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

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Draft Taxation Ruling

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*

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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 explains three general pre-conditions which are prerequisite to any expenditure being eligible real expenditure for the purposes of the PRRTAA. Expenditure cannot give rise to deductible expenditure for the purposes of section 32 of the PRRTAA, or to transferred expenditure taken into account in working out liability to the tax, if it does not meet all three pre-conditions. Expenditure which satisfies all three pre-conditions must also meet other legislative requirements to be deductible expenditure or transferred expenditure.

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.

Background

3. Petroleum resource rent tax (PRRT) is essentially a tax on a person with 'assessable receipts' from a petroleum project. The PRRTAA taxes the excess of their 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'. PRRT is a petroleum project tax not an enterprise tax. A person may be involved in a wider enterprise than the petroleum project, and even in relation to the petroleum project may incur expenditure and derive income for income tax purposes (or may include accounting assets and liabilities for accounting purposes) that do not relate to deductible expenditure or assessable receipts under the PRRTAA.

4. To be deductible expenditure or transferred expenditure, expenditure must derive from amounts liable to be paid in carrying on or providing particular operations, facilities and 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'. In some circumstances exploration expenditure can and so must be transferred to another petroleum project of the same taxpayer or a petroleum project of a member of the same company group as the taxpayer to be offset against assessable receipts of the other project.

5. Section 21 determines the liability to pay tax by reference to the taxable profit of a 'person' in relation to a petroleum project.

6. Section 22 specifies how to calculate a person's taxable profit in relation to a petroleum project and in relation to a year of tax. Subsection 22(1) provides that the taxable profit of a year is the excess of 'assessable receipts' in that year over the sum in that year of:

(a) the deductible expenditure incurred by the person in relation to the project;

(b) any expenditure transferred to the project by the person under section 45A; and

(c) any expenditure transferred by another person to the person and project under section 45B.

7. Assessable receipts are first derived from a petroleum project generally a number of years after the taxpayer starts to incur eligible real expenditure on the project giving rise to deductible expenditure. Whether the expenditure is exploration expenditure, general project expenditure or closing-down expenditure (together defined as eligible real expenditure in section 2) can be determined at the time that the expenditure was actually incurred. However, the amount of deductible expenditure or transferred expenditure derived from eligible real expenditure will generally be known only at the time the expenditure can be absorbed against assessable receipts of a project, because the rate of augmentation of the expenditure depends on the classification of expenditure which is determined by reference to the petroleum project against whose assessable receipts the expenditure is to be absorbed.

Ruling

Pre-conditions common to eligible real expenditure

8. There are three general pre-conditions common to eligible real expenditure, the only expenditure giving rise to deductible expenditure or transferred expenditure under the PRRTAA. The expenditure must:

(a) be incurred by the person in relation to the 'petroleum project', as defined;

(b) be incurred in carrying on or providing operations, facilities or other things of a kind referred to in sections 37, 38 or 39; and

(c) not be 'excluded expenditure' under section 44.

9. Each of these pre-conditions must be satisfied in relation to any amount which gives rise to eligible real expenditure, in relation to the petroleum project.

Basic structure of the provisions

10. There is taken to be a petroleum project in relation to any eligible production licence that is in force (subsection 19(1)). Assessable receipts and deductible expenditure in relation to a petroleum project may arise both before and after a relevant eligible production licence is in force (sections 31 and 45). A combined project is a single petroleum project that relates to two or more eligible production licences because they have been combined by their inclusion in a project combination certificate (subsection 19(2)).

11. PRRT only applies to a person's interest in a 'petroleum project' on the basis of the excess of their 'assessable receipts' over their 'deductible expenditure' in relation to the petroleum project and the transferred expenditure available to the project. PRRT does not apply to the entire business of the taxpayer or to the whole of their particular business which includes the petroleum project. PRRT does not apply according to the taxpayer's taxable income and income tax deductions for income tax purposes, either generally or for the particular business including the petroleum project or for the petroleum project. PRRT does not apply according to the taxpayer's accounting treatment including profit, loss, assets and liabilities, either generally or for the particular business including the petroleum project or for the petroleum project.

12. A person's entitlement to deductions for expenditure on a petroleum project is determined by sections 37, 38 and 39 which define exploration expenditure, general project expenditure and closing-down expenditure respectively. These sections also provide that a reference to incurring of the relevant expenditure is a reference to payments liable to be made in carrying on or providing operations, facilities and other things specified in each of those sections. When payments are liable to be made is a question of fact and it requires the person to have carried on or provided the operations, facilities or other things specified (or to be taken to have carried on or provided them) and to have completely subjected itself to pay a presently existing liability. Payments do not have to be involuntary to be liable to be made, however; payments which are not enforceable are liable to be made, for PRRT purposes, when they are actually made.

13. What constitute the operations, facilities and other things comprising a petroleum project is set out in subsection 19(4). These consist of recovery of petroleum (including gas) from the relevant production licence area and any further activities such as processing or treatment of petroleum and moving or storage of petroleum or a marketable petroleum commodity (MPC) so far as they are up to the point that the petroleum is sold or an MPC produced from the petroleum is sold or otherwise becomes an excluded commodity (marketable petroleum commodity, petroleum and excluded commodity are terms defined in section 2), together with services, facilities for services, and employee amenities (as defined in section 2) in connection with such operations, facilities or things.

14. Only expenditure incurred in actually carrying on one of the identified activities or in providing one of the identified facilities or other things can be exploration expenditure, general project expenditure or closing-down expenditure. That cannot be read as including all expenditure necessary, in a commercial or business sense, if or because those activities or things are to occur. The exchange losses in funding mining operations covered in the judgment of Gummow J in the first instance in *Robe River Mining Co Pty Ltd v. Federal Commissioner of Taxation* (1988) 84 ALR 369; 88 ATC 4701 (the Robe River case) were not incurred in carrying on prescribed mining operations. The use of the word 'in' in the phrase 'in carrying on or providing' requires the expenditure to have a direct relationship with the operations, facilities and things that comprise the petroleum project as the word 'in' has been judicially construed as a restrictive word.

Exploration expenditure

15. Exploration expenditure incurred consists of payments liable to be made (or taken to be incurred) in or in connection with exploration for petroleum in the eligible exploration or recovery area in relation to the petroleum project (the eligible exploration or recovery area has been defined in section 5 in relation to an exploration permit, in relation to a retention lease and in relation to a production licence that is in force at the time). Exploration expenditure incurred also includes payments liable to be made in recovering petroleum (including gas) from the eligible exploration or recovery area before the relevant production licence applies, and in any further activities such as processing or treatment of the petroleum recovered by exploration expenditure and moving or storage of that petroleum or an MPC so far as they are up to the point that the petroleum is sold or an MPC produced from that petroleum is sold or otherwise becomes an excluded commodity, and services, facilities for services and employee amenities (as defined) in connection with those activities (also refer to Examples 3 and 10 of this draft Ruling). Exploration expenditure also includes payments liable to be made in procuring the processing of the petroleum recovered by exploration expenditure so far as that processing is of internal petroleum of the project, or of external petroleum of another petroleum project. And it includes any exploration permit, retention lease or other fee (but not an excluded fee) liable to be paid in relation to the carrying on or providing of any of those operations, facilities or other things.

16. The eligible exploration or recovery area in relation to a petroleum project differs as between pre-1 July 2008 petroleum projects and post-30 June 2008 petroleum projects (subsections 5(1), 5(2), 5(3) and 5(4) relate to pre-1 July 2008 petroleum projects; subsections 5(5), 5(6) and 5(7) relate to post 30 June 2008 petroleum projects). Expenditure that relates to a different eligible exploration or recovery area is not exploration expenditure of the project, but if it is exploration expenditure of another project it will give rise to transferred expenditure to the project so far as the relevant transfer rules are satisfied.

General project expenditure

17. General project expenditure consists of expenditure incurred in carrying on or providing the operations, facilities and things that constitute the petroleum project (defined in subsection 19(4); refer to paragraph 13 of this draft Ruling); in carrying on or providing activities preparatory to carrying on or providing those operations, facilities and things and specifically including carrying out feasibility or environmental studies; in purchase of external or internal petroleum (defined in section 2) for processing in the petroleum project (and in some cases, expenditure incurred in procuring another person to process petroleum recovered from the petroleum project) (also refer to Examples 4 to 6 of this draft Ruling). And it includes any production licence or other fee (but not an excluded fee) liable to be paid in relation to the carrying on or providing of any of those operations, facilities or other things. Expenditure cannot be general project expenditure to the extent it is exploration expenditure or closing-down expenditure.

18. Expenditure incurred in carrying on or providing employee amenities can only be within exploration expenditure or general project expenditure if the employee amenities are not being provided for the purpose of profit making. The purpose for which the employee amenities are provided must be understood in light of all relevant facts and circumstances, taking account of the period over which the employee amenities are provided, and having regard to the full costs involved. A purpose of profit making is not identified by comparing only the (otherwise) deductible expenditure with the (otherwise) assessable receipts of providing a particular amenity.

Closing-down expenditure

19. Closing-down expenditure consists of expenditure incurred in operations involved in the closing-down of a petroleum project including any environmental restoration and disposal of property. It also includes consideration given to dispose of project property, so far as that consideration relates to future closing-down expenditure, and excess future closing-down expenditure over that absorbed in reducing assessable property receipts to zero. But it does not include expenditure so far as future closing-down expenditure in relation to that expenditure has reduced assessable property receipts or has been allowed as a deduction.

Bad debts

20. Bad debts in relation to petroleum project assessable receipts are eligible real expenditure by operation of section 40. If written off before any general project expenditure or closing-down expenditure has been incurred by the person, the bad debts are exploration expenditure. If written off after general project expenditure has been incurred but before closing-down expenditure has been incurred by the person, the bad debts are general project expenditure. If written off after closing-down expenditure has been incurred by the person, the bad debts are closing-down expenditure (amounts received for written off bad debts are assessable receipts).

Apportionment and excluded expenditure

21. Only expenditure incurred in carrying on or providing the operations, facilities and other things referred to in sections 37, 38, 39 and which is not excluded expenditure can be eligible real expenditure of the petroleum project that can give rise to deductible expenditure or transferred expenditure. If only a part of a payment liable to be made is so incurred, that part but only that part can be eligible real expenditure. The part of the payment can be identified only so far as the corresponding part of what the expenditure is liable to be paid for can be identified as in carrying on or providing those operations, facilities or other things.

22. Sections 37, 38 and 39 specifically exclude excluded expenditure (as defined in section 44) incurred in relation to the petroleum project from being exploration expenditure, general project expenditure or closing-down expenditure respectively. Excluded expenditure includes interest payments; repayments of principal; other borrowing costs; dividend payments; share issue costs; private override royalties; equity capital repayments; income tax payments; fringe benefits tax payments incurred before 1 July 2006; GST payments; payments to get (other than by grant) or to buy into permits, leases, licences or authorities; payments to acquire interests in petroleum project profits, receipts or expenditures; administrative or accounting costs, salary, wages or other work costs incurred only indirectly; and payments in respect of land or buildings for use in connection with administrative or accounting activities so far as the land or buildings are not located at or adjacent to a project operations site.

23. The wording of the PRRTAA implicitly provides for apportionment as expenditure can only be deductible expenditure so far as part of it is incurred in relation to a petroleum project, is derived from exploration expenditure, general project expenditure or closing-down expenditure under sections 37, 38 and 39 respectively and it is not excluded expenditure under section 44.

24. Under paragraph 44(j), if a payment for administrative or accounting costs, or of salary, wages or other work cost serves two or more objects indifferently, only one of them being the carrying on of those petroleum project operations, facilities or other things, no part of the payment is incurred in carrying on those project things and no part of the payment can give rise to eligible real expenditure. A payment identified by category (such as legal fees, insurance premiums, or wages) will need more information to identify any part that is in carrying on or providing relevant project operations, facilities or other things.

Record keeping

25. Section 112 requires a person to keep records that record and explain all transactions and other acts that are relevant to ascertaining their liability under the PRRTAA. This includes records to support any claim for deductible expenditure or transferred expenditure. Records must be retained for a period of seven years from the date of assessment for the year of tax in which the relevant amount is claimed as deductible expenditure or transferred expenditure. If records are not retained longer, and no offence is committed, the taxpayer still bears the onus of establishing that expenditure – there is no deeming of claims of expenditure to be valid once records are not specifically required to be retained.

Examples

In relation to a petroleum project

Example 1 – Exploration expenditure and general project expenditure incurred in an exploration permit area in relation to the petroleum project

26. 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, exploration costs and general project costs were incurred in carrying on or providing operations, facilities and other things outside the existing production licence area but within the exploration permit area from which the existing production licence was derived (the general project costs were in carrying on or providing operations and facilities preparatory to production from this area once a further production licence is obtained). Can the exploration and general project costs constitute exploration expenditure and general project expenditure of the petroleum project in relation to the existing production licence?

27. 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 exploration costs may constitute exploration expenditure of the petroleum project in relation to the existing production licence pursuant to section 37.[1] Exploration expenditure actually incurred on one petroleum project will give rise to transferred expenditure used up on another petroleum project, so far as the relevant requirements are satisfied.

