GOLD: TAX ISSUES

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It is not only an honour to be invited to present a paper to AMPLA — it is an experience. A speaker receives instructions which are clear and which include guidance as to the length of the written paper and constraints as to speaking time. We also receive a synopsis of sub-headings each of which in my case could form a complete topic within itself.

The whole topic would not be of widespread interest, if it were not for statements of intent by the Federal Government in its June 1985 White Paper which indicated an intention to tax gold mining income commencing in the 1986–1987 year of income. This intention was common to the now famous Options A, B and C.

By 19 September 1985, and after some heavy lobbying by at least one State Government facing an upcoming election, the stance taken in the Treasurer's statement entitled 'Reform of the Australian Taxation System' was:

> *GOLD MINING*
> The draft White Paper proposal to tax income from gold mining has not been adopted.
> An independent inquiry has been established to examine the impact of the White Paper proposal on the gold mining industry.
> That inquiry will report to the Government during the first half of 1986.[1]

The independent inquiry has now been extended into the second half of 1986 but the Treasurer has announced that the changes resulting from the inquiry will be effective from 1 July 1986.

This paper is written in the first half of 1986, presented after 1 July 1986 and before the date on which the inquiry is due to report. Against this background the first topic I am asked to address is:

STATUS AS EXEMPT INCOME

Subject to certain conditions, income from gold mining in Australia is exempt from income tax.

Section 23(o) of the Income Tax Assessment Act 1936 (as amended) (the Act) provides that the following income is exempt:

> (o) income, other than income from the production, treatment or sale of pyrites, derived from the working of a mining property in Australia, where the working of the mining property by the taxpayer for the period from the commencement by him of mining operations on that property to the end of the year of income has been principally for the purpose of obtaining gold, or gold and copper and where in the latter case, the value of the gold obtained from that property by the taxpayer in that period is not less than two-fifths of the value of the output of that property in that period, other than the value of the pyrites.

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1 *Op. cit.* 17.

In 1936 the section read as follows;

> (o) the income derived by a person from the working of a mining property in Australia or in the Territory of New Guinea principally for the purpose of obtaining gold, or gold and copper, provided that in this case the value of the output of gold is not less than forty per centum of the total value of the output of the mine.

You will note the section has remained virtually unchanged except to take into account the matter of pyrites (1952) and to exclude Papua New Guinea at the time of that country's independence (1973).

For a July 1986 paper it only seems necessary to make brief reference to the following points:

- Income from sale of pyrites is assessable income.
- Exemption from tax depends upon satisfying the mathematical formula contained in section 23(o), that is 40 per cent of value of production (excluding pyrites) must be gold.
- The mathematical formula accumulates from commencement of mining through the years of income until mining ceases, that is it is possible for some years to be taxable and following years to be exempt.
- If the mathematics are satisfied the whole of the income from the mine (other than pyrites) is exempt *e.g.* the sale of copper and silver from a mining property would be exempt provided the value of gold produced is at least 40 per cent of the aggregate value produced (excluding pyrites).
- If the mathematics are not satisfied in a year of income the whole of the income is assessable, including income from gold mining.

In summary, it is clear that provided a taxpayer satisfies the provisions of section 23(o) of the Act the income from gold mining is exempt — AS THE LAW STANDS AT PRESENT. However, adhering strictly to the heading 'Status as Exempt Income' one would have to answer — Tenuous!!

It is appropriate to remind you that Income Tax Assessment Bill (No. 5) 1973 contained a provision to repeal section 23(o). Clause 4 of the bill related to exemptions and the Explanatory Memorandum circulated by the then Treasurer, The Hon. Frank Crean MP, blandly stated:

> The repeal of paragraphs (o) and (p) of section 23 will bring to an end exemptions of mining income that have been available under those provisions.

It is now a matter of history that section 23(o) survived.

The 1973 Bill to repeal section 23(o) contained no provisions on how the tax on gold mining was to be introduced, how past expenditures were to be treated and this will be addressed later.

