MT 93/2 - Petroleum Resource Rent Tax: deductibility of payments made to contractors and others to procure the carrying on or providing of operations, etc. in relation to a petroleum project

Miscellaneous Taxation Ruling
Petroleum Resource Rent Tax: deductibility of payments made to contractors and others to procure the carrying on or providing of operations, etc. in relation to a petroleum project

Miscellaneous Taxation Rulings do not have the force of law. Each decision made by the Australian Taxation Office is made on the merits of each individual case having regard to any relevant Ruling.

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What this Ruling is about

1. This Ruling explains:

   A. The characterisation of payments made by a person (the taxpayer) to procure the carrying on or providing of operations, facilities or other things by another person (such as a contractor) in relation to a petroleum project as provided in section 41 of the *Petroleum Resource Rent Tax Assessment Act 1987* (the Act).

   B. When the payments become deductible expenditure of the taxpayer.

   C. The interaction between section 41 and section 44 of the Act.

   D. The distinction between expenditure incurred on behalf of the taxpayer and other expenditure incurred in the course of providing operations, facilities or other things for the taxpayer.

2. The reference in section 41 to a liability to make a payment to procure the carrying on or providing of operations, facilities or other things is a reference to operations, facilities or other things referred to in sections 37, 38 and 39 of the Act. These sections include:

   (a) operations and facilities involved in or connected with exploration for petroleum in the exploration permit area, the retention lease area or the production area and various other services in relation to a petroleum project;

(b) operations, facilities and other things comprising the petroleum project; and

(c) the carrying on of operations involved in closing down the project

which for the purposes of this Ruling will be referred to as 'the project services'.

Ruling

A. Characterisation of payments made to a contractor

3. A payment made to a contractor to have the contractor carry on or provide the project services may constitute exploration expenditure or general project expenditure or closing down expenditure depending on the nature of the project services carried on or provided by the contractor.

4. Where the contractor carries on the exploration activities of the project, the payment by the taxpayer to the contractor will be treated as exploration expenditure of the taxpayer.

5. Where the contractor carries on or provides several project services, for example, exploration and production, the payments will take the nature of the respective services carried on or provided by the contractor. That is, amounts paid for exploration work will be treated as exploration expenditure of the taxpayer and amounts paid for production work will be treated as general project expenditure of the taxpayer.

6. If a composite fee is paid to the contractor to carry on or provide various project services the fee will need to be dissected on a reasonable and bona fide basis over the various project services. A dissection will also need to be made where the contractor provides both project services and other services.

7. Payments to contractors for services which do not relate to or comprise a petroleum project will not constitute deductible expenditure. For instance, where payments are made for exploration, production and marketing operations the amount referable to marketing would not constitute deductible expenditure because marketing is not one of the operations, facilities and other things that comprise or relate to a petroleum project.

B. When are payments to a contractor deductible expenditure of the taxpayer

8. Payments to a contractor become deductible expenditure in the form of exploration expenditure, general project expenditure or closing down expenditure at the time when the liability to make a payment to procure the carrying on or providing of the project services is incurred. A taxpayer does not have to wait until the contractor expends the money received from the taxpayer on the project services before it is entitled to a deduction under the Act. However, the arrangement between the parties may be such that the taxpayer may come under no liability to the contractor until the contractor has expended or has committed moneys towards the project services.

9. The question as to when a taxpayer incurs a liability to the contractor for the purposes of procuring the carrying on or providing the project services is to be determined according to the same principles applicable in relation to the question of incurrence arising under section 51 of the *Income Tax Assessment Act 1936* (ITAA). That is to say, a liability is generally regarded as having been incurred where the liability is a presently existing liability and the taxpayer has completely subjected itself to the liability.

C. Interaction between section 41 and section 44 of the Act

10. Where the payment by the taxpayer to the contractor is made for the sole purpose of carrying on or providing the project services (for example, to drill exploration wells or construct a platform) then the whole of the contract payments are deductible to the taxpayer. The fact that the contractor spends the money or the make-up of the fee includes money spent on items of expenditure listed in section 44 (for example paying fringe benefits tax for employees engaged in the project) is irrelevant.

11. It is the taxpayer's expenditure and not the contractor's expenditure which is tested against section 44.

D. Distinction between expenditure incurred on behalf of the taxpayer and other expenditure incurred in the course of providing operations, facilities or other things for the taxpayer.

12. Section 41 of the Act will not apply to a payment made to allow another person to incur expenditure on the taxpayer's behalf, or to put that person in funds to meet expenditure incurred on the taxpayer's behalf. Section 44 will apply to the expenditure incurred on the taxpayer's behalf, because that expenditure is the taxpayer's own expenditure.