28. For the general project costs to constitute general project expenditure of the petroleum project related to the existing production licence the PRRTAA does not require all such things to be carried on or provided in the production licence area, and because the production licence area is offshore many of the things in relation to the project are likely to be carried on or provided elsewhere. But they must all relate in the specified ways to the project in relation to that production licence. The general project cost was incurred in carrying on or providing preparatory operations and facilities, but these were not in relation to the petroleum project relating to petroleum recovered from the area of the existing production licence. As the cost was not incurred in relation to that petroleum project, it is not able to give rise to deductible expenditure in relation to that project.

29. However, the general project cost that is not in relation to the petroleum project may still be eligible real expenditure able to give rise to deductible expenditure in relation to another petroleum project derived from the exploration permit area.

Example 2 – Exploration expenditure incurred in an eligible exploration or recovery area of a lease derived petroleum project

30. A company that holds an interest in 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 (so the petroleum project in relation to that production licence is a pre-1 July 2008 petroleum project). The company later incurred exploration expenditure in exploring the exploration permit area that is outside the retention lease area (and so outside the production licence area). This exploration expenditure has not yet been applied as deductible expenditure or transferred expenditure against any petroleum project. Can the company offset the exploration expenditure incurred outside the retention lease area against the assessable receipts of its petroleum project derived from the retention lease?

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[1] 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.

31. The eligible exploration or recovery area for the 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.[2] 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 cannot be eligible real expenditure of the petroleum project in relation to the lease derived production licence. The company may not offset the exploration expenditure under consideration in deductible expenditure in relation to the petroleum project with the lease derived production licence, because even if it is otherwise exploration expenditure giving rise to deductible expenditure it is not exploration expenditure in relation to that project.

32. However, the expenditure 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. Exploration expenditure in relation to the other project will give rise to transferable expenditure so far as the relevant requirements are satisfied. The company will 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.

Example 3 – Mobilisation of drilling equipment under a drilling program

33. An Australian company holds an interest in three exploration permits, for each of which there is taken to be a separate petroleum project (clause 14 of the Schedule to the PRRTAA). 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?

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[2] 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 (and, 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 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.

34. 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.[3] 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. Although the expenditure incurred by the Australian company for the mobilisation of drilling rig may meet the definition of exploration expenditure in section 37, the expenditure must be apportioned appropriately among all the petroleum project activities covered by the drilling program to identify the exploration expenditure on each project. 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 in connection with each of the other petroleum projects, and must be apportioned accordingly.

35. Note – Example 3 of this draft Ruling relates to deductibility of expenditure incurred in procuring a third party to carry on or provide operations, facilities or other things in relation to the petroleum project. Section 41 applies to treat the company as having done those things itself and as having incurred the liability to procure the third party as a liability incurred in doing those things itself. Section 41 is discussed in detail in draft Taxation Ruling 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*.

[3] 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.

'In carrying on or providing' the petroleum project

Example 4 – Board and lodgings

36. Employees engaged only in the physical recovery of petroleum from a petroleum project and their family members receive board and lodgings at or adjacent to the site where the petroleum project operations, facilities or other things are being carried on or provided. The board and lodgings are provided by the taxpayer over a period free, or for charges at less than cost, providing a subsidy, or at cost. Are the costs of providing this board and lodging incurred by the taxpayer in carrying on or providing the operations, facilities or other things comprising the petroleum project (or otherwise specified as eligible)?

37. The costs of providing board and lodging to employees and their families are incurred in carrying on or providing employee amenities and so in carrying on or providing the operations, facilities or other things comprising the petroleum project, and may give rise to deductible expenditure, to the extent that the employees are engaged in carrying on any of the operations, facilities or other things comprising the petroleum project (subparagraph 19(4)(b)(v)). The employees physically engaged only in the recovery of petroleum from the production licence area for the project are certainly engaged in carrying on or providing operations, facilities or other things that are part of the things comprising the petroleum project. The provision of board and lodging is the provision of employee amenities to those employees and their families and is in connection with the operations, facilities or other things the employees carry on or provide (paragraph 19(4)(b) and section 2). Boarding and lodging such employees and their dependants is part of the operations, facilities or other things comprising the petroleum project. The cost of providing the board and lodging could give rise to eligible real expenditure on the project, and any charges for the board and lodging would be assessable receipts of the project under section 29.

38. However, board and lodging provided for more than actual cost would be provided for the purpose of profit-making, would not be employee amenities under section 2 and so would not be part of the operations, facilities or other things comprising the petroleum project. As stated in paragraph 18 of this draft Ruling, whether employee amenities are provided for the purpose of profit-making is determined by taking into consideration all the relevant facts and circumstances, including the period over which the employee amenities are provided, and having regard to the full costs involved. The costs of board and lodging provided for the purpose of profit-making would not be eligible real expenditure. In that case charges for the board and lodging would not be assessable receipts under section 29 either. Whether an employee amenity is provided for the purpose of profit-making is a question of fact.

Example 5 – Employee engaged in activities to support other employees at the petroleum project site office

39. The duties of an administration employee stationed at the site office of a petroleum project are:

- to maintain time keeping records for employees performing petroleum project operations at the project site;
- to send time keeping information in relation to the project site employees to the payroll section;
- to implement the occupational health and safety policy and measures at the project site; and
- to maintain employee amenities at the project site.

40. Employees engaged at the project site are engaged only in carrying on the operations, facilities and other things comprising the particular petroleum project. Are the salary and wage costs of the administration employee incurred in carrying on or providing the operations, facilities or other things comprising the petroleum project?

41. The administration employee's salary and wage costs are wholly attributable to the workers on site who are carrying on or providing the operations, facilities or other things comprising the petroleum project the cost of which is eligible real expenditure. The functions of time keeping and employee amenities at the operations site are an integral and direct part of the operations performed by site employees directly involved in carrying on the petroleum project. So the administration employee's salary and wage costs are themselves directly liable to be paid in carrying on or providing the operations, facilities or other things provided by the site workers and to them as employee amenities, and they are eligible real expenditure.

Example 6 – Entertainment

42. Entertainment is provided to employees. Are entertainment costs incurred in carrying on or providing the operations, facilities or other things comprising the petroleum project?

43. Entertainment costs may be incurred in carrying on or providing the operations, facilities or other things comprising the petroleum project to the extent that they form part of the salary package or working conditions of an employee who is directly engaged in carrying on or providing the operations, facilities or other things for the petroleum project, costs of which are eligible real expenditure. The costs of other entertainment, for example a Christmas party for head office staff or entertainment expenses incurred by company directors, are unlikely to give rise to eligible real expenditure.

Example 7 – Payment for access to land subject to native title claim

44. A company pays an annual amount to the local community that has native title over the land on which the company has set up its petroleum processing plant. The plant involves only upstream activities of a petroleum project: that is, it involves only activities up to the point at which petroleum or an MPC is sold, or the point at which an MPC becomes an excluded commodity otherwise. Can the payment for obtaining access to land give rise to eligible real expenditure?

45. So far as the payment relates to continued access to land for carrying on or providing upstream activities of the petroleum project, the payment may give rise to eligible real expenditure of the petroleum project. However, if the payment is made for other reasons such as that the land is used for downstream activities or for other projects, only the component directly relating to the activities of the petroleum project may give rise to eligible real expenditure. The company may apportion the payment on a reasonable basis (for example, land area used for the petroleum project and land area used for other activities). The issue of direct and indirect costs (and apportionment) is discussed in detail in 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 8 – Cost Contribution Arrangements

46. 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 and risks of developing, producing or obtaining research results that the overseas company has or may develop in its research programs.[4] The results are available for any purpose to which they may seem relevant, whether in the petroleum project activities or in non-project upstream and downstream activities, free of further charge to those who have entered into the CCA. Those that do not enter into the CCA may access particular results by licensing of those results. The amount payable by the subsidiary company under the CCA is claimed by the joint venture participants in proportion to their interests in the project as eligible real expenditure under sections 37, 38 or 39. Can the members of the joint venture claim their share of the CCA as giving rise to eligible real expenditure?

[4] 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 to 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.

47. The CCA amount liable to be paid by the joint venture participants can only give rise to eligible real expenditure if it is incurred in carrying on or providing operations, facilities or other things of kinds referred to in sections 37, 38 or 39 So far as the CCA amount is paid for research results already known and to be used directly in carrying on or providing such things, it may be: but if it is so paid to any extent this is likely to be minor, as known results could be obtained without the ongoing CCA commitment. So far as the CCA amount is paid to have particular research carried out, it is unlikely to be in carrying on or providing any of the particular things of kinds referred to in sections 37, 38 or 39. In practice, CCAs do not commonly allow either a joint venture operator agreeing to the arrangement or the joint venturers as a group to decide what their CCA contribution will be applied to.

48. To constitute eligible real expenditure, the CCA amount must be incurred in carrying on or providing the operations, facilities or other things that comprise the petroleum project or otherwise give rise to eligible real expenditure. Suppose the CCA is for the development, production or acquisition of operations, facilities or other things of that kind in the project: then to the appropriate extent the expenditure under the CCA is in carrying on or providing those operations, facilities or other things and may be eligible real expenditure of the project. However, suppose the CCA is to some extent for the carrying on or providing of operations, facilities or other things of that kind in the project: then to that appropriate extent the expenditure under the CCA is taken to be eligible real expenditure of the contributors.

49. Commonly what is supported is not even related particularly to the interests of the payer, but rather to the wider technical interests of all common group members and of the overall business purposes of the group as a whole worldwide. In the circumstances of such a typical CCA, the amount paid will not have any requisite connection with the petroleum project as it is not liable to be paid directly in carrying on or providing any of the operations, facilities or other things referred to in sections 37, 38 or 39. Consequently in a typical CCA such an amount paid would not give rise to eligible real expenditure.

50. Note – Example 8 of this draft Ruling relates to deductibility of expenditure incurred in procuring a third party to carry on or provide certain things in relation to the petroleum project. Section 41 applies if a payment is made to procure the carrying on or providing of operations, facilities or other things of a kind referred to in sections 37, 38 or 39 so as to treat the company as having done those things itself and as having incurred the liability to procure the third party as a liability incurred in doing those things itself. For a detailed discussion of how section 41 operates, refer to TR 2010/D6.

Example 9 – Legal costs relating to a private override royalty agreement

51. A company incurred legal costs on a private override royalty agreement in relation to a petroleum project. Are the legal costs incurred in carrying on or providing the operations, facilities or other things for the petroleum project, the cost of which is eligible real expenditure?

52. Such legal costs are not incurred in carrying on or providing any of the operations, facilities or other things of a kind referred to in sections 37, 38 or 39. In the context of a petroleum project, a private override royalty agreement is an agreement by which a person agrees to make a payment in the nature of a royalty to another person (the other person not being a government or government body), usually calculated by reference to a percentage or share of the gross or net value or of the quantity of petroleum produced (or of some product form or component of it), and often in exchange for valuable information provided or a right foregone by the other party. A private override royalty agreement necessarily relates, in a general way, to the product on which it is payable. If that product is from a petroleum project, the royalty has some association with the project. But this does not identify of itself any operations, facilities or other things which the royalty is liable to be paid in carrying on or providing. On the contrary, the royalty is ordinarily payable only after the operations, facilities or other things have been carried on and product recovered.

53. These legal costs have been incurred in relation to an agreement for private override royalty payments, and the royalty payments are not incurred in carrying on or providing any operations, facilities or other things in relation to the petroleum project of a kind referred to in sections 37, 38 or 39. The legal costs are not incurred in carrying on or providing such operations, facilities or other things either. Paying the royalty would also be excluded expenditure under paragraph 44(e), but the legal costs are not incurred in carrying on or providing the relevant operations, facilities or other things of the project for more general reasons.

Example 10 – Outside opinion on seismic data

54. An Australian joint venture participant of a petroleum project provides its overseas parent company with seismic data collected by the joint venture operator in relation to the exploration permit area. The overseas parent company reviews the data and invoices its subsidiary for the costs of undertaking the review. Is the liability to make a payment to the overseas parent a liability incurred by the joint venture participant in carrying on or providing the operations, facilities and other things comprising the petroleum project?

55. If the review analysed the data so as to work out the features of what there is in the exploration permit area (even if this knowledge will also facilitate a determination by the joint venturer as to what further exploration or well development it will support), the expenditure may qualify as exploration expenditure and so as eligible real expenditure. However, if the review was not part of carrying on operations, facilities or other things of the petroleum project, the cost of which is eligible real expenditure (for example, if the review is not by way of exploration but is used to revise the credit rating or funding position of the Australian subsidiary venturer), then the review costs will not constitute eligible real expenditure.

56. Note – Examples 10 and 11 of this draft Ruling in part describe expenditure incurred in procuring a third party to carry on or provide certain things. Section 41 applies if a payment is made to procure the carrying on or providing of operations, facilities or other things of a kind referred to in sections 37, 38 or 39 so as to treat the company to have done those things itself and to have incurred the liability in doing those things itself. For a ruling on how section 41 operates, refer to TR 2010/D6.

Example 11 – Joint venture participant parent's review of costs/information

57. An Australian subsidiary company of a multinational petroleum group is a participant in a petroleum project joint venture. The Australian subsidiary copies all the information received from the joint venture operator (for example, details of planned activities, exploration data, reports of studies, invoices from the joint venture operator) to its overseas parent company which reviews the information provided. The parent company invoices the Australian subsidiary for reviewing the information. Is the amount invoiced to the Australian subsidiary by its overseas parent company for analysing the information incurred in carrying on or providing the operations, facilities or other things comprising the petroleum project?

