 10AA*

The assessable income thus derived would not be income from the carrying on of a mining business for the purposes of Division 10. Even if the expectancy holder had some other mining business, his receipts from the expectancy would not be incidental thereto—except perhaps under a joint venture arrangement, where the taxpayer would be both carrying on a mining business, and also holding (for example) an overriding royalty over the interest of his co-venturer.[56]

If an overriding royalty in cash is regarded as involving the payment of a share of income, then, in the case of petroleum, section 124AJ(2)(a)

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[54] See Parsons and Kenneally, note 8 *supra*, Ch. II Proposition 11, 20-24. In the case of a sublease, the receipt of the overriding royalty in cash (whether regarded as payment for the *right* to mine or explore, or as payment for the *exercise* of such rights) would clearly be income, and would therefore not fall within the second exception to the said Proposition 11.

[55] See discussion at note 23 *supra*.

[56] *Cf. Freeman* v. *Commissioner of Taxation (N.S.W.)* (1954) 6 A.I.T.R. 93, where the derivation of income from the operation of electricity plant was held to be incidental to the carrying on of the mining operations in which the plant was used.

would apply in a reservation situation, whether the reservation occurred on sublease or on assignment. If section 124AJ(2)(a) did apply, then the income received by the holder of the overriding royalty would be assessable income from petroleum for the purposes of Division 10AA. In a carve-out situation, however, section 124AJ(2)(a) could only apply if the overriding royalty was granted in consideration of the holder carrying out exploration operations or prescribed petroleum operations in the area concerned,[57] or if the carve-out was effected by sublease and sub-sublease.[58]

In the case of a production payment in cash (whether created by reservation or by carve-out), there might be a further argument that section 124AJ(2) cannot apply at all, on the ground that once a production payment holder has received a certain amount his right to receive anything further ceases—so that what is received is simply a sum of money payable *out of* the working interest owner's income, not a *share* of that income. But this argument seems unconvincing. The production payment holder can receive nothing unless there is income; it is a share of that income, and nothing else, to which he is entitled. The payment thus characterised as income will retain that character even though, upon receipt of a certain sum, the production payment holder's right to further payments will cease.

(c) *Offsetting of Costs and Expenses*

Can the expectancy holder, in a reservation situation, offset against the receipt of royalty or production payments his expenditure on exploration and prospecting before reservation? The answer will depend on the basis on which the payments received are treated as assessable income. If section 51(1) must be relied upon for a deduction, the chances will be slim.

If the payments were taxed under section 26(a), or as compensation for anticipated income or revenue assets, so that only the amount of the gain were taken into account,[59] then it might be possible in a case of reservation on assignment to take prior expenses into account in determining the extent of the gain. In a sublease situation, however, there would be no realisation of an asset, and this argument would not apply.

If the payments were assessed to tax as rent, periodic payments or royalties, there would be little scope for any deduction for prior expenditure.

Where the overriding royalty or production payment was created by way of carve-out, the holder could claim that he ought to be taxed on a "profit emerging" basis, and that therefore his costs of acquiring the

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[57] See Oser and Nicholls, note 19 *supra*, 29-30.
[58] *Cf.* § IV(2)(b) *infra*.
[59] See note 7 *supra*.

expectancy should be taken into account. This, however, would involve the problem of the proper basis for calculation of the emerging profit.[60]

It might also be possible to claim a deduction under section 26AA, on the basis that part of the payment represented undeducted purchase price in respect of an annuity.[61]

2. *The Position of the Working Interest Owner*

(a) *Assessable Income*

Is the amount paid to the holder of an overriding royalty in cash or production payment in cash included in the assessable income of the working interest owner? Prior to the decision in *Calgary & Edmonton Corporation Ltd* v. *Minister of National Revenue*,[62] a number of Canadian cases had indicated that (under overriding royalties in cash reserved on sublease or assignment) the payments were not so included, since they never became a part of the working interest owner's income.[63] The *Calgary & Edmonton* case, however, appears to require that the party receiving the payment must have an interest in the minerals from which the proceeds were derived. On this basis, it would be difficult to see how the working interest owner could avoid the inclusion of the payments in his own assessable income where the overriding royalty holder had neither an interest in the mineral concession, nor a right to take production in kind.

Another Canadian case, however, may suggest a different result. In *Wilson* v. *Minister of National Revenue*,[64] the testator had devised his business and its working premises to his son subject to certain obligations, one of which was to make monthly payments of $500 to the widow. The testator charged the land with the annuity and provided that during the widow's lifetime the title to the land was to remain in the names of trustees. According to Rand J.:

> The benefit conferred is what remains after the deduction of what is reserved. Here the possessory value is transmuted into the income of the business, charged, by way of reservation, with the annual payment: there is constituted in substance an equitable rent charge which never becomes income, in the beneficial sense, of the taxpayer in whose revenue it appears. It lies, then, either within . . . the word "rent", . . . or it is to be treated as the property or interest of the beneficiary mother throughout its process of

[60] See § II(2) *supra*.

[61] See note 23 *supra*.

[62] Note 9 *supra*.