EXEMPT NATURE OF THE SALE OF RIGHTS TO MINE GOLD AND INCOME RECEIVED FROM SALE OF RIGHTS TO MINE GOLD

This topic requires examination of sections 23(p) and 23(pa).

Section 23(pa) as presently enacted is as follows:

> (pa) income derived by a person from the sale, transfer or assignment by the person of his

rights to mine, in a particular area in Australia, for gold or for any prescribed metal or prescribed mineral, being a person who is a bona fide prospector, that is to say:
(i) a person (other than a company) who has personally carried out the whole or the major part of the field work of prospecting for gold or for the prescribed metal or prescribed mineral, as the case may be, in that area, or has contributed to the expenditure incurred in the work of prospecting and development in that area; or
(ii) a company which has itself carried out the whole or the major part of such field work,
except that:
(iii) where, under Division 10, or under the Division for which that Division was substituted, a deduction has been allowed or is allowable from the assessable income of the taxpayer of any year of income in respect of expenditure on exploration or prospecting in a particular area, this paragraph applies to so much only of the income of the taxpayer derived from the sale, transfer or assignment by him of rights to mine in that area as exceeds the sum of any deductions so allowed or allowable; and
(iv) this paragraph does not apply in respect of a sale, transfer or assignment of any right to mine for a metal or mineral, other than gold, if:
(A) any party or parties of the one part to the sale, transfer or assignment has or have the power (whether under the terms of the transaction or otherwise) to control, directly or indirectly, the entry into the transaction by, or the activities in connexion with the mining rights of, a party of the other part; or
(B) any person or persons has or have the power (whether under the terms of the transaction or otherwise) to control, directly or indirectly, the entry into the transaction by, or the activities in connexion with the mining rights of, a party of the one part and a party of the other part to the sale, transfer or assignment;

Section 23(p), of the 1936 Act read as follows:

(p) income derived by a bona fide prospector from the sale, transfer or assignment by him of his rights to mine for gold in a particular area in Australia or in the Territory of New Guinea. For the purpose of this paragraph 'bona fide prospector' means a person, other than a company who has personally carried out the whole or major part of the field work of prospecting for gold in the particular area, or who has contributed to the expenditure incurred in the work of prospecting and development in that area, and includes a company which has itself carried out the whole or major part of such work.

The headings for this section were given as separate topics but I have chosen to amalgamate them because they each deal with section 23(p) and its successor, section 23(pa). As mentioned earlier, section 23(p) was repealed effective from 21 August 1973. Section 23(pa) was enacted as part of Income Tax Assessment Amendment Bill (No 3) 1977 introduced by the then Treasurer, The Right Hon. Phillip Lynch MP. The new section had application in relation to income derived after 25 October 1977. For practical purposes the section had a four year holiday. It is relevant to consider these sections because the terms of reference for the gold inquiry appointed by the Government contain specific reference to not only section 23(o) but also section 23(pa).

Turning initially to examine the nature of the proceeds of sale of rights to mine gold it is necessary to point out that the exemption under either section 23(p) or 23(pa) applied to 'income derived by a person'. It should also be mentioned that whilst this paper relates to gold that, as with section 23(o), sections 23(p) and 23(pa) are not restricted in their operation to matters relating to gold. The latter sections apply to gold and a comprehensive list of minerals described as prescribed minerals. During the 23(p) era and in the 23(pa) years it has not been of particular

importance to determine whether or not the proceeds or profits received from sale of rights to mine constitute income or capital, especially in the case of individual taxpayers. The situation has never been quite so clear in the case of companies. Although there have been no primary tax considerations the correct categorization of profits from sale of rights to mine can have significant flow-on tax considerations, particularly in the case of a distribution by a liquidator or a bonus share issue.