13. This is because expenditure incurred by a person acting in that regard as an agent is incurred by the taxpayer. When the taxpayer puts a person acting in that regard as an agent in funds for the purpose, or incurs the liability to do so, the taxpayer is not procuring the operations, facilities or other things from that person. Rather, because the person is in that regard an agent, the operations, facilities or other things will be procured by the taxpayer, acting by the agent who incurs the expenditure on the taxpayer's behalf.

Date of effect

14. This Ruling sets out the current practice of the ATO and is not concerned with a change in interpretation. Consequently, it has a past and future application. That is, it applies (subject to any limitations imposed by statute) for a year of tax commencing both before and after the date on which it is issued. The basic principles and exceptions to the general rule of past and future application for Rulings are more fully set out in TR 92/20.

Explanations

A. Characterisation of payments made to a contractor

General

15. Section 41 is not an operative provision which determines the deductibility or otherwise of an item of expenditure. To determine what constitutes deductible expenditure one must first turn to section 32 of the Act. That section lists seven classes of expenditure all of which are further defined in subsequent sections, namely, sections 33, 34, 34A, 35, 35A, 35B and 39. These definitions take us to three specific categories of expenditure under which an item of expenditure must first fall before they come to be considered for section 32 purposes. These specific categories of expenditure are:

Section 37 - exploration expenditure;

Section 38 - general project expenditure; and

Section 39 - closing down expenditure.

16. Generally speaking, exploration expenditure will comprise expenditure incurred by a person in carrying on or providing operations and facilities and other services associated with exploration for petroleum in an exploration permit area, a retention lease area or a production licence area.

17. General project expenditure will in the main be expenditure incurred in carrying on or providing the operations, facilities and other things associated with the recovery of petroleum from a production licence area.

18. Closing-down expenditure will be expenditure incurred by a person in carrying on operations involved in closing down the project, including any environmental restoration as a consequence of closing down the project.

19. All three sections redefine 'expenditure incurred' as being 'payments liable to be made by the person' for the operations facilities and other things referred to above. Whether the latter expression adds anything to the meaning of the first expression is not clear. If anything, they tend to reinforce the need for the liability to be a presently existing liability.

20. Thus before an item of expenditure can be characterised as deductible expenditure the person must be liable to making the payments and must also carry on or provide the project services. In addition to these two tests, the expenditure must not be excluded expenditure as defined in section 44.

21. In terms of the provisions of sections 37, 38 and 39, the contractor and not the taxpayer would be the person who would directly be liable to make payments for exploration expenditure, general project expenditure and closing-down expenditure. The contractor would also be the person who would actually carry on or provide the project services.

22. Section 41 achieves deductibility of the expenditure in the hands of the taxpayer by:

(a) deeming the operations, facilities or other things to have been carried on or provided by the taxpayer, and

(b) deeming the whole liability incurred by the taxpayer for procuring the operations etc. to have been incurred by the taxpayer in carrying on or providing the operations etc.

In this way, the deeming provisions of section 41 achieve the tests of deductibility contained in sections 37, 38 and 39. By treating the whole liability incurred to the contractor as being incurred in carrying on or providing the operations it disregards the effects of section 44.

Apportionment of section 41 payments

23. A further question relevant to the issue of characterisation is the question of whether the provisions of the Act allow for the apportionment of expenditure incurred for mixed purposes. The general deduction provisions of the Act are silent on the question. They do not contain the apportioning language, namely *'to the extent to which'*, that section 51 of the ITAA has. However, some sections of the Act do specifically recognise apportionment. For instance, in relation to expenditure on property for partial project use section 42 of the Act apportions that expenditure on a usage basis. Likewise, subsection 37(2) provides for the apportionment of any exploration permit fee between an exploration permit area and a retention lease area in circumstances where subsection 5(3) applies.

24. In the context of a payment under section 41 the characterisation of the liability into exploration expenditure, general project expenditure and closing down expenditure is an essential prerequisite to deductibility. As discussed above, section 41 achieves this by deeming the liability to be incurred in carrying on or providing the project services. It is therefore necessary to look at what the contractor has contracted to do. Where the payment is for procuring one type of service only, e.g., exploration, no problems arise and the payment will be deemed to be exploration expenditure. However, where the payment is to procure a number of different project services, apportionment between the project services is essential in order to arrive at the deemed character of the payment.

25. We consider that apportionment is available for the purposes of determining what part of an amount of expenditure is properly referable to the purposes of procuring the project services referred to in section 41. The real question is what sort of apportionment does the Act permit in respect of the type of expenditure referred to in section 41.

