

GST/HST Policy Statement

P-128R2

TAX TREATMENT OF A SUPPLY OF AN UNDIVIDED WORKING INTEREST IN THE ASSETS OF A MINE OR AN OIL OR GAS WELL

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Legislative references	Section 162 and subsections 221(2) and 228(4) of the <i>Excise Tax Act</i> (the Act)
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Note: Please note that the following policy statement, although correct at the time of issue, may not have been updated to reflect any subsequent legislative changes.

Issue

The tax treatment of a supply of an undivided working interest in the assets (tangible personal property, real property and mineral rights) of a mine or an oil or gas well.

Decision

In order to spread the risk when exploring for or exploiting a mineral deposit, a number of people or companies may have an interest in the property. The interest usually takes one of two forms – a royalty interest or a working interest.

A royalty interest entitles the holder of the interest to a fee based on the units or value of production. The royalty interest can take a variety of forms. For example, it may be a gross overriding royalty.

A gross overriding royalty is an interest in the revenue from the sale of product (e.g. oil, gas, iron, gold) produced at a specific property. It is usually expressed as a percentage of the gross revenue from the property (i.e., it is paid by the working interest owner(s) from gross revenues before any expenses and claims by working interest owner(s) are deducted).

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La version française de ce document est intitulée
*Traitement fiscal de la fourniture d'une participation
directe indivise dans l'actif d'une mine ou d'un puits de gaz
ou de pétrole.*



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A working interest is the right to explore for, produce and own a mineral (e.g. oil, gas, iron, gold) and all real and tangible personal property, bought or built, in order to explore for or exploit that mineral deposit. A person with a working interest is obligated to pay operating costs and is entitled to revenue based on total sales less royalties (such as gross overriding royalties) and taxes.

When a number of people each hold a working interest in the property, their interests are usually undivided. This means that each person holding a working interest has an interest in all of the property and none of them can claim an exclusive interest in any part of the property, except by acquiring all of the other working interests.

A person can obtain an undivided working interest in the assets of an oil or gas well either by purchasing all or part of the working interest held by another person or by converting a gross overriding royalty into a working interest in the well.

A person usually obtains an undivided working interest in the assets of a mine by purchasing all or part of the working interest held by another person.

When the working interest is acquired by purchasing all or part of the working interest held by another person, the consideration paid may be money or it may be a working interest in another mineral property. Sales or swaps of working interests in producing properties are common in the resource sector.

When a gross overriding royalty is converted into a working interest, the holder of the royalty interest supplies the royalty interest in exchange for a supply of an undivided ownership interest in the mine or oil or gas well.

A person can also acquire an undivided working interest in a mineral property under a farm-out agreement. This policy statement does not apply to the supply of a working interest under a farm-out agreement if subsection 162(4) of the Act applies. The Appendix to this policy statement outlines the application of subsection 162(4) to these supplies.

When a person acquires an undivided working interest in the assets of a mine or an oil or gas well, through either of the previously mentioned methods, the transaction normally includes the transfer of an interest in tangible personal property, real property and the right to explore for and exploit a mineral deposit (“the mineral rights”).

The real property may include:

- (a) buildings, plants, refineries, sheds, pipelines or gathering systems, railway tracks; etc. and/or
- (b) reinforcing ground controls (such as the casings cemented into the ground, cable bolts or grouted supports).

In all provinces except Quebec, tangible personal property may include*:

- (a) machinery used in an underground mine, such as skids, elevators, conveyor belts, compressors, generators, crushers, and ore carts;
- (b) vehicles used in an underground mine, such as loaders, tractors, fork-lifts, and back-hoes;
- (c) personal property used in an underground mine, such as helmets, lights, shovels, dynamite, hand-held drills, and ladders;
- (d) machinery used on the surface at a mine, such as skids, conveyor belts, drills, mills or grinders (may be real property if permanently affixed to the plant at the mine);
- (e) vehicles used on the surface at a mine, such as earth-movers, graders, ore trucks, loaders, tractors, forklifts, and dump trucks;
- (f) machinery used in an oil/gas well, such as well-heads, blow-out preventers, and pump-jacks; and
- (g) machinery used on the surface at an oil/gas well, such as separators, heater-treaters, storage tanks, flow-lines, and pipelines (both flow-lines and pipelines may be real property if permanently affixed to the land)

It must be determined on a case-by-case basis whether a supply of an undivided working interest in the assets of a mine or an oil or gas well is a single supply or multiple supplies of the components (i.e., tangible personal property, real property and mineral rights, each of which may have a different tax status). To make this determination the criteria in Policy Statement P-077R2, *Single and Multiple Supplies*, should be applied.

In most cases, however, where a person acquires an undivided working interest in the assets of a mine or an oil or gas well, multiple supplies are being made.

According to the general rules under Part IX of the Act, the supply of tangible personal property, by itself, would be taxable and the vendor, if a registrant, would be required to collect and account for the tax.

The supply of the real property, by itself, would also be taxable, unless an exempting provision in Schedule V to the Act applies. The vendor would not, however, be required to collect and account for the tax if the supply was made to a person who is registered for GST/HST (provided that the supply is not a supply of a residential complex to an individual). The supplier would also not collect tax if the supplier was a non-resident or was a resident of Canada only because it was deemed to be a resident in respect of activities carried on through a permanent establishment of the non-resident in Canada. Instead, the purchaser would be required to account for the tax on the supply and self-assess the tax payable.