[63] Notably the *B. & B. Royalties* case, note 34 *supra*; the *Roseberry-Surprise* case, note 27 *supra*; and *Snyder* v. *Minister of National Revenue* [1939] S.C.R. 384. See the editorial note to the *Calgary & Edmonton* case, [1955] Canada Tax Cases 161, 162.

[64] [1955] S.C.R. 352.

coming into existence. . . . [B]eneficially it never becomes income of the taxpayer.[65]

Fauteaux and Kellock JJ. agreed. The charge had "diverted from the business, in a measure equal to the amount necessary to its satisfaction, such income [as] it produced and thus, and to this extent, prevented it becoming income to the appellant".[66]

The result has been criticised as creating "an artificial distinction for income tax purposes between a reservation of interest and a personal covenant unsupported by a reservation, even though these may require substantially the same sort of payments to be made by the taxpayer".[67] But the reasoning seems consistent not only with *Roseberry-Surprise Mining Co. Ltd* v. *R.* and *Snyder* v. *Minister of National Revenue*[68] (where the income was already charged in favour of a third party when the property was received), but also with the *B. & B. Royalties* case[69] (where the right to a share of mineral production was reserved at the time of sublease). The real question is whether *Wilson's* case can be relied upon in Australia. In order to do so, it might be necessary to have the mineral concession held by a trustee. However, in view of the Australian provisions with regard to taxation of trust estates, this might not be considered worthwhile. Apart from that problem, apparent conflicts with Australasian authorities can, I suggest, be resolved.[70]

Where an overriding royalty in cash arises by carve-out, the *Calgary & Edmonton* case suggests that the payments to the overriding royalty holder should also be included in the working interest owner's assessable income, since it cannot be said that ownership of the working interest is conditional upon the payments being made. The ownership was in

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[65] *Id.*, 357.

[66] *Id.*, 376 *per* Fauteaux J., summarising and supporting the similar view of Kellock J., 361. Estey and Locke JJ. dissented.

[67] Cohen, "The Troublesome 6(1)(j)" (1964) 12 *Canadian Tax J.* 176, 182.

[68] As to both of which see note 63 *supra*.

[69] Note 34 *supra*.

[70] As to *Grant* v. *Commissioner of Taxes* [1948] N.Z.L.R. 871, *Calvert* v. *Commissioner of Taxes for Victoria* (1927) 40 C.L.R. 142, and *Colonial Mutual Life Assurance Society Ltd* v. *Federal Commissioner of Taxation* (1953) 89 C.L.R. 428, Rand J. distinguished them in *Wilson's* case, 356, on the ground that in each of them the facts involved "an agreement whereby the taxpayer purchased property on which he carried on business for a price which included the payment of an annuity". As to *Bern* v. *Commissioner of Taxes* [1950] N.Z.L.R. 632 he held, 356-357, that the judgment had wrongly "purported to apply" *Tata Hydro-Electric Agencies Ltd* v. *Commissioner of Income Tax* [1937] A.C. 685; but that in the *Tata* case the payments "were capital payments as part of the price paid for the agency", whereas in the *Bern* case "the property came charged with the annuity as a reservation: there was no question of price or a capital outlay as the means of acquisition. The difference between the two situations is, I think, basic". One might add that in the *Colonial Mutual* case it was apparently never argued that the payments involved had never become a part of the taxpayer's income; and even if the point had been argued, the case was one of a rent charge over what had at all material times been the taxpayer's property. There was never a "reservation" of the kind envisaged in *Wilson's* case.

existence before the creation of the expectancy, and the *Wilson* approach is thus not applicable. It may be possible, however, to lay a foundation for such an approach by first subleasing the mineral concession to the working interest owner and the overriding royalty holder, and then having those parties grant a sub-sublease to the working interest owner, subject to the reservation of the overriding royalty.[71]

(b) *Deductions for Payments to the Expectancy Holder*

If the amount paid to the holder of an overriding royalty in cash or production payment in cash is included in the assessable income of the working interest owner, is he entitled to a deduction in respect of such payment?

In the case of a reservation on a sublease (subject to the discussion of subleases below),[72] he should be able to obtain a deduction under section 51(1). In the case of an assignment, however, unless it were so structured as to come within *Wilson's* case, the payments would not be deductible. They would be regarded as outgoings of a capital nature: as a capital payment for the right to extract and sell the minerals, not part of the cost of the minerals or the expense of producing them.[73]

Similiar problems would arise in a carve-out situation. Are the payments to be regarded as the cost of acquiring the capital injected into the business on the creation of the expectancy, or is the transaction better seen as analogous to a loan, with any deduction therefore restricted to the "interest" component? The same doubt affects overriding royalties in kind and production payments in kind.[74]

In the case of an overriding royalty in cash (whether reserved or "carved out"), where the overriding royalty holder has received his expectancy in return for carrying out exploration or prospecting operations or prescribed petroleum operations, the effect of section 124AJ(2) will need to be considered, in relation to the working interest owner's right not only to obtain a deduction for the payment, but to offset the income against exploration and prospecting expenditures prior to 17 August, 1976, and against residual previous capital expenditures under Division 10AA.[75]

(c) *Deductions for Exploration and Development Costs*

If the payments to the expectancy holder are *not* included in the working interest owner's assessable income, the position will correspond to that

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[71] *Cf.* § IV(1)(a) *supra.*

[72] See § VI *infra.*

[73] *Calgary & Edmonton* case, note 9 *supra. Cf. Cliffs International* case, note 47 *supra; Colonial Mutual* case, note 70 *supra; Stow Bardolph* case, note 9 *supra,* 1516 *per* Jenkins L.J.

