IT 2642 - Income tax: mining exploration and prospecting expenditure

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TAXATION RULING IT 2642

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I 1012735	**EXPLORATION AND PROSPECTING EXPENDITURE**	**122J, 122JF, 122A 124AH, 124AA, 124AB, 124B**

OTHER RULINGS ON TOPIC : IT 2208, IT 363

TITLE: INCOME TAX: MINING EXPLORATION AND PROSPECTING EXPENDITURE

NOTE: . Income Tax Rulings do not have the force of law.

. Each decision made by the Australian Taxation Office is made on the merits of each individual case having regard to any relevant Ruling.

Section 122J of Division 10 of Part III of the Income Tax Assessment Act 1936 (the Act) allows deductions for expenditure incurred by the taxpayer on exploration or prospecting for minerals (but not petroleum) on mining tenements in Australia. Section 122JF of Division 10 allows a deduction for expenses incurred on exploration or prospecting for quarrying materials. Similarly, section 124AH of Division 10AA allows deductions for expenditure incurred on exploration or prospecting in Australia for the purposes of discovering petroleum. With the repeal of paragraph 23(o), income derived from gold mining is assessable from 1 January 1991. Consequently, any exploration or prospecting expenditure on gold mining will be deductible under Division 10 from that date (note Division 16H for transitional arrangements).

2. This Ruling addresses the questions of when exploration or prospecting commences and ceases for the purposes of the two Divisions and what types of expenditure are included within their terms. These questions are necessary as different bases of deduction and treatment of carry forward losses apply depending upon whether the nature of the expenditure qualifies as "exploration or prospecting" expenditure or whether it is "preliminary" or "development" expenditure. The Ruling discusses exploration or prospecting expenditure by reference to sections 122J and 124AH.

3. It is noted that with the removal of the seven-year restriction on the carry forward of losses it may not be so important in the future to make any distinction between expenditure which qualifies for deduction under sections 122J or 124AH, and that which qualifies under subsection 51(1).

However, the debate could continue in respect of prior year losses and the recoupment of certain allowable capital expenditure on property under sections 122K and 124AM.

4. Subject to subsections 122J(4D) and 124AH(4C), sections 122J and 124AH allow exploration or prospecting expenditure to be deductible in full in the year in which it is incurred. Any excess expenditure over the amount of a taxpayer's assessable income after deducting all other allowable deductions can be carried forward indefinitely to be deducted against the assessable income of subsequent years. This situation applies to section 122J expenditure incurred after 21 August 1984 and to section 124AH expenditure incurred after 17 August 1976. Expenditure incurred prior to these dates can only be claimed against mining income or income from petroleum.

5. This Ruling reflects the approach adopted by this Office on various interpretational issues arising from the operation of the mining provisions in relation to exploration and prospecting expenditure.

RULING

Preliminary Expenditure

6. The type of expenditure considered under this heading consists of reconnaissance costs incurred before the acquisition of any mining rights, and any costs incurred on or in relation to the acquisition of exploration or prospecting rights other than the acquisition made under a section 122B or section 124AB notice. Other preliminary costs of a general administrative nature incurred by exploration or prospecting entities are considered in Taxation Ruling IT 2208.

7. As far as general mining entities are concerned, subsection 122J(1) only allows deductions for expenditure incurred on exploration or prospecting if it is "on any mining tenements" in Australia. A mining tenement is taken to mean a prospecting licence, exploration licence, mining lease, general purpose lease or a miscellaneous licence granted or acquired under a Commonwealth Act, a State Act or a law of a Territory of the Commonwealth and includes the specified piece of land in respect of which the mining tenement is so granted or acquired. As indicated, subsection 122J(1) - see also subsection 122J(4D) - specifically requires the existence of a mining tenement at the time exploration or prospecting is carried out. It does not require that the person incurring the expenditure to be the holder of the mining tenement. Hence, this Office accepts that it is sufficient if the taxpayer is given authority or permission to enter and explore by the holder of the mining tenement over the area. Taxation Ruling IT 363 reflects this view.