The supply of the mineral rights, by itself, would be deemed not to be a supply pursuant to subsection 162(2) of the Act, unless the purchaser was a consumer or a non-registrant who acquired the rights in the course of a business of supplying the minerals to consumers.

Therefore, in most cases, the vendor would collect the tax on the consideration for the tangible personal property, and the purchaser, if registered, would account for and self-assess the tax payable on the supply of the real property. No tax would apply to the supply of mineral rights.

* Please note that in the province of Québec, some of the tangible personal property listed will be real property for GST purposes.

Examples

EXAMPLE NO. 1 – Sale of a Working Interest

Facts

1. A has agreed to sell half of its working interest in a diamond mine located in Ontario to B for \$1,000,000.
2. A and B are both registered for GST/HST purposes.
3. A's working interest in the mine consists of a 40% interest in the following assets, which include tangible personal property, real property and mineral rights:
 - a mining permit issued by the Province of Ontario,
 - residential complexes (may be exempt under Schedule V, Part I to the Act),
 - a mine office,
 - a refinery, with milling and grinding equipment,
 - machinery and supplies sheds,
 - drills, hand-held and truck mounted,
 - crushers,
 - elevating equipment,
 - mining equipment for personnel,
 - vehicles, and
 - other mining equipment.

Decision

A would charge GST on the consideration for the tangible personal property (e.g. mining equipment for personnel, crushers, vehicles), B would account for the GST on the consideration for the taxable supplies of real property (e.g. mine office, refinery) and no tax would be collected on the supply of the mineral rights (e.g. mining permits).

Rationale

Based on the facts and the criteria in Policy Statement P-077R2, *Single and Multiple Supplies*, A is making a number of supplies when the working interest in the diamond mine is sold.

EXAMPLE NO. 2 – Conversion of a Royalty or Gross Overriding Royalty Interest to a Working Interest

Facts

1. Pursuant to an agreement between A and B, B receives a 20% gross overriding royalty in the revenue from an oil well located in Alberta.
2. A and B are both registered for GST/HST purposes.
3. B has decided, pursuant to the terms of the agreement, to convert its gross overriding royalty into a 40% working interest in the property.
4. The agreement between A and B is not in respect of a farm-out arrangement.
5. As a result of the conversion of its gross overriding royalty, B will receive an undivided 40% interest in the petroleum and natural gas rights and the real and tangible personal property located at the well.

Decision

The supply of the gross overriding royalty to A is deemed not to be a supply pursuant to paragraph 162(2)(c) of the Act. Therefore, B does not have to collect and account for tax on this supply. A is making a supply of a 40% working interest to B, composed of tangible personal property, real property and a right to explore for or exploit a mineral deposit. A would collect and account for the GST on the consideration for the supply of the tangible personal property; B would account for the GST on the consideration for the supply of the real property; and the supply of the right to explore for or exploit a mineral deposit would be deemed not to be a supply.

Rationale

Based on the facts, a barter transaction has occurred since B is supplying its 20% gross overriding royalty interest in the oil well to A in exchange for a 40% working interest in the property. The criteria in Policy Statement P-077R2, *Single and Multiple Supplies*, would indicate that A is making a number of supplies when the working interest in the oil well is sold.

Appendix

This policy statement does not apply to supplies of working interests in the assets of a mine or an oil or gas well made under a written farm-out agreement.

Most farm-outs in the natural resource sectors are classified as either typical farm-outs or widespread farm-outs.

Under a typical oil and gas farm-out agreement, one party (the “farmor”) has an interest in certain lands, either as a lessee or as the owner. Another party (the “farmee”) agrees to drill a test well on the lands to the contract depth, complete the well and then equip, cap or abandon the well (“exploratory work”) in exchange for a working interest in the property. The farmor normally retains a gross overriding royalty, which is convertible into an agreed upon percentage working interest in the well at a certain point in time (referred to as “payout”). At payout, the farmor normally exchanges the royalty interest for an ownership interest in the well, including any depreciable property located on the property.

In a typical farm-out arrangement in the mining sector, the farmee (called an optionee) may agree to perform a specified dollar amount of exploration and/or development work (“exploratory work”) on the contracted property. Upon completion of the work the farmee acquires an agreed-upon percentage working interest in the mine.

In a widespread farm-out arrangement, the farmee receives an interest in another resource property (i.e., not the property that is being explored or developed), or receives property other than an interest in a resource property.

Where the supply of the working interest is made under a farm-out agreement, subsection 162(4) may apply to deem the value of all or a part of the consideration to be nil. Generally, GST/HST will not apply in a typical farm-out transaction unless there is some monetary consideration.

Where the farmee receives other property from the farmor, as in a widespread farm-out, the farmee is deemed to have made a taxable supply of services to the farmor as consideration for the other property. GST/HST will apply to both the supply of the other property made to the farmee, and the deemed supply of services made to the farmor, based on the fair market value of that other property.

At payout, when the farmor converts its royalty interest into a working interest, the value of certain tangible personal property used in the exploration or development of mineral resources on the unproven property, and supplied by the farmee to the farmor, will be deemed under subsection 162(4) to be nil.