58. The question is whether and to what extent the review of the information by the overseas parent company was itself in carrying on or providing the operations, facilities or other things that comprise the petroleum project or otherwise give rise to eligible real expenditure, or was not in carrying on or providing those things.

59. Consider review by the overseas parent, analysing project data using proprietary techniques of the parent. If interpretation of data by the joint venturer or joint venture operator is part of exploration activities, the interpretation of data by the overseas parent for the subsidiary joint venturer might be part of exploration activities of the petroleum project too. Conversely, consider review by the overseas parent of project data to compare it to other projects of the worldwide group so as to decide which projects to prefer for additional investment. Such comparisons, even if paid for by the subsidiary joint venturer, are not carrying on or providing any of the facilities, operations or other things the cost of which is eligible real expenditure.

60. The cost of review of project information is not eligible real expenditure of the petroleum project beyond the extent to which the review is carrying on or providing relevant project operations, facilities or other things.

Example 12 – Voluntary payment

61. A worker was injured in the course of carrying on the operations of a petroleum project of a company. The company decided to make an ex gratia payment to the worker to support the family of the worker while the worker was recovering from the injury.

62. The worker was injured while carrying on eligible activities of the petroleum project of the company. Therefore, the accident took place in the course of carrying on or providing those activities. The ex gratia payment was liable to be made in carrying on the petroleum project when it was actually paid and will constitute eligible real expenditure then.

Example 13 – Promotional DVD

63. A company incurs expenditure on producing a promotional DVD that illustrates that it is a pioneer company in the exploration of petroleum and that it uses state of the art technology and equipment in relation to a petroleum project. Is the cost of producing the DVD incurred in carrying on or providing the operations, facilities or other things comprising the petroleum project?

64. A DVD of this nature is generally aimed at corporate advertising and community public relations. Its cost is not expenditure incurred in carrying on or providing any operations, facilities or other things for the petroleum project of a kind the cost of which is eligible real expenditure. Consequently, the expenditure will not constitute eligible real expenditure of the petroleum project.

Example 14 – Bank Guarantee for rehabilitation of a site

65. A company incurred expenditure on obtaining a bank guarantee (required by the government) to assure the company's capacity for rehabilitation of the sites where it carries out operations related to its petroleum project. Is the expenditure incurred for the purpose of obtaining the bank guarantee eligible real expenditure?

66. The expenditure is likely to arise as a precondition of getting permission to operate in any way on the petroleum project sites. The expenditure has not been incurred in carrying on or providing any of the operations, facilities or other things the cost of which gives rise to eligible real expenditure under sections 37, 38 or 39. So it is not eligible real expenditure. Expenditure incurred in obtaining a bank guarantee cannot give rise to eligible real expenditure of the petroleum project, no matter how the expenditure on the guarantee is referred to in the bank guarantee agreement or whatever the conditions on which the expenditure arises. The expenditure may also be excluded expenditure under section 44 if the arrangement is such that the expenditure is a borrowing cost.

Example 15 – Deductibility of fines and legal costs

67. An industrial accident occurred in the course of processing petroleum project petroleum into a marketable petroleum commodity (MPC). A statutory authority fined the company for being negligent in maintaining the equipment that caused the accident. The company incurred legal expenses in relation to the fine. Are the fine and legal expenses eligible real expenditure of the petroleum project?

68. The fine imposed for breaching the relevant legislation and the legal expenses relating to the fine are incurred at most because of the way operations, facilities or other things of the project were carried on or provided. Those operations were in processing recovered petroleum into an MPC of the project. But the fine and the legal expenses are not liable to be paid in carrying on or providing the processing of recovered petroleum; rather, they are incurred subsequent to and only in relation to what was carried on or provided.

69. In any event, the fine and the legal expenses are administrative expenditure and incurred indirectly in administering the petroleum project. Consequently, they are not incurred in carrying on or providing the operations, facilities or other things of a kind referred to in sections 37, 38 or 39, are excluded expenditure otherwise, and are not eligible real expenditure.

Example 16 – Graduated return to work costs and increased workers' compensation insurance premium

70. An industrial accident occurred in the course of processing petroleum project petroleum into an MPC. The employees injured in the accident were provided with a graduated return to work and the workers' compensation premiums increased as a result of the accident. Are the employee costs associated with the graduated return to work and the increased workers' compensation premium costs eligible real expenditure of the petroleum project?

71. The expenditure incurred in providing graduated return to work to employees injured in an accident, and the increased workers' compensation insurance premiums following an accident, are themselves incurred directly in carrying on or providing both what the injured worker was carrying on or providing before the accident and afterwards, and in carrying on or providing what the workers to whom the increased premium relates, respectively.

72. The graduated return to work additional expenditure is incurred directly in carrying on or providing the processing operations in which the accident occurred and in carrying on or providing what the worker does during the graduated return; if either is in carrying on or providing the relevant project operations, facilities or other things so is the additional expenditure. The increased workers' compensation insurance premiums are incurred directly in carrying on or providing the operations, facilities or other things on which the employee work and on which the insurance premium is applied. It is not to any extent in carrying on or providing the operations, facilities or other things in which the injury occurred, because the increased premium is only in relation to the risk it covers.

Apportionment

Example 17 – Allocation of expenditure between exploration expenditure and general project expenditure

73. A company holds an interest in an exploration permit and an interest in a production licence derived from the exploration permit after 1 July 2008. The company is carrying on further exploration in the exploration permit area outside the production licence area. It is also recovering and processing petroleum from the production licence area. The company occasionally moves some of its equipment and staff from the exploration permit area to the production licence area (and vice-versa) to meet its operational needs. The relevant staff and equipment are only engaged in carrying on exploration in the exploration permit area or in the operations of recovery and processing of petroleum from the production licence area at any particular time. What is the relevant basis for the company to apportion the expenditure it incurs between the exploration permit and the production licence?

74. The production licence derived from the exploration permit is a post-30 June 2008 petroleum project. Consequently, the expenditure incurred in the exploration permit area but outside the production licence area is not eligible real expenditure of the petroleum project in relation to the production licence, because the exploration permit area is not part of the eligible exploration or recovery area in relation to the project after the production licence derived from the permit comes into force. To establish the correct amounts of eligible real expenditure that are attached to any petroleum project in relation to the exploration permit area beyond the production licence area and to the petroleum project in relation to the production licence, the company must identify which parts of the payments it is liable to make are in carrying on or providing the relevant operations, facilities or other things of the one and which are in carrying on or providing the relevant operations, facilities or other things of the other.[5]

75. If payments relate to the time spent by a staff member or a piece of equipment, and the company can account for the time spent by the particular staff member or by the piece of equipment on exploration in the exploration permit area or on recovery and on processing of petroleum from the production licence area separately, the company may identify accordingly which parts of its time-based payments for the staff member and for the piece of equipment are for the production licence petroleum project and which parts are for any exploration permit area petroleum project. This basis of apportionment can be achieved by maintaining appropriate 'time writing' records and explanations for each affected employee and an appropriate log book for time spent by each item of equipment moved between the production licence and the exploration permit.

Example 18 – Allocation of expenditure between two petroleum projects

76. A company maintains two petroleum projects and both are producing petroleum under production licences. The two production licence areas offshore are located a few hundred kilometres apart with one onshore site office at which the operations, facilities and other things are carried on or provided to service the two projects. Whenever there is an operational need, staff are moved from one project to the other. Similarly, equipment is sometimes moved between the projects. The motor vehicle fleet at the site office is also used for both projects. Can the company apportion the expenditure incurred at the site office by using the amount of assessable petroleum receipts derived from each project in a year of tax as the basis of apportionment?

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[5] MT 2004/1 explains that, for the purposes of the provisions about transfer of interests in project receipts, such transfers are effective before any production licence has issued and so before there is taken to be a petroleum project. Exploration expenditure required to be transferred to another project may also arise before any production licence has issued in relation to the project from which it must be transferred.

77. No. The part of expenditure liable to be paid in carrying on or providing particular operations, facilities or other things can be identified only by identifying the part of what the expenditure is liable to be paid that is in carrying on or providing those operations, facilities or other things. Expenditure that is not based on the level of assessable petroleum receipts of different petroleum projects cannot be separated into parts for each project by the level of those receipts in the different projects. Identifying part of the expenditure as for one project or for another requires adopting a basis for the allocation of that type of expenditure that is reasonable, that is, that reasonably reflects the extent to which the expenditure was in carrying on or providing specified operations, facilities or other things for one project rather than the other project.

78. Petroleum project assessable receipts are not directly proportional to the expenditure on the project and the ratio for one petroleum project of assessable receipts and of deductible expenditure is not inherently or generally the same as the ratio for another project.

79. As a guide, the salary package of a staff member who works on more than one petroleum project (or spends part of their working time on activities that do not give rise to eligible real expenditure and part on carrying on or providing project things) during a year of tax may ordinarily be apportioned by 'time writing', because ordinarily the salary package is proportionately for the time the staff member spends working on different activities. The 'time writing' should identify how much of their working time was spent directly on one thing or another such as in carrying on or providing operations, facilities or other things for each project, because staff are remunerated for their time working for the employer. 'Time writing' (or log book method) can also be suitable for determining the share of expenditure for the use of a piece of equipment which is used part of the time for some purposes and part of the time for other purposes and for which costs are proportionate to time used.

80. The expenditure actually incurred on motor vehicles can be allocated by using a log book for each vehicle showing distance travelled (allocating the actual expenditure in relation to a vehicle on the basis of the activity in which mileage was travelled for each petroleum project and was travelled otherwise). This is because ordinarily motor vehicle expenditures are proportionately for the distance travelled for different purposes.

81. However, if administrative or accounting costs or wages, salary or other work costs are incurred indirectly, even if in carrying on or providing operations, facilities or other things of a kind referred to in sections 37, 38 or 39, then paragraph 44(j) excludes them from eligible real expenditure. Similarly, if the costs constitute payments in respect of land or buildings used in connection with administrative or accounting activities, not being land or buildings located at or adjacent to the site or the sites at which the operations, facilities or other things of a kind referred to in sections 37, 38 or 39 are themselves carried on or provided, paragraph 44(k) excludes the payments from deductibility.

82. For a discussion on the application of paragraphs 44(j) and 44(k), refer to TR 2010/D5. The topic of apportionment of expenditure has also been discussed in TR 2010/D5.

Excluded expenditure

Example 19 – Payments of fringe benefits tax

83. A company incurs fringe benefits tax payments in relation to employees engaged in carrying on the operations, facilities and other things comprising the petroleum project. Can the payment of fringe benefits tax give rise to eligible real expenditure?

84. Fringe benefits tax payments incurred after the year of tax ended 30 June 2006 may give rise to eligible real expenditure of the petroleum project if the fringe benefits have been provided as part of a salary package. So far as the relevant salary package gives rise to eligible real expenditure, that share of related fringe benefits tax is eligible real expenditure. Before 1 July 2006, fringe benefits tax payments were excluded expenditure under paragraph 44(h).

Record keeping

Example 20 – Eligible real expenditure: establishing exploration expenditure

85. A company incurs expenditure in the course of conducting exploration activities in an exploration permit area and seeks to claim those expenses against the assessable receipts of a petroleum project constituted by a production licence later derived from the exploration permit. What are the elements that need to be supported by the records that record and explain the transactions for the purpose of ascertaining the PRRT liability?

86. To establish the amount that will constitute exploration expenditure, the onus rests with the company to show that and what part of the expenditure was incurred in carrying on or providing the operations, facilities and other things for the petroleum project the cost of which is eligible real expenditure of the project.

87. Section 112 requires a person to keep records that record and explain all transactions and other acts that are relevant to ascertaining their liability under the PRRTAA. This includes records to support any claim for exploration expenditure. However a taxpayer who commits no offence under the section still has the onus of establishing the eligible real expenditure from which they derive their deductible expenditure and the expenditure transferred to their relevant petroleum project.

Date of effect

88. 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).

Commissioner of Taxation
30 June 2010

Appendix 1 – Explanation

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.

89. Division 3 of Part V of the PRRTAA deals with deductible expenditure of the person in relation to the 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 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).

90. It is a specific requirement of each of sections 37, 38 and 39 that as well as meeting the particular requirements of the relevant section the expenditure must not be 'excluded expenditure'. Section 44 defines 'excluded expenditure'.

91. As a result, there are three general pre-conditions common to eligible real expenditure under sections 37, 38 and 39, the only expenditure from which deductible expenditure or transferred expenditure can be derived.[6] The expenditure must:

(a) be incurred by the person in relation to a 'petroleum project', as defined

(b) be incurred in carrying on or providing operations, facilities or other things of a kind referred to in sections 37, 38 or 39; and

(c) not be 'excluded expenditure' under section 44.

92. This draft Ruling considers each of these prerequisites or pre-conditions to deductibility in more detail. However, it does not discuss the further requirements if any particular expenditure is to be general project expenditure, exploration expenditure or closing-down expenditure. Nor does it discuss other requirements, such as the conditions applicable to exploration expenditure for it to be transferable exploration expenditure for the purposes of transfer to another petroleum project.

[6] Note that bad debts, where they give rise to deductible expenditure, do so by giving rise to exploration expenditure, to general project expenditure, or to closing-down expenditure under section 40.