8. Accordingly, preliminary expenditure incurred by a mining or exploration company on surveys (mainly aerial surveys including

the use of satellites, regional aerial photographic and geophysical studies and the study of heat flows) over broad areas of the Australian continent before the acquisition of a mining tenement is not deductible under subsection 122J(1) as it cannot qualify as expenditure on "any mining tenements".

9. This contrasts with the position with petroleum mining, where subsection 124AH(1) does not require exploration or prospecting expenditure to be incurred specifically on mining tenements. Subject to subsection 124AH(4C), and provided the expenditure satisfies the qualifying activities of "exploration or prospecting" as defined in subsection 124AH(7), the expenditure is an allowable deduction under subsection 124AH(1) regardless of whether a mining tenement exists at the time the expenditure is incurred. Consequently, similar expenditure to that in paragraph 8 above qualifies as a deduction under subsection 124AH(1).

10. It has been argued that preliminary expenditure of the kind described in paragraph 8, although not deductible under subsection 122J(1), is of such a general nature that it should be regarded as part and parcel of any exploration and prospecting business. It is accepted that expenditure of this nature would normally be deductible under subsection 51(1). If a mining company incurs such expenditure, however, it would normally be of a capital nature and thus not be deductible under subsection 51(1). Of course, if in the case of a petroleum mining company subsection 124AH(1) allows deductions for preliminary expenditure, the consideration under subsection 51(1) would not be called for as the specific provision prevails over the general provision.

11. Expenditure on or in relation to the acquisition of rights to enter upon an area with a view to exploration or prospecting thereon does not qualify for deduction under sections 122J or 124AH. Neither is it deductible as allowable capital expenditure under sections 122A or 124AA because the acquisition of those rights is not made under the section 122B or 124AB notice as referred to in paragraph 5 herein. Examples of expenditure in this category are:-

survey fees to check the mineral claim areas;

advertising to comply with mining regulations;

attending at Court hearings to confirm rights;

payments to holders of tenements for abortive options;

buying-in and compensation payments to landlords for rights to enter property;

application fees for exploration licences;

legal costs in connection with (v) and (vi) above; and

costs incurred in negotiating and effecting farm-out arrangements.

12. It is considered that expenses relating to the acquisition of exploration or prospecting rights are clearly of a capital nature in the case of a mining company having the general intention of developing any discoveries made. In such cases, expenses of the kind listed in paragraph 11 would not be deductible under subsection 51(1).

13. This may be contrasted with the case of an exploration or prospecting company that intends to make its profit not by mining but by assigning or selling its rights to mine should the area prove profitable. Such a company derives assessable income from the sale of its rights unless exempt under paragraph 23(pa) and the cost of acquiring exploration or prospecting rights is deductible under subsection 51(1). This view is further supported by the Federal Court decision in F.C. of T. v. Ampol Exploration Limited (1986) 69 ALR 289 which suggests that expenditure incurred by an exploration or prospecting company in carrying on the kinds of activities ordinarily involved in exploration or prospecting will often constitute expenditure of a revenue nature.

Exploration and Prospecting Expenditure

14. "Exploration or prospecting" is defined in subsection 122J(6) to mean any one or more of the following:

(a) geological mapping, geophysical surveys, systematic search for areas containing minerals, and search by drilling or other means for minerals within those areas; and

(b) search for ore within or in the vicinity of an ore-body by drives, shafts, cross-cuts, winzes, rises and drilling, but does not include operations in the course of working a mining property.

The term is also defined in subsection 124AH(7) to include geological, geophysical and geochemical surveys, exploration drilling and appraisal drilling but does not include development drilling or operations in the course of working a petroleum field.

15. These definitions are considered to be sufficiently wide to cover aerial photogeological and magnetometer surveys, seismic surveys (which, as generally understood, are included in the concept of geophysical surveys), ore body or petroleum field evaluation projects and environmental impact studies. They include marking out an area with posts (pegging) and rent paid to a government on claims.

16. Other costs such as transport, materials, labour and plant required to carry on exploration or prospecting qualify for deduction under sections 122J or 124AH. Plant in this context

includes necessary vehicles, drilling equipment used both on and offshore. Offshore equipment includes sea-going drilling rigs, work boats, tugs, barges and helicopters as well as shore facilities used to service the offshore operations. Caravