



***TR 2010/D6 - Petroleum resource rent tax:  
deductibility of expenditure to procure the carrying  
on or providing of operations, facilities or other  
things by another person in relation to a petroleum  
project, as provided by section 41 of the Petroleum  
Resource Rent Tax Assessment Act 1987***

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 This ruling is being reviewed as a result of a recent court/tribunal decision. Refer to Decision Impact Statement: [Esso Australia Resources Pty Ltd v Commissioner of Taxation \(Published 5 October 2012\)](#).



## Draft Taxation Ruling

Petroleum resource rent tax: deductibility of expenditure to procure the carrying on or providing of operations, facilities or other things by another person in relation to a petroleum project, as provided by section 41 of the *Petroleum Resource Rent Tax Assessment Act 1987*

Contents	Para
<b>PROPOSED LEGALLY BINDING SECTION:</b>	
<b>What this Ruling is about</b>	<b>1</b>
<b>Background</b>	<b>6</b>
<b>Ruling</b>	<b>8</b>
<b>Examples</b>	<b>22</b>
<b>Date of effect</b>	<b>68</b>
<b>NOT LEGALLY BINDING SECTION:</b>	
<b>Appendix 1:</b>	
<i>Explanation</i>	69
<b>Appendix 2:</b>	
<i>Alternative views</i>	140
<b>Appendix 3:</b>	
<i>Your comments</i>	145
<b>Appendix 4:</b>	
<i>Detailed contents list</i>	147

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## What this Ruling is about

1. This draft Ruling explains aspects of deductibility of certain expenditure under the *Petroleum Resource Rent Tax Assessment Act 1987* (PRRTAA). It relates to payments made by a person to procure the carrying on or providing of operations, facilities or other things of a kind referred to in sections 37, 38 or 39 of the PRRTAA by another person in relation to the petroleum project, as provided for in section 41 of the PRRTAA.

2. All references to legislation in this draft Ruling are to the PRRTAA unless otherwise indicated. A reference in this draft Ruling to a taxpayer is a reference to a person with an interest in the assessable receipts of a petroleum project.

3. Under section 32, a person may be eligible to claim as deductible expenditure the expenditure, incurred by that person in relation to an eligible petroleum project, of the kinds referred to in section 32 that arise from exploration expenditure, general project expenditure or closing-down expenditure (together known as 'eligible real expenditure'). Section 41 generally applies where a person (referred to as the 'eligible person') incurs a liability to make a payment to procure another person (a third party) to carry on or provide the operations, facilities or other things, the expenditure for which, had the eligible person carried on or provided the operations, facilities or other things themselves, would constitute eligible real expenditure. The operations, facilities or other things the eligible person is liable to pay to procure are deemed to have been carried on or provided by the eligible person and not by the third party. The payment liable to be made by the eligible person to procure the carrying on or providing of such things is deemed to have been incurred by that person in carrying on or providing those things.

4. As a consequence, the payments liable to be made by the person may qualify as eligible real expenditure from which deductible expenditure and transferred expenditure derive for the purposes of calculating the petroleum resource rent tax (PRRT).

5. This draft Ruling is not relevant to expenditure incurred in procuring another person to stabilise, transport, store, recover or process petroleum recovered from a petroleum project if it amounts to processing of internal petroleum in relation to the project or processing of external petroleum in relation to another petroleum project as such processing is defined in the PRRTAA.

## **Background**

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6. PRRT is essentially a tax on a person with 'assessable receipts' from a petroleum project. The PRRTAA taxes the excess of the person's project 'assessable receipts' over their project 'deductible expenditure' and the expenditure transferred to that project from another project of the person or of the company group of which the person is a member. It allows expenditure on such a project and expenditure eligible to be transferred to the project, each whether of a capital or a revenue nature, to be fully recovered, after compounding augmentation, from 'assessable receipts' of the petroleum project before PRRT is payable on any excess, the 'taxable profit'. In order to be deductible expenditure or transferred expenditure, the expenditure must derive from amounts liable to be paid in carrying on or providing particular operations, facilities or other things (such as things specified as making up the petroleum project or otherwise specified in the PRRTAA), and the expenditure must not be 'excluded expenditure'.

7. A person may carry on or provide operations, facilities or other things in relation to the petroleum project themselves (including through their employees or agents) or through third parties acting on their behalf (including independent contractors if they are not agents). Expenditure may be incurred in getting someone else to do things in relation to the petroleum project; the cost of which would have been eligible real expenditure had the person done those things themselves. This draft Ruling explains the circumstances in which payments liable to be made by a person to procure another person to carry on or provide the operations, facilities or other things, the expenditure on which would otherwise constitute eligible real expenditure of the person, may give rise to eligible real expenditure in relation to the petroleum project of the person.

## **Ruling**

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### **Scope of section 41**

8. If an eligible person incurs a liability to make a payment for someone else to carry on or provide operations, facilities or other things of a kind referred to in sections 37, 38 or 39, section 41 treats the person as having carried on or provided those things and treats the liability to make the payment as having been incurred by the person in carrying on or providing those things.

9. A payment is liable to be made to procure the carrying on or providing of relevant operations, facilities or other things for a petroleum project so far as and to the extent that the carrying on or providing of those things is the consideration for the payment, taking account of all the things the carrying on or providing of which, is the consideration for the payment. A payment is not for the carrying on or providing of relevant things according to their relative importance to the payer. So, for instance, a payment is not made wholly to procure the carrying on or providing of relevant operations, facilities or other things for a petroleum project if other things are also required to be carried on or provided as consideration for the payment, even if the eligible person incurred the liability only because the consideration included carrying on or providing the relevant operations, facilities or other things.

### **Other legislative requirements still apply**

10. Section 41 does not itself provide that the liability the person incurs is or may give rise to eligible real expenditure. Whether and to what extent the liability so incurred may give rise to eligible real expenditure depends on applying the other provisions of the PRRTAA to what the eligible person is taken to have carried on or provided and to the liability taken to have been incurred by the person in carrying on or providing those things.

11. Whether and to what extent the payment liable to be made by an eligible person to the third party is exploration expenditure, general project expenditure or closing-down expenditure under sections 37, 38 or 39 respectively, from which deductible expenditure or transferred exploration expenditure for the purposes of the PRRTAA derives, depends on what the eligible person is deemed to have carried on or provided, which the payment is deemed to have been incurred in carrying on or providing. So that depends on the extent to which the payment was made to get the third party to carry on or provide things set out in sections 37, 38 or 39 (including by reference to items set out in subsection 19(4) as constituting the petroleum project) (refer to Examples 1, 3 and 5 of this draft Ruling).

12. Payments liable to be made are not exploration expenditure, general project expenditure or closing-down expenditure under sections 37, 38 or 39 from which deductible expenditure or transferred exploration expenditure derives so far as they are excluded expenditure under section 44. Section 41 may give rise to deductible expenditure only by identifying what the eligible person incurred the liability to make the payment to the third party for carrying on or providing as being carried on or provided by the eligible person rather than by the third party, and, in treating the liability as incurred by the person themselves in carrying on or providing what the third party was liable to be paid to carry on or provide.

13. So the deeming in section 41 does not preclude the application of section 44 and does not alter the position that excluded expenditure cannot give rise to eligible real expenditure. Only expenditure which is liable to be made in having the third party do things, the cost of which would have been eligible real expenditure of the person had the person done those things themselves, can ever be eligible real expenditure because of the deeming in section 41. The deemed expenditure is eligible real expenditure only so far as it then meets the requirements of sections 37, 38 or 39, including that it not be excluded expenditure under section 44 (refer to Examples 2, 3, 4 and 9 of this draft Ruling).

### **Apportionment**

14. Expenditure must be apportioned to identify the part of any payments liable to be made to third parties that is to procure them to carry on or provide operations, facilities or other things of a kind referred to in sections 37, 38 or 39. That part of the expenditure is subject to the deeming in section 41. And that part of the expenditure must be apportioned between the different operations, facilities or other things it is to procure, in applying to the expenditure subject to deeming the tests to identify what parts of it are eligible real expenditure, and what parts are not, such as because those parts are excluded expenditure under section 44. Apportionment may result in some of the expenditure subject to the deeming being treated as not deductible (for example, it may be excluded expenditure) and some of the expenditure being treated as eligible real expenditure.

Expenditure or a part of the expenditure liable to be paid to the third party may not be eligible real expenditure because, for instance:

- what was carried on or provided by the third party was not done in carrying on or providing the operations, facilities or other things of a kind referred to in sections 37, 38 or 39 (for example, it is or is for a downstream operation or activity – refer to Examples 2 and 8 of this draft Ruling); or
- what was carried on or provided by the third party cannot give rise to eligible real expenditure due to the application of section 44 (for example, the payment is of administrative or accounting costs incurred only indirectly – refer to Examples 4 and 9 of this draft Ruling).

15. If a payment is liable to be made by a person solely for a third party to carry on or provide operations, facilities or other things, and the expenditure incurred by the person is incurred in carrying on or providing things expenditure on which is wholly eligible real expenditure covered by sections 37, 38 or 39, then the full amount of the payment gives rise to eligible real expenditure (refer to Example 1 of this draft Ruling).

### **Payments to agents**

16. Section 41 does not apply to payments by a person to their agent, if the payments are made in that capacity. The acts of an agent are those of the principal; remuneration to the agent is not a payment made to have the agent carry on or provide relevant petroleum project operations, facilities or other things, as the principal themselves carries on or provides those things. However, the payment to the agent may be itself a payment liable to be made by the principal in carrying on or providing the operations, facilities or other things the principal carries on or provides by its agent.

17. Section 41 therefore is inapplicable to contributions by which joint venturers put the joint venture operator who is acting as their agent in funds to incur projected expenditure for which each venturer will be liable to the extent of their particular share. Such contributions are not payments made to procure the carrying on or providing of relevant operations, facilities or other things. Rather, when the joint venture operator incurs the expenditure, the joint venturer's liability for their share of that expenditure is then a payment the joint venturer is liable to make in carrying on or providing that which the expenditure incurred by the operator is for.

**Agreement to do a range of things**

18. Payment may be liable to be made to have the third party do whatever of a range of things the person may require them to do, and the arrangement may provide for the third party to charge the person on the basis of the actual expenditure incurred by the third party in doing each thing so done as required (perhaps the payment liable to be made is at cost or perhaps it may include a specified mark up of the actual expenditure incurred by the third party). In such cases, the actual payment liable to be made is for each thing done to the extent of the part of the charge due based on the third party's actual expenditure in doing the thing. The deeming under section 41 is that the part of the charge is taken to be expenditure by the eligible person in themselves carrying on or providing the particular thing the third party did or was to do (and that the thing is taken to have been carried on or provided by the eligible person, not the third party). So it is the nature of that thing that must be individually considered to determine the extent to which the part of the charge that is the payment for it (taken to be incurred by the person in themselves carrying on or providing that thing) may give rise to eligible real expenditure (refer to Example 2 of this draft Ruling).

**Anti-avoidance provisions**

19. General anti-avoidance provisions under Subdivision A of Division 6 apply to an arrangement under which any of the persons entering into or carrying out the arrangement would be concluded to have done so for the sole or dominant purpose of enabling an eligible person to obtain a tax benefit or benefits. This conclusion is an objective one, based on specified matters only. Incurring a liability to make a payment to procure the carrying on or providing by another person of operations, facilities or other things of a kind referred to in sections 37, 38 or 39 produces deeming under section 41. That deeming may provide a tax benefit. However, obtaining that tax benefit is not inherently the sole or dominant purpose of incurring the liability, as procuring the carrying on or providing of the relevant petroleum project operations, facilities or other things is the purpose of the payment and without particular additional facts and circumstances no tax avoidance purpose is dominant.

20. If a payment liable to be made by a person is one to which deeming under section 41 applies, and the deemed expenditure is eligible real expenditure, Subdivision B of Division 6 may apply so that the amount of the deemed expenditure may be reduced to what it would have been had the parties been dealing with each other at arm's length in relation to the transaction giving rise to the deemed expenditure. Deeming under section 41 does not have the effect that the transaction under which a taxpayer incurs a liability to make a payment to procure the carrying on or providing by another person of relevant petroleum project operations, facilities or other things is taken not to have occurred for PRRT purposes, and Subdivision B of Division 6 applies to that transaction in the same way as to any other transaction.

**Time of incurring liability to make payments**

21. A liability to make a payment to which section 41 applies is incurred for the purposes of the PRRTAA when the liability arises. Generally, liability to make a payment to procure a third party to carry on or provide operations, facilities or other things arises only when the third party has performed its part of the contract, but this is not a requirement for there to be a liability to pay to which section 41 applies and in some situations a person may incur a liability to pay before the third party has performed its obligation (wholly or partly) (refer to Example 6 of this draft Ruling).

**Examples****Example 1 – Fixed price consideration paid to a third party to drill an exploration well**

22. A company procures a third party to drill an exploration well exploring for petroleum in the eligible exploration or recovery area for the company's petroleum project for a fixed price consideration. Does the consideration to the third party, when it is liable to be paid, constitute eligible real expenditure of the company?

23. The company is paying consideration to the third party to carry on or provide operations, facilities or other things of a kind referred to in sections 37, 38 or 39. The exploration well is part of operations and facilities involved in or in connection with exploration for petroleum in the eligible exploration or recovery area for the company's petroleum project, and such operations and facilities are among those referred to in section 37 by paragraph 37(1)(a). So paying the third party to procure them to drill the exploration well is paying the third party to carry on or provide something, the expenditure on which could constitute eligible real expenditure of the company if it had been carried on or provided by the company. Section 41 provides that those operations, facilities or other things have been carried on or provided by the company rather than by the third party, and the liability of the company to the third party has been incurred by the company in itself carrying on or providing those operations, facilities or other such things. As a consequence, eligible real expenditure of the company is worked out under section 37 as if the company itself had become liable to pay the amount in itself drilling the exploration well.

24. As the company is liable to pay the third party only to provide operations, facilities or other things of the kind referred to in sections 37, 38 or 39, the costs actually incurred by the third party because it drills the exploration well, which may include items that would otherwise constitute excluded expenditure pursuant to section 44 (for example, indirect labour costs), do not impact on the treatment of the consideration paid by the company.

**Example 2 – Third party procured to operate the upstream and downstream facilities of operations related to a PRRT project for consideration based on direct and indirect costs including notional costs plus a profit mark-up**

25. A company contracts with a third party for the third party to operate upstream and downstream facilities of the project. The project includes integrated operations producing marketable petroleum commodities ('upstream') which are further processed to produce other products ('downstream'), and those products are then sold. The petroleum project is limited under the PRRTAA to the operations, facilities or other things of a kind referred to in sections 37, 38 or 39; it includes nothing for purposes after marketable petroleum commodities become excluded commodities, so it includes nothing for purposes after marketable petroleum commodities are moved away for further processing. Further, the petroleum project only includes specific things before that point.

26. The consideration is payments liable to be made. If part of the consideration is for the third party to carry on or provide operations, facilities or other things of the kinds referred to in sections 37, 38 or 39, they are deemed by section 41 to be carried on or provided by the company and not the third party; and that part of the consideration is deemed to have been incurred by the company in carrying on or providing those things.

27. Suppose the consideration liable to be paid by the company is measured by the actual direct labour costs to the third party of each particular operation provided by the third party, and a portion of all the overhead costs incurred by the third party for all its activities according to that share of the third party's total direct labour costs, plus a profit mark-up. To what extent does the consideration payable by the company constitute eligible real expenditure of the company?

28. The company is paying to procure the third party to carry on or provide what it is to carry on or provide under the arrangement. The part of what it pays that is for any particular thing is the part identified by the actual labour cost of the third party in carrying on or providing that thing, because of the way the consideration is measured. As no other direct costs or other identification of the particular operations, facilities or other things is made by the agreement, there is no other basis on which the part of the consideration to procure the particular operations, facilities or other things can be identified.

29. The other overhead costs are not a way of identifying the part of the expenditure that is to procure particular operations, facilities or other things, because those costs are simply distributed mechanically in working out the charge rather than by being in carrying on or providing a particular operation, facility or other thing. But they can be taken into account in quantifying the consideration apportioned according to those direct labour costs. For a detailed discussion of this issue, refer to draft Taxation Ruling TR 2010/D5 Petroleum resource rent tax: excluded expenditure under paragraphs 44(j) and 44(k) of the *Petroleum Resource Rent Tax Assessment Act 1987* – administrative, accounting, wages, salary, other work costs, and overhead expenditure; land or buildings for use in accounting or administration not adjacent to the operations site.

### **Example 3 – Procuring a related party to interpret seismic data**

30. Company A (a joint venture participant in a petroleum project) engages Company B (a related company) to review seismic data collected by the joint venture operator in relation to the 'eligible exploration area' of the project. Company B will analyse the data and provide a report to Company A for a payment based on the accounting cost to Company B of the analysis and report plus a profit mark-up on that amount. Can company A treat the payment as eligible real expenditure?

31. By the operation of section 41, the proportion of costs (such as salary costs incurred by Company B) that are incurred directly in carrying on or providing the operations, facilities and other things for the petroleum project on Company A's behalf will constitute eligible real expenditure of Company A. Certain other costs that are incurred by Company B, such as salaries and salary overhead costs, that are incurred indirectly cannot give rise to eligible real expenditure of Company A.

32. To the extent that the nature of the service procured by Company A is not the carrying on or providing of operations, facilities or other things of a kind referred to in sections 37, 38 or 39 for the petroleum project, that part of the consideration liable to be paid to Company B is not subject to section 41 and cannot otherwise constitute eligible real expenditure of Company A. This could arise, for example, if the seismic review is not carried on or provided in or in connection with petroleum project exploration; or if the review is not in carrying on or providing preparatory operations or facilities to those comprising the project. Further, deeming under section 41 will not result in it being deemed to be eligible real expenditure, if the consideration taken by section 41 to be incurred by Company A in itself carrying or providing the seismic review is excluded expenditure under section 44.

33. The cost for the seismic review would be outside the things referred to in sections 37, 38 or 39, or its cost would be excluded expenditure under section 44, if it is directed to working out costs of further development to position Company A for negotiations for the acquisition of more, or disposal of some, of its interest in the project.

34. If Company B is acting as the agent of Company A, its actions are those of its principal. If it incurs underlying costs as agent, the underlying costs have been and are taken to have been incurred by Company A. No deeming under section 41 applies to Company A's payment – the acts of an agent are those of the principal, Company A itself carries on or provides the seismic review, and so the payment is not to procure the carrying on or providing of the seismic review by Company B.

#### **Example 4 – Administrative cost incurred in carrying on the petroleum project as well as other things**

35. A company owns and operates an eligible production licence from the area of which petroleum is recovered. The company also owns and operates the processing facilities for the production of liquefied natural gas (LNG) from the petroleum recovered from the production licence area. A contractor was engaged to provide certain administrative activities that relate to all processes from recovery of petroleum to its processing and liquefaction into LNG and its loading and shipping to purchasers. The contractor does not hold an interest in any petroleum project. Does the whole amount liable to be paid to the contractor constitute eligible real expenditure of the company?

36. By the operation of section 41, the part of the consideration paid to the contractor that was incurred to procure the contractor carrying on or providing the operations, facilities and other things of a kind referred to in sections 37, 38 and 39 may constitute eligible real expenditure of the company. As the things referred to in sections 37, 38 and 39 can only apply to a petroleum project, as defined, section 41 can only apply to administrative activities under consideration in carrying on or providing such activities, necessarily only of the upstream part of the project (here, the recovery of petroleum and its processing into sales gas). Section 41 cannot apply to the administrative activities to the extent they relate to other activities including those in the downstream part of the project (here, the conversion of sales gas to LNG and selling and shipping the LNG).

37. For administrative costs to constitute eligible real expenditure of the petroleum project, they must be directly incurred in carrying on or providing those operations, facilities or other things for the petroleum project the cost of which is eligible real expenditure of a kind identified by sections 37, 38 or 39 (otherwise being excluded expenditure under paragraph 44(j), as discussed in TR 2010/D5). If section 41 operates, it deems the administrative activities to be carried on or provided by the company and not the contractor, and it deems the payments to the contractor to be incurred by the company in carrying on or providing the administrative activities.

**Example 5 – Mobilisation of drilling equipment under a drilling program**

38. An Australian company holds an interest in three exploration permits, for each of which there is a separate petroleum project. A company from Singapore is carrying out exploration drilling for the Australian company on each permit area under a drilling program. The Singapore company charges different rates for the time the drilling rig is being mobilised (this includes moving the drilling rig from Singapore to Australia) and for the time that is spent in drilling. Can the cost of mobilisation of the drilling rig from Singapore to the first exploration permit of the Australian company be treated as exploration expenditure of the petroleum project for the first exploration permit of the Australian company?

39. The mobilisation of the drilling rig is not an operation that is itself carrying out exploration in the eligible exploration or recovery area of the first petroleum project. However, it is an operation in connection with petroleum project exploration to the extent that it is for the purpose of providing the drilling rig to carry out exploration drilling for a petroleum project.<sup>1</sup> Had the Australian company owned the drilling rig, the operation of moving the drilling rig to the exploration permit areas would have met the definition of an operation in connection with petroleum project exploration. Here the movement from Singapore is for the purposes of exploration drilling on all three petroleum projects. As a matter of fact, the drilling rig and its services would be available to any of the three projects only because of the overall drilling program in Australian waters including all three permit areas.