26. In *Ronpibon Tin NL v. FC of T,* 78 CLR 47 the High Court explained the different ways that apportionment should proceed under subsection 51(1) of the ITAA. The court considered that there were two kinds of expenditure that would require apportionment. At page 59 the court observed:

> ' It is perhaps desirable to remark that there are at least two kinds of items of expenditure that require apportionment. One kind consists in undivided items of expenditure in respect of things or services of which distinct and several parts are devoted to gaining or producing assessable income and distinct and several parts to some other cause. In such cases it may be possible to divide the expenditure in accordance with the applications which have been made of the things or services.

> The other kind of apportionable items consists in those involving a single outlay or charge which serves both objects indifferently. Of this director's fees may be an example. With the latter kind there must be some fair and reasonable assessment of the extent of the relation of the outlay to assessable income. It is an indiscriminate sum apportionable, but hardly capable of arithmetical or rateable division because it is common to both objects.'

27. The former kind of expenditure is one capable of dissection by reference to the things or services acquired by the expenditure or by the applications made of the things or services. For instance, a fee paid to a contractor to carry out exploration activities on two separate projects is capable of dissection according to the amount attributable to each project. Likewise, a fee paid to carry out the development activities of a project and the marketing of the products produced from the project is dissectible on the basis of the services provided. On the other hand, the service fee on a truck used for several purposes is an 'undivided item of expenditure' capable of dissection 'in accordance with the applications which have been made' by determining how many kilometres relates to use in respect of each purpose. *Ronpibon's* case dealt with the second type of expenditure of which directors fees were an example.

28. The view that apportionment of the first kind is available where there is no express apportioning power is supported by the decision of the High Court in *FC of T v. McLaurin,* 104 CLR 381 in the context of section 25 of the ITAA. At page 391 the court observed:

> 'It is true that in a proper case a single payment or receipt of a mixed nature may be apportioned amongst the several heads to which it relates and an income or non-income nature attributed to portions of it accordingly.... But while it may be appropriate to follow such a course where the payment or receipt is in settlement of distinct claims of which some at least are liquidated,...., or are otherwise ascertainable by calculation...., it cannot be appropriate where the payment or receipt is in respect of a claim or claims for unliquidated damages only and is made or accepted under a compromise which treats it as a single, undissected amount of damages. In such a case the amount must be considered as a whole....'

29. Another case where apportionment was considered in relation to provisions which are silent on the question of apportionment is *Dampier Mining Company Ltd v. FC of T* 79 ATC 4469; 10 ATR 193. Here the Full Federal Court had to consider whether payments made by the company to a dredging contractor for removing soil from the sea-bed, spreading and compacting it on leased land on which a tertiary crusher was to be erected and on which ore was to be stored

and blended after treatment in the crusher was allowable capital expenditure for the purposes of Division 10. The payment had the dual purposes of deepening a harbour and reclaiming the leased land on which prescribed mining operations were carried on. The Commissioner had apportioned the payment between the cost of extraction from the sea-bed and the cost of conveying the soil to the land and there spreading and compacting it. Deane J, with whom the other members of the court agreed, held that only the expenditure referable to raising and compacting the actual site of the tertiary crusher was allowable capital expenditure. It may be gathered from this case that the Federal Court accepted, by implication, that apportionment was available.

30. The matter went on appeal to the Full High Court (81 ATC 4329; 11 ATR 928) on the issue as to whether the payment was wholly deductible under subsection 88(2). The subsection contained no provision for apportionment. Gibbs CJ approached the matter on the basis that apportionment was available but concluded that in the circumstances the fact that the expenditure provided a side benefit did not preclude the full amount of the expenditure being incurred for the purposes of the subsection. Mason and Wilson JJ in their joint judgment also concluded that the whole of the expenditure was deductible under the subsection. Their Honour's remarked that the subsection contains no provision which requires the making of an apportionment but recognised that in some circumstances a taxpayer may find it necessary to apportion the costs of making improvements between two parcels of land which are the subject of separate leases.

31. It is also clear from the observations made in the cases referred to above that not all single payments or receipts lend themselves to apportionment. When a provision of a Statute provides that money be outlaid in a particular way the approach adopted by the Full High Court in *Dampier Mining* and by the courts in *Robe River Mining Co. Pty Ltd v FC of T,* 89 ATC 4606; 19 ATR 1648 and *FC of T v. Mount Isa Mines Ltd,* 91 ATC 4154; 21 ATR 1294 may need to be adopted.