Prima facie, proceeds received as lump sum consideration for the sale of rights to mine would normally be regarded as capital. As with other property such proceeds would only constitute income according to ordinary concepts if the taxpayer was in the business of dealing in rights to mine. The proceeds or profits may also constitute income if the sale occurred within twelve months of acquisition[2] or if the rights were acquired for the purpose of profitmaking by sale or as part of a profitmaking undertaking or scheme.[3]

The distinction between capital and revenue is well discussed in the cases of *McFarlane and Keyte v. FC of T.*[4] Those cases cover several years of income commencing in the 23(p) era and finishing in what I have referred to as the holiday period. The case is worth reading simply for the down to earth evidence given by the taxpayers. The Court found that the proceeds from sale of rights to mine in the case did not constitute income for any purpose of the Act and in particular under section 26(a). The Judge concluded:

> My conclusion as to section 26(a) makes it unnecessary to consider section 23(p) and I express no opinion upon it.

The case of *Biggs v. FC of T*[5] was not referred to in the *McFarlane/ Keyte* cases.

In the *Biggs* case the Court found as a matter of fact that the taxpayer was in the business of exploring and dealing in rights to mine. The Court further held that in the absence of section 23(p) the income arising was income according to ordinary concepts and so far as section 23(p) did not apply then income was assessable under section 25.

The *Biggs* case was a hotch-potch of issues involving; profits on sale of shares, profits on sale transfer or assignment of 'rights to mine'; and other receipts such as option fees in relation to 'rights to mine'.

This paper will not discuss in detail the term 'rights to mine' or the term 'bona fide prospector'. The Commissioner has vigorously contested these issues but it is submitted there is now sufficient case law to establish that the courts take both a wide and common sense view of the meaning of those terms.

Returning to the *Biggs* case the taxpayer was assessed under section 26(a) on profits on sale of certain shares, was assessed under section 25 on option fees received in respect of areas which were held to be rights to mine

2 s. 26 AAA.
3 s. 26(a) which has been supplanted by s. 25A
4 81 A.T.C. 4364.
5 75 A.T.C. 4172

and had section 23(p) apply to proceeds received where there was an actual sale transfer or assignment of rights to mine. The option fees were assessable because of the general finding that any receipts by Biggs in respect of the mineral bearing areas constituted income according to ordinary concepts. Section 23(p) did not operate simply because an option fee is an option fee — not consideration for sale transfer or assignment of the relevant property. On one analysis the taxpayer really only won one of the three issues in dispute. This enabled the Commissioner to maintain a sum of $11,894 was assessable income, however the balance of the sum in dispute, $1,754,129 was held to be not assessable.

TAX QUESTIONS THUS FAR

It seems appropriate at this time to not dwell upon an in depth analysis of the fine interpretations of the past but to ask some of the questions the decisions could raise and to ponder some possibilities for the future.

For example, it has been mentioned in relation to section 23(o) that a taxpayer may derive exempt income or assessable income depending on satisfying a mathematical formula on a year by year basis. Where a taxpayer is operating a gold mine where the gold is commingled with other minerals and the application of the formula results in the income being assessable in a particular year how does one properly compute the allowable deductions in relation to that year? It seems quite simple that operating expenses would be deductible under section 51 but how does one take into account certain capital expenditures? Depreciation may not pose too many difficulties but consider expenditures such as housing, shaft sinking, roads and other non-depreciable infrastructure costs.

In the *Biggs* case the Court found the taxpayer was in the business of exploring and prospecting. As mentioned earlier income which did not fall squarely within section 23(p) was found to be assessable under section 25. Although the matter was not raised, why were not the exploration and prospecting costs claimed as deductions against the option fees under section 51? What happens with prospecting expenditure deductions which are incurred over several years of income and it is not known whether or not the rights to mine will be sold, optioned or even abandoned? Is section 122J an exclusive provision in dealing with exploration and prospecting expenses? How does this relate to gold exploration bearing in mind Division 10 and section 122J apply only to minerals obtained from 'prescribed mining operations' being mining operations carried on for the purpose of producing assessable income?