40. Section 41 treats the mobilisation operation as having been carried on by the Australian company and it also deems the payment liable to be made by the Australian company for the mobilisation operation as incurred by the company in carrying on or providing the mobilisation of the drilling rig. Whether the liability incurred by the Australian company gives rise to exploration expenditure of the company on each petroleum project is determined by referring to section 37. Mobilising the drilling rig from Singapore is only partly in connection with exploration drilling on the first permit. So only part of the charge is in the mobilisation that is in relation to that petroleum project. Part is in mobilisation carried on or provided in each of the other petroleum projects, and must be apportioned accordingly.

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<sup>1</sup> In *Re BHP Petroleum Pty Ltd and Collector of Customs* (1987) 11 ALD 413 (AAT No. 3194), the Administrative Appeals Tribunal decided in a customs case that the movement of the applicant's drilling ship from one exploration area to another exploration area (not adjacent to the first area), was not an operation that is exploration, prospecting or mining and was not a connected operation carried out at an adjacent place. The movement of the drilling ship was an operation connected with exploration but it was not an operation carried out in the exploration area and was not carried out at an adjacent place.

**Example 6 – When expenditure is incurred**

41. A company entered into an agreement in June 2007 with a contractor for work to be performed to carry on or provide things of which the cost would constitute eligible real expenditure to the company had the company carried on or provided those things itself. The work was to be paid for once performed, on invoice, according to a basis set in the agreement. In July 2007 the contractor performed the work and provided a tax invoice to the company. Can the company claim the deductible expenditure that arises from the payment against its assessable receipts for the 2006-07 year of tax?

42. The company is deemed by section 41 to have done the work and carried on or provided the relevant things itself. The contract was made in the 2006-07 year of tax. The work was done and the invoice provided in July 2007, in the 2007-08 year of tax.

43. The company was not liable to make the payment, and did not incur the expenditure, in the 2006-07 year of tax. The agreement set the basis on which it would be liable to pay – but the company was not liable to make any payment when entering into the agreement. The liability to pay for the work was contingent upon the contractor performing the task and invoicing on the basis set in the agreement. The agreement was an executable contract as at 30 June 2007 (refer to *Commissioner of Taxation v. Malouf* [2009] FCAFC 44). There was no deductible expenditure incurred at 30 June 2007, as there was up to that date no work performed, no invoice, and so no amount liable to be paid by the company.

**Example 7 – Funds committed to a joint venture operation**

44. Company X is a joint venture participant and the joint venture operator and Company Y is another joint venture participant in a joint venture which carries on a petroleum project. Each holds an interest in the assessable receipts of the petroleum project. At the start of a calendar month, Company X provides a proposed plan of project works for the following month and the estimated expenditure of the joint venture for those works (referred to as committed expenditure in the Joint Venture Agreement). Company X makes a cash call to the other venturers, including company Y, each for their share of the estimated expenditure, so as to be put in funds to incur the expenditure for the joint venture. Company Y pays its share of the contribution called, in accordance with the joint venture agreement. Does the cash-call amount paid by company Y give rise to eligible real expenditure of company Y when it is called by, or paid to, company X?

45. As joint venture operator, Company X carries on the operations, facilities and other things for the petroleum project partly on its own behalf and partly on behalf of each other joint venturer including Company Y. If the contribution called from Company Y is a payment to procure the carrying on or providing of those project operations, facilities and other things, then so far as those things are of the kinds referred to in sections 37, 38 or 39 they are things Company Y is deemed to carry on or provide by section 41, and the payment is to that extent incurred by Company Y in carrying on or providing those things when Company Y is liable to pay it.

46. However, the usual form of joint venture arrangements for petroleum projects is that no participant, whether the operator or any other, incurs or accepts obligations other than to the extent of its agreed part of those obligations. In such cases, a contribution of cash-call amounts to the joint venture account is not itself a payment to procure the carrying on or providing of the relevant things. The contribution only puts the joint venture operator in funds in anticipation of expenditure that the joint venturers are each expected to be liable to pay to others for those things. In that case, the cash-call amount is not a payment to which section 41 applies and is not in carrying on or providing any of the relevant things. It does not give rise to eligible real expenditure of Company Y either at the time the cash call is made or when company Y pays the cash call amount to company X.

47. The joint venturers each incur expenditure that may give rise to eligible real expenditure when the joint venture operator actually incurs a pecuniary liability of the kind which the call provides for (refer to *Commissioner of Taxation v. Malouf* [2009] FCAFC 44). The expenditure they then incur may be more or less than the amount of the call (as the cash call is commonly only a pre-estimate). Company X incurs its share of any eligible real expenditure directly under sections 37, 38 or 39. Company Y may incur its part of Company X's expenditure directly (so far as Company X is acting as its agent) or it may be taken to incur a liability in itself carrying on or providing what is actually carried on or provided by Company X (by the application of section 41).

## **Example 8 – Cost Contribution Arrangements for research results**

48. An Australian subsidiary company of a multinational petroleum group is the joint venture operator of a petroleum project joint venture. The subsidiary company is among many worldwide subsidiaries that enter into a Cost Contribution Arrangement (CCA) with an overseas group company to share the costs of developing, producing or obtaining research results that the overseas company may develop in its research programs.<sup>2</sup> Those results and past results are available to CCA participants for any purpose, free of further charge to those who have entered into the CCA.

49. Each joint venture participant claims part of the amount payable by the subsidiary company under the CCA as eligible real expenditure under the PRRTAA. Is it eligible real expenditure?

50. A payment is liable to be made to procure the carrying on or providing of relevant operations, facilities or other things for a petroleum project so far as and to the extent that the carrying on or providing of those things is what is procured by or in consideration for the payment, taking account of all the things the carrying on or providing of which is procured by or in consideration for the payment. A payment is not for the carrying on or providing of relevant things according to their relative importance to the payer. So, for instance, a payment is not made wholly to procure the carrying on or providing of relevant operations, facilities or other things for a petroleum project if other things are also required to be carried on or provided as consideration for the payment, even if the eligible person incurred the liability only because the consideration included carrying on or providing the relevant operations, facilities or other things.

51. The CCA amount liable to be paid by each joint venture participant is paid for the existing research results already known and for the further research program of the overseas group company. If any part of the amount is for any particular existing result or for any particular further research project, this is only a part corresponding to that share of all those results and projects.

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<sup>2</sup> A CCA is a contractual arrangement between business enterprises to share the costs and risks of developing, producing or obtaining assets, services or rights, and to define the interests of each participant in those assets, services or rights. A CCA for research results would typically involve charging costs of the research activities among all participants in the CCA and sharing of results of the research and any income from sharing of research results with third parties among all the participants in the CCA. What constitutes a CCA has been discussed in detail in Taxation Ruling TR 2004/1 Income tax: international transfer pricing – cost contribution arrangements.

52. Some particular result could be used directly in carrying on or providing relevant operations, facilities or other things for the petroleum project, and so a part of the payment that is for that result might be in carrying on or providing such things: but if it is so paid to any extent this part is likely to be minor, as known results could be obtained without the ongoing CCA commitment, and as research directed to an unknown outcome is not itself in carrying on or providing operations, facilities or other things using the research results. In practice, CCAs do not commonly allow a member of the CCA (or those it represents) to decide what work their CCA contribution will be applied to or any work to be done under the CCA research program.

53. In the circumstances of such a typical CCA, the amount paid has no requisite connection with the petroleum project as it is not liable to be paid directly *in carrying on or providing* any of the things referred to in sections 37, 38 or 39, whether directly or by deeming under section 41. Consequently, in a typical CCA such an amount paid does not constitute eligible real expenditure from which deductible expenditure or transferred expenditure are derived.

#### **Example 9 – Fees paid to a recruitment agency**

54. A company with an interest in the assessable receipts of a petroleum project has engaged the services of a recruitment agency to recruit employees. Is the fee charged by the recruitment agency incurred in carrying on or providing the operations, facilities or other things comprising the petroleum project?

55. Section 41 only applies in relation to payments liable to be made to procure another person to carry on or provide operations, facilities and other things of a kind referred to in sections 37, 38 and 39. So it is necessary to work out to what extent the payment to the recruitment agency is for it to carry on or provide such things.

56. Recruitment can be in carrying on or providing such things only so far as it is recruitment of those whose work it is to carry on or provide such things. So far as those recruited are to work only partly in that way, or so far as only some of those recruited are to work in that way, only that part of the expenditure incurred in recruitment can be in carrying on or providing those things.

57. If a recruitment agency is paid for recruitment, section 41 deems that part of the recruitment to be carried on or provided by the company and deems the corresponding part of the payment liable to be made to the recruitment agency to be paid by the company in itself carrying on or providing the recruitment.

58. Expenditure on recruitment is an administrative cost. The deemed expenditure of the company on recruitment is excluded expenditure so far as it is incurred indirectly, under paragraph 44(j) (for a detailed discussion of paragraph 44(j) refer to TR 2010/D5). General recruitment expenditure that can be allocated only indirectly to particular work of particular recruits is incurred only indirectly; advertising for recruits, for instance, or short listing from a range of candidates for a range of positions, cannot be allocated directly to particular work of particular recruits.

59. However, suppose (in a fairly common practice) that the recruitment agency is paid only on the basis of the wages of the worker actually engaged for a minimum period, with a rebate should the worker not continue to work for a minimum period. To that extent, the net payment liable to be made to the recruitment agency is directly in carrying on or providing the operations, facilities or other things that the worker is directly to carry on or provide. So, for example, so far as the worker is on the petroleum project drilling rig and wholly and directly engaged in carrying on or providing operations, facilities or other things for the project over the minimum period, the net payment to the recruitment agency could be eligible real expenditure of the company under sections 37, 38 or 39 either as part of the cost of the worker's activities over the minimum period or as recruitment costs that are administrative costs incurred directly due to the application of section 41.

**Example 10 – Exploration expenditure and general project expenditure incurred in an exploration permit area in relation to the petroleum project**

60. A company holds an exploration permit from which an eligible production licence was derived in 2007. So there is a petroleum project in relation to that production licence. In 2008 the company incurred a liability to pay another person for carrying out exploration and conducting a feasibility study (which did not amount to exploration, as it was conducted in carrying on or providing preparatory operations and facilities for production once a further production licence is obtained), both done only in relation to an area outside the production licence area but within the exploration permit area from which the production licence was derived. Is the payment exploration expenditure and general project expenditure of the petroleum project in relation to the existing production licence?

61. As the company has incurred a liability to make a payment to the other person to procure carrying out exploration and conducting a feasibility study, section 41 applies to treat the company as having itself carried out the exploration and conducted the feasibility study done (paragraph 41(1)(a)) and as having incurred the expenditure to the other person in doing so (paragraph 41(1)(b)).

