Real property valuation considerations for mining and infrastructure

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In brief

The recent Federal Court decision of *Resource Capital Fund IV LP v Federal Commissioner of Taxation [2014] FCA 41* (**RCF IV**) set out a number of positions that could be of importance to mining and infrastructure enterprises and investors.

In particular, the Court made certain findings in relation to the identification of 'real property' and its value which could be of particular significance for:

- foreign investors looking to exit from a long-term investment in Australia, from a capital gains tax (CGT) and foreign resident withholding declaration perspective;
- investors looking to invest into a mining or infrastructure project, from a duty perspective;
- any mining or infrastructure enterprises undergoing a cost-setting calculation; and
- any enterprise that relies on the valuation of its land to support its thin capitalisation position.

For further information regarding the treaty and tax compliance aspects of the decision, refer to our TaxTalk Alert, which was published on 9 February 2018.

In detail

Two Resource Capital Funds (RCF IV and RCF V) owned and sold shares in an Australian company, Talison Lithium Limited (Talison), which conducted an integrated lithium mining and processing enterprise. The Commissioner of Taxation issued assessments to each fund in respect of the profit made on the sale of the Talison shares, partly on the basis that those shares constituted indirect Australian real property interests for the purposes of Division 855 in the *Income Tax Assessment Act 1997* (ITAA 1997).

The funds contested the assessments on several grounds, including on the basis that membership interests in Talison did not satisfy the principal asset test contained in section 855-30 of the ITAA 1997. Satisfaction of this test relevantly depended on whether the value of any 'mining, quarrying or prospecting' rights held by Talison and its subsidiaries exceeded the value of all other assets held by Talison and its subsidiaries.

The Court accepted the taxpayer's arguments, and held that the principal asset test was not satisfied.

The key findings of the Court and the implications are set out in the table below.

Issue	**Position of the court**	**Implication**
Identification of land		
Treatment of non-mining leases	The Court considered whether two 'general purpose leases' and one 'miscellaneous licence' fell within the definition of 'mining, quarrying or prospecting right' for the purposes of Division 855 of the ITAA 1997. To this end, the Court had to determine whether the leases and licence were '*in respect of* buildings or other improvements' that were on the relevant mining land. The Court adopted a fairly strict interpretation of this language, and determined that the leases and licence fell short of the required standard, as the rights in respect of the buildings and improvements were granted under other instruments (e.g. the mining leases themselves). The general leases and the licence merely allowed for particular non-mining operational activities within the relevant buildings.	The Court declined to aggregate the rights granted under the various leases, and considered them separately. Taxpayers should carefully consider the nature of any statutory licences which they possess to determine whether those licences constitute mining, quarrying or prospecting rights (and therefore are deemed to be real property for the purposes of the non-resident capital gains tax provisions). Merely because the licences have been granted under mining or petroleum legislation is not sufficient, but instead the nature of the rights granted under the licence (especially whether that licence in isolation permits the extraction of resources) will likely be determinative.
Carve-out of buildings[1]	The Court considered the precedent of *TEC Desert Pty Ltd v Commissioner of State Revenue (WA)* (2010) 241 CLR 576. The Court found that the buildings and improvements that were not used in the 'mining' operations of the enterprise should be carved out from the value of any mining right. However, the Court held that a right to dump tailings in a dam should be considered a mining right. Once the Court had determined that a	Despite indicating some willingness to depart from the authority of *TEC Desert*, the Court appeared to accept that plant and improvements affixed to a tenement should be treated as chattels. It is important to note that the *TEC Desert* decision has previously been the subject of criticism, and this decision may provide it some support. However, the Court's finding that certain assets affixed to land covered by a statutory licence are chattels rather than real property could have broader

[1] At [99]-[100].

	right to use the buildings was not a 'mining right', no further consideration was given to whether such buildings were real property.	significance. For example, certain infrastructure relating to mining, oil and gas (including processing of liquefied natural gas (LNG)) and general infrastructure may not be considered to be real property under this reasoning. From a stamp duty perspective, most jurisdictions specifically legislated against *TEC Desert* to limit the impact of the decision. The evaluation of these arguments may still arise in certain jurisdictions depending on the particular factual scenario and landholder duty base.
Valuation of land		
Net-back method	The Court accepted that the valuation experts were not able to identify an existing market for the purposes of determining the value of the mining leases. The Court accordingly accepted the use of the 'net-back' method for this purpose. The net-back method was largely preferred over the residual value (market) method as it was capable of delineating between the mining and operational functions of the enterprise, as required by statute in the view of the Court. The Court identified that the precedent of *Resource Capital Fund III LP v Commissioner of Taxation [2013] FCA 363* should not stand for the proposition that the 'net-back' method is generally inappropriate. Instead, the Court cited *Placer Dome Inc v Commissioner of State Revenue [2017] WASCA 165, [52]-[60]* as support for the proposition that valuation methods other than comparable sales may be necessary where that methodology is not appropriate or possible.	The decision of the Court reiterates that the selection of a valuation methodology is fact-specific and should be undertaken in light of the particular statutory context. Our comments in respect of the *Placer Dome* case (refer to our TaxTalk Alert) continue to be relevant. That is, any valuation must be supported by a rigorous and nuanced explanation as to why the selected methodology is preferable. A review of the case law illustrates that it is difficult to construct common threads as differing perspectives emerge. The inputs that a valuer relies upon, how the transaction is framed in the statutory context, and the instructions provided to the valuer are critical in determining whether a robust valuation is produced which is fit for purpose. We await with interest the reasoning of the WA State Administrative Tribunal on the correct methodology to be adopted in the instance of *Placer Dome*. Similarly, we await with interest the views of the High Court (now that special leave has been granted) to determine whether a resources company can possess sources of goodwill.