[74] *Cf.* § III(3)(a) *supra.*

[75] See note 19 *supra.*

outlined above[76] in relation to overriding royalties in kind and production payments in kind. If the payments *are* so included, there should be no problem in obtaining deductions for *all* exploration and development costs, whether attributable to the expectancy or to the working interest.

3. *Production Payments in Cash at the End of the Payout Period*

The position will correspond to that for production payments in kind.[77]

V CARRIED INTERESTS

1. *General Principles*

The essence of a carried interest arrangement is that D finances operations on a mining concession owned by C in consideration of a right to one hundred per cent of the proceeds until such time as the cost of development and any operating costs have been recouped, whereupon the payout period comes to an end.[78] The usual intention will be that both the income and the expenditure in the payout period should be attributed to the "carrying" party, D; and in the United States this result can usually be achieved "by adopting the appropriate mechanics".[79] The mechanics are important, however. The different types of carried interest and net profit interest are substantially identical in economic effect; but their tax implications may be very different.[80]

2. *Manahan Carried Interests*

(a) *On Creation*

Under a Manahan carried interest arrangement C assigns the entire mineral concession to D with a provision that upon complete payout (that is, upon the recovery of all production costs including any operating costs), an undivided share in the mineral concession will revert to C. Under this kind of arrangement in the United States,

> *D* reports 100% of the proceeds [of sale of production] as taxable income during payout and takes 100% of the deductions. The deductions include depreciation on equipment during payout. However, at the end of the payout period when the reversion occurs, *D* will be required to capitalize into his depletable basis [for the purposes of cost depletion] the same proportion of unrecovered depreciable basis as that proportion of ownership in the lease which reverts to *C*. Also since *C* has no investment in such depreciable property, he may not take depreciation thereon.

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[76] See § III(3)(c) *supra.*

[77] See § III(4) *supra.*

[78] Maxfield, "The Income Taxation of Mining Operations", in Rocky Mountain Mineral Law Foundation, *American Law of Mining* (1960-1978) Vol. 5, Title XXVIII, 181-182.

[79] *Ibid.*

[80] *Ibid.*

> *D* may only deduct and depreciate the expenditures he incurs during the carrying relationship which are attributable to his permanent interest, *i.e.*, the interest he retains after payout and reversion, if he does not hold his permanent interest and the carried interest for the complete payout period.[81]

Under the Australian legislation, the position is rather more complex. To begin with, if at the time of creation there was any property on the mineral concession in respect of which depreciation has been allowed or allowable, there will be a question of whether a balancing charge is to be included in the assessable income of C under section 59(2) (subject to an election under section 59(2A)), or of whether such a charge is deductible under section 59(1).

There is a further question of whether the balancing charge should be calculated under section 59 or section 59AA. If the Manahan arrangement makes it clear that the carried party C has a "reversionary" interest, and that this reversion is an interest in the mineral concession as opposed to a contractual right, section 59AA would seem to be the appropriate provision (since "the person . . . who owned the property before the change has . . . an interest in the property after the change"). If section 59AA does not apply and section 59(1) does, the calculation of consideration under section 59(3) would proceed under paragraph (a) or (c) if the transaction were treated as a sale, and otherwise under paragraph (d).[82]

Deductions for depreciation of plant in the hands of the carrying party D will be governed by sections 60 and 62.

Under Division 10 and Division 10AA, sections 122R and 124AO correspond to section 59AA. Section 122K (for general mining) and section 124AM (for petroleum) might also apply, as might section 122DA(1)(a)(ii) (for general mining) and section 124ADA(1)(c)(ii) (for petroleum).

In relation to exploration and prospecting expenditure for which no deduction has been allowed or become allowable in the hands of C, such expenditure will remain available for use against income from a mining business under section 122J, unless and to the extent that it has been included in a notice under section 122B. For petroleum, subject to any notice under the corresponding section 124AB, the expenditure is likewise available for use: against assessable income from petroleum under section 124AM in the case of expenditures on or before 17 August, 1976, and against assessable income generally in the case of later expenditures. If a notice has been given under section 122B or 124AB, the amount thus notified is included in the allowable capital expenditure of D under section 122A(1)(d) (general mining) or

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[81] *Ibid.*

[82] See the citations in note 9 *supra.*

section 124AA(2)(b) (petroleum). A corresponding amount is deducted from the residual previous capital expenditure of C under section 122C(1)(d) or 124AC(1)(b), and from the residual capital expenditure of C under section 122DA(1)(b) or 124ADA(1)(d); and is taken out of the exploration and prospecting expenditure available to C to be carried forward under section 122J or 124AH.[83]

The next question is whether, if the carrying arrangement contemplates that the permanent interest of D will be fifty per cent, C should be regarded as deriving income by entering into the arrangement, the measure of such income being the difference between the value of the work to be undertaken and the cost to C of the fifty per cent working interest to which D will be permanently entitled. Suppose, for example, that after expending $100,000 on acquisition and exploration, C enters into a carried interest arrangement whereby D is to receive a permanent half working interest in return for drilling a well at a cost of $500,000. Could it be said that C is selling a half interest which cost him $50,000 in return for half the cost of drilling the well, namely $250,000, thus deriving a gain of $200,000 taxable under section 25(1) or section 26(a)? I submit that the transaction ought not to be treated as giving rise to assessable income under either section, since it is merely the realisation of a capital asset. In any event, despite section 21, there has been no receipt which can be described as a receipt in the carrying on of a business.

Further, section 26(a) would be inapplicable because the mineral concession was not acquired for the purpose of resale at a profit. Even if C had the carrying arrangement in mind when acquiring the concession, one might speak of an acquisition not for the purpose of resale at a profit but for the purpose of effecting a saving, to be treated as analogous to the obtaining of a taxation deduction.[84] On the same reasoning, the transaction should not be held to amount to a profit-making undertaking or scheme, because the effecting of a saving did not involve the making of a profit.

Assuming, however, that a court was inclined to the view that there may be some taxable profit or gain involved, one would need to identify the "proceeds" or measure of value against which costs were to be offset in calculating the taxable profit or gain. What, for example, is the value

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[83] See ss. 122J(5) and 124AH(5).

[84] The argument would be that the purpose of acquisition was not to resell at a profit, but to realise part of the mineral concession (or an undivided interest therein), thus enabling C to effect a saving in that he would not have to expend the share of costs corresponding to his retained interest in the concession. *Cf. Loxton* v. *Commissioner of Taxation* (1973) 47 A.L.J.R. 95, 98 ("the view . . . that a mere saving of tax can be regarded as a profit within s. 26(a) . . . is untenable"); Deane, "The Profit of Having to Pay Less Tax" (1972) 1 *Australian Tax Rev.* 75. But note that in *Loxton's* case the "saving" was the purpose for which the shares were acquired; in our context the purpose of acquisition could only be one of realisation in a way which would effect a saving.

of the covenant to carry out the work? The actual cost of the work will not be known until the work is completed; and while the agreement might stipulate a precise sum to be expended, there is normally no such dollar commitment. To measure the value of the work by the cost of carrying it out would thus be extremely difficult. To measure it by ultimate success or failure would be even more speculative, and in any event wrong in principle. If there is any profit or gain, it ought to be ascertained at the time of the making of the arrangement.

It would seem that such difficulties of measurement might well deter a court from asserting a taxable profit or gain.

As to petroleum, section 124AJ(3) would need to be considered. There is no corresponding provision as to general mining.[85]

(b) *During the Payout Period*

As D is entitled in the payout period to one hundred per cent of the mineral concession, it is clear that one hundred per cent of the proceeds of sale of the minerals would be included in D's assessable income. None of such proceeds would be included in the assessable income of C.

The income so received by D would be income from a mining business, to be offset against his exploration and prospecting expenditures under section 122J. In the case of petroleum, the income would be assessable income from petroleum for the purposes of Division 10AA.

During the payout period D would be entitled to deductions for all expenditures otherwise allowable under section 51(1), regardless of whether any share might be attributable to the carried interest of C.[86] Similarly, D could obtain depreciation deductions (if otherwise available under section 54) in respect of all plant and other property installed after the commencement of the carrying arrangement.

Subject to any comments below on sections 122T and 124AQ, exploration and prospecting expenditure by D after creation and before the payout period would qualify for deductions under section 122J (as to general mining) and section 124AH (as to petroleum). All other capital expenditure allowable under Division 10 or Division 10AA would also be the allowable capital expenditure of D.

Obviously, neither section 122T nor section 124AQ[87] could apply in relation to the half share of expenditures attributable to D's fifty per cent permanent interest. Nor could those sections apply to the balance. The fact that D is entitled to a hundred per cent interest in the mineral concession until he has received an amount equal to his total expenditure does not mean that he is or will be recouped, since he only becomes

[85] But see Oser and Nicholls, note 19 *supra*, 32.

[86] Since all the proceeds of sale of production during the payout period would be included in the assessable income of D.

[87] See Oser and Nicholls, note 19 *supra*, 33-34.

so entitled if and insofar as there is sufficient production to achieve payout. Even if there is a recoupment, being that share of the proceeds of sale of production attributable to the fifty per cent which is not D's permanent interest, those proceeds are included in D's assessable income under section 25(1).[88] Accordingly, neither section 122T nor section 124AQ will operate to deem Division 10 or Division 10AA (respectively) inapplicable.

(c) *At the End of the Payout Period*

At this stage sections 59AA,[89] 122R and 124AO will come into operation, giving rise to a question of whether a balancing charge is to be included in D's assessable income under sections 59, 122K and 124AM respectively.