62. To be exploration in relation to the petroleum project, it must be exploration in the eligible exploration or recovery area for the project (paragraph 37(1)(a)). As the petroleum project in relation to the existing production licence is a pre-1 July 2008 petroleum project, the eligible exploration or recovery area for that petroleum project includes the exploration permit area in relation to the exploration permit to which the production licence is related (paragraph 5(2)(a)). Consequently, the costs incurred by the company for exploration may constitute exploration expenditure of the petroleum project in relation to the existing production licence pursuant to section 37.<sup>3</sup>

63. For payment to procure the feasibility study to be in relation to the petroleum project derived from a production licence, the feasibility study must be for operations or facilities preparatory (paragraph 38(1)(a)) to carrying on or providing the operations, facilities and other things comprising the petroleum project (paragraph 38(1)(b) and subsection 19(4)). As the feasibility study was for production from an area that lies outside the production licence area of the existing production licence, the feasibility study was not preparatory to production from the area of the existing production licence. Therefore, expenditure incurred on conducting the feasibility study does not constitute general project expenditure and is not eligible real expenditure in relation to that petroleum project. However, the expenditure may constitute general project expenditure of the company in relation to any petroleum project derived subsequently from the exploration permit area.

**Example 11 – Exploration expenditure incurred in an eligible exploration or recovery area of a lease derived petroleum project**

64. A company that holds an exploration permit applied for and was granted a retention lease derived from the exploration permit area. Before 1 July 2008, the company was granted a production licence derived from the retention lease area. The production licence was issued before 1 July 2008 (so the petroleum project in relation to that production licence is a pre-1 July 2008 petroleum project). The company later incurred a liability to pay another person for carrying out exploration in the exploration permit area that is outside the retention lease area (and so outside the production licence area). Is the liability of the company to pay for the other person's exploration able to give rise to eligible real expenditure of the petroleum project in relation to the production licence derived from the retention lease?

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<sup>3</sup> For a permit derived post 30 June 2008 petroleum project, from the date the production licence comes into force, the eligible exploration or recovery area of the project ceases to include any area that lies outside the production licence area. Therefore, the expenditure incurred outside that area will not be exploration expenditure of the existing petroleum project. The company will be able to transfer exploration expenditure in the exploration permit area to its existing production licence petroleum project under section 45A so far as the conditions specified in that section and Part 5 of the Schedule to the PRRTAA are satisfied.

65. As the company has incurred a liability to make a payment to the other person for carrying out exploration, section 41 applies to treat the company as having carried out the exploration itself, and not the other person (paragraph 41(1)(a)). Section 41 also applies to treat the company as having incurred the liability to pay the other person in itself carrying out the exploration (paragraph 41(1)(b)). Whether and to what extent the expenditure constitutes exploration expenditure of the company for the petroleum project in relation to the production licence is determined by applying section 37.

66. The eligible exploration or recovery area for a lease derived petroleum project includes the retention lease area (paragraph 5(2)(b)). It never includes the exploration permit area that is outside the retention lease area, for a pre-1 July 2008 petroleum project.<sup>4</sup> Exploration in the exploration permit area outside the retention lease area is not exploration within the eligible exploration or recovery area of the lease derived production licence. The company's expenditure, as deemed by section 41, cannot be eligible real expenditure of the petroleum project in relation to the lease derived production licence. Even if it is otherwise exploration expenditure giving rise to deductible expenditure it is not exploration expenditure in relation to that project. However, it may be exploration expenditure in relation to another petroleum project derived from the exploration permit area, which would give rise to deductible expenditure in relation to that project.

67. Expenditure in relation to another petroleum project may be transferable expenditure so far as relevant requirements are satisfied. The company is able to transfer exploration expenditure on the petroleum project for the exploration permit area to its lease derived production licence petroleum project under section 45A so far as the conditions specified in that section and Part 5 of the Schedule to the PRRTAA are satisfied.

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<sup>4</sup> For a lease derived post 30-June 2008 petroleum project, up to the date the retention lease comes into force, the eligible exploration or recovery area of the project includes any area that lies within the exploration permit area from which the retention lease was derived. Since this example relates to expenditure incurred after the grant of a production licence (therefore, after the date of grant of the retention lease), the expenditure will not constitute exploration expenditure of the existing production licence. However, the company will be able to transfer exploration expenditure in the exploration permit area to its existing production licence petroleum project under section 45A so far as the conditions specified in that section and Part 5 of the Schedule to the PRRTAA are satisfied.

## **Date of effect**

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68. It is proposed that when the final Ruling is issued, it will apply both before and after its date of issue. However, the Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10). We invite you to comment on the proposed date of effect of the final Ruling, noting the existing non-legally binding status of Miscellaneous Taxation Ruling MT 93/2. Appendix 3 to this draft Ruling provides details on where to send your comments.

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**Commissioner of Taxation**

30 June 2010

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## Appendix 1 – Explanation

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❶ ***This Appendix is provided as information to help you understand how the Commissioner’s preliminary view has been reached. It does not form part of the proposed binding public ruling.***

69. Division 3 of Part V deals with deductible expenditure of the person in relation to a petroleum project. Section 32 defines deductible expenditure. A reference to deductible expenditure pursuant to section 32 is a reference to the classes of expenditure referred to in paragraphs 32(a) to 32(g). The various classes of expenditure have been further defined in sections 33, 34, 34A, 35, 35A, 35B and 39. The different classes of expenditure reflect differences in applicable compounding or augmenting calculations and in the order in which each class of expenditure is absorbed against assessable receipts. To be ‘deductible expenditure’ the actual expenditure from which an amount derives must originate as eligible real expenditure (as defined in section 2), that is, as exploration expenditure (section 37), general project expenditure (section 38) or closing-down expenditure (section 39).

70. Transferred expenditure under sections 45A (transferred expenditure of the taxpayer on another petroleum project) and 45B (transferred expenditure of another member of the same company group as the taxpayer on another petroleum project), which include any expenditure transferred by direction of the Commissioner under section 45C, originate only from the ***incurred exploration expenditure amount*** itself in relation to that other petroleum project (clause 1, Schedule to the PRRTAA). Any ***incurred exploration expenditure amount*** is made up of certain exploration expenditure under section 37 and of ***uplifted frontier expenditure*** worked out under section 36C from ***designated frontier expenditure*** (section 2), itself made up only of certain exploration expenditure under section 37. To be transferred expenditure the actual expenditure from which an amount derives must be exploration expenditure of another petroleum project.

71. There is no direct reference to section 41 in the various deductibility and definition sections that have been referred to in paragraph 69 of this draft Ruling.

**Section 41**

72. Section 41 is as follows:

**41 Effect of procuring the carrying on of operations etc. by others**

- (1) Where a person (in this section referred to as the **eligible person**) incurs or incurred a liability to make a payment to procure the carrying on or providing of operations, facilities or other things of a kind referred to in section 37, 38 or 39 by another person, then, for the purposes of this Act:
  - (a) the operations, facilities or other things shall be taken to have been carried on or provided by the eligible person and not by the other person; and
  - (b) the liability shall be taken to have been incurred by the eligible person in carrying on or providing the operations, facilities or other things.
- (2) This section does not apply if the other person carries on or provides the operations, facilities or other things as part of the processing of external petroleum, or internal petroleum, in relation to a petroleum project other than the project to which the operations, facilities or other things referred to in subsection (1) relate.

***Section 41 is not a deduction provision in itself***

73. Unlike section 32, the wording of section 41 does not make any direct statement to the effect that any particular expenditure to which the section relates is deductible expenditure of the taxpayer (in this draft Ruling and explanation, a taxpayer is a person with an interest in the assessable receipts of a petroleum project). Therefore, section 41 does not directly determine the deductibility or otherwise of an item of expenditure. Nor does it directly state that any particular expenditure of the taxpayer is eligible real expenditure, or is any of the particular kinds of eligible real expenditure, under sections 37, 38 or 39. Section 41 is only a deeming provision, having the effect that in certain circumstances particular activities, operations or other things are taken to be carried on or provided by the taxpayer (rather than the third party the taxpayer is liable to pay to have carry on or provide them) and that what the taxpayer is liable to pay for having the third party do so is incurred by the taxpayer in carrying on or providing those things. The taxpayer must still rely on the other sections of the PRRTAA as they apply having regard to what is deemed under the section in order to claim a deduction for the expenditure they incur.

**Conditions for subsection 41(1) to apply**

74. For subsection 41(1) to apply, the taxpayer must be liable to pay to procure certain things to be done by someone else. What is procured must be the carrying on or providing of operations, facilities or other things of a kind referred to in sections 37, 38 or 39. For example, if what is procured is the carrying on or providing of operations, facilities or other things downstream of a petroleum project, the deeming provisions of subsection 41(1) cannot apply to take those operations, facilities or other things to be carried on by the taxpayer or to take the liability that is incurred by the taxpayer to be incurred by the taxpayer in carrying on or providing those things.

75. What is procured and deemed to be carried on or provided by the taxpayer rather than by the third party must be carried on or provided by the third party in relation to the petroleum project, as defined, if it is to be subject to section 41 and if it is to be eligible real expenditure under sections 37, 38 or 39. It must meet the other requirements of those sections too. Some important pre-conditions to the application of sections 37, 38 and 39 are discussed in detail in draft Taxation Ruling TR 2010/D4 Petroleum resource rent tax: general pre-conditions common to deductibility of expenditure of a kind referred to in sections 37, 38 and 39 of the *Petroleum Resource Rent Tax Assessment Act 1987*.

76. Subsection 41(1) can only apply to a person in relation to a petroleum project to the extent that the payment liable to be made by the person is to procure a third party to carry on or provide operations, facilities and other things of the kinds referred to in sections 37, 38 and 39, which are each for a petroleum project in some particular way. So payment for other things, whether because they are not for a petroleum project in the particular way, or because they are not for a petroleum project at all, is not subject to deeming under subsection 41(1).

77. Subsection 41(2) ensures that deeming under subsection 41(1) does not apply if a person with an interest in a petroleum project pays a fee to another person to extract, stabilise, transport, store or process petroleum as internal petroleum of the project or external petroleum of some other project. The tolling fee paid by the person procuring such services for a petroleum project constitutes eligible real expenditure of the person in relation to that project pursuant to paragraphs 37(1)(c) or 38(1)(d) and so should not also be subject to overlapping deeming under section 41. The discussion in this draft Ruling is primarily about the application and effect of deeming under subsection 41(1). A reference to section 41 applying in relation to a person or a petroleum project should be taken to be a reference to deeming under subsection 41(1) applying to the person or the petroleum project, unless stated otherwise.

***How does section 41 provide for deductibility of the expenditure to which it applies?***

78. Where a person incurs a liability to make a payment to procure someone else to carry on or provide operations, facilities or other things of a kind referred to in sections 37, 38 or 39, section 41 treats the person (and not the third party) as having carried on or provided those operations, facilities or other things (paragraph 41(1)(a)). Section 41 also treats the liability to have been incurred by the person in themselves carrying on or providing those operations, facilities or other things (paragraph 41(1)(b)).