Expiry of leases	The Court indicated that a mining lease should be valued only by reference to the remaining term of the lease, rather than by reference to any additional period by which the lease may be extended (implicitly, even if such extension is likely).	This requirement means that mining leases with a term less than the expected life of the mine may be of less value than anticipated, due to the assumptions that have been imposed upon valuation experts. The details of the terms of a lease (including any remediation obligations, and potentially the statutory context around renewals of the lease) and the relevant asset situated on the lease will need to be carefully considered to accurately value both assets. This could also be relevant to owners of infrastructure projects where the physical assets have a life greater than associated contracts or statutory licences.
Allocation of residual value	The Court accepted that the expected cash-flows beyond the expiry of the lease still had value, however this was a value based on an expectation rather than a right, and therefore could not be considered to be part of the mining leases. The Court accepted that this value (equal to AUD 117.9 million) was attributable to an 'intangible' asset. This amount also contained the value of any additional exploration that was expected to occur beyond the expiry of the lease. The Court concluded that this intangible was not taxable Australian real property (TARP), and did not otherwise attempt to identify a particular asset to which value of the intangible should be attributed.	Any value that is attributed to a residual expected cash-flow intangible may not be considered TARP, which is helpful for taxpayers from a Division 855 perspective. In a cost-setting context, this may also lead to substantial value being attributed to a non-recoverable asset class (i.e. no depreciation deductions may be available in respect of the intangible). Furthermore, there was some debate amongst the expert witnesses as to whether this residual asset would be an asset for accounting purposes. Whilst not relevant to this decision, this nuance could be important in the context of thin capitalisation calculations and revaluations. However, care should be taken in extrapolating the principle decided in this case (i.e. whether or not the value was attributable to TARP) to other statutory contexts (such as thin capitalisation and tax consolidation). We note that any residual value allocated to intangible assets in a share acquisition often has a beneficial outcome from a stamp duty perspective. Taxpayers should consider the appropriate treatment to be adopted given the differing outcomes between income tax and stamp duty.

Other comments		
Foreign resident CGT withholding	The Court did not need to consider this issue as the relevant provisions were not yet enacted. Where a purchaser acquires interests in an entity from a foreign resident vendor, the purchaser is prima facie required to withhold 12.5 per cent of the purchase price and remit that amount to the Commissioner of Taxation.	Foreign resident vendors in this context may represent that the interests in question do not constitute an indirect Australian real property interest which will relieve the purchaser of the obligation to withhold. Based on the complexity of the evidence and the nuanced findings in RCF IV, it may be more difficult for vendors to make this representation without having performed substantial valuation work.
Scope of 'mining' operations	The Court favourably quoted the decision of *FCT v Broken Hill Pty Co Ltd (1969) 120 CLR 240*, in which the High Court drew a distinction between the extraction of materials (mining) and the treatment of materials (non-mining). To this end, the High Court noted that iron ore mining operations are concerned with extracting iron ore (meaning that further treatment, such as size adjustment, does not qualify as 'mining'), while gold-mining operations are concerned with extracting gold (meaning that some post-extraction refinement can conceivably count as 'mining', for instance if the extracted materials are 'slum dumps'). The Court stated that the post-extraction processing functions of Talison did not constitute mining, despite the fact that lithium-mining operations are arguably concerned with extracting technical grade or chemical grade concentrate (i.e. more analogous to gold than iron ore).	Previously, it may have been arguable that the concept of 'mining' should be extended beyond mere extraction in respect of certain materials (e.g. rare earth metals) that inherently require substantial post-extraction work. This precedent is expected to now stand in the way of such an argument, which may help taxpayers in a TARP-analysis context. It will be interesting to consider whether this distinction could also be applied in other related areas of the tax law, including provisions relating to natural resource payments and/or mining capital expenditure.

The takeaway

Although it remains to be seen whether the Commissioner of Taxation will appeal the decision, in the interim, RCF IV casts significant doubt on certain previously accepted aspects of valuing mining and infrastructure enterprises for Division 855 purposes. Additionally, the effect of the case on valuations may have flow-on effects through thin capitalisation, foreign resident CGT withholding, cost-base setting and stamp duty (depending on the treatment of mining rights in the state or territory in question).

Let’s talk

For a deeper discussion of how these issues might affect your business, please contact:

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