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PROSPECTING FOR TAX DEDUCTIONS

THE ATO CONSOLIDATES AND CLARIFIES ITS VIEWS ABOUT WHEN EXPLORATION AND PROSPECTING COSTS ARE IMMEDIATELY DEDUCTIBLE

The Commissioner of Taxation has released *TR 2015/D4 - Income Tax: deductions for mining and petroleum exploration expenditure* (**Draft Ruling**). The Draft Ruling will replace *TR 98/23 - Income Tax: Mining exploration and prospecting expenditure* with effect from 28 October 2015.

In the Draft Ruling, the Commissioner provides further detail on how he considers expenditure is treated under section 40-730 of the *Income Tax Assessment Act 1997* (**ITAA 1997**). Section 40-730 provides an immediate deduction for certain expenditure relating to exploration or prospecting for minerals (including petroleum). The Draft Ruling does not cover section 40-80 of the ITAA 1997, which provides for an immediate deduction for the cost of assets used in exploration or prospecting for minerals. Further guidance will be released on section 40-80 in due course.

The Draft Ruling highlights that the Commissioner will focus on the actual substance of the expenditure and the purpose behind it in the context of exploration or prospecting. On this basis, understanding the definitions contained within section 40-730 becomes critical to understanding how to obtain deductions under this section.

The extensive detail provided in the Draft Ruling gives valuable insight into the actual activities that the Commissioner will deem to be deductible. We now have comfort that the vast majority of activities that are in connection with determining the economic feasibility of a mine, including the re-examination of suspended or abandoned projects will be deductible, however, expenses such as the costs incurred in applying for exploration licences will not be.

BACKGROUND AND OBJECTIVES

There are a number of reasons why *TR 98/23* was replaced by the Draft Ruling. Firstly, *TR 98/23* was written in terms of Division 330 of the ITAA 1997, which has since been replaced with Division 40. Further, the Draft Ruling is intended to address current industry practices and concerns, several of which have changed or emerged since 1998.

As exploration and prospecting expenditure is immediately deductible, by not making a decision to mine a taxpayer could theoretically extend the period in which their expenditure is deductible. This is because after a decision to mine, the costs are more likely to be on capital account and not deductible.

Given this context, the ruling is intended to clarify the emphasis (or lack thereof) that the Commissioner puts on a taxpayer's decision to mine. In the Commissioner's words, a decision to mine "does not provide a bright line for determining the nature or character of expenditure incurred before or after the decision". Whether or not expenditure is exploratory, and therefore immediately deductible, is not determined merely by reference to the point in time that decision to mine is made.

In the Commissioner's view, certain expenditure incurred prior to a decision to mine may nonetheless not be deductible. Examples given include costs incurred in relation to long-lead assets where such costs are incurred prior to a decision to mine, alternatively, feasibility studies undertaken after a decision to mine on a separate part of a tenement may be immediately deductible.

SECTION 8-1

The Commissioner confirms that a taxpayer may be able to deduct expenditure under the general deduction provision (section 8-1 of the ITAA 1997) even where it meet the criteria for a deduction under section 40-730. In the circumstances where a deduction is available under both provisions, the provision that allows the highest deduction would be the most appropriate for the purposes of section 8-10.

To satisfy the positive limbs of section 8-1, the taxpayer must be undertaking a mining or exploration business. If a taxpayer incurs expenditure in exploration activities for a new type of mineral that it has not previously mined, the Commissioner considers that this will likely fail the positive limb as a sufficient nexus to the existing income earning operations of the business does not exist.

In relation to the negative limbs, importantly, the Commissioner does not consider there to be a presumption that expenditure on exploration or prospecting for minerals will be of a capital nature. The usual test in relation to the benefit sought by undertaking the expenditure and the facts of a particular case will be paramount in determining its character.

SECTION 40-730

Scope and application of subsection 40-730(1)

Unlike section 8-1, expenditure of both a revenue and capital nature is deductible under section 40-730. In the Commissioner's view, in section 40-730(1), the use of the word 'on', as required by section 40-730(1) as opposed to 'in connection with' or similar, requires a close or direct connection between the expenditure and exploration activity, otherwise the words in 'connection with' or 'in relation to' might have been used.

While the Commissioner accepts that some exploration activities can be undertaken before a miner acquires an interest in an exploration permit, for example aerial surveys, in his view expenditure relating to the acquisition of exploration or prospecting rights is not incurred 'on' exploration or prospecting activities.

SCOPE OF SECTION 40-730 EXAMPLES

The Commissioner considers the following types of expenditure to fall outside the scope of section 40-730 where they are incurred in acquiring exploration permits or rights:

- Survey fees to check the mineral claims area;
- Advertising to comply with mining regulations;
- Attending court hearings to confirm rights;
- Payments to holders of tenements for abortive rights;
- Lump sum buying-in and lump sum compensation payments to landlords or other interested parties for long term rights to enter the property;
- Application fees for exploration licences;
- Costs incurred in negotiating and effecting farm-out and farm-in arrangements.