79. As section 41 only deems the person to have carried on or provided what is procured to be actually carried on or provided by the third party, and to have incurred the liability in carrying on or providing what is actually procured to be carried on or provided by the third party, it follows that the expenditure deemed under the section must still meet all the conditions in the PRRTAA for the expenditure to be eligible real expenditure and to give rise to deductible expenditure or transferred expenditure. Sections 37, 38 and 39 must be applied to the deemed expenditure to identify any part of it that is eligible real expenditure and under which provision, and so the three general pre-conditions common to eligible real expenditure discussed in TR 2010/D4 apply in considering deemed expenditure by way of payments made to procure other persons to carry on or provide operations, facilities and other things of a kind referred to in sections 37, 38 and 39 (refer to Examples 1, 3 and 5 of this draft Ruling).

***How is expenditure classified into exploration expenditure, general project expenditure and closing-down expenditure?***

80. As explained in paragraphs 10, 73, 78 and 79 of this draft Ruling, section 41 does not directly give rise to deductible expenditure. It follows that section 41 does not provide any guidance as to whether any of the expenditure to which section 41 applies is eligible real expenditure of some kind, or what part of any eligible real expenditure is exploration expenditure, general project expenditure or closing-down expenditure. Whether and to what extent a payment liable to be made by a person to a third party is exploration expenditure, general project expenditure or closing-down expenditure is determined by applying sections 37, 38 and 39, taking into account any deeming under section 41. If the operations, facilities and other things for which payment is to procure to be carried on or provided by the third party are only partly covered by one of the above sections, apportionment of expenditure into components is necessary to identify any part of the payment liable to be made that is to procure the third party to carry on or provide those things.

81. The other requirements of expenditure to qualify as exploration expenditure, general project expenditure or closing-down expenditure as stipulated in sections 37, 38 and 39 as well as subsection 19(4) or any other provision of the PRRTAA must also be satisfied, taking account of any deeming under section 41.

82. For example, in order to qualify as exploration expenditure, the operations, facilities or other things procured to be carried on or provided by the third party that amount to carrying out exploration are taken to be carried on or provided by the person themselves. But even if taken to be carried on or provided by the person the exploration activities, operations or things must be of a specified kind under section 37, involved in or in connection with exploration for petroleum in the eligible exploration or recovery area in relation to the exploration permit, retention lease or production licence as those terms are defined in sections 2 and 5 (refer to Examples 10 and 11 of this draft Ruling).

#### **The interaction between sections 41 and 44**

83. Some taxpayers contend that, if what is to be provided or carried on by a third party are operations, facilities or other things of a kind referred to in sections 37, 38 or 39, the full amount of the liability incurred by the person to pay for the third party to carry on or provide those things must be eligible real expenditure which gives rise to deductible expenditure or transferred expenditure. In other words, it is contended by some that none of the substantive requirements of sections 37, 38 or 39 apply to limit what of the deemed expenditure under section 41 is eligible real expenditure. One requirement of each of those sections is that expenditure not be excluded expenditure under section 44. It is contended by some taxpayers that section 44 does not apply to treat as excluded expenditure any payments that are made to a third party for things of a kind referred to in sections 37, 38 and 39.

84. This contention is incorrect. Section 41 is only a deeming provision. As far as a liability to make a payment to a third party is concerned, section 41 only deems the liability to have been incurred by the person in themselves carrying on or providing the relevant operations, facilities or other things. The deductibility of the liability taking account of the deeming is then determined by other provisions of the PRRTAA.

85. When a person incurs expenditure in themselves carrying on or providing operations, facilities and other things of a kind referred to in section 37, the expenditure does not give rise to exploration expenditure if that payment constitutes excluded expenditure as defined in section 44. It can give rise neither to deductible expenditure nor to transferred expenditure for PRRT purposes. Similarly, expenditure incurred in carrying on operations, facilities or other things of a kind referred to in sections 38 and 39 of the PRRTA does not give rise to general project expenditure and closing-down expenditure respectively to the extent that the payment relates to items of expenditure that constitute excluded expenditure. The expenditure cannot give rise to deductible expenditure. In other words, sections 37, 38 and 39 are the only gateways to eligible real expenditure and they include the express reference to and exclusion of any expenditure that is excluded expenditure.

86. The phrase 'of a kind referred to in section 37, 38 or 39' in subsection 41(1) does not deem the expenditure to be eligible real expenditure. The deeming extends to any operations, facilities or other things of the kinds described in sections 37, 38 and 39, whether payment in carrying on or providing them would be eligible real expenditure or not. The expenditure so deemed is eligible real expenditure only so far as the same expenditure actually in carrying on or providing what the third party is to carry on or provide would be eligible real expenditure. This intent of the Parliament is clear from the following comments in relation to section 41 in the Explanatory Memorandum to the Petroleum Resource Rent Tax Assessment Bill 1987 (the Explanatory Memorandum), emphasis added:

This clause will apply where a person (the 'eligible person') is liable to pay another person (for example, a contractor) to carry on or provide the operations, facilities or other things **the expenditure on which constitutes exploration expenditure, general project expenditure or closing-down expenditure** by virtue of clauses 37, 38 and 39 respectively. Where a liability to make such a payment has been incurred, paragraph (a) will operate to deem the operations, facilities or other things to have been carried on or provided by the eligible person rather than by the other person. By paragraph (b), the payment liable to be made by the eligible person to procure the carrying on or provision of the operations, facilities, etc. will be taken to have been made in carrying on or providing the operations, facilities, etc. As a consequence, the expenditure incurred by the eligible person will qualify as deductible expenditure for the purposes of determining any petroleum resource rent tax liability of the eligible person.<sup>5</sup>

87. It is evident that Parliament intended that the requirements of sections 37, 38 or 39 be satisfied. If and to the extent that the liability to pay another person in light of deeming under section 41 does not meet the requirements of those sections, the expenditure does not give rise to eligible real expenditure.

88. If and so far as section 41 applies to deem in circumstances wider than sections 37, 38 and 39 themselves, section 41 does no more than make the operations, facilities or other things it describes those of the payer rather than the payee and to make the payment for the third party to carry on or provide expenditure incurred by the payer in themselves carrying on or providing the operations, facilities or other things. As sections 37, 38 and 39 are still the only gateways to inclusion of the deemed expenditure in deductible expenditure, any greater width in section 41 could have no effect of extending what eligible real expenditure under sections 37, 38 or 39 could relate to.

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<sup>5</sup> Explanatory Memorandum, Petroleum Resource Rent Tax Assessment Bill 1987, Notes on Clauses, Clause 41, p 72.

89. Therefore, even so far as all of the operations, facilities and other things that a person incurs a liability to pay to have a third party carry on or provide are operations, facilities or other things that are of a kind referred to in sections 37, 38 or 39, not all of the liability need be eligible real expenditure which gives rise to deductible expenditure or transferred exploration expenditure. Various pre-conditions including that the expenditure be in relation to that petroleum project and that the expenditure not be excluded expenditure under section 44 may apply to the payment liability (in full or in part). Payments liable to be made, whether generally or taking account of deeming under section 41, are not exploration expenditure, general project expenditure or closing-down expenditure from which deductible expenditure or transferred exploration expenditure derives so far as they are excluded expenditure under section 44.

90. This is consistent with the report to the Parliament in November 1992 on the operation of the PRRTAA.<sup>6</sup> In response to industry submissions on the application of section 44 to expenditure deemed to have been incurred by a taxpayer due to the operation of section 41, the report stated as follows:

**Payment to contractors (sections 41 and 44)**

*Issue*

Under section 41 of the Act, payments to a contractor to carry on or provide certain project operating facilities or things are deemed to be a deductible cost. Industry submits that the Australian Taxation Office should not examine a contractor's expenses to test for eligibility under Section 44 (excluded expenditures).

*Comment*

Taxpayers could pay contractors partly for work on a petroleum project and partly for other work and then reduce their PRRT obligations accordingly. The Australian Taxation Office therefore has a responsibility to examine what a contractor is paid to do in order to determine the part of that payment that is deductible.

(Also refer to Examples 1 to 4 of this draft Ruling.)

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<sup>6</sup> *Report on the Operation of the Petroleum Resources Rent Tax Assessment Act 1987*, November 1992, Department of Primary Industries and Energy (Commonwealth).

### **Apportionment**

91. A payment is liable to be made to procure the carrying on or providing of relevant operations, facilities or other things for a petroleum project so far as and to the extent that the carrying on or providing of those things is what is procured by or in consideration for the payment, taking account of all the things the carrying on or providing of which is procured by or in consideration for the payment. A payment is not for the carrying on or providing of relevant things according to their relative importance to the payer. So, for instance, a payment is not made wholly to procure the carrying on or providing of relevant operations, facilities or other things for a petroleum project if other things are also required to be carried on or provided as consideration for the payment, even if the eligible person incurred the liability only because the consideration included carrying on or providing the relevant operations, facilities or other things.

92. Suppose a payment procures several things to be carried on or provided, only some of which are relevant operations, facilities or other things for the petroleum project. Only part of the payment is to procure the relevant things. An analogy is payment under a home maintenance contract: if the important element to the home owner is roof repair, but payment under the contract also gets the gutters cleared and the lawn mowed, the payment cannot be treated as paid wholly to procure roof repair.

93. Sections 37, 38 and 39 are self apportioning. This is discussed in paragraphs 21, 23, 121 and 182 of TR 2010/D4. A person must consider each of the operations, facilities and other things that they procure to be carried on or provided by a third party and may as a practical test ask the question, 'if I were to carry on or provide those operations, facilities or other things myself, would my expenditure in doing so fall under sections 37, 38 or 39?' They should then classify the expenditure accordingly into exploration expenditure, general project expenditure and closing-down expenditure respectively. So far as the payment is to procure the carrying on or providing of operations, facilities or other things expenditure in carrying on or providing which would not be within those sections, section 41 has no application to the payment.

94. To the extent that the operations, facilities and other things that are procured to be carried on or provided by the third party are taken to be carried on or provided by the person, and the payment to procure those operations, facilities or other things to be carried on or provided is expenditure taken to be incurred by the person in carrying on or providing them, if the expenditure so deemed otherwise falls under section 37 in relation to the person's petroleum project and so far as the deemed expenditure is not excluded expenditure, the payment should be treated as exploration expenditure in relation to that petroleum project. A similar analysis is required to determine the proportion of the payment that may give rise to general project expenditure or closing-down expenditure in relation to the petroleum project under sections 38 and 39 respectively.

95. There could be instances where another person may be contracted to provide operations, facilities or other things for the petroleum project as well as for things that are not and that do not give rise to eligible real expenditure. As stated in paragraph 74 of this draft Ruling, section 41 can only apply to operations, facilities or other things that relate to a petroleum project as only such things are of a kind referred to in sections 37, 38 and 39. If only part of what is carried on or provided by the third party qualifies for deeming under section 41, it follows that only a part of the expenditure of the person to procure those things to be carried on or provided by the third party can qualify for deeming under section 41. Therefore, it is necessary to apportion the expenditure incurred by the person into two parts – a part that is subject to deeming under section 41 and may qualify as eligible real expenditure and a part that is not subject to deeming under section 41 and may not qualify as such expenditure.