93. A combined project can broadly be considered as a single project consisting of two or more production licence areas (and associated operations, facilities etc.) in respect of which a project combination certificate has been issued under section 20. Combined projects are not separately referred to in this draft Ruling as the pre-conditions to the deductibility of expenditure under sections 37, 38 and 39 as discussed in this draft Ruling are equally relevant to all petroleum projects including combined projects.

94. A taxpayer's taxable profit in relation to a petroleum project and a year of tax for the purposes of the PRRT is the excess of assessable receipts over the sum of the taxpayer's deductible expenditure in relation to that project, and of amounts transferred to that project from another petroleum project of the taxpayer or from another petroleum project of the taxpayer's company group (subsection 22(1)). Exploration expenditure must be transferred to the extent it can be, under sections 45A and 45B and in accordance with the Schedule to the PRRTAA. But all such transferable exploration expenditure derives from exploration expenditure of the transferring project under section 37 and so from expenditure to which each of the prerequisites or pre-conditions to deductibility applies. Accordingly transferable exploration expenditure is not specifically referred to in this draft Ruling as the pre-conditions are equally relevant to such expenditure as to all expenditure derived from eligible real expenditure.

The first pre-condition to deductibility – the expenditure must be incurred by the person in relation to a 'petroleum project', as defined

95. The liability to pay PRRT arises 'in respect of the taxable profit of a person of a year of tax in relation to a petroleum project', worked out under the PRRTAA, according to section 21. That taxable profit, according to subsection 22(1), arises 'Where, in relation to a petroleum project and a year of tax', assessable receipts exceed the sum of deductible expenditure and amounts transferred. So assessable receipts derived by a person and deductible expenditure incurred by the person (and amounts transferred) are those in a year of tax and in relation to the petroleum project.

96. Section 32 identifies deductible expenditure as the sum of a taxpayer's expenditure of each of seven classes. The seven classes of expenditure differ according to the way in which they have been augmented and in the order in which they are deducted against the assessable receipts (which matters if not all expenditure is deducted in a particular year, as further augmentation will apply to what has not been deducted). But each of the seven classes is defined as derived from one of three underlying categories, namely, exploration expenditure, general project expenditure and closing-down expenditure, which are defined in sections 37, 38 and 39 respectively. These expenditures are collectively defined as ***eligible real expenditure*** in section 2. Each of the three sections defines the expenditure incurred as payments liable to be made by the person in carrying on or providing particular operations, facilities, activities or other things specified by the section.

97. Transferred amounts are defined by reference to exploration expenditure, because they can arise under sections 45A and 45B (including by direction of the Commissioner under section 45C) only from the ***incurred exploration expenditure amount*** itself in relation to some 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. Therefore, all transferred amounts are derived only from the underlying exploration expenditure, and must be in relation to a petroleum project.

98. So any kind of deductible expenditure and of transferred expenditure must be 'in relation to a petroleum project'. Does this mean that all expenditure in relation to a petroleum project is deductible expenditure, with the classes of expenditure and the underlying categories from which they derive merely a way of classifying what is in any case deductible expenditure? Or is there deductible expenditure in relation to a petroleum project only so far as there is expenditure strictly of one category or another?

Deductible expenditure in relation to a petroleum project is only of specific kinds

99. The first pre-condition to deductibility requires that, to be deductible, expenditure must be incurred by a person in relation to a relevant petroleum project. It is deductible expenditure incurred in relation to that project only if the eligible real expenditure from which it derives is liable to be paid by the person in one or another of the specific ways identified by sections 37, 38 and 39. Each of those is involved in the project in its own identified way, in carrying on or providing particular operations, facilities or other things or for other particular purposes themselves each relating to the petroleum project in the way each requires. The PRRTAA itself describes these ways in which expenditure can arise as 'the carrying on or providing of operations, facilities or other things of a kind referred to in section 37, 38 or 39' (quoting subsection 41(1)) or in cognate terms. All other expenditure that is not liable to be paid in one of the specified ways but that might be said to relate to a petroleum project only in other ways is not able to give rise to deductible expenditure.

The concept of a 'petroleum project'

100. A taxpayer's business (whether in an income tax or in a commercial sense) and a petroleum project are not the same thing. A taxpayer's business is an enterprise (or combination of several enterprises) in its own right. PRRT applies only to a particular petroleum project and then only on the basis of the assessable receipts and deductible expenditure under the PRRTAA, not to the enterprise (or enterprises) of the taxpayer collectively or as a whole and not to all receipts and all expenditures of the taxpayer (or to all of the taxpayer's assessable income and deductions for income tax purposes, or to all assets and liabilities or to all entries in the profit and loss of the taxpayer for accounting purposes), either generally or in relation to its petroleum business or only the petroleum business to which the production licence in relation to which a petroleum project relates.

101. For example, raising equity capital and paying a dividend to the shareholders is generally part of the enterprise of an ordinary company. While the money for paying a dividend may be generated by the activities that comprise a petroleum project, the payment of a dividend to the shareholders is not ordinarily an activity that is carried out as part of or in carrying on or providing the activities that constitute a petroleum project. Therefore, expenditure incurred in paying a dividend to the shareholders will not be incurred in relation to a petroleum project. The same is true of borrowing to finance a taxpayer's business and expenditure to do so and expenditure required by the borrowing entered into. Expenditure incurred in relation to finance is not ordinarily an activity carried out as part of or in carrying on or providing the activities that constitute a petroleum project. Therefore, the expenditure will not be incurred in relation to a petroleum project.

102. As PRRT is assessed to a taxpayer on a project basis, the concept of a petroleum project is an essential aspect of the tax. The basic criterion for determining the existence of a petroleum project is whether an eligible production licence is in force. There is taken to be a petroleum project in relation to any eligible production licence that is in force (under subsection 19(1)), although, assessable receipts and deductible expenditure in relation to a petroleum project may generally arise both before and after a relevant eligible production licence is in force (under sections 31 and 45).

103. Section 19 defines a petroleum project with reference to an eligible production licence (for combined projects, there may be more than one eligible production licence). In establishing those items of expenditure which are deductible for PRRT purposes, sections 37, 38 and 39 include references to expenditure incurred in carrying on or providing operations, facilities and other things comprising the petroleum project. What constitute the operations, facilities and other things comprising the petroleum project are set out in subsection 19(4).

104. By paragraph 19(4)(a), the operations and facilities for the recovery of petroleum (which includes gas and other natural hydrocarbon streams, by definition) from the production licence area or production licence areas in relation to the project will always form part of the petroleum project. In this regard, 'facilities' is defined in section 2 to mean land, buildings, plant, equipment and other facilities. 'Operations' is not defined in the PRRTAA and its ordinary meaning in the context of a business is activities of a business directed to business ends. In the context of a petroleum project, activities that are directed at recovery of petroleum from the production licence area or areas of the project are such operations for the purposes of the PRRTAA.

105. The other things that may form part of the petroleum project so far as they are carried on or provided are specified in paragraph 19(4)(b). These are:

(a) by subparagraph 19(4)(b)(i), the operations and facilities involved in moving petroleum so recovered to and between any storage or processing facilities prior to the production of any MPC from the petroleum;

(b) by subparagraph 19(4)(b)(ii), the operations and facilities involved in the storage, processing or treatment of petroleum so recovered to produce any MPC from the petroleum;

(c) by subparagraph 19(4)(b)(iii), the operations and facilities involved in the moving or storage of any such MPC before it becomes an excluded commodity (as defined in section 2);

(d) by subparagraph 19(4)(b)(iv), the services, or facilities for the provision of services, in connection with the operations, facilities, amenities and services referred to in section 19. In this regard, 'services' is defined in section 2 to mean water, light, power, access, communications or other services;

(e) by subparagraph 19(4)(b)(v), the employee amenities in connection with the operations, facilities and services referred to in section 19. 'Employee amenities' is defined in section 2 to mean not-for-profit housing, health, educational, recreational, welfare or other similar facilities and services for, or facilities and services involved in the supply of meals to, employees and dependents of employees,

and, so far as this occurs, carrying on or providing those things for internal petroleum, or external petroleum, in relation to the project (as provided for the avoidance of doubt by subsection 38(2)).

106. In summary, a petroleum project under the PRRTAA consists of the activities in recovering petroleum (including gas) from a particular relevant offshore area, and all further activities so far as they are up to the point that the petroleum is sold or an MPC is sold or further processed into something else or (say, because an MPC is moved away from its place of production other than to adjacent storage, or is moved away from such adjacent storage) the MPC becomes an excluded commodity. If more than one MPC is produced by a petroleum project, it is possible that one of the MPCs (for example, condensate) is produced and becomes an excluded commodity at a stage while the remaining petroleum (for example, sales gas) is still being processed to produce one or more other MPCs. It follows that the petroleum project boundary will include the production of all MPCs and all further activities so far as they are in relation to the MPCs until the MPCs become excluded commodities, and no further. Once an MPC has become an excluded commodity, any further activities in relation to it such as in producing another product from the MPC will not be within the boundary of the petroleum project for PRRT purposes.

107. A petroleum project itself does not include other activities that are 'in relation to' the activities that are the project even if they are necessary to the overall business in the course of which, or for the purposes of which, the petroleum project is carried on. So sections 37, 38 and 39 also identify other specific things on which expenditure can arise that is eligible real expenditure from which deductible expenditure of the taxpayer in relation to the project, or expenditure transferred to the project from another project, must arise.

108. PRRT is not imposed on a taxpayer's whole business, but only on a narrowly defined subset of activities, both in relation to assessable receipts and in relation to deductible expenditure and transferred expenditure. There is always an argument that what is done in one area of a business depends in a sense on, or requires in a sense other things to be done in, other parts of the business. For instance, a taxpayer may contend for Sarbanes-Oxley compliance expenditure (because of burdens effectively imposed on a USA parent company) and for income tax compliance expenditure as necessary so that the taxpayer's petroleum project will continue: the burdens imposed on the USA parent for non-compliance with Sarbanes-Oxley, or on the taxpayer for non-compliance with income tax requirements, could make it practically impossible for the taxpayer to continue in operation and so for the taxpayer to continue the petroleum project activities. But none of the petroleum project activities specified in subsection 19(4) or other things specified in sections 37, 38 or 39 include, or are precluded by, either Sarbanes-Oxley requirements or income tax compliance requirements. And neither Sarbanes-Oxley reporting nor income tax compliance activities arise in carrying on or providing any of the petroleum project operations, activities or other things or in carrying on or providing any of the other things specified in sections 37, 38 or 39.

109. As expenses are consistently brought into eligible real expenditure only by specific provisions contained in sections 37, 38 and 39, and as the petroleum project itself includes no other things, it follows that expenditure incurred in ensuring compliance with the income tax legislation, Sarbanes-Oxley compliance, membership of industry associations and other broadly corporate expenditures would not be incurred in carrying on a petroleum project, irrespective of whether the taxpayer has a diverse business or has an interest in just one petroleum project and all their business activity relates to that petroleum project.

110. When a company holds an interest in only one petroleum project and the entity's only enterprise involves recovery of petroleum from the project and processing of the petroleum to produce one or more MPCs for sale, it has been contended by some taxpayers that all the expenditure incurred by the company is in relation to the petroleum project and is therefore eligible real expenditure for PRRT purposes.

111. This contention is not correct. It is based on the assumption that a company's business and a petroleum project in relation to which it has an entitlement to assessable receipts are the same thing. As discussed in paragraph 100 of this draft Ruling, this is not the case. Moreover, it will also be discriminatory because if the contention is accepted, it will allow an entity with an interest in only one petroleum project to claim deductible expenditure for some of the activities for which no deduction is available to an entity that holds an interest in more than one petroleum project or in other businesses or activities other than petroleum project activities. It will also result in the taxpayer being able to claim deductible expenditure for wider expenditure incurred on certain activities without having to include any wider income from those activities as assessable receipts.

112. Where expenditures relate to another part of a business, in the case of a conglomerate of many business activities, it is simple and easy to illustrate the application of the concept of a petroleum project to distinguish expenditure so far as it is on those other businesses as not giving rise to deductible expenditure, and receipts or deemed receipts from those other businesses as not giving rise to assessable receipts. It is similarly simple to illustrate that if a taxpayer's activities include deriving other products from MPCs and selling those products, expenditure on those further activities which are not included in the petroleum project and the receipts or deemed receipts from them do not give rise to deductible expenditure and to assessable receipts. But it is equally necessary and sound where a business is confined to one petroleum project and its associated business operations, expenditures and activities only. The use of simple illustrations involving many petroleum projects, or many businesses, in extrinsic and other explanatory material for the PRRT does not connote anywhere that expenditure gives rise to deductible expenditure of a petroleum project unless it relates to another business or to another petroleum project.

113. It would be wrong to accept that, in the context of the PRRT, expenditure on anything other than activities covered by sections 37, 38 or 39 (or section 24 or section 25, where relevant costs of a sale reduce assessable receipts) is expenditure 'in relation to' the petroleum project in the sense required by the PRRTAA. Under each of sections 37, 38 and 39, the expenditure identified and the deductible expenditure derived from it must be liable to be made in carrying on or providing certain things (or in purchasing certain things, or in procuring someone else to do certain things) in relation to the petroleum project as defined by section 19, or as specifically included by sections 37, 38 or 39.