32. In *Robe River Mining* the Full Federal Court once again considered the use, in the definition of 'allowable capital expenditure' in section 122A, of the phrase 'in carrying on prescribed mining operations' when considering the deductibility of exchange losses resulting from the repayment of loans used for the purposes of prescribed mining operations. It was said that the phrase suggests a quite direct relationship between the expenditure and the operations. It was further said the word 'in' has been judicially construed as a restrictive word and if the whole section provides a context within which individual expressions should be understood, it seems to be concerned with expenditures having a fairly direct relationship with the things and activities specified. It was concluded that the

expenditure in question was not incurred in carrying on prescribed mining operations.

33. In *Mount Isa Mines*, the taxpayer claimed a deduction for the cost of a new retaining wall for a substantial earth and rock dam which was built to contain tailings. The dam was used to safely dispose of the residue following the processing of the ore removed from the mine. One of the questions the Full Federal Court had to consider in this case was whether the expenditure on the retaining wall was deductible under subparagraph 122A(1)(a)(iii) as being expenditure 'in providing..... water, light or power for use on,.....the site of prescribed mining operations'. The taxpayer argued that under the subparagraph it was not necessary to show that the sole purpose of the dam was to provide water, it was enough if that was one of the purposes.

34. Pincus and Ryan JJ in their joint judgment observed that in many contexts it is necessary to decide whether a right depending upon the existence of a stipulated purpose can be claimed, where what is done has a number of purposes. They went on to say that:

> 'There is no general rule that such a condition - i.e., one expressly or implicitly requiring the existence of a purpose - is satisfied, if it is shown that a stipulated purpose was one of the proponent's purposes, nor is it so that ordinarily the purpose must be a dominant one; each provision must be considered in its own context. Here, there is no express mention of "purpose" and the words used are simply "in providing ...water...for use on...the site..." In an ordinary use of language, expenditure is not spoken of as having been incurred "in" a certain way unless that is the way in which it has been at least substantially if not solely, incurred'.

35. Section 41 is indeed a provision which must be considered in its own context. A payment to a contractor without the assistance of the deeming provisions of the section would ordinarily not qualify as exploration, general project or closing down expenditure. The section recognises that the payment to a contractor can be made to procure several services of the type referred to in sections 37, 38 and 39. The section implicitly recognises that a payment will need to be apportioned over the various project services for which it was made. By the same reasoning, apportionment becomes necessary to separate that part of the payment to the contractor that is referable to other things and activities.

36. Generally speaking, contractors are likely to calculate the fee they charge by taking into account three things: the direct costs of the services provided; a portion of overhead expenses; and a profit margin. Where a taxpayer makes a payment to cover many

miscellaneous things, only some of which are of the type referred to in sections 37, 38 or 39, a taxpayer will only be allowed a deduction for the appropriate direct costs, the proportionate overheads and the profit margin for the particular services that come within those sections.

37. In some cases the amount referable to the services may be easy to calculate. For example, if a contractor driller agreed to provide exploration drilling services to a taxpayer for both an off-shore and an on-shore project 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 drilling for the respective projects and multiply by the $5,000. Where a floating fee is adopted, that is, the fee is calculated on a *cost plus method,* than the profit margin referable to a PRRT project would simply be determined by applying the mark up to the expenditure that relates to the PRRT project. In other cases, the apportionment may need to be made on some fair and reasonable basis.

38. One would expect that a payment to a contractor should be capable of dissection over the various project services and other things and activities for which the payment is made. However, if for some reason a payment to a contractor is of such type that it cannot be dissected the test of 'direct relationship' referred to in the *Robe River Mining* case and the 'substantial or sole purpose' test in *Mount Isa Mines* case may need to be applied to determine the deductibility of the payment.

B When do the payments become deductible expenditure of the taxpayer

39. Section 41 refers to the incurrence of a liability to make a payment to procure the things specified in the section. It is at the point when that liability is incurred by the taxpayer that a deduction would ordinarily be available to the taxpayer in respect of the payments.

40. The tests to be applied for determining when an item of expenditure or a liability to make a payment is incurred are those enunciated in such cases as *FC of T v. James Flood Pty Ltd* (1953) 88 CLR 492; *Nilsen Development Laboratories & Ors v FC of T* (1981) 144 CLR 616; and *Coles Myer Finance Ltd v. FC of T* 93 ATC 4214; 25 ATR 95, in the context of section 51 of the ITAA. That is to say, a liability is generally regarded as having been incurred where the liability is a presently existing liability and the taxpayer has completely subjected itself to the liability.