96. If operations, facilities and other things procured to be carried on or provided by the third party fall under more than one of sections 37, 38, 39 or are non-project things, the relevant expenditure to procure them must be identified accordingly. If such expenditure is paid to a third party for carrying out a number of things making it necessary to apportion the payment, the apportionment must be made on a reasonable and bona fide basis. An arbitrary allocation of expenditure cannot give rise to a valid claim for deductible expenditure. However, if a particular expenditure liable to be paid by a person would constitute general project expenditure and at the same time exploration expenditure or closing-down expenditure, the PRRTAA ensures that such expenditure constitutes exploration expenditure as far as it can, then closing-down expenditure as far as it can, and only any residue is general project expenditure.

97. Two common reasons for a liability to pay a third party not giving rise to eligible real expenditure on a petroleum project are:

- what was procured to be carried on or provided by the third party was not done in carrying on or providing the operations, facilities or other things of a kind referred to in sections 37, 38 or 39 or not for that petroleum project (for example, it is or is for a downstream operation or activity beyond the point at which any petroleum is sold or any marketable petroleum commodity becomes an excluded commodity); or
- what was carried on or provided by the third party cannot give rise to deductible expenditure due to the application of requirements of sections 37, 38 or 39 such as that the expenditure on it not be excluded expenditure under section 44 (for example, the payment as deemed under section 41 is an administrative or accounting cost incurred indirectly).

98. What constitutes a reasonable basis for apportionment is discussed in TR 2010/D4 and TR 2010/D5. The principles of apportionment discussed in these draft Rulings are equally relevant to apportionment of liabilities arising to procure another person to carry on or provide operations, facilities or other things of a kind referred to in sections 37, 38 or 39 (refer to Examples 2, 4, 5 and 9 of this draft Ruling).

**Under what circumstances would a person have to test the expenditure of a third party against section 44?**

99. A person would not be expected to test the expenditure actually incurred by a third party to carry on or provide the operations, facilities or other things procured by a liability subject to deeming under section 41 in many circumstances. If all that the third party is procured to do is to carry on or provide operations, facilities or other things expenditure of the person on which is exploration expenditure, general project expenditure or closing-down expenditure under sections 37, 38 or 39, the entire payment to the third party is that kind of expenditure under those sections applied taking account of the deeming under section 41 regardless of what the third party spends the payment they are liable to receive on. So if expenditure is liable to be paid to procure a third party only to provide operations, facilities or other things of a kind referred to in sections 37, 38 or 39 and the calculation of the amount of the payment includes, say, taking into account charges for general overheads and of a profit component, the character of the payment is not affected.

100. But a payment may be to procure a third party to carry on or provide operations, facilities or other things of such a nature that, when deemed under section 41 to be carried on or provided by the person, the expenditure deemed to be in carrying on or providing them is, not eligible real expenditure, but excluded expenditure, by way of financing or interest costs; of administrative or accounting costs or salary, wage or other work costs indirectly incurred; or of any other kind of excluded expenditure. To that extent the expenditure liable to be paid to procure what the third party carries on or provides is not eligible real expenditure.

101. For example, if a person enters into a contract to pay a certain amount as consideration to have a third party supply and assemble a drilling platform of certain specifications, the whole payment for the supply and assembly of the drilling platform may give rise to eligible real expenditure as the cost of providing the same drilling platform had the person done it themselves would have been eligible real expenditure. This is notwithstanding that in negotiating the contract price, and even expressly in working out that price, the third party (and possibly the person) would have taken into consideration all elements of the third party's actual and notional costs, some of which would constitute excluded expenditure or would not be expenditure at all if the person were to incur those costs themselves in themselves doing the same things (also refer to Example 1 of this draft Ruling).

102. On the other hand, the third party may be procured to do those things including things related to the supply and assembly of the drilling platform that the person requires from time to time but also including associated activities such as administrative and accounting activities indirectly involved, indirect work, provision of administrative or accounting land and buildings remote from the operations, facilities or other things, and so on.

103. In this case, the payment to procure the third party to do a particular thing may constitute excluded expenditure, for example, because the thing is by way of administrative and accounting activities whose costs are incurred only indirectly (also refer to Example 2 of this draft Ruling).

104. A person may be liable to make a payment to procure a third party do whatever of a range of things the person required them to do, and the payment may be charged to the person on the basis of the actual expenditure incurred by the third party in doing each thing so done as required (perhaps the amount of the payment liable to be made is at cost or perhaps it may include a specified mark up of the actual expenditure incurred by the third party). The payment actually liable to be made may cover procuring many miscellaneous things, only some of which are of a kind referred to in sections 37, 38 or 39. Only that part of the payment which was to procure things of a kind referred to in those sections is subject to deeming under section 41, but not that part which is to procure other things. None of the deemed payment is eligible real expenditure if it is excluded expenditure.

105. In such cases, part of the actual payment liable to be made is for each thing done to the extent of the part of the charge based on the third party's actual expenditure in doing the thing. The deeming under section 41 is that the part of the charge is taken to be expenditure incurred by the eligible person in themselves carrying on or providing the particular thing the third party did (and that the thing is taken to have been carried on or provided by the eligible person, not the third party). So it is the nature of that thing and of expenditure in carrying on or providing it that must be individually considered to determine the extent to which the part of the charge that is the payment, taken to be incurred by the person to carry on or provide that thing, may give rise to eligible real expenditure.

106. In some cases the part of an amount referable to particular services provided may be easy to calculate. For example, if a contractor driller agreed to provide exploration drilling services to a person for both a PRRT project drilling and other drilling at a fixed rate of say \$5,000 a day, the appropriate way to apportion the fee would be to determine the days spent on the respective drilling and multiply by the \$5,000. If a floating fee is adopted, that is, the fee is calculated on a cost plus method, then the fee referable to drilling for a PRRT project would simply be determined by applying the required mark up to the cost that relates to the PRRT project drilling. In other cases, the apportionment may need to be made on some other fair and reasonable basis.

**Division 6 of Part V*****Arrangements to enable tax benefit***

107. Division 6 of Part V of the PRRTAA contains two types of anti-avoidance provisions. Subdivision 6A of the PRRTAA contains a set of provisions concerning arrangements to obtain tax benefits. These provisions are similar to the Part IVA provisions of the *Income Tax Assessment Act 1936*. A person who enters into an arrangement ('arrangement' has been very widely defined in section 50 of the PRRTAA) to obtain a tax benefit (defined in section 51 of the PRRTAA to broadly include a reduction in assessable receipts or an increase in the amount of deductible expenditure of the person, resulting in a reduced PRRT liability) risks the application of section 53 of the PRRTAA by the Commissioner to cancel the tax benefit. A cancellation of tax benefit under section 53 of the PRRTAA is normally accompanied by the imposition of an administrative penalty under Division 284 of Schedule 1 to the *Taxation Administration Act 1953* (TAA).

108. General anti-avoidance provisions may equally apply to arrangements if any of the persons entering into or carrying out the arrangements would be concluded to have done so for the sole or dominant purpose of enabling an eligible person to obtain a tax benefit or benefits. This conclusion is an objective one, based on specified matters only.

109. Incurring a liability to make a payment to procure the carrying on or providing by another person of operations, facilities or other things of a kind referred to in sections 37, 38 or 39 produces deeming under section 41. That deeming may provide a tax benefit. It is in light of the deeming that an amount of deductible expenditure may be taken to be incurred by the taxpayer.

110. However, obtaining that tax benefit is not inherently the sole or dominant purpose of incurring the liability, as procuring the carrying on or providing of the relevant petroleum project operations, facilities or other things is the purpose of the payment and without particular additional facts and circumstances no purpose of securing a tax benefit will be dominant for anyone involved in the arrangement for incurring the liability. Though no eligible real expenditure would be incurred for a payment to procure another person to carry on or provide relevant operations, facilities or other things for a petroleum project without the application of deeming under section 41, this is no different to the position of eligible real expenditure actually incurred by the taxpayer in themselves carrying on or providing relevant operations, facilities or other things: that expenditure, too, would not give rise to eligible real expenditure were it not liable to be paid and so were no arrangement made under which it is liable to be paid.

***Non-arm's-length transactions***

111. Subdivision B of Division 6 applies to non-arm's length transactions (whether they are not at arm's length by reason of connection between the parties or for any other reason). When a payment liable to be made by a person is one to which section 41 applies, the transaction under which it arises is as much subject to Subdivision B of Division 6 as any other transaction. So if the payment gives rise to an amount of eligible real expenditure, taking account of the deeming under section 41, that exceeds the amount of eligible real expenditure that would have arisen if the transaction were an arm's length transaction, the Commissioner has the power to reduce the amount of eligible real expenditure to what it would have been had the transaction been an arm's length transaction (section 58). In working this out, the Commissioner may take account of the actual transaction under which the person is liable to pay to procure the third party to carry on or provide the relevant operations, facilities or other things, as this is a relevant transaction and it may be in this transaction that the parties are connected or that the transaction is otherwise not an arm's length transaction.

112. The Explanatory Memorandum provides the following comments in relation to non-arm's length transactions:

***Subdivision 6B – Non-arm's length transactions***

Subdivision B will apply in relation to transactions which, although not entered into for the sole or dominant purpose of obtaining a tax benefit for Subdivision A purposes, are not at arm's length – with the result that, in relation to a petroleum project, the assessable receipts of a person are less than could have been expected or the person's deductible expenditure is greater than could have been expected.

**Clause 58: Non-arm's length expenditure**

This clause of Subdivision B will apply to a non-arm's length transaction under which a person incurs deductible expenditure in excess of that which could reasonably have been expected to otherwise have been incurred.

The clause will apply where, under a transaction, a person has incurred eligible real expenditure (defined to mean exploration expenditure, general project expenditure or closing-down expenditure in terms of clauses 37, 38 and 39 respectively) in relation to a petroleum project (paragraph (a)) and the conditions specified in paragraphs (b) to (d) have been met. Paragraph (b) requires that the Commissioner of Taxation, having regard to any connection between the parties to the transaction or any other relevant circumstances, be satisfied that the transaction is not an arm's length transaction within the meaning of that term in clause 56. In terms of paragraph (c), the amount of the expenditure incurred must be more than the amount (the 'reduced expenditure') that could reasonably have been expected to have been incurred in an arm's length transaction. In those circumstances and where the Commissioner determines that the clause should apply (paragraph (d)), the deductible exploration expenditure, general project expenditure or closing-down expenditure (as the case may be) will be limited to the amount of the reduced expenditure.