114. The phrase 'in carrying on or providing' in sections 37, 38 and 39 requires a close or direct connection between the relevant expenditure and the operations, facilities or other things which comprise the petroleum project as defined by section 19. This requirement is discussed in more detail in the explanation of the second pre-condition to deductibility at paragraphs 164 to 180 of this draft Ruling.

The meaning of 'incurred'

115. A petroleum project is, under section 19, taken to commence when an eligible production licence comes into force and is taken to cease when the production licence ceases to be in force. However, section 45 makes it clear that eligible real expenditure may be incurred by a person in relation to a petroleum project, except in relation to the Bass Strait project, at any time before the project commenced or after the project ceased. In relation to the Bass Strait project, the expenditure may be incurred by a person at any time on or after 1 July 1990, including a time after the project has ceased.

116. The PRRT is generally referred to as on an accrual/derivation basis. PRRT assessable receipts are derived when amounts or consideration are receivable; the eligible real expenditure from which PRRT deductible expenditure derives is incurred when payments are liable to be made (sections 37, 38 and 39). Timing is significant in PRRT because of augmentation, both to maintain real value and to provide minimum rates of return before liability to PRRT. Real value and the required rate of return will be provided only by augmentation according to the time between when payment is liable to be made and when receipts are receivable, making it necessary to ascertain those times correctly.

117. The question as to when expenditure is liable to be made by a taxpayer for the purposes of procuring goods and/or services in the carrying on or providing operations, facilities and other things comprising the petroleum project is to be determined according to similar principles as applicable in relation to the question of incurrence arising under section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997). That is to say, 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.

The expression 'payments liable to be made by the person' reinforces the need for the liability to be a presently existing liability. For example, if a contract provides for payment to be made at a point in time after delivery of the contract services, for PRRT purposes the payment is incurred at that subsequent point in time, the time when payment is liable to be made. Correspondingly, if a contract provides for payment to be made before delivery of the contract services, for PRRT purposes the payment is incurred at that earlier time, the time when payment is liable to be made.

118. The issue of the timing of incurring expenditure for income tax purposes was recently considered by the Full Federal Court in *Commissioner of Taxation v. Malouf* [2009] FCAFC 44. The Full Federal Court held that to be deductible, the pecuniary liability must be actually incurred. The court did not allow the taxpayer to claim a deduction for the expenditure in the relevant year because the contract was not an unconditional agreement subject to defeasance only by unforeseen events. The taxpayer's obligation to pay under the contract was dependent upon further performance by the vendor, and upon the happening of events which were expected but were under the control of neither party.

119. Consequently, expenses accrued but not yet liable to be paid, for example, accruing employee leave entitlements and provisions for contingent costs such as provisions for platform dismantling do not constitute a deductible loss or outgoing for income tax purposes and are not payments liable to be made for PRRT purposes.

120. Joint venture cash call amounts paid by a joint venture participant to the joint venture operator that is effectively acting as an agent for the joint venturers may constitute advances by them for expenditure that is anticipated. In such circumstances it is only when the joint venture operator actually incurs a liability for eligible real expenditure, that the joint venture participants can claim a deduction for their share of the relevant eligible real expenditure. The advance is not itself an amount liable to be paid in carrying on or providing the things the anticipated expenditure will be incurred in carrying on or providing. The topic of joint ventures is discussed in detail in TR 2010/D5 and TR 2010/D6.

121. A cost incurred by a taxpayer may require apportioning if only a part of the cost qualifies as eligible real expenditure. For example, suppose a taxpayer with an interest in a petroleum project negotiates with a local community to establish and run a regional airport which would be used for flights serving the petroleum project as well as for all other flights, the airport thus being for the benefit of the community. The proportion of the cost which may qualify for deduction is the part of the payment liable to be made in carrying on or providing the operations, facilities and other things of a kind referred to in sections 37, 38 and 39. The proportion of the cost which will not qualify as eligible real expenditure of the project is the amount that is not attributable to the petroleum project, including downstream, corporate and local community activities, and including activities directed towards other future petroleum projects or to other business activities.

122. While it is acknowledged that apportionment may be difficult in some circumstances, the Commissioner will approach an apportionment of the expenditure on a reasonable basis in light of proper consideration of the relevant circumstances. The apportionment of payments of administration or accounting costs or wages, salary and other work costs only partly incurred in carrying on or providing petroleum project operations, facilities and other things referred to in sections 37, 38 or 39 requires consideration of the extent to which such costs are incurred only indirectly and this is discussed in detail in TR 2010/D5.

123. If eligible real expenditure has actually been incurred in a year of tax in accordance with the discussion in the previous paragraphs, the PRRTAA will generally treat the deductible expenditure derived from it as not having been incurred in that year of tax to the extent that the deductible expenditure exceeds the assessable receipts in that year against which the expenditure can be offset.[7]

124. For example, under subsection 33(3), if an amount of expenditure incurred by a person in a year of tax in relation to a petroleum project exceeds the assessable receipts of the person derived in relation to the project in that year, the excess amount is augmented and deemed to have been incurred on the first day of the following year of tax. Subsection 33(3) relates to class 1 augmented bond rate general expenditure. Similar deeming provisions are contained in the PRRTAA for class 1 augmented bond rate exploration expenditure (subsection 34(3)), class 2 augmented bond rate general expenditure (subsection 34A(4)), and class 1 GDP factor expenditure (subsection 35(3)). Class 2 augmented bond rate exploration expenditure and class 2 GDP factor expenditure are deemed not to have been incurred in a year of tax if there are insufficient assessable receipts in relation to the project and the relevant expenditure cannot be transferred to another project/person. These two classes of expenditure are deemed to have been incurred in the year of tax in which and to the extent that there are sufficient assessable receipts in relation to the project that can be offset by the augmented amounts of the expenditure or there are sufficient assessable receipts in relation to another petroleum project to which the augmented amount of the expenditure will be transferred (Parts 2 to 7 of the Schedule to the PRRTAA).

[7] The treatment of closing-down expenditure of a taxpayer that cannot be offset against assessable receipts of the taxpayer in a year of tax is different to the other classes of expenditure. A taxpayer with excess of closing-down expenditure generally receives a credit in the year of tax in which the expenditure is actually incurred (section 46). A discussion about each class of expenditure, including the order of their deductibility is included under the second pre-condition to deductibility.

The second pre-condition to deductibility – the expenditure must be incurred in carrying on or providing operations, facilities or other things of a kind referred to in sections 37, 38 or 39

125. Section 32 lists the following classes of expenditure which may, if incurred by a person in relation to a petroleum project in a year of tax, qualify as deductible expenditure for the purpose of ascertaining the person's taxable profit in that year in relation to the petroleum project:

(a) class 1 augmented bond rate general expenditure;

(b) class 1 augmented bond rate exploration expenditure;

(c) class 2 augmented bond rate general expenditure;

(d) class 1 GDP factor expenditure;

(e) class 2 augmented bond rate exploration expenditure;

(f) class 2 GDP factor expenditure;

(g) closing-down expenditure.

126. Class 1 augmented bond rate general expenditure is general project expenditure incurred prior to 1 July 1990 and no more than 5 years before the production licence in relation to the petroleum project came into force.

127. Class 1 augmented bond rate exploration expenditure is exploration expenditure incurred prior to 1 July 1990 and no more than 5 years before the production licence in relation to the petroleum project came into force.

128. Class 2 augmented bond rate general expenditure is general project expenditure, incurred on or after 1 July 1990 and no more than 5 years before the date specified in the notice issued under subsection 258(7) of the *Offshore Petroleum and Greenhouse Gas Storage Act 2006* in relation to the petroleum project.

129. Class 1 GDP factor expenditure is general project expenditure incurred in any financial year or exploration expenditure incurred before 1 July 1990 and in either case, incurred more than 5 years before the production licence in relation to the petroleum project came into force.

130. Class 2 augmented bond rate exploration expenditure is exploration expenditure actually incurred in a financial year starting on or after 1 July 1990 and no more than 5 years before the commencement of the year of tax in which the date specified in the notice issued under subsection 258(7) of the *Offshore Petroleum and Greenhouse Gas Storage Act 2006* in relation to the petroleum project occurs.

131. Class 2 GDP factor expenditure is exploration expenditure that is incurred in a year of tax starting on or after 1 July 1990 but that does not qualify as Class 2 augmented bond rate exploration expenditure.

132. Closing-down expenditure consists of certain expenditures made in carrying on operations involved in closing-down a petroleum project.

133. Whether an item of expenditure is class 1 expenditure or class 2 expenditure and whether it is augmented bond rate expenditure or GDP factor expenditure is relevant in determining the augmentation rate and the order in which different types of expenditure are deducted when there are insufficient assessable receipts to absorb all the expenditure. The order in which the different classes of expenditure appear in section 32 is the order in which each class of expenditure (or the augmented amount of the expenditure, if applicable) is deducted from the assessable receipts derived in relation to the petroleum project.

134. The seven classes of expenditure in section 32 can be grouped into three categories, namely, exploration expenditure, general project expenditure and closing-down expenditure which have been defined in sections 37, 38 and 39 respectively. The words 'expenditure incurred by the person in relation to a petroleum project' have been defined in relation to each of the three categories of expenditure in sections 37, 38 and 39. Each of the three sections requires that the expenditure must be liable to be made by the person in carrying out the things covered by that section.

135. For some purposes of the PRRTAA, these different things are referred to as 'the carrying on or providing of operations, facilities or other things of a kind referred to in section 37, 38 or 39' (quoting subsection 41(1)). So far as the sections include payments liable to be made, for instance, in purchasing internal petroleum or external petroleum in relation to the project, or in procuring certain stabilisation, transportation, storage, recovery or processing of internal petroleum of the project or of project petroleum as external petroleum of another project are included (see paragraphs 37(1)(c), 38(1)(c) and 38(1)(d)). The short form reference to 'operations, facilities or other things of a kind referred to in section 37, 38 or 39' means all the different purposes for which payments might be made or taken to be made under those provisions, and there is no occasion to test particular purposes as perhaps not within the meaning of the short form words without regard to their context in the PRRTAA.

136. Whether an item of expenditure that has been incurred in a year of tax meets the various conditions for the deductibility of expenditure including the three pre-conditions and whether it gives rise to exploration expenditure, general project expenditure or closing-down expenditure can be determined at the time of incurring the expenditure. However, the amount of deductible expenditure derived from eligible real expenditure will generally be known at the time it can be absorbed against assessable receipts because the rate of augmentation of the expenditure depends on the classification of expenditure under section 32 and the period of augmentation.

137. Transferred amounts are defined by reference to exploration expenditure, because they can arise under sections 45A and 45B (including by direction of the Commissioner under section 45C) only from the ***incurred exploration expenditure amount*** itself in relation to some 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. All transferred amounts are derived only from the underlying exploration expenditure, and must be in relation to a petroleum project.

138. So any kind of deductible expenditure and of transferred expenditure must be derived from eligible real expenditure in relation to a petroleum project, that is, from exploration expenditure, general project expenditure, or closing-down expenditure under sections 37, 38 or 39 respectively.

139. The discussion in this draft Ruling is limited to the deductibility of expenditure because it derives from eligible real expenditure under sections 37, 38 and 39. Effective deductibility under other sections, for example, expenses payable in relation to a sale (not deductible expenditure but reducing assessable receipts under sections 24 and 25) and deduction for a bad debt so far as the debt was brought to account as an assessable receipt (deemed eligible real expenditure of an appropriate kind by section 40), are not otherwise covered by this draft Ruling.

The meaning of 'exploration expenditure'

140. All exploration expenditure of a petroleum project as defined in section 37 must be expenditure incurred by a person in carrying on or providing operations, facilities or other things associated with exploration for petroleum in the eligible exploration or recovery area of the project in one or other of the ways specified by the section. The meaning of 'in carrying on or providing' is discussed later in this explanation (refer to paragraphs 164 to 180 of this draft Ruling). So it will be necessary to show for what payments were liable to be made by the taxpayer.

141. By paragraph 37(1)(a), payments that are liable to be made in carrying on or providing operations and facilities involved in or in connection with exploration for petroleum in the eligible exploration or recovery area in relation to the petroleum project are included in exploration expenditure (refer to Examples 1 and 2 of this draft Ruling).

142. To qualify for deductibility, payments that are liable to be made in carrying on or providing operations and facilities that are not themselves exploration for petroleum but are involved 'in connection with' exploration for petroleum may still constitute exploration expenditure. However, the exploration which the operations or facilities must be involved in is itself required to be carried on in the eligible exploration or recovery area. For example, if a mobilisation cost is incurred in delivering a drilling rig from Singapore to operate a drilling program in a number of exploration areas, the operation of delivering the drilling rig to the exploration areas does not constitute exploration: and even if it did, it would not be exploration in any of the exploration areas. However, the mobilisation of the drilling rig is an operation in connection with exploration, so far as it relates to exploration in each of the exploration areas.[8] The proportion of the mobilisation cost that is attributable to an eligible exploration area is a matter of fact based on the relevant circumstances. Only that proportion of the mobilisation cost that is attributable to the eligible exploration or recovery area constitutes exploration expenditure pursuant to paragraph 37(1)(a) (refer to Example 3 of this draft Ruling).