What of the future? If section 23(o) is repealed how will past capital costs be taken into account in determining future taxable income? The following over simplified example demonstrates the point.

Assume — gold mine acquired on 30 June 1986 for $200,000 (not including depreciable assets) and estimated life is 10 years.

Exempt		
Sales		80,000
Less, Operating costs	50,000	
Amortization	20,000	70,000
Profit and exempt income		10,000
Taxable		
Sales		80,000
Less, Operating costs	50,000	
Amortization	20,000	70,000
Net profit before tax		10,000
Add, Amortization — not allowable		20,000
Taxable income		30,000
Tax at 50%		$15,000
Net profit before tax		10,000
Tax as above		15,000
Net loss after tax		($ 5,000)

If section 23(pa) is repealed, and bearing in mind that exploration and prospecting expenses are now deductible against all forms of income, will all outback residents have built in tax deductions, especially if each owns a metal detector? One can imagine the proliferation of all sorts of claims for depreciation, vehicle expenses and perhaps even wages to wife if a prospecting business on a small individual scale is brought within the purview of the general provisions of the Act.

It may be difficult for the Commissioner to assert that the activities of certain prospectors do not amount to the carrying on of a business as is often the case in small primary production activities. Unlike hobby farms, it is not difficult for even major exploration companies to spend millions and find nothing. In making this statement I mention, for the sake of completeness, I realise the onus of proof rests with the taxpayer.

On the other hand let us assume section 23(pa) is not repealed. One can then envisage all explorers and prospectors lodging section 52 notices in relation to all mineral claims. This is because it would be advantageous to have the claims as 'revenue' assets to keep them out of the grips of the proposed capital gains tax. It is but a short step to cases where the Commissioner of Taxation is arguing that assets held by taxpayers are capital rather than revenue — quite a change from the past.

I shall comment further on the effect of the imputation system in relation to dividends later in this paper.

No doubt all of the little questions raised above will be answered when the enabling legislation is tabled in Parliament.

TREATMENT ON AND OFF MINE SITE

Where a taxpayer extracts ore from the ground it matters not whether the ore is treated on or off the mine site. The resultant gold mineral is gold produced from the working of a mining property and falls for consideration under section 23(o) of the Act. The contentious area arises in

respect of tailings. Old tailings dumps contain valuable residual gold which may be extracted by modern techniques.

It was held in the case of *Parker v. FC of T*[6] the treatment of purchased tailings is not 'working of the mining property'. Accordingly where tailings are purchased and transported away from the mine site for processing it has been held that the exemption afforded by section 23(o) does not apply. Where tailings are treated on the mining property on which the dumps are situated the Commissioner of Taxation accepts that such re-treatment constitutes the working of a mining property and the exemption is available. In *Henderson v. FC of T*[7] it was held that the treatment of purchased tailings formed part of carrying on 'mining operations'. These two cases distinguish very carefully the meaning of the words used in section 23(o). The exemption applies to income derived from the 'working of the mining property' and *Henderson's* case decided that that term was different from the term 'mining operations'. Parker relied heavily on the *Henderson* case in argument before the Court and it is often thought the distinction between the two is fairly fine. This is not really the case. The court in the *Henderson* case was not concerned with section 23(o) but with section 26(a). There was a further issue in that Henderson subscribed capital to a company by way of calls. In fact the call moneys paid in respect of which the deduction was claimed was in effect a plough-back of part of the proceeds which the Commissioner had attempted to tax under section 26(a). As the law then stood section 78(1)(b) allowed a deduction for one third of the amount of call moneys subscribed to a company which carried on mining operations. The Court held that the treatment of tailings in that case constituted the carrying on of mining operations within section 78(1)(b) but this case was not concerned with section 23(o).