113. Deeming under section 41 does not have the effect that the transaction under which a taxpayer incurs a liability to make a payment to procure the carrying on or providing by another person of relevant petroleum project operations, facilities or other things is taken not to have occurred for PRRT purposes, and Subdivision B of Division 6 applies to that transaction in the same way as to any other transaction.

114. The taxpayer's eligible real expenditure is incurred under the transaction by which the payment to procure someone else to carry on or provide relevant operations, facilities or other things for the petroleum project is liable to be made (paragraph 58(a)). The Commissioner will be satisfied that the transaction is not an arm's length transaction if the connection between the parties or if other relevant circumstances show that the parties were not dealing at arm's length in relation to that particular transaction (paragraph 58(b)); evidence of a wider framework between them, arrived at itself at arm's length, may show in some circumstances that the transaction itself is not at arm's length (for instance, a party might agree to pay more in a particular transaction which increases eligible real expenditure under a framework agreement that correspondingly less is paid in a transaction which is irrelevant to PRRT). If that transaction is not an arm's length transaction, and leads to a payment that is more than could reasonably have been expected had it been an arm's length transaction, the Commissioner may apply the arm's length rule and the eligible real expenditure will be reduced to the amount it could reasonably have been expected to be had the transaction been an arm's length transaction.

115. If the Commissioner makes a determination to reduce the amount of eligible real expenditure under section 58, the reduction is normally accompanied by the imposition of an administrative penalty under Division 284 of Schedule 1 to the TAA.

### **When is expenditure incurred?**

116. Section 41 refers to incurring a liability to make a payment so as to procure the things specified in the section. It is at the point when that liability to make the payment is incurred by the person that a deduction would ordinarily be available to the person in respect of the payment. The liability must be a presently existing liability and the person must have completely subjected itself to the liability.

117. The word 'procure' is defined in the Macquarie Dictionary<sup>7</sup> as meaning 'to obtain or get by care, effort, or the use of special means'. The cases referred to in Stroud's Judicial Dictionary of Words and Phrases<sup>8</sup> state that the dictionary meaning can be paraphrased as 'see to it'. It is said that an obligation to 'procure' something to be done by another person connotes, at any rate, that the obliger is to take steps to procure its being done (per Fry LJ, *Lowther v. Caledonian Railway Co.* [1892] 1 Ch 73); a payment without such steps might not be to procure anything.

118. The above definition of the word 'procure' suggests two things. First, the liability to make the payment to procure the third party can arise, depending on the circumstances of a case, before the third party has performed its obligation. Secondly, that the payee need not be the person who actually performs the obligation. Section 41 does not expressly refer to 'a liability to make a payment to another person' to procure the carrying on or providing of operations, facilities or other things 'by that other person'. In other words, section 41 applies if the liability is one to make a payment to one person to procure something to be carried on or provided by a different person (for instance, a payment might be to a company to procure something to be carried on or provided by a key employee, subsidiary or related entity of that company).

119. Section 41 refers to 'incurring of a liability to make a payment to another person' by the taxpayer which is very similar to the wording 'expenditure incurred by a person' used in sections 37, 38 and 39. Moreover, section 41 is only a deeming provision. The extent and timing of deductibility of the liability is to be determined by referring to sections 37, 38 and 39. When a taxpayer incurs an amount of expenditure for the purposes of sections 37, 38 and 39 is discussed under the subheading *The meaning of 'incurred'* in TR 2010/D4. That discussion is equally relevant where section 41 applies to a liability (also refer to Examples 6 and 7 of this draft Ruling).

120. A liability is generally regarded as having been incurred if the liability is a presently existing liability and the taxpayer has completely subjected itself to the liability. In most practical cases, the expenditure is liable to be paid only when the third party has performed its part of the promise but in some situations a person may incur a liability to pay before the third party has performed its obligation (wholly or partly). While contracts that involve expending relatively smaller amounts may be entered into orally or by direct approach without any written or formal contract document, contracts for relatively larger amounts are usually entered into as a result of a tendering process or after formal negotiations or both. The terms and conditions of such agreements are generally contained in a formal agreement or agreements. The application of those terms and conditions determines when the person incurs a liability to pay to the third party.

<sup>7</sup> [Multimedia], Version 5.0.0, 1/10/01.

<sup>8</sup> 7<sup>th</sup> edition, London Sweet & Maxwell 2006.

121. The onus of proof that expenditure was eligible real expenditure, incurred in carrying on the petroleum project, in carrying on or providing relevant operations, facilities or other things of a kind referred to in sections 37, 38 or 39, and not excluded expenditure lies with the person. This onus is separate from the obligation that the person must keep proper records to support the calculation of the amounts claimed as a deduction and to explain the transactions – it is not satisfied simply because no record keeping offence has been committed.

### **Joint ventures**

122. Petroleum projects generally involve large financial investments and large commercial risks and it is common for a number of persons to hold a part interest in a petroleum project. In such cases, the persons may incorporate a jointly owned company to derive the project assessable receipts and incur the project deductible expenditure, or may form a partnership to run the petroleum project by which the partners will themselves do so. Such persons may also form an unincorporated joint venture that is not a partnership, in which each has an entitlement to part of the petroleum recovered and products produced by the project, and appoint a joint venture operator, who may or may not be one of the venturers or be a company owned by the venturers, to run the petroleum project. Frequently, the operations and activities carried on by the joint venture also include other operations and activities beyond what constitutes a petroleum project, such as collateral operations and downstream operations and activities.

123. A joint venture operator may carry on or provide (through its employees) particular operations, facilities or other things that comprise the petroleum project or it may itself procure other persons to do so, or may employ a combination of the two. So the operator may incur expenditure in carrying on or providing operations, facilities or other things itself, or in procuring another person to do so.

124. The relationship between the joint venture operator and the other venturers may be in some respects that of a principal (the venturers) and an agent (the operator) who incurs expenditure on behalf of the principal. What an agent does is done by the principal themselves, so in these respects section 41 would have no operation.

125. In other respects, the joint venture operator may be carrying on or providing operations, facilities or other things for the other venturers in its own capacity (as another person for the purposes of section 41) in which case the individual venturers may pay effectively to procure the services of the joint venture operator to carry on or provide the operations, facilities and other things that comprise the petroleum project.

126. Because joint venturers generally wish to avoid being partners and wish to avoid any more than their share of the project liabilities, while ensuring only they are entitled to their share of the project products in kind, the responsibilities of an operator are likely to be closely defined by the joint venture agreement, and the actual conduct of the operator and the conduct and entitlements of the joint venturers are likely to be monitored mutually to ensure that partnership and unintended liability in common are avoided. The joint venture agreement is an important guide to determining what expenditure the co-venturers each incur and what it is for, and in determining whether, in incurring particular expenditure itself, the joint venture operator is acting on behalf of the co-venturers or as ‘another person’ in circumstances to which deeming under section 41 applies.

127. In some cases, in carrying on or providing relevant operations, facilities or other things, an operator will be acting (or apparently acting) generally as an agent of the petroleum project participant joint venturers and incurring expenditure as their agent to the extent required under their particular shares. In others, the operator will only act as agent of a participant in negotiating sales of the participant’s share of commodities produced by the project, or will never act as an agent for another joint venturer at all. Actual cases commonly range between these extremes. But agency is rarely completely absent from an operating agreement: after all, the whole point of an operating agreement is usually to have the operator act on behalf of co-venturers and with their authority, at least in some respects.

128. Agency may be limited to certain powers. It may co-exist with other relationships too. So an operator who is, in the broad sense, an independent contractor may also incur some expenditure as the agent of the venturers, or not. And even an operator who is an employee of the venturers, or of one of them, may or may not incur any expenditure as their agent.

129. An operator who is also one of the venturers in a joint venture might not act as the agent of the other venturers in incurring particular expenditure. If not, section 41 may apply to payments the other venturers incur to procure the operator to carry on or provide relevant petroleum project-related operations, facilities or other things and section 44 may have no application to the other venturers merely because the operations, facilities or other things provided by the operator are wholly within sections 37, 38 and 39 and the payments all give rise to eligible real expenditure.

130. However, the operator in such circumstances may actually incur expenditure of its own as one of the venturers. So much of its expenditure as is in carrying on or providing that part of the operations, facilities or other things for the petroleum project which the operator has been procured by the other venturers to provide cannot be eligible real expenditure, because those operations, facilities or other things are taken not to have been carried on or provided by the operator, under paragraph 41(1)(a). The balance of the operator's expenditure is in carrying on or providing those things and so may be eligible real expenditure: and may not be, because it may be excluded expenditure under section 44. For example, the operator may have expenditure incurred on administrative or accounting activities that is incurred indirectly. Therefore, the operator's own deductible expenditure, in effect the portion of its overall project-related expenditure that is not reimbursed, may be subject to section 44.

131. Section 41 is applicable to much of the expenditure of participants to operators under typical joint venture operating agreements. So far as a participant is liable to pay to procure expenditure of an operator in carrying on or providing relevant petroleum project things, the participant and not the operator is taken to be incurring the expenditure and undertaking or providing the operations, facilities and other things which the expenditure of the operator is in carrying on or providing; and the participant is taken to be the one incurring the expenditure it is liable to pay to procure (that might itself be expenditure to which section 41 applies, such as where the operator is to pay to procure another person to carry on or provide relevant operations, facilities or other things for the petroleum project). Generally, this will be only a share of what is procured, according to how the joint venture agreement operates in the circumstances. The operator is correspondingly excluded from having incurred deductible expenditure to that extent.

132. It has been stated by some industry representatives that the operations and activities of any unincorporated joint venture as well as its accounts are subject to a fair amount of scrutiny by the co-venturers. The accounts may be audited by an independent auditor. Therefore, it is contended by them that a statement provided to a co-venturer by a joint venture operator informing them of their share of the joint venture expenditure should be accepted as sufficient proof of incurring eligible real expenditure.

133. This contention cannot be agreed to ordinarily because frequently, the operations, facilities and other things that are carried on or provided under a joint venture agreement extend beyond what constitutes a petroleum project for PRRT purposes and the operations, facilities or other things to be carried on or provided extend beyond any of the things of a kind referred to in sections 37, 38 or 39. Moreover, some of the operations, facilities or other things that are carried on or provided may be for the carrying on or providing of such things but may not give rise to eligible real expenditure because requirements for eligible real expenditure may not be met, for instance because expenditure may constitute excluded expenditure under section 44. The scrutiny of the accounts by participants is generally directed to maintaining the benefits of the joint venture structure, such as avoiding joint liability or partnership, and to ensuring overall compliance with the joint venture agreement, but is not commonly directed to the requirements of the PRRTAA.