143. To qualify for deductibility as exploration expenditure, the payments that are liable to be made in carrying on or providing operations and facilities involved in exploration for petroleum in the eligible exploration or recovery area need not themselves be made in that area and the operations and facilities involved in exploration in that area need not themselves be carried on or provided in that area. However, whether operations and facilities are carried on or provided in the eligible exploration or recovery area of the petroleum project or not, the extent to which they are involved in exploration in that area will need to be worked out as only to that extent will they be exploration expenditure pursuant to paragraph 37(1)(a). The information needed to work this out will vary widely according to the circumstances. For instance, the cost of moving the drilling rig discussed in paragraph 142 of this draft Ruling would be likely to be involved in exploration in each relevant exploration or recovery area to the extent of the time spent by the rig drilling exploration holes in each area as a proportion of all its drilling time in Australia, or to the extent of the time spent in each area as a proportion of all its time spent in areas where it drills. The terms of the arrangement under which moving and using the drilling rig are paid for will need to be taken into account in working out the most appropriate basis for apportionment.

[8] 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 to 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.

144. In relation to a pre-1 July 2008 petroleum project derived from a retention lease area, exploration within the exploration permit area but outside the retention lease area for the project does not attach to the eligible exploration or recovery area of the petroleum project. Consequently, expenditure incurred in carrying on or providing the operations or facilities for or in connection with that exploration may not be connected to exploration in a relevant area for that project and may remain undeductible for PRRT purposes in relation to that petroleum project. However, such exploration in relation to a post-1 July 2008 petroleum project is in the relevant eligible exploration or recovery area and so expenditure incurred in carrying on or providing that exploration or in carrying on or providing operations or facilities in connection with that exploration may constitute exploration expenditure in relation to the petroleum project under paragraph 37(1)(a).

145. Other things expenditure in which may form part of exploration expenditure are also specified in subsection 37(1). These are:

(a) by subparagraph 37(1)(b)(i), payments liable to be made in carrying on or providing operations and facilities involved in the recovery of petroleum from the eligible exploration or recovery area (other than any production licence area) in relation to the project;

(b) by subparagraph 37(1)(b)(ii), payments liable to be made in carrying on or providing operations and facilities involved in moving any petroleum so recovered to or between any storage or processing facilities before the production of any MPC from the petroleum;

(c) by subparagraph 37(1)(b)(iii), payments liable to be made in carrying on or providing operations and facilities involved in the storage, processing or treatment of any petroleum so recovered to produce any MPC from the petroleum;

(d) by subparagraph 37(1)(b)(iv), payments liable to be made in carrying on or providing operations and facilities involved in the moving or storage of any such MPC before it becomes an excluded commodity;

(e) by subparagraph 37(1)(b)(v), payments liable to be made in carrying on or providing services, or facilities for the provision of services, in connection with the operations, facilities, amenities and services referred to in section 37;

(f) by subparagraph 37(1)(b)(vi), payments liable to be made in carrying on or providing the employee amenities in connection with the operations, facilities and services referred to in section 37;

(g) by paragraph 37(1)(c), expenditure in procuring another person to stabilise, transport, store, recover or process petroleum recovered from the eligible exploration or recovery area (other than any production licence area) in relation to the project, if that stabilisation, transportation, storage, recovery or processing constitutes the processing of internal petroleum in relation to the project or external petroleum in relation to another petroleum project;

(h) by subsection 37(1), any exploration permit, retention lease or other fee related to carrying on or providing any of the other specified things (provided the fee is not an excluded fee). Excluded fees are cash bidding type payments under the *Offshore Petroleum and Greenhouse Gas Storage Act 2006*.

146. In summary, exploration expenditure under the PRRTAA also includes expenditure on the activities in recovering petroleum (including gas) from a particular relevant offshore area before a production licence applies. It also includes expenditure on all further operations, facilities or other things in relation to the recovered petroleum so far as they are before a production licence applies and up to the point that the petroleum is sold or an MPC is sold or further processed into something else or (say, because an MPC is moved away from its place of production other than to adjacent storage, or is moved away from such adjacent storage) the MPC becomes an excluded commodity otherwise.[9]

147. Expenditure directed to operations, facilities or other things from the eligible exploration or recovery area after and so far as it becomes a production licence area is not exploration expenditure under the PRRTAA, whether incurred at a time before or only after the production licence is issued. So development expenditure of the petroleum project in relation to a production licence is not exploration expenditure whether incurred before or after the production licence issues.

148. If more than one MPC is produced by a petroleum project, it is possible that one of the MPCs (for example, condensate) is produced and becomes an excluded commodity at a stage while the remaining petroleum is still being processed to produce one or more other MPCs (for example, sales gas). It follows that exploration expenditure extends to expenditure on the production of all MPCs and all further activities so far as they are in relation to the MPCs until the MPCs become excluded commodities, and before a production licence applies, and no further. Once an MPC has become an excluded commodity, any further activities in relation to it such as in producing another product from the MPC are not exploration expenditure for PRRT purposes.

[9] An exploration permit or a retention lease is treated as a petroleum project for the purposes of determining the amount of transferable exploration expenditure that can be transferred to an eligible petroleum project (clause 14 of the Schedule to the PRRTAA).

149. To be exploration expenditure, the expense payments must be liable to be made in carrying on the operations, facilities and other things involved in or in connection with exploration as specified in section 37. 'Exploration' is not elsewhere defined in the PRRTAA and it is not a word with a technical or special meaning within the petroleum industry. Consequently, the word 'exploration' takes on its ordinary meaning.

150. The ordinary meaning of exploration expenditure is what is directed to determining whether there is a commercial discovery of resources, as distinct from determining whether a particular kind of mining operation or project in relation to a commercial discovery of resources that has already been made is commercially viable (or is presently so). No 'bright line test' exists to determine the point at which expenditure ceases to be part of exploration expenditure and becomes part of expenditure on development or when expenditure is on another non-exploration activity. This can only be determined by a detailed analysis of the nature of the activity on which the expenditure is incurred.

151. The meaning of exploration expenditure for PRRT purposes is, however, extended by the provisions of section 37. Broadly, while most of the exploration expenditure will be incurred in discovering and verification of petroleum reserves in the eligible exploration and recovery area, in some instances exploration expenditure may be incurred in recovering petroleum from the eligible exploration or recovery area, moving and storage of that petroleum, its further processing or treatment to produce an MPC and the moving or storage of the MPC as well as services and employee amenities in relation to these activities. Payments made to another person to stabilise, transport, store, recover or process petroleum recovered from the eligible exploration or recovery area (but not so far as it is incurred in relation to a production licence area) can also be exploration expenditure. So far as such expenditure is incurred in relation to a production licence area, and so in relation to production from a production licence area, it is not exploration expenditure; so the production extension does not apply to the part of any payments that is directed to production from the area once a production licence is expected to apply to it. The extension under section 37 is apt to include exploration-stage recovery and production that might otherwise not be part of exploration in its usual meaning.

152. The income tax provisions differ somewhat in relation to the meaning of exploration. They expressly include a range of activities in exploration and prospecting (under subsection 40-730(4) of the ITAA 1997), including certain sorts of feasibility expenditure and including obtaining information associated with the search for, and evaluation of, areas containing minerals or quarry materials. The PRRTAA conversely expressly includes some feasibility and environmental study expenditure in general project expenditure where preparatory to carrying on or providing the operations, facilities and other things comprising the petroleum project (under paragraph 38(1)(a)).

153. Notwithstanding the differences in relation to the meaning of exploration attributable to legislative provisions of the income tax and PRRT law, if expenditure forms part of exploration and prospecting for income tax because it is within the ordinary meaning of exploration (rather than within meanings altered by or affected by income tax legislation that differs from the PRRTAA), it provides guidance in determining the meaning of exploration for PRRT purposes. So, for instance, feasibility study payments where the nature of the study is within the ordinary meaning of exploration for income tax purposes are within exploration for PRRT purposes too; the words of paragraph 38(1)(a) do not exclude it.

154. So far as eligible real expenditure qualifies as exploration expenditure within the meaning of section 37, it does not constitute general project expenditure within the meaning of subsection 38(1), as under that subsection payments are general project expenditure only so far as they are not excluded expenditure, not exploration expenditure and not closing-down expenditure.

The meaning of 'general project expenditure'

155. General project expenditure as defined in section 38 comprises payments (not being excluded expenditure, exploration expenditure or closing-down expenditure) that are liable to be made in carrying on or providing the operations, facilities and other things comprising the petroleum project pursuant to paragraph 38(1)(b), or that are payments liable to be made in doing other things specified in the section. What constitutes the operations, facilities and other things comprising the petroleum project is set out in subsection 19(4) as explained in paragraphs 104 to 106 of this draft Ruling. The meaning of 'in carrying on or providing' is explained at paragraphs 164 to 180 of this draft Ruling.

156. The other things expenditure in which may form part of a taxpayer's general project expenditure are specified in subsection 38(1). These are:

(a) by paragraph 38(1)(a), carrying on or providing operations and facilities preparatory to the operations, facilities or other things comprising the petroleum project, including carrying out any feasibility or environmental study (refer to Example 1 of this draft Ruling);

(b) by paragraph 38(1)(c), payments liable to be made in purchasing internal petroleum in relation to the project or external petroleum as part of the petroleum project;

(c) by paragraph 38(1)(d), payments liable to be made in procuring another person to stabilise, transport, store, recover or process petroleum recovered from the production licence area or areas in relation to the petroleum project, if that stabilisation, transportation, storage, recovery or processing constitutes the processing of internal petroleum in relation to the project or external petroleum in relation to another petroleum project;

(d) by subsection 38(1), any production licence or other fee (provided the fee is not an excluded fee) liable to be paid in relation to the carrying on or providing of any of the other operations, facilities or other things referred to in section 38. Excluded fees are cash bidding type payments under the *Offshore Petroleum and Greenhouse Gas Storage Act 2006.*

157. Broadly, general project expenditure includes the expenditure incurred in operations, facilities or other things preparatory to or in carrying on or providing particular operations, facilities and other things associated with the recovery of petroleum from a production licence area. If expenditure is incurred up to the point at which petroleum is sold or at which an MPC becomes an excluded commodity in moving and storage of the petroleum recovered from the production licence area, its further processing or treatment to produce an MPC, or the moving or storage of the MPC as well as in carrying on or providing services and employee amenities in connection with these activities, the expenditure will also be general project expenditure (refer to Example 4 of this draft Ruling). Payments made to another person to purchase internal or external petroleum in relation to the petroleum project or to stabilise, transport, store, recover or process petroleum recovered from the production licence area as internal petroleum of the project or as external petroleum of another project will also be general project expenditure.

158. If eligible real expenditure that could otherwise be general project expenditure qualifies as exploration expenditure within the meaning of section 37 or as closing-down expenditure within the meaning of section 39, it is taken not to constitute general project expenditure within the meaning of section 38. For example, expenditure incurred in relation to a feasibility study can be general project expenditure. However, if the expenditure is also exploration expenditure, it is taken to that extent not to constitute general project expenditure.

159. Some expenditure incurred in carrying on or providing operations or facilities in the eligible exploration or recovery area may not be exploration expenditure pursuant to section 37. This expenditure may also not be general project expenditure if it is not incurred in carrying on the operations, facilities and other things comprising the petroleum project (refer to Example 1 of this draft Ruling).

The meaning of 'closing-down expenditure'

160. Closing-down expenditure is defined in section 39 as payments liable to be made by a person in carrying on operations involved in closing-down the petroleum project, specifically including any environmental restoration as a consequence of closing-down the project (subsection 39(1)). It also includes consideration given to dispose of project property, so far as that consideration relates to future closing-down expenditure, and excess future closing-down expenditure over that absorbed in reducing assessable property receipts to zero (subsections 39(2) and 39(3)). What would otherwise be assessable property receipts and included in assessable receipts under section 27 are reduced by future closing-down expenditure under subsection 27(3), but not below zero under subsection 27(4). Future closing-down expenditure relates to project property which continues to be used beyond its project use subject to an infrastructure license (section 2D). But there is no closing-down expenditure so far as future closing-down expenditure in relation to that expenditure has reduced the person's assessable property receipts or has been allowed as a deduction (subsection 39(4)).

161. Expenditure on the removal of, for example, a drilling platform from a production licence area as part of closing-down the petroleum project would ordinarily qualify as closing-down expenditure. However, expenditure is not incurred in closing-down the project just because some part of the operations ends. For example, if an entity which has decided to close-down some existing production wells in a production licence area acts to dismantle the production platform and move it to another location within the production licence area to serve new wells drilled for the recovery of petroleum, the operation of dismantling and relocating the platform would not be an operation involved in closing-down the project and would not give rise to closing-down expenditure. It is not in closing-down the project, although dismantling and removing the production wells might otherwise have been required as part of closing-down the project and might have been carried out in closing-down the project even before all other project operations, facilities or other things had ended. However, the expenditure incurred on the operation of dismantling and relocating the platform would still be able to qualify as eligible real expenditure under section 38.

162. A petroleum project would not be taken to be closing-down by reason only of a temporary cessation of activities. In the case of a combined project, if one or more (but not all) of the eligible production licences specified in a current project combination certificate cease to be in force, the combined project will continue in relation to those production licences that remain in force (subsection 19(3)). Closing-down expenditure in relation to a combined petroleum project can only be incurred so far as it is in relation to closing-down the project. Whether there is any such expenditure when one or some of the production licences cease to be in force requires consideration of what the expenditure is for; for instance the extent to which it is for permanently closing-down some part of the project, as distinct from the extent to which it is for relocating assets or for consequences of only temporary cessation of some activity.