Any expenditures by D upon exploration and prospecting for which no deduction has been allowed or become allowable will be carried forward by D until the next year in which there is an excess of the type contemplated by sections 122J and 124AH. Where, however, the expenditure has been included in a notice under section 122B or 124AB, the amount so included is applied to reduce the amount available to D to be carried forward.[90]

If such a notice has been given in respect of capital expenditure which has been included in D's allowable capital expenditure, but in respect of which no deduction has been allowed or become allowable, such expenditure will be taken out of the residual capital expenditure of D under Division 10 or Division 10AA (by the operation respectively of sections 122DA(1)(b) and 124ADA(1)(d), and the corresponding provisions in relation to expenditure before 17 August, 1976); and with certain limitations will be included in the allowable capital expenditure of C (by the operation of sections 122A(1)(d) and 124AA(2)(b)).

If no section 122B or 124AB notice is given by the parties in respect of property in which the ownership interests change on reversion of a fifty per cent interest to C, and if capital expenditure on such property has been included in D's allowable capital expenditure, but no deduction has been allowed or become allowable, then such expenditure may be taken out of the residual capital expenditure of D by the operation of sections 122DA(1)(a)(ii) and 124ADA(1)(c)(ii) (and the equivalent provisions for expenditure before 17 August, 1976).

In relation to allowable capital expenditures by D after the creation of the carrying arrangement, in respect of which deductions have been allowed or become allowable to D, sections 122K and 122AM will

[88] Alternatively, quite apart from recoupment, they might be so included as proceeds received in carrying on a business.

[89] See § V(2)(a) *supra*.

[90] See ss. 122J(5) and 124AH(5).

operate to bring into assessable income or allow as a deduction to D any balancing item calculated in accordance with those sections. To avoid this inclusion of a balancing item in D's assessable income, the value of the property transferred at the end of the payout period should be specified for the purposes of sections 122R and 124AO as being equal to the difference between the total expenditure of a capital nature in respect of the property and the deductions which have been allowed or will become allowable. Perhaps the inclusion of an appropriate form in the original agreement would suffice.[91]

3. *Herndon Carried Interests*

(a *On Creation*

Under a Herndon carried interest arrangement C assigns to D an undivided interest in the mineral concession and a production payment payable out of one hundred per cent of C's reserved interest until D has recouped all exploration and development expenditures, including operating costs. In the United States, the response for taxation purposes has been

> to permit *D* to deduct and depreciate development expenditures attributable to his interest in the lease . . . and to require *D*'s capitalizing into depletable basis the balance. *C* may not deduct any such development expenditures since he has not incurred them. *D* is taxed on 100% of the proceeds during payout, because of the undivided interest in the lease and the production payment.[92]

In Australia, the question of taxable profit or gain raises problems already discussed for the Manahan situation.

Exploration and prospecting expenses of C incurred prior to the creation of the carried interest arrangement will, unless they are the subject of a section 122B or section 124AB notice, continue to be carried forward by C under sections 122J(1) and 124AH(1), until income from a mining business (section 122J(2)) or assessable income from petroleum (section 124AH(2)) or other assessable income (section 124AH(4A)) becomes available: in which case deductions in the amounts specified in those sections will be allowed thereunder. Any excess will then be carried forward under sections 122J(4), 124AH(4) and 124AH(4B).

If there is any property on the mineral concession in respect of which depreciation has been allowed or become allowable, sections 59 and 59AA would need to be considered.[93]

Assuming that there have been no allowable deductions in respect of any expenditure included in the allowable capital expenditure of C

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[91] See also Oser and Nicholls, note 19 *supra*, 57-61.
[92] Maxfield, note 78 *supra*, 183.
[93] See § V(2)(a) *supra*.

under Division 10 or Division 10AA, there will still be the question of reductions in C's residual capital expenditure. If such expenditures are included in a section 122B or 124AB notice, then to that extent they are taken out of C's residual capital expenditure and into the allowable capital expenditure of D. However, where no such notice is given, C's residual capital expenditure may be reduced to the full extent of such expenditure by the operation of sections 122DA(1)(a)(ii) and 124ADA(1)(c)(ii). Equivalent provisions apply to expenditure prior to 17 August, 1976.

(b) *During the Payout Period*

It is clear that all sales proceeds during the payout period would be included in the assessable income of D. So far as such proceeds relate to D's half working interest, they would be his income of a mining business, or assessable income from petroleum, for the purposes of Division 10 or Division 10AA. So far as they arise from the production payment, that characterisation would depend on the criteria already discussed for production payment interests. The application of those criteria would affect D's ability to offset such income (as to general mining) against exploration and prospecting expenditures, and (as to petroleum) against those and other capital expenditures on or before 17 August, 1976, which have been included in residual previous capital expenditure or unrecouped previous capital expenditure under Division 10AA.[94]

It seems clear that D will be entitled to deductions under section 51(1) and section 54 for expenses attributable to the production payment share of production, since all income from the sale of total production will be assessable income of D.[95]

(c) *At the End of the Payout Period*

The question of balancing charges would arise under sections 59AA, 122R and 124AO. The application of these last two sections would depend on whether expenditures attributable to the production payment had initially been included in the allowable capital expenditure of D; and, if so, on whether deductions in respect thereof had been allowed or had become allowable to D.

