Following on from recent Federal Budget restrictions on exploration deductions, the New South Wales State Government has announced increases to duty on exploration tenements. On the same day, the Administrative Appeals Tribunal handed down a decision on exploration and PRRT.

**Deduction for exploration – PRRT and income tax impacts**

On 29 May 2013, the Administrative Appeals Tribunal (AAT) made a number of determinations as to whether various categories of expenditure qualified as exploration for Petroleum Resource Rent Tax (PRRT) (*ZZGN v Commissioner of Taxation* [2013] AATA 351).

While the decision is of particular relevance for resource companies in the oil and gas sector that are subject to PRRT, the Tribunal’s interpretation of ‘exploration’ has broader implication for all resources companies due to the ability to obtain up front income tax deductions for exploration expenditure.

The PRRT issues should also be read in the context of the Australian Taxation Office’s (ATO) current compliance program which states that approximately 45 claims for an immediate income tax deduction for mining, quarrying or prospecting rights will be reviewed to ensure they ‘accord with legislative requirements’.

**The PRRT issue**

PRRT applies at a 40% rate to ‘taxable profits’ of an oil or gas project. While general project expenditure is deductible under the PRRT, exploration expenditure can be transferred to other projects.

For PRRT purposes, deductions are available for payments ‘involved in, or in connection with, exploration’. 
The Tribunal concluded that the meaning of ‘exploration’ had to be read in the context of the relevant act and assistance may be gained from the word’s ordinary meaning. The Tribunal found that exploration extended to:

- survey techniques to identify prospective oil and gas fields
- scientific and technical analysis in evaluating results, and
- drilling appraisal wells to provide a more accurate indication of the size and quality of the reserves.

However, feasibility studies of the field for future development and production were found not to come within the meaning of exploration for the purposes of PRRT.

The income tax issue

Income tax law allows an immediate upfront deduction for expenditure incurred on exploration and prospecting activities. Up until the May 2013 budget, a deduction was also allowed for the cost of acquiring mining rights and other depreciating assets, when those assets are first used for exploration and prospecting.

However, in contrast to the PRRT legislation, the income tax law contains a statutory definition of ‘exploration and prospecting’ which extends to certain feasibility studies.

The ATO has been active in reviewing claims for upfront deductions – particularly those relating to first use of acquired tenements when feasibility studies are in progress as opposed to physical exploration, when assets have been acquired close to the time when a decision to mine is made, when mining lease applications are lodged, or where exploration is undertaken on mining leases.

Where it is determined that the expenditure has been incurred in respect of assets that are not first used for exploration, deductions are instead spread over the effective life of the tenement – typically, the life of the mine.

So while this recent decision provides some insight into principles of interpretation in this area, it does not directly impact current ATO audit activity in respect of feasibility studies and income tax.

Practical issues – for both PRRT and income tax

The AAT decision considered whether expenditure in the following categories met the requirements to be classified as ‘exploration’:

- costs incurred by an operator and funded by cash calls on the taxpayer
- costs incurred by a parent and charged back to the taxpayer, and
- employee costs of the taxpayer.

This case and current ATO audit activity highlights the need to obtain contemporaneous evidence of the nature and purpose of activities and expenditure, particularly as a project moves from field exploration through various aspects of feasibility, into development and a decision to mine.

Given that, in many cases, exploration activities may be undertaken by subcontractors, or arranged by an operator, project participants need to ensure that:

- they have (or can obtain) details of the exact nature of the work done, and whether it was done for an objective purpose of or in connection with exploration, particular kinds of feasibility or development
- subcontracted exploration activities appropriately describe the nature and purpose of the work, both in terms of the contract and any invoicing or other documentation to support the work that was actually done, and
minority participants, in particular, will need to ensure that they obtain necessary information from operators to support any claims.

Companies that have previously made claims for exploration expenditure on directly acquired tenements or acquired subsidiaries that hold tenements should:

- review their positions in light of the decision
- consider whether they have the necessary evidence to support how the exploration tenements were actually used, and
- collate and retain documentary evidence to defend ATO challenge and support any possible litigation.

**New South Wales Government increases stamp duty on mining tenements**

The New South Wales government will introduce significant changes to the stamp duty payable on dealings with exploration tenements from 1 July 2013. These changes come on top of recent government announcements that the abolition of unlisted marketable securities duty, mortgage duty and business asset transfer duty will be deferred indefinitely to fund the State’s contribution to the Federal Government’s Gonski education reforms. Those duties were due to be abolished on 1 July 2013.

The specific changes relating to mining tenements will have a significant impact on the New South Wales mining industry. Rather than abolishing duty on statutory licences such as exploration tenements, the changes released yesterday:

- expand the definition of ‘land’ to include exploration licences, assessment leases and opal prospecting claims and not just mining leases and mineral claims
- require the value of a mining tenement to be determined having regard to the value of any mining information relating to that tenement, and
- include the value of anything fixed to the land over which the tenement is granted, such as wash plants and rail infrastructure etc, in the value of the mining tenement itself.

This means that all transfers in New South Wales mining tenements will continue to be subject to transfer duty. Also, when landholder duty applies to dealings in shares or units, that duty will increase to the extent the relevant company or trust owns:

- exploration licences
- mining information in relation to any of its mining tenements, and
- fixtures attached to the land the subject of the mining tenements.
These changes will significantly increase the duty on both direct and indirect dealings in New South Wales mining tenements. More than ever, careful and early consideration of the duty consequences of resources transactions is required.

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