Recognizing the dangers inherent for an accountant attempting to interpret a statute for an eminent gathering of lawyers, I tend to the view that for section 23(o) to apply it is necessary to satisfy both of the terms rather than distinguish between them. For section 23(o) to apply the taxpayer must:

- Have sold from the working of the mining property; and
- Satisfy the 40 per cent formula for the period from the commencement of mining operations on that property to the end of the year of income.

The Commissioner accepts the treatment of tailings on the property on which they are situated as satisfying the provisions of the section 23(o).

The term 'mining operations' has been the subject of considerable litigation in the general mining sense. In *FC of T v. Broken Hill Pty. Co. Ltd.*[8] reservations were expressed as to whether or not the expression extended to any work done on the property subsequent to the winning of the mineral for the purpose of completing the recovery of the desired end product of the whole activity. In the case of prescribed mining operations covered under Division 10 this particular doubt was substantially

6 (1953) 90 CLR. 489.
7 (1943) 68 CLR. 29.
8 69 A.T.C. 4028.

eliminated by specific legislation which extends the allowable capital expenditure to treatment plant. Interestingly for Division 10 to apply to treatment plant it is not necessary that the treatment plant be located at or near the mine site. Case history has been about where mining, as that term is generally understood, finishes and processing beyond the mining stage commences. What the law and the practice seem to have established is that treatment of tailings on the site on which they are situated constitutes both the working of a mining property and mining operations whilst treatment of tailings away from the site on which they are situated does not produce exempt income. If the extraction of the tailings from the dump constitutes mining operations it would seem that if the treatment plant is situated elsewhere, then the treatment plant should be owned by a separate legal entity which treats those tailings for a toll so that the entity which extracts the tailings does not itself participate in the treatment. Would this artificial segregation of the recovery of ore activities and the treatment thereof then make section 23(o) work?

STRUCTURE OF VENTURES

Where different parties come together to exploit a resource it is necessary to consider the structure through which the operations will occur. The common forms are:

- A company in which all the participants hold shares.
- A partnership (limited or otherwise).
- A joint venture.
- A unit trust.

Joint ventures are now very well known in the Australian mining scene and I do not propose to add to the papers which have been delivered at conferences such as this in the past. The important points to be made for the future are the effect of the proposed imputation system of company tax. Regardless of whether or not section 23(o) survives it seems clear the proposed imputation system will apply to dividends paid by gold mining companies. It is also important to note that unit trusts which qualify as public unit trusts will be treated like companies and distributions from those trusts will also be subject to the imputation system. Dividends paid by gold mining companies out of exempt income are currently taxable in the hands of shareholders and in this sense the imputation system has little effect if one ignores the possibility of the recipient having a lower marginal rate than the company rate of tax. However in the case of unit trusts the decision to treat distributions as dividends represents a marked departure from the past. Exempt income distributed by a trust has traditionally retained its exempt character as it passes through to the unitholders. Even if section 23(o) were to continue unitholders in a public unit trust would effectively be taxed on their distributions which would in turn effectively lose their exempt character.

One could reach the conclusion that with the imputation system for dividends and the distinction between public and private unit trusts that the system could not equitably maintain the section 23(o) exemption bearing in mind the different flow-on effects depending on the structure of the venture. This point becomes painfully clear when one also

contemplates the situation of a non-resident participating in a gold venture *per* medium of a branch operation. It would be difficult to expect the Government to allow the situation to continue where branch gold mining operations continue to enjoy exempt status when the profits from those Australian source exempt earnings are being taxed in the home country of the participant.

COMMINGLED MINERALS

I was given some examples of gold occurring with other minerals these being copper and bauxite. It is now a matter of public record that the Worsley Bauxite/Alumina Joint Venturers have discovered that certain areas of their bauxite leases are contaminated with significant deposits of gold.

The question of commingled minerals has really been addressed in my earlier comments on section 23(o). You will recall that earlier in the paper it was indicated that section 23(o) would apply provided the 40 per cent value of gold formula was satisfied. In practice the answer is not quite so simple.