In relation to D's exploration and prospecting expenditure, sections 122J and 122B (as to general mining) and sections 124AH and 124AB (as to petroleum) would need to be considered. As to sections 122C and 122B (for general mining) and sections 124AC and 124AB (for

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[94] See note 19 *supra*.

[95] This is so even though not all of such income will necessarily be income from mining or assessable income from petroleum; and even though some part of such income may first be derived by C, who must then include it in *his* assessable income and claim a deduction for the amount payable under the production payment.

petroleum), the application of those sections to reduce D's residual capital expenditure would depend on whether expenditures attributable to the production payment had been included in his allowable capital expenditure in the first instance.

In relation to general mining, the entire operations of D are operations for the purpose of producing assessable income. Even though C may also have derived the income attributable to the production payment, D's assessable income must include one hundred per cent of sale proceeds. The expenditure attributable to the production payment, as well as that attributable to D's half working interest, should therefore be included in D's allowable capital expenditure and exploration and prospecting expenditure.

In relation to petroleum, it is enough that the operations are for the purpose of obtaining petroleum; they need not be for the purpose of obtaining assessable income, or of obtaining such income from petroleum. D's allowable capital expenditure and exploration and prospecting expenditure can therefore include the expenses attributable to the production payment.

4. *Abercrombie Carried Interests*

(a) *On Creation*

Under the Abercrombie arrangement—widely used in the United States before *United States* v. *Cocke*[96]—C assigned to D a half interest in the mineral concession, with a provision entitling D to all the proceeds of sale of production during the payout period. (In *Commissioner of Internal Revenue* v. *J.S. Abercrombie Co.*,[97] the Fifth Circuit Court of Appeals had held that, since D in effect made a loan to C of the moneys advanced to pay C's proportionate share of exploration and exploitation costs after creation of the arrangement, the proceeds attributable to C's interest during payout, though actually received by D, were taxable to C.)

In Australia, such an arrangement would give rise at the time of creation to the same problems as the Herndon arrangement.

(b) *During the Payout Period*

On the simple assignment of a half interest to D, only half the proceeds of sale of production would be received by D as income from a mining business (within section 122J), or assessable income from petroleum (within Division 10AA), since D would have only a half interest in the mineral concession itself. As for the income attributable to the fifty per cent carried interest, this income would (on one analysis) be derived as assessable income by C, who would then account for it to

[96] (1968) 399 F. 2d 433, *cert. denied* (1969) 394 U.S. 922.
[97] (1947) 162 F. 2d 338.

D and claim a deduction therefor. Thereupon it would be included in D's assessable income, either as a recoupment of his previous outgoings[98] or as ordinary income of a business. D would be able to treat it as income from a mining business, but not as assessable income from petroleum.

It may, however, be possible to structure the arrangement as one in which the minerals are owned by D at the instant of severance from the ground, so that any proceeds therefrom are income of D and not of C.[99] In that event D should be able to treat the income attributable to the fifty per cent carried interest as income from a mining business, and possibly also as assessable income from petroleum.

As to deductions under sections 51 and 54, or Division 10 and Division 10AA, in respect of those expenditures attributable to the carried interest of C which would have been deductible if D had held a hundred per cent interest, D's position will be the same as for a Herndon carried interest arrangement. C, of course, will not be entitled to any deductions under sections 51(1) and 54, nor to inclusion of any amounts in his allowable capital expenditure or exploration and prospecting expenditure under Division 10 or Division 10AA, since the relevant expenditure will not be incurred by C.

Alternatively, it might be possible to structure an Abercrombie transaction as a joint venture arrangement giving D a ninety per cent interest and C a ten per cent interest, so that D would advance to C an amount enabling C to pay for his ten per cent share of exploration and development costs, and would only be repaid if and insofar as there were sufficient proceeds from the sale of C's ten per cent share of production. C would have no personal obligation to repay the moneys, and would actually be involved in their expenditure, albeit by way of "advances" from D.[100]

(c) *At the End of the Payout Period*

Sections 59AA, 122R and 124AO will not be applicable because there will be no change in the ownership of any relevant property. No question of any balancing charges could therefore arise. Correspondingly, there will be no base cost for any subsequent claim to depreciation by C.

There will be no reduction in D's residual capital expenditure. Sections 122B and 124AB will not apply; the property and any information relating thereto are already owned by C and D in equal shares.

Any exploration and prospecting expenditure which D had incurred before the arrangement was made, and which was not at that time the

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[98] *H.R. Sinclair & Son Pty Ltd* v. *Federal Commissioner of Taxation* (1966) 114 C.L.R. 537; but see *Allsop* v. *Federal Commissioner of Taxation* (1965) 113 C.L.R. 341, 351. And see Oser and Nicholls, note 19 *supra*, 43-44.

[99] See § III(3)(b) *supra*.

[100] See Oser and Nicholls, note 19 *supra*, 34.

subject of a section 122B notice, will remain available to C to be offset against any assessable income from a mining business. For petroleum, subject to any section 124AB notice given when the arrangement was made, such expenditure will be similarly available for use—against assessable income from petroleum in the case of expenditures on or before 17 August, 1976, and against assessable income generally in the case of later expenditures.