163. Some items of expenditure can fall into the category of general project expenditure or closing-down expenditure depending on the circumstances surrounding the expenditure. The wording of section 38 ensures that if an item of expenditure meets the definition of closing-down expenditure and that is what it is, it will not be general project expenditure too.

The meaning of 'in carrying on or providing'

164. There is no general concept under the PRRTAA that all expenditure however it is in relation to a petroleum project is, or gives rise to, deductible expenditure. Only expenditure which is in some sense in relation to a petroleum project can give rise to deductible expenditure: but not all expenditure which is in relation to a petroleum project gives rise to deductible expenditure.

165. Under each of sections 37, 38 and 39, eligible real expenditure (from which any deductible expenditure and transferred expenditure must derive) must be payments liable to be made in carrying on or providing certain operations, facilities or other things (or in purchasing certain things, or in procuring someone else to do certain things) in relation to a petroleum project.

166. The starting point in determining what are the things, the expenditure in the carrying on or providing of which constitutes exploration expenditure, general project expenditure or closing-down expenditure, is provided in sections 37, 38 and 39 in light of the specification by subsection 19(4) of what operations, facilities and other things comprise the petroleum project. As was addressed earlier in this draft Ruling, the operations, facilities and other things that may be carried on or provided that comprise a petroleum project are the operations and facilities for the recovery of petroleum; and, so far as they are carried on:

(a) the operations and facilities involved in moving petroleum so recovered to and between any storage or processing facilities prior to the production of an MPC;

(b) the operations and facilities involved in storage, processing or treatment of petroleum so recovered to produce an MPC;

(c) the operations and facilities involved in the moving or storage of the MPC before it becomes an excluded commodity;

(d) the services (as defined), or facilities (as defined) for the provision of services, in connection with the operations, facilities, amenities and services comprising the petroleum project; and

(e) the employee amenities in connection with the operations, facilities, amenities and services comprising the petroleum project.

167. These operations, facilities and things include carrying on or providing them for external petroleum, or internal petroleum, in relation to the petroleum project (as provided for the avoidance of doubt by subsection 38(2)). Internal petroleum exists if petroleum recovered from the project's production licence area is to be sold to, or recovered or processed by, one person entitled to derive assessable receipts of the project but from or for another person entitled to derive assessable receipts from the project (section 2). External petroleum exists if petroleum is not recovered from the project's production licence area but the project operations, facilities or other things are applied to it; assessable receipts arise for it accordingly (section 2).

168. A petroleum project does not include all other activities that are 'in relation to' the operations, facilities and things that comprise the project even if the other activities are in some sense necessary to the overall business of the taxpayer in the course of which, or for the purposes of which, the petroleum project is carried on. In other words, the PRRTAA does not treat expenditure as eligible real expenditure giving rise to deductible expenditure simply on the basis that but for the petroleum project, the expenditure would not have been incurred.

169. For example, the salary costs of an employee who works at the petroleum project site office and whose duty it is to maintain attendance records and human resource management of staff working at the processing facility are incurred in carrying on the operations of the petroleum project (refer to Example 5 of this draft Ruling). This is because the particular salary costs are all costs directly attributable to the human resource management of the staff as part of their working solely in carrying on or providing operations of the petroleum project that constitute the project. The salary costs of a human resource manager whose role it is to recruit and select staff for engagement in the petroleum project may not be incurred in carrying on or providing the relevant activities for the petroleum project, even though such costs are incurred in relation to the project. Time spent generally on recruitment and in selecting possible recruits who are to carry on or provide the operations, facilities and other things that comprise the petroleum project is not spent directly in carrying on or providing what recruits are to carry on or provide.

However, salary costs for the time spent in actually recruiting the particular workers who actually carry on or provide the operations, facilities or things that constitute the petroleum project are incurred in carrying on or providing the things that the workers carry on or provide (also refer to Example 13 in TR 2010/D5).

170. If the human resource management employee is engaged partly in management of staff carrying on the operations, facilities and other things that constitute the petroleum project and partly in other work, the salary costs must be apportioned to establish that part of the expenditure which is incurred in carrying on or providing the operations, facilities and other things that constitute the petroleum project. Any part of the expenditure that is administrative expenditure not incurred directly must also be excluded from eligible real expenditure. This is discussed in more detail in TR 2010/D5.

171. The use of the word 'in' in the phrase 'in carrying on or providing' requires the expenditure to have a direct relationship with the operations, facilities and things that comprise the petroleum project as the word 'in' has been judicially construed as a restrictive word.[10] Not every prerequisite, even an essential prerequisite, is itself in doing the things to which it is prerequisite. The income tax principles similarly limit what is 'in' the relevant project operations, facilities or things.

172. Regardless of what might be contended if the words of subsection 22(1) ('in relation to a petroleum project and a year of tax') and section 32 ('deductible expenditure incurred by a person in a financial year in relation to a petroleum project') were to be read alone, once regard is had to the terms of sections 37, 38 and 39, it is clear that there is no operative extension of 'deductible expenditure' generally to expenditure 'in relation to' anything. Only expenditure incurred in actually carrying on one of the identified activities or in providing one of the identified facilities or things is ever capable of being exploration expenditure, general project expenditure or closing-down expenditure. That cannot be read as extending generally to expenditure necessary, as a commercial or business matter, if or because those activities or things are to occur. The parallel to the exchange losses covered in the judgment of Gummow J in the first instance in *Robe River Mining Co Pty Ltd v. Federal Commissioner of Taxation* (1988) 84 ALR 369; 88 ATC 4701 (the Robe River case) is clear.

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[10] While considering the deductibility of expenditure under subsection 51(1) of the *Income Tax Assessment Act 1936* in *Lodge v. Federal Commissioner of Taxation* 72 ATC 4174, Mason J of the High Court held that although expenditure on nursery fees incurred by a single mother for the care of her infant daughter was incurred for the purpose of earning assessable income and it was an essential prerequisite of the derivation of that income, the expenditure was not incurred in, or in the course of, preparing bills of cost, the activities or operations by which the appellant gained or produced assessable income. In *Lunney v. Commissioner of Taxation* (1958) 100 CLR 478 the High Court rejected the claim that the expenses of travelling between home and work were an allowable deduction based on the proposition that it is not enough to show that the expenditure was an essential prerequisite to the derivation of assessable income. A similar approach was adopted by Gummow J in *Robe River Mining Co Pty Ltd v. Federal Commissioner of Taxation* (1988) 84 ALR 369; 88 ATC 4701.

173. In the *Robe River* case the question was whether the exchange losses incurred on borrowed funds in a foreign currency to finance the taxpayer's prescribed mining operations were 'expenditure in carrying on prescribed mining operations' for the purposes of section 122A of the *Income Tax Assessment Act 1936* which dealt with allowable capital expenditure. They were not 'in carrying on' those operations, however much they related to those operations in a business or commercial sense. In his decision Gummow J stated:

> …the direct or close connection which is necessary between the expenditure and the carrying on of the prescribed mining operations, such close connection being supplied by the word 'in' [in the phrase 'in carrying on prescribed mining operations']

174. It was further said that 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 direct relationship with the things and activities specified. The decision of Gummow J was affirmed by the Full Federal Court (*Robe River Mining Co Pty Ltd v. Federal Commissioner of Taxation* 89 ATC 4606). In concluding that the expenditure in question was not incurred in carrying on prescribed mining operations, the Full Federal Court said:

> The use of the phrase 'in carrying on prescribed mining operations' **suggests a quite direct relationship between expenditure and the operations** [emphasis added], to be distinguished from the looser relationship which would be expressed by the words 'in connection with' if they were used in a provision of this kind.

175. Referring to section 38, in *Woodside Energy Ltd v. Commissioner of Taxation (No. 2)* [2007] FCA 1961 (the Woodside case) French J of the Federal Court stated at paragraph 276 of the judgment:

> In my opinion the requirement that expenditure contemplated by s 38 is liable to be made in carrying on or providing operations, facilities and other things comprising the project is incapable of covering the hedging losses the subject of these proceedings. **The section contemplates a close connection between the expenditure and the physical activities involved in the petroleum project** [emphasis added].

176. In the *Woodside* case, the primary argument advanced by the taxpayer was that the hedging expenses were incurred in relation to the sale of hedged petroleum. Therefore, the expenses should be taken into consideration as costs of the sale in calculating the assessable petroleum receipts under section 24. Alternatively, the taxpayer argued that hedging expenses were deductible as general project expenditure under section 38 in carrying on or providing relevant petroleum project operations, facilities or other things. French J determined that hedge losses were neither taken into account in calculating the assessable petroleum receipts being 'expenses payable…in relation to the sale', nor were the hedge losses deductible expenditure that can be offset against assessable receipts as derived for the purposes of section 38. Woodside's appeal against the judgment of French J was dismissed by the Full Federal Court (*Woodside Energy Ltd v. Commissioner of Taxation* [2009] FCAFC 12) and leave to appeal to the High Court was not sought.

177. To further illustrate the direct relationship required of expenditure with the activities which are the petroleum project, in a large company group, there may be a number of entities that have interests in petroleum projects in Australia and overseas. If one of the members of the company group undertakes research activities generally in relation to technical issues in exploration, recovery and processing of petroleum, the cost of carrying out the research and the information obtained in the process may be shared among the group members. The costs incurred to have access to the latest research information may not be deductible under the PRRTAA if the access to research information is not clearly part of the carrying on of activities specified in sections 37, 38 and 39 in relation to a particular petroleum project. This is likely to be the case if the information obtained relates generally to upstream as well as downstream processes or otherwise to technical matters not needing to be resolved as part of carrying on or providing the operations, facilities or other things constituting the particular petroleum project.

178. In such cases, even if it could be accepted that some of the expenditure incurred gives access to information that may be relevant 'in relation' to or 'in connection' with the activities of a specific petroleum project, or is part of the information needed for the overall business in the context of which the project is carried on, that is not sufficient for the expenditure to constitute general project expenditure or exploration expenditure. The expenditure to carry out research or to access research information must bear a direct or close relation to, or connection with, carrying on or providing the operations, facilities and other things comprising the petroleum project so that the expenditure arises in carrying on or providing those things (refer to Example 8 of this draft Ruling).

179. The purpose tests laid out in the relevant provisions require that the expenditure be incurred in carrying on or providing the operations, facilities or other things constituting the petroleum project in relation to the relevant production licence, or otherwise be in doing things directly related to that project. Those things relate to actual physical exploration in and recovery of petroleum from the eligible exploration or recovery area related to the project, or to recovery of petroleum from the project area, in some way. All examples of deductible expenditure contained in the Explanatory Memorandum to the Petroleum Resource Rent Tax Assessment Bill 1987 have this characteristic. Expenditure on non-project-specific research or on access to a general body of research information or any similar costs are notably absent from the examples of petroleum project expenditure mentioned in the Explanatory Memorandum.

180. By way of a further illustration, legal expenditure incurred in setting up and administering the rights of the parties under a joint venture agreement for a joint venture which includes a petroleum project in its activities is generally not likely to be incurred to any extent in carrying on or providing the operations, facilities and other things constituting the petroleum project, or any other of the things expenditure in which is eligible real expenditure. Such legal expenditure should be expected not to give rise to deductible expenditure or to transferred expenditure for PRRT purposes.

Apportionment

181. A relevant question to consider is whether and how the provisions of the PRRTAA allow for the apportionment of expenditure incurred for mixed purposes in identifying a part of the expenditure that is eligible real expenditure. The general deduction provisions are not explicit on the question. They do not contain the express apportioning language, generally using 'to the extent', that section 8-1 of the ITAA 1997 has. However, some sections do specifically recognise apportionment. For instance, in relation to expenditure on property for partial petroleum project use, section 42 of the PRRTAA expressly apportions that expenditure on a usage basis. Likewise, subsection 37(2) of the PRRTAA expressly provides for the apportionment of any exploration permit fee between an exploration permit area and a retention lease area if subsection 5(3) of the PRRTAA applies.

182. Sections 37, 38 and 39 are self-apportioning: that is, expenditure is within the sections to the extent, and only to the extent, that it is of the kind identified. In other words, if a taxpayer incurs an expenditure partly in carrying on or providing one or more activities that form part of the activities mentioned in sections 37, 38 and 39 and partly in one or more activities that do not form part of the activities mentioned in sections 37, 38 and 39, then the expenditure must be apportioned between the two sets of activities and only so far as the expenditure is in the former set of activities may it be deductible under the PRRTAA. The basis of apportionment must be reasonable and the onus is on the taxpayer 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 ascertaining the taxable profit (refer to Examples 17 and 18 of this draft Ruling). The apportionment of payments of administration or accounting costs or wages, salary and other work costs only partly incurred in carrying on or providing petroleum project operations, facilities and other things referred to in sections 37, 38 or 39 is discussed in TR 2010/D5.

The third pre-condition to deductibility – the expenditure must not be 'excluded expenditure' under section 44

183. It is a specific requirement of sections 37, 38 and 39 that 'excluded expenditure' is not to be included in the amounts of exploration expenditure, general project expenditure and closing-down expenditure. Excluded expenditure is not included in eligible real expenditure and no deductible expenditure derives from it. No transferred expenditure derives from it either.