Meaning of exploration and prospecting in subsection 40-730(4)

The Commissioner notes that the definition of 'exploration or prospecting', in sub-section 40-730(4) includes its ordinary, natural meaning. That meaning includes the following:

- Discovery and identification of the existence, extent and nature of minerals;
- Searching to discover the minerals or resource;
- The process of ascertaining the size of the discovery;
- Appraising the physical characteristics of the mineral or resource; and
- Activities so closely connected with exploration or prospecting, as is reasonable to be considered part of it.

In addition to the ordinary meaning of 'exploration or prospecting', as just discussed, subsection 40-730(4) expands the definition to include a range other activities such as mapping, surveys, undertaking various systematic searches, exploration and appraisal drilling and feasibility studies among other things.

Activities that are specifically listed in subsection 40-730(4) are express additions and will satisfy the legislative definition even if they are undertaken as part of extractive operations.

EXPRESS ADDITION EXAMPLE

Geological mapping provided it satisfies the conditions in subsection 40-730(1), will still be considered exploratory at *any stage of the operation* as it is an express addition to the definition of 'exploration or prospecting'.

Economic Feasibility Studies under 40-730(4)(c)

Additionally, included in the extended meaning of 'exploration or prospecting' for section 40-730, are economic feasibility studies (**EFS**). An EFS is a study the purpose of which is to determine whether to mine.

The Draft Ruling sets out an extensive list of *relevant matters to interpret the scope of EFS*, which are:

- Economic feasibility is not determined on the basis of whether it would exist for some 'hypothetical' miner in an objective scenario. Whether a study is an EFS imports the perspective and purposes of the miner that commissioned it;
- An EFS may include consideration of a miner's individual circumstances to determine whether or not they will mine;
- EFS include the assessment of commercial viability;
- EFS include technical feasibility studies, pilot programs, research and development activities, environmental impact and heritage preservation studies;
- EFS includes studies that 'refine' or 'redo' existing studies to identify whether projects remain viable;
- EFS can include the re-examination of a project that has been suspended, recycled or abandoned; and
- Considerations of the economic feasibility of various development options, or how best to develop the resource are not EFS if the miner is no longer considering whether or not to mine.

The Draft Ruling notes that there is no requirement for a study to have a substantially, main or exclusive purpose of assessing the viability of mining. As such studies can be undertaken for multiple purposes and still be classified as an EFS.

ECONOMIC FEASIBILITY STUDY EXAMPLES

Activities that are part of EFS and deductible under subsection 40-730(1) include:

- Activities to evaluate the upstream and downstream infrastructure for the selected basis of design for a potential mine; and
- Obtaining cost estimates and assurances to form part of the economic feasibility of the mine.

Activities beyond ascertaining the economic feasibility of a project, not deductible under subsection 40-730(1), and not deductible under section 8-1 include:

- 'Long lead' items purchased from specialist vendors which take a long time to manufacture or fabricate; and
- Detailed engineering and design of the plant, procurement of equipment and assets, or construction works.

Meaning of subsection 40-730(2) - non-deductible costs incurred in 'operations in the course of working a mining property' and 'development drilling for petroleum'

Further, section 40-730(2) contains a number of exclusions which may serve to prevent amounts that may have otherwise been deductible under subsection 40-730(1). This includes exploratory expenditure that is also 'on' operations in the course of working a mining property or 'on' development drilling for petroleum.

The Commissioner indicates that development of a mining property or petroleum field by spending amounts for the purpose of 'getting at' or 'getting out' the resources will be non-deductible under sub-section 40-730(2). Such expenditure is to be classified as 'on' operations in the course of working that property or field, and will no longer

be exploratory, especially as 'getting at' or 'getting out' minerals can only occur once a decision to mine has been made.

Further, the Draft Ruling notes that where an activity is assessing whether a new mine, mine extension or expansion would be economically feasible on an already existing mining property, it is to be distinguished from an 'operations activity', and therefore deductible. The Draft Ruling contains an extensive list of indicative factors to assist in resolving whether the activity is properly regarded as development of an existing mine.

CONCLUSION

Whilst this Draft Ruling does not provide an entirely new interpretation of deductions for mining and petroleum exploration expenditure, it does provide a much more comprehensive guide to section 40-730 and its operation.

Importantly, the Draft Ruling indicates the Commissioner's emphasis on what is to be considered 'exploration or prospecting expenditure'. It is clear that it is the intention of the Commissioner, that 'exploration or prospecting expenditure' is not to be determined by reference to when the decision to mine was made.

The Draft Ruling, instead, provides a clear indication that the expenditure in question will be assessed in the context of the ordinary and statutory definitions of "exploration and prospecting" by reference to the intention behind the expenditure and the specific facts of each case.

MORE INFORMATION

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