VI NET PROFITS INTERESTS

Rather than a limited carried arrangement in which the carry only relates to particular specified work or particular expenditure, after which expenditures are borne by the parties in proportion to their respective interests in the mineral concession, the parties may provide for an unlimited carry by sublease of the entire working interest to D with a reservation to C of a net profits interest.

> A net profits interest ordinarily provides for a percentage of net proceeds after the deduction of development and operating costs. If a net profit interest is intended, the parties should take care that *D* receives all the operating rights and all rights in the equipment on the lease [or mineral concession].[101]

In the United States, it is said to be "reasonably clear" that

> *D* reports all the income from the property other than the actual amount going to *C*. From *C*'s point of view, the consequence is adverse because *C*'s depletion deduction is reduced since *C* is reporting a percentage of net rather than gross. Because of this consequence, the parties usually will prefer a limited carry in which after payout a percentage of the working interest reverts and the parties share operating costs.[102]

In Australia, such arrangements require an analysis broadly similar to that for overriding royalties in cash and production payments in cash. There is, however, a need to consider whether D is entitled to a deduction in respect of the payments made to C (the net profits interest holder), if those payments have also been included in the assessable income of D.

If the arrangement arose on assignment of the mineral concession to the present working interest owner, then (unless it were so structured as to come within *Wilson's* case)[103] the payments would be expenditures of a capital nature.[104] The mineral concession is a capital asset;[105] and the net profits interest payments, though payable by D out of revenue and reasonably regarded as necessarily incurred in carrying on a

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[101] Maxfield, note 78 *supra*, 189.
[102] *Ibid.*
[103] Note 64 *supra*.
[104] See the citations in note 73 *supra*.
[105] See the citations in note 9 *supra*.

business for the purpose of gaining or producing assessable income, are part of the purchase price for that asset.

If the net profits interest was reserved as rent on a sublease, then in principle the rental payments should be allowable deductions under section 51(1). Under the *Boulder Perseverance* case[106] and the *Midland Railway* case,[107] however, there might be a threshold question of whether the payments involved an outgoing in the gaining or producing of assessable income (as section 51 requires), or a sharing of the taxable fund. In the latter event there could be no deduction under section 51(1), whether the fund to be divided was the taxable income (as Fullagar J. held in dissent in the *Midland Railway* case) or the taxable profits (as in *Boulder Perseverance*).

The correct approach appears to be that of the Commonwealth Taxation Board of Review:[108]

> The fact that an outgoing takes the form of an application of profits . . . [has] no bearing on the question whether it was incurred in gaining the assessable income. Section 109 is concerned with whether, and not how, the relevant outgoing was paid or credited and section 51 is concerned with the purpose for which, or the circumstances in which, the outgoing was incurred and not with the means employed by the taxpayer for the purpose of providing for the outgoing.

In the *Midland Railway* case Dixon and Kitto JJ. adopted a similar approach.[109]

If the holder of the net profits interest is not entitled to a recurring interest in profits, his receipts will not be regarded as a share of the taxable income.[110] So, too, if his share of net profits is independent of whether the working interest owner's business as a whole makes a profit. The situation will then be governed by *George Thompson & Co. Ltd* v. *Commissioners of Inland Revenue*,[111] where under a shipping charter arrangement a share of net profits from each voyage was held to be deductible since it was calculated entirely on the profits of each individual voyage, regardless of overall profit. Even if the working interest owner's business is solely confined to the mineral concession which is subject to the arrangement, the fact that the payments are calculated by reference to net profits should not on "profit sharing"

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[106] *Commissioner of Taxation (W.A.)* v. *Boulder Perseverance Ltd* (1937) 58 C.L.R. 223.

[107] *Federal Commissioner of Taxation* v. *Midland Railway Co. of Western Australia Ltd* (1952) 85 C.L.R. 306.

[108] 10 C.T.B.R. Case 95, 278; 1968 reprint 611, 612.

[109] *Per* Dixon J. on appeal, note 107 *supra*, 312-313; *per* Kitto J. at first instance, *Midland Railway Co. of Western Australia Ltd* v. *Federal Commissioner of Taxation* (1950) 81 C.L.R. 384, 393.

[110] *Per* Dixon J. on appeal, note 107 *supra*, 317.

[111] (1927) 12 Tax Cas. 1091, 1099, distinguishing *A.W. Walker & Co.* v. *Commissioners of Inland Revenue* [1920] 3 K.B. 648.

grounds preclude the applicability of section 51(1), provided it is made clear that the fund of net profits to be shared is not the fund which constitutes taxable income under the Act.