184. Section 41 generally applies if 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 in carrying on or providing which would constitute eligible real expenditure of the eligible person if they carried on or provided those things themselves. 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. Section 41 does not provide that any of the expenditure to which it applies is deductible expenditure or eligible real expenditure, but rather provides that particular expenditure is taken to be incurred in carrying on or providing particular things. If eligible real expenditure, from which deductible expenditure and transferred expenditure derive, arises in light of the provisions of section 41 it does so only so far as what section 37, 38 or 39 takes to be incurred in carrying on or providing particular things is not excluded expenditure. The operation of section 41 is discussed in detail in TR 2010/D6.

185. Section 44 defines excluded expenditure by providing an exhaustive list of such expenditure. Payments of amounts give rise to excluded expenditure so far as they are:

(a) payments of principal or interest on a loan or other borrowing costs, or are interest components of hire-purchase payments. These exclusions, together with the exclusion of dividends and equity issue or repayment, prevent double dipping, as the PRRT provides for notional financing costs of all deductible expenditure in its compounding regime. Note that the expenditure of the borrowed funds (or of equity raised) may, however, give rise to deductible expenditure, as may the principal component of a hire-purchase payment.

(b) payments of dividends.

(c) the cost of issuing shares or the repayment of equity capital.

(d) private override royalty payments. For this purpose, a private override royalty is a payment in the nature of a royalty made to other than a government or government body, usually calculated by reference to a percentage or share of the gross or net value or of the quantity of petroleum produced (or of some part or component of it). It is logical that such payments are excluded from being deductible expenditure of the payer as the royalties received do not constitute assessable receipts in relation to the petroleum project for the payee.

(e) payments to acquire, or to acquire an interest in, an exploration permit, a retention lease, a production licence, a pipeline licence or an access authority, other than payments by way of fees for the grant of the permit, lease licence or authority. Cash bidding payments, however, are excluded fees which are specifically not included in exploration expenditure under the terms of subsection 37(1) or in general project expenditure under subsection 38(1) (and which can never be closing-down expenditure under section 39).

(f) payments to acquire interests in petroleum project profits, receipts or expenditure (this exclusion also precludes double counting as acquirers get their appropriate share of deductible expenditure based on eligible real expenditure of the vendor and the vendor's predecessors).

(g) income tax payments. A payment of PRRT is itself deductible for income tax purposes, so that including income tax in deductible expenditure would produce compounding income tax and PRRT deductions.

(h) fringe benefits tax payments, up to the year of tax ended 30 June 2006 (refer to Example 19 of this draft Ruling).

(i) payments of GST under the GST legislation.

(j) payments of administrative or accounting costs, wages, salaries or other work costs incurred indirectly in carrying on or providing the operations, facilities and other things of a kind referred to in sections 37, 38 and 39. For example, if a person has diverse interests only one of which is a petroleum project for PRRT purposes, no part of the head office expenses such as accounting and auditing fees, pay-roll preparation costs, and the costs of maintaining the head office motor vehicle fleet, will constitute eligible real expenditure. However, if the head office expenditures are clearly directly identified with carrying on or providing relevant things for the petroleum project, such as project engineering design cost of an item of petroleum recovery equipment for the project, and are not incurred indifferently with some other object of the person, the expenditure will not constitute excluded expenditure. For more discussion on this topic, refer to TR 2010/D5.

(k) payments for or in respect of land and buildings for use in connection with the petroleum project related administrative or accounting activities, unless the location of the land or buildings is at, or adjacent to, the project site or sites. For more discussion on this topic, refer to TR 2010/D5.

186. As a matter of statutory interpretation, the express exclusions from eligible real expenditure in section 44 suggest that the things excluded would otherwise be capable of being eligible real expenditure, at least sometimes. The same reasoning applies in reading the express extensions to eligible real expenditure in sections 37, 38 and 39. So far as specific matters are added beyond general references to ‘carrying on or providing the operations, facilities and other things comprising the project’ (paragraph 38(1)(b), and the equivalent production activities in paragraph 37(1)(b)) and ‘carrying on or providing operations and facilities involved in or in connection with exploration for petroleum’ (paragraph 37(1)(a)), there is a clear implication that the general words would not always include the specific references. So, for instance, exploration permit, retention lease, production licence and other fees might not as such be liable to be paid in the course of carrying on or providing exploration or production activities.

Record keeping

187. Section 112 of the PRRTAA 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. Regardless of whether an offence has been committed under section 112, in any proceedings relating to an objection against assessment, the provisions of Part IVC of the *Taxation Administration Act 1953* (TAA) apply. Those provisions include section 14ZZK of the TAA, in relation to a review of an objection decision by the Administrative Appeals Tribunal (AAT), and section 14ZZO of the TAA, in relation to Federal Court appeals against objection decisions. Each of these sections provides that the taxpayer has the burden of proving that any assessment is excessive, or for other taxation decisions that the decision should not have been made or should have been made differently. It follows as a practical matter that the onus of proof that the expenditure was incurred in carrying on the operations, facilities and other things comprising the petroleum project and was not excluded expenditure is on the taxpayer. The taxpayer must sufficiently evidence and explain each claim for deductible expenditure (refer to Example 20 of this draft Ruling).

188. The records must be retained for seven years after the completion of the transactions or acts to which they relate. If expenditure is incurred in an earlier year of tax to the year of tax in which the expenditure is claimed as a deduction against assessable receipts, the period for retaining the records applies from the date of assessment for the year of tax in which the expenditure was claimed as a deduction, as the making of the assessment for the return in which the expenditure is claimed is an act relevant for the purpose of ascertaining the taxpayer's liability under the PRRTAA.

189. If records are not retained longer, and no offence is committed, the taxpayer still bears the onus about that expenditure – there is no deeming of claims of expenditure to be valid once records are not specifically required to be retained.

Appendix 2 – Alternative views

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.

190. Alternative 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

Eligible real expenditure

191. The PRRT regime is designed to balance the rate of tax (40% of taxable profits, deductible against income tax) with a generous deductibility of costs. Section 44 explicitly lists the various categories of expenditure that are not eligible real expenditure. The inclusion of section 44 indicates that all other expenditure incurred, if it is in any way in relation to the petroleum project up to the point when an MPC becomes an excluded commodity, is eligible real expenditure of the project.

Analysis

192. If the view expressed in paragraph 191 of this draft Ruling is correct, it would mean that the first and second pre-conditions discussed in this draft Ruling have no application under the PRRTAA. A petroleum project is defined in section 19 and definitions of exploration expenditure, general project expenditure and closing-down expenditure are included in sections 37, 38 and 39 respectively. Subsection 19(4) defines what is meant by 'operations, facilities and other things comprising a petroleum project' for the purposes of the PRRTAA. Only the expenditure that falls into one of the categories of the expenditure listed in section 32 can give rise to deductible expenditure. The view expressed in paragraph 191 of this draft Ruling ignores the existence of specific sections that allow only certain categories of expenditure to give rise to deductible expenditure.

193. For expenditure to constitute deductible expenditure, Parliament intended that the requirements of section 37, 38 or 39 be satisfied. Expenditure does not constitute eligible real expenditure merely because it is not excluded expenditure within the meaning of section 44. This is discussed in detail in Appendix 1 of this draft Ruling.

Alternative view 2

The meaning of 'in carrying on the petroleum project'

194. The Parliament never intended to give a narrow meaning to the concept of 'in carrying on the petroleum project'. The PRRTAA treats all expenditure on operations, facilities or other things that support the petroleum project as deductible expenditure.

Analysis

195. This issue is discussed at paragraphs 164 to 180 in Appendix 1 of this draft Ruling. The PRRT is a tax that is assessed on a narrow project basis, both in relation to deductible expenditure and in relation to assessable receipts. The PRRTAA includes in assessable receipts and the eligible real expenditure giving rise to deductible expenditure or transferred expenditure only those receipts and expenses that arise in carrying on or providing particular things for the petroleum project. As PRRTAA is a project tax and not an enterprise tax, only eligible real expenditure of the specified kinds can ever give rise to deductible expenditure.

Appendix 3 – Your comments

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

197. 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 Tax Office website at www.ato.gov.au.

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

Due date:	**13 August 2010**
Contact officer:	**Bhim Nagpal**
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	prrt@ato.gov.au
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Appendix 4 – Detailed contents list

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

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations

TR 2004/1; MT 2004/1;
TR 2006/10; TR 2010/D5;
TR 2010/D6

Subject references:

- derived
- employee amenities expenses
- entertainment expenses
- feasibility study expenses
- incurred
- joint ventures
- mining and petroleum
- PRRT
- PRRT assessable receipts
- PRRT closing-down expenditure
- PRRT deductible expenditure
- PRRT excluded expenditure
- PRRT exploration expenditure
- PRRT general project expenditure
- PRRT taxable profit

Legislative references:

- PRRTAA
- PRRTAA 2
- PRRTAA 2D
- PRRTAA 5(1)
- PRRTAA 5(2)
- PRRTAA 5(2)(a)
- PRRTAA 5(2)(b)
- PRRTAA 5(3)
- PRRTAA 5(4)
- PRRTAA 5(5)
- PRRTAA 5(6)
- PRRTAA 5(7)
- PRRTAA 19
- PRRTAA 19(1)
- PRRTAA 19(2)
- PRRTAA 19(3)
- PRRTAA 19(4)
- PRRTAA 19(4)(a)
- PRRTAA 19(4)(b)
- PRRTAA 19(4)(b)(i)
- PRRTAA 19(4)(b)(ii)
- PRRTAA 19(4)(b)(iii)
- PRRTAA 19(4)(b)(iv)
- PRRTAA 19(4)(b)(v)
- PRRTAA 20
- PRRTAA 21
- PRRTAA 21(1)
- PRRTAA 22
- PRRTAA 24
- PRRTAA 25
- PRRTAA 27
- PRRTAA 27(3)
- PRRTAA 27(4)
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- PRRTAA 35(3)
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- PRRTAA 35B
- PRRTAA 36C
- PRRTAA 37
- PRRTAA 37(1)
- PRRTAA 37(1)(a)
- PRRTAA 37(1)(b)
- PRRTAA 37(1)(b)(i)
- PRRTAA 37(1)(b)(ii)
- PRRTAA 37(1)(b)(iii)
- PRRTAA 37(1)(b)(iv)
- PRRTAA 37(1)(b)(v)
- PRRTAA 37(1)(b)(vi)
- PRRTAA 37(1)(c)
- PRRTAA 37(2)
- PRRTAA 38
- PRRTAA 38(1)
- PRRTAA 38(1)(b)
- PRRTAA 38(1)(c)
- PRRTAA 38(1)(d)
- PRRTAA 38(2)
- PRRTAA 39
- PRRTAA 39(1)
- PRRTAA 39(2)
- PRRTAA 39(3)
- PRRTAA 39(4)

- PRRTAA 40
- PRRTAA 41
- PRRTAA 41(1)
- PRRTAA 42
- PRRTAA 44
- PRRTAA 44(e)
- PRRTAA 44(h)
- PRRTAA 44(j)
- PRRTAA 44(k)
- PRRTAA 45
- PRRTAA 45A
- PRRTAA 45B
- PRRTAA 45C
- PRRTAA 46
- PRRTAA Division 6
- PRRTAA 112
- PRRTAA Schedule Clause 1
- PRRTAA Schedule Part 2
- PRRTAA Schedule Part 3
- PRRTAA Schedule Part 4
- PRRTAA Schedule Part 5
- PRRTAA Schedule Part 6
- PRRTAA Schedule Part 7
- ITAA 1936 former 51(1)
- ITAA 1936 former 122A
- ITAA 1997 8-1
- ITAA 1997 40-730(4)
- Offshore Petroleum and Greenhouse Gas Storage Act 2006 285(7)
- TAA Pt IVC
- TAA 14ZZK
- TAA 14ZZO

Case References:

- Commissioner of Taxation v. Malouf [2009] FCAFC 44
- Lodge v. Federal Commissioner of Taxation (1972) 72 ATC 4174
- Lunney v. Commissioner of Taxation (1958) 100 CLR 478
- Re BHP Petroleum Pty Ltd and Collector of Customs (1987) 11 ALD 413 (AAT No. 3194)
- Robe River Mining Co Pty Ltd v. Federal Commissioner of Taxation (1988) 84 ALR 369; 88 ATC 4701; (1988) 19 ATR 1648
- Robe River Mining Co Pty Ltd v. Federal Commissioner of Taxation (1989) 88 ALR 50; 89 ATC 4606; (1989) 20 ATR 708
- Woodside Energy Ltd v. Commissioner of Taxation (No. 2) [2007] FCA 1961; (2007) 69 ATR 465
- Woodside Energy Ltd v. Commissioner of Taxation ; (2009) 174 FCR 91; [2009] FCAFC 12; (2009) 74 ATR 922

Other references:

- Explanatory Memorandum to the Petroleum Resource Rent Tax Assessment Bill 1987
- PRRT discussion paper (2009) – Pre-conditions to the deductibility in calculating petroleum resource rent tax of exploration, general project and closing-down expenditure incurred in carrying on or providing operations, facilities or other things of a kind referred to in sections 37, 38 and 39 of the *Petroleum Resource Rent Tax Assessment Act 1987*

ATO references

NO:	1-1PUXSZB
ISSN:	1039-0731
ATOlaw topic:	Petroleum Resource Rent Tax