I should mention at this stage one aspect that I have not mentioned previously. I have made several references to the fact that it is necessary for section 23(o) to apply to both sell gold from the working of a mining property and satisfy the mathematical formula. Technically the 40 per cent test referred to in section 23(o) applies only in the case of mines which produce gold and copper as distinct from gold and other minerals. So the 40 per cent test applies only in the case of a gold and copper mine and in a case where you have gold commingled with another mineral it is necessary that the mining operations on that property have been 'principally for the purpose of obtaining gold'.

The term 'principally' indicates a dominant purpose is required and I would submit this is not necessarily determinable only by reference to value of output.

Where the mineralized area is large, as in the case of bauxite leases, it is necessary to determine for the purposes of section 23(o) just what is the mining property. If upon a particular delineated area a taxpayer conducts several mining operations the question arises as to whether you have one mining property which is being worked in several locations or several mining properties within the one large area. One cannot generalize and, to use the usual out-clause, each case must be examined in the light of its individual circumstances. However it does become a relatively simple matter to excise the gold bearing area from the other areas and conduct a separate and distinct mine. The distinction can be made clearer where a separate legal entity is formed to conduct the gold mining operations leaving the original entity to carry on with the non-exempt operations. Well, it was simple until the September 19 Statement by the Treasurer.

There are other practical matters which at the present time not only make a rigid distinction desirable but essential. Take for example decisions relating to joint use of facilities. Care must be taken in this area because use of assets for the production of exempt income may lead to the disallowance of investment allowance claims and depreciation claims.

Another important area when dealing with exempt and non-exempt income is the management of section 80 losses. As you are aware section 80 losses are reduced by any net exempt income derived by a taxpayer and it is always a pity to waste good exempt income against losses which would be deductible against future assessable income.

CONCLUSION

The foregoing comments are an attempt to summarize the position of tax issues relating to gold under the present law with some comments as to how gold mining may fit with the proposed changes to the Australian taxation system. It is not the purpose of this paper to debate the pros and cons of removing the exemption which is presently available under section 23(o). However I do think it is reasonable to express a wish that any decision to change the existing system should carry with it the responsibility to give clear guidance as to how any transition may occur, with particular reference to the treatment of committed undeducted capital expenditures regardless of whether or not they would be deductible under the general provisions of the income tax law.

The Industries Assistance Commission (IAC) in Report No. 128 entitled 'Production of Gold' published in 1977 recommended very strongly the abolition of the exemptions available to the gold mining industry. The IAC report did acknowledge that regard would need to be had to past capital expenditures. It stated[9]

> it has again been assumed by the Commission in arriving at its recommendations that gold producers will be allowed to carry forward the balance of unrecovered losses and unrecouped capital expenditures arising out of their gold mining activities in recent years.

The Commission was urged to specify in some detail the transition provisions which should be available, however the Commission chose to pass this responsibility to the Government. The general thrust of the IAC report was, on a progressive basis, to phase in taxation for gold miners such that after a five year period gold miners would be treated identically for taxation purposes to general miners. Such a recommendation sounds fine in theory but it is submitted that the transition provisions cannot be underrated. For example in an exempt regime a gold miner may commit more of its production to the repayment of borrowings, even in the form of a gold loan, than cash flows could permit if income tax were payable. Earlier mention was made of costs which may be incurred in the gold mining industry which are not deductible in general mining.

A simple example is the cost of acquiring a gold mining area. Return on investment economics dictate that a person may pay a larger premium for an investment which produces exempt income in comparison with an investment which produces assessable income. An investor is primarily interested in either case in the net return after tax. It follows that as a transition matter it is not only appropriate to examine what may be deductible but also the timing of those deductions especially where projects are geared.

9 *Op. cit.* 31.

This paper attempts to summarize the present position of the law in a period of considerable uncertainty. Only time will tell if this brief review of the relevant sections has any enduring benefit.