In the end it comes back to a question of whether the sublease of a mineral concession can be said to involve acquisition of a capital asset. A mineral lease for a payment determined wholly or partly by the amount or value of the minerals extracted is not a "sale" of the minerals, even though ownership of them vests in the lessee when he acts on the arrangement. The payment is not for the grant of the right to extract the minerals, but for the exercise of the right.[112] "A lease by which the owner or lessor grants to the lessee the privilege of mining and operating the land in consideration of the payment of a certain stipulated royalty on the mineral produced, creates the relationship of landlord and tenant. . . . [W]hatever is paid for the occupation and use of the premises, whether it be in money or kind, is equally in substance rent, and . . . the royalties received are rentals".[113] This is so "although [the mineral capacity of] the soil is gradually exhausted, and the royalty is not paid out of [any] renewing produce".[114] The fact that in a net profits arrangement the rent is not fixed as a royalty but in a slightly different way should not affect these conclusions.

There are, however, arguments the other way. In the *Tata Hydro-Electric* case[115] the appellants, on acquiring an agency business, had assumed obligations to service certain preexisting loans by payment not only of interest but of one quarter of all commissions received. The Privy Council held that

> the obligation to make these payments was undertaken by the appellants in consideration of their acquisition of the right and opportunity to earn profits, that is, of the right to conduct the business, and not for the purpose of producing profits in the conduct of the business. If the purchaser of a business undertakes to the vendor as one of the terms of the purchase that he will pay a sum annually to a third party, irrespective of whether the business yields any profits or not, it would be difficult to say that the annual payments were made solely for the purpose of earning the profits of the business. It would seem to make no difference that the annual sum should be made payable out of a particular receipt of the business, irrespective of the earning of any profit from the business as a whole. The case of a transferee of a business undertaking liability, for example, for the rents under current

[112] *Stanton's* case, note 3 *supra*, 642; and see the *Sherritt Gordon* case also cited in note 3 *supra*.

[113] Ricketts, *American Mining Law* (1943) § 2; quoted in Helmick and Tippit, "Royalty Interests and Ore Payments", in Rocky Mountain Mineral Law Foundation, note 78 *supra*, Vol. 3, Title XVII, 434 n. 8.

[114] 2 Woods, *Landlord and Tenant* (1881) 445; quoted in Helmick and Tippit, note 113 *supra*, 434 n. 8.

[115] Note 70 *supra*.

leases of the premises in which the business was carried on by the transferor and is to be carried on by the transferee is quite a different case, for the rents paid are clearly an outlay necessary for the earning of profit.[116]

Similarly, in *Murray (Inspector of Taxes)* v. *Imperial Chemical Industries Ltd*,[117] the grant by the taxpayer company of exclusive sub-licences of certain patents was held to be a disposition of a capital asset, indistinguishable for tax purposes from an actual assignment of patent rights; and in *Nethersole* v. *Withers (Inspector of Taxes)*,[118] the grant of motion picture rights to Kipling's novel *The Light that Failed* was held to be a partial realisation by the copyright holder of her capital asset. Both these cases, of course, were concerned with whether the payments were income in the hands of the recipients, rather than whether they were deductible from assessable income in the hands of the payors. However, it might well be argued that where a mineral concession is subleased for substantially the whole of its anticipated life, what the sublessee receives is "the right and opportunity to earn profits", so that payments thereunder should be regarded as payments for the acquisition and continued holding of those rights.[119]

Under Division 10 and Division 10AA, any expenditure incurred in "acquiring" a mineral concession or petroleum concession is apparently assumed to be a capital expenditure.[120] Although sections 122B and 124AB use the word "purchase", they are not restricted to assignment but extend to sublease.

If there is a sharing of profits, there will be a risk that the holder of the net profits interest and the working interest owner will be held to be in partnership in respect of all the income. This could create real problems in achieving a treatment for taxation purposes which would correspond to the commercial intentions of the parties.[121]

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[116] *Id.*, 695.

[117] Note 10 *supra*, esp. 1051-1052 *per* Lord Denning M.R.

[118] [1946] 1 All E.R. 711 (C.A.), *aff'd* [1948] 1 All E.R. 400 (H.L.). In the Court of Appeal, 715, Lord Greene M.R. observed: "One might perhaps have expected that where a piece of property . . . is turned to account in a way which leaves in the owner what we may call the reversion in the property so that upon the expiration of the rights conferred . . . the property comes back to the owner intact, the sum paid as consideration for the grant of the rights, whether consisting of a lump sum or of periodical or royalty payments, should be regarded as of a revenue nature. [But] we emphasise the word 'intact' . . . since, save in the special cases of wasting property, if the property is permanently diminished or injuriously affected, it means that the owner has to that extent realised part of the capital of his property as distinct from merely exploiting its income-producing character".

[119] *Cf.* the *Stow Bardolph* and *H.J. Rorke* cases, both note 9 *supra*.

[120] *Cf. Utah Development Co.* v. *Federal Commissioner of Taxation* (1975) 5 A.L.R. 474, 491 *per* Newton J.

[121] These problems would be additional to that of the legal liability of the holder of the net profits interest for the debts of the working interest owner under general partnership law.

VII CONCLUSION

This and its companion article have considered only some of the methods of financing mineral resource ventures and their taxation implications. Even as to the methods here considered, it is clear that different ways of structuring and analysing a financing arrangement will have different tax implications. I have not even attempted to answer all of the questions I have raised. I trust, however, that these articles will serve to provide the conceptual matrix within which such questions can be further considered.