41. However, the High Court in the *Coles Myer Finance* case said that deductibility also depends on the question of how much of that liability is properly referable to the income year in question. Whilst the provisions of section 32 do not speak in terms of the apportioning

language of section 51 of the ITAA the expenditure is nevertheless made referable to a particular financial year. The expenditure is also made specifically referable to the carrying on or the provision of the services under sections 37, 38 and 39 by the deeming provisions of section 41. But as the payment under section 41 is to 'procure' the project services it stands to reason that the incurrence of the liability under section 41 can arise before the project services are actually provided by the contractor.

42. The word 'procure' is defined in the *Macquarie Dictionary* as meaning 'to obtain or get by care, effort, or the use of special means'. The cases referred to in *Stroud's Judicial Dictionary* 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).

43. The above definition of the word procure suggests two things. First, that the liability to the contractor can arise, depending on the circumstances of a case, before the project services are actually provided. Secondly, that the contractor need not be the person who actually provides the project services. Section 41 does not expressly refer to *'a liability to make a payment to another person'* to procure the carrying on or provision of the project services *'by that other person'*. In other words, section 41 is literally capable of being construed to apply where the liability is one to make a payment to one person to procure the project services by a different person.

C. Interaction between section 41 and section 44 of the Act

44. Section 44 lists various items of expenditure which fall within the expression 'excluded expenditure'. Sections 37, 38 and 39 disqualify such expenditure from being exploration expenditure, general project expenditure and closing-down expenditure. As section 41 refers to sections 37, 38 and 39 the question arises as to whether the fee charged by the contractor should be reduced to the extent of any items of excluded expenditure that formed part of the fee. The answer is that no reduction is permitted.

45. It is to be noted that section 41 contains no express reference to 'excluded expenditure' and no reference to 'exploration expenditure', 'general project expenditure' or 'closing-down expenditure' incurred by another person and paid or reimbursed by the taxpayer. If that formulation had been adopted, the meaning of each of those three specific classes of expenditure would have to be determined by reference back to sections 37, 38 and 39 and each class of expenditure which is 'excluded expenditure' would have to be left out from the

amount of deductible expenditure. However, the reference back to sections 37, 38 and 39 in section 41 is not a reference back to the classes of expenditure defined therein but to the kinds of operations, facilities and things referred to therein.

D. Distinction between expenditure incurred on behalf of the taxpayer and other expenditure incurred in the course of providing operations, facilities or other things for the taxpayer

46. The agreement between the parties, and any apparent authority given by the taxpayer, control the question whether a person incurs particular expenditure on behalf of the taxpayer or whether the person is incurring the expenditure in their own right, in the course of carrying on or providing operations, facilities or things related to the project. This is an application of the general law of principal and agent, and the detail of that law is not appropriate to cover in this Ruling. A few general observations may help distinguish the two situations in the context of projects to which the petroleum resource rent tax applies.

47. If a taxpayer incurs a liability to pay for the provision or carrying on of project-related operations, facilities or other things, the person to whom payment is to be made will generally have to incur expenditure of their own in order to provide or carry on those things. That person's expenditure is not the taxpayer's expenditure to which section 44 might apply. But if the person is instead the taxpayer's agent, incurring the expenditure on its behalf, the fact that the agent must be put in funds, or that the taxpayer incurs a liability to put the agent in funds, is not something to which section 41 applies. An agent is simply a person who does something on behalf of another with the other's authority or apparent authority.

48. Joint ventures which are not partnerships are commonly formed to conduct projects to which the PRRT applies. Often, such joint ventures appoint an operator, who may or may not be a venturer. Because joint venturers generally wish to avoid being partners, the responsibilities of an operator are likely to be closely defined by agreement, and the actual conduct of the operator and the joint venturers is likely to be monitored to ensure that the agreement is followed. That agreement is an important guide to whether, in incurring particular expenditure, the operator is acting on behalf of the venturers.

49. In some cases, an operator will be acting (or apparently acting) generally as an agent of the project participants. In others, the operator will only act as agent of a participant in negotiating sales of commodities produced by the project. Actual cases commonly range between these extremes. But agency is rarely completely absent: 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.

50. 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 expenditures as the agent of the venturers. And even an operator who is an employee of the venturers, or of one of them, may not incur any expenditures as their agent.

51. An operator who is also one of the venturers in a joint venture may not act as the agent of the other venturers in incurring particular expenditure. In such a case, section 41 will apply to the payments the other venturers incur to the operator to carry on or provide project-related operations, facilities or other things, and section 44 will have no application to the other venturers merely because the operator actually incurs expenditure of its own to which the section applies. However, the operator's own deductible expenditure, in effect the unreimbursed portion of its overall project-related expenditure, is subject to section 44; the operator cannot incur a liability to itself, and so to which section 41 would apply.

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- Coles Myer Finance Ltd v. FC of T 93 ATC 4214; 25 ATR 95
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