134. Section 41 does not apply to a payment made to allow a third party to incur expenditure on the person's behalf, or to put the third party in funds to meet expenditure incurred on the person's behalf. This is because the part of the expenditure incurred by a third party acting in that regard as an agent is itself incurred by the person themselves, in carrying on or providing what the expenditure of the third party carries on or provides. When the person puts a third party acting in that regard as an agent in funds for the purpose, or incurs the liability to do so, the person is not procuring the carrying on or providing of the operations, facilities or other things from the agent (whether by them or by another party with whom the agent is yet to contract). Rather, because the third party is in that regard an agent, the person is themselves carrying on or providing the operations, facilities or other things or is themselves procuring them to be carried on, acting through the agent (refer to Example 7 of this draft Ruling).

135. The agreement between the parties and any actual or ostensible authority given by the person determine whether a third party incurs particular expenditure on behalf of the person or whether the third party incurs the expenditure in their own right, in the course of carrying on or providing the operations, facilities or other things for the petroleum project themselves. A few general observations may help distinguish the two situations in the context of petroleum projects to which the PRRTAA applies.

136. Whether a third party is acting as agent of a person or is acting as an independent party in carrying on or providing relevant operations, facilities or other things for the petroleum project of the person can be determined only by referring to the effect of any agreement between the parties. The following are some of the factors that need to be taken into consideration in order to interpret the relationship between the parties:

- the level of control exercised by the person;
- basis of remuneration (the expenditure incurred by the third party plus a mark up or an otherwise agreed amount);

- ability of the third party to benefit from being more efficient;
- who is liable to bear the cost of remedying poor quality work;
- is the third party in the business of providing similar services to other industry participants for payment;
- period of engagement (ongoing relationship or one off contract);
- is there a specific agreement for specific services or a general operating agreement;
- is the third party a related party, and if so, is there a formal contract between the parties and on what terms; and
- if the third party is a related party, did the person actually transfer funds to the related party or were only journal entries made.

137. A payment incurred by a joint venturer may require apportioning if only a part of the payment is such that it qualifies as eligible real expenditure. For example, suppose a petroleum project joint venture negotiates with a local community to establish and run a regional airport which would be used for the petroleum project as well as for the benefit of the community. Each venturer pays its share of the liabilities in establishing and running the airport. The part of the venturer's payments liable to be made in establishing and running the airport which may give rise to eligible real expenditure from which deductible expenditure derives is no more than the amount attributable to carrying on the operations, facilities and other things of a kind referred to in sections 37, 38 and 39. The part of the cost which does not qualify as eligible real expenditure includes any cost that is not a payment liable to be made (such as depreciation or other notional cost), and any part of the cost that is a payment but is not in carrying on or providing the relevant operations, facilities or other things of the petroleum project, including paying for downstream, corporate and local community activities, and for activities directed towards other future petroleum projects. While it is acknowledged that apportionment may be difficult in some circumstances, if proper consideration is applied the Commissioner will seek to accept an apportionment of the expenditure on a reasonable basis.

## **Record keeping**

138. Section 112 requires a person to keep records that record and explain all transactions and other acts engaged in by the person or any other person that are relevant for the purpose of ascertaining the person's PRRT liability, and to retain them for seven years, so that the person commits an offence if these requirements are not met. The ATO may examine any invoices, contracts and other records in relation to expenditure to which section 41 applies, whether kept as records to meet the requirements of section 112 by the taxpayer or not. The onus is on the taxpayer to show that a payment to procure particular services is in relation to the petroleum project, constitutes exploration expenditure, general project expenditure or closing-down expenditure and is not excluded expenditure under the PRRTAA. That onus is not discharged merely because no record keeping offence under section 112 is committed (say, because records were destroyed only after the retention period under section 112 expired).

139. If section 41 is applicable, records that record and explain relevant transactions and acts must show what the payment liable to be made was to procure another person to carry on or provide and what part of the payment was to procure the carrying on or providing by the other person of relevant operations, facilities or other things for the petroleum project. This may be in addition to the records that would otherwise be needed. In the same way, the onus on the taxpayer if section 41 is claimed to apply will include establishing the elements of section 41, as well as the matters that would otherwise have to be established.

## **Appendix 2 – Alternative views**

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**❶** *This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the proposed binding public ruling.*

140. Alternatives views relating to the issues discussed in the Explanation section of this draft Ruling have been considered in this section. The reasons the Commissioner considers the alternative views to be incorrect are explained in the 'Analysis' following each alternative view.

### **Alternative view 1**

***Section 41 operates independently to make expenditure eligible real expenditure or deductible expenditure***

141. Section 41 determines the deductibility or otherwise of an item of expenditure on its own without any need to refer to any other section of the PRRTAA.

### ***Analysis***

142. As explained in paragraphs 69 to 82 of the Explanation section, section 41 only deems the liability incurred by the person to a third party to have been incurred by the person in carrying on or providing certain operations, facilities and other things in relation to the petroleum project even though in actuality they are carried on or provided by another person and the expenditure was not in carrying on or providing them but in procuring that someone else do so. Section 41 does not provide any guidance on whether a deemed item of expenditure is deductible or not or whether an item of deemed expenditure may give rise to exploration expenditure, general project expenditure or closing-down expenditure. Other provisions of the PRRTAA, including sections 37, 38, 39 and 44 in particular, must be applied in light of the deemings under section 41 to determine whether and to what extent expenditure gives rise to eligible real expenditure and whether it is exploration expenditure, general project expenditure or closing-down expenditure.

**Alternative view 2*****Interaction between sections 41 and 44***

143. Section 44 does not apply when section 41 applies. If what has been carried on or provided by another person is of a kind referred to in sections 37, 38 or 39, then the deeming of what has been provided to be carried on or provided by the person liable to pay to have it provided means that the full amount of the liability incurred is eligible real expenditure apart from any further consideration of the requirements of those sections. So the requirement under those sections that each kind of eligible real expenditure not be excluded expenditure under section 44 need never be considered. There is no requirement to refer to sections 37, 38 and 39 and so to section 44 to determine the deductibility or otherwise of the payment and its classification into exploration expenditure, general project expenditure and closing-down expenditure.

***Analysis***

144. To constitute eligible real expenditure, a person must first consider whether the expenditure meets the conditions contained in sections 37, 38 or 39. Those conditions include that the expenditure not be excluded expenditure under section 44. If deeming under section 41 applies, it is what the expenditure is deemed to be in carrying on or providing, and in light of what operations, facilities or other things the person liable to pay is deemed to be themselves carrying on or providing, that must meet the requirements of sections 37, 38 or 39 and so must not be excluded expenditure under section 44. Only eligible real expenditure which meets those requirements can ever give rise to deductible expenditure or transferred exploration expenditure for the purposes of the PRRTAA.

## **Appendix 3 – Your comments**

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145. You are invited to comment on this draft Ruling. Please forward your comments to the contact officer by the due date.

146. A compendium of comments is also prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- publish on the ATO website at [www.ato.gov.au](http://www.ato.gov.au).

Please advise if you do not want your comments included in the edited version of the compendium.

<b>Due date:</b>	<b>13 August 2010</b>
<b>Contact officer:</b>	<b>Bhim Nagpal</b>
<b>Email address:</b>	<b><a href="mailto:bhim.nagpal@ato.gov.au">bhim.nagpal@ato.gov.au</a> <a href="mailto:prrt@ato.gov.au">prrt@ato.gov.au</a></b>
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**Appendix 4 – Detailed contents list**

147. The following is a detailed contents list for this Ruling:

	<b>Paragraph</b>
<b>What this Ruling is about</b>	<b>1</b>
<b>Background</b>	<b>6</b>
<b>Ruling</b>	<b>8</b>
Scope of section 41	8
Other legislative requirements still apply	10
Apportionment	14
Payments to agents	16
Agreement to do a range of things	18
Anti-avoidance	19
Time of incurring liability to make payments	21
<b>Examples</b>	<b>22</b>
Example 1 – Fixed price consideration paid to a third party to drill an exploration well	22
Example 2 – Third party procured to operate the upstream and downstream facilities of operations related to a PRRT project for consideration based on direct and indirect labour costs plus a profit mark-up	25
Example 3 – Procuring a related party to interpret seismic data	30
Example 4 – Administrative cost incurred in carrying on the petroleum project as well as other things	35
Example 5 – Mobilisation of drilling equipment under a drilling program	38
Example 6 – When expenditure is incurred	41
Example 7 – Funds committed to a joint venture operation	44
Example 8 – Cost contribution arrangement for research results	48
Example 9 – Fees paid to a recruitment agency	54
Example 10 – Exploration expenditure and general project expenditure incurred in an exploration permit area in relation to the petroleum project	60
Example 11 – Exploration expenditure incurred in an eligible exploration or recovery area of a lease derived petroleum project	64
<b>Date of effect</b>	<b>68</b>
<b>Appendix 1 – Explanation</b>	<b>69</b>

Section 41	72
<i>Section 41 is not a deduction provision in itself</i>	73
<i>Conditions for subsection 41(1) to apply</i>	74
<i>How does section 41 provide for deductibility of the expenditure to which it applies?</i>	78
How is expenditure classified into exploration expenditure, general project expenditure and closing-down expenditure	80
The interaction between sections 41 and 44	83
Apportionment	91
Under what circumstances would a person have to test the expenditure of a third party against section 44?	99
Division 6 of Part V	107
<i>Arrangements to enable tax benefit</i>	107
<i>Non-arm's-length transactions</i>	111
When is expenditure incurred?	116
Joint ventures	122
Record keeping	138
<b>Appendix 2 – Alternative views</b>	<b>140</b>
Alternative view 1	141
<i>Section 41 operates independently to make expenditure eligible real expenditure or deductible expenditure</i>	141
<i>Analysis</i>	142
Alternative view 2	143
<i>Interaction between sections 41 and 44</i>	143
<i>Analysis</i>	144
<b>Appendix 3 – Your comments</b>	<b>145</b>
<b>Appendix 4 – Detailed contents list</b>	<b>147</b>

## References

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*Previous draft:*

Not previously issued as a draft

*Related Rulings/Determinations*

TR 2004/1; TR 2006/10;  
TR 2010/D4; TR 2010/D5

*Subject references:*

- incurred
- joint ventures
- mining & petroleum
- PRRT
- PRRT assessable receipts
- PRRT closing-down expenditure
- PRRT deductible expenditure
- PRRT excluded expenditure
- PRRT exploration expenditure
- PRRT general project expenditure

*Legislative references:*

- PRRTAA 2
- PRRTAA 5(2)(a)
- PRRTAA 5(2)(b)
- PRRTAA 19(4)
- PRRTAA Pt V Div 3
- PRRTAA 32
- PRRTAA 32(a)
- PRRTAA 32(b)
- PRRTAA 32(c)
- PRRTAA 32(d)
- PRRTAA 32(e)
- PRRTAA 32(f)
- PRRTAA 32(g)
- PRRTAA 33
- PRRTAA 34
- PRRTAA 34A
- PRRTAA 35
- PRRTAA 35A
- PRRTAA 35B
- PRRTAA 36C
- PRRTAA 37
- PRRTAA 37(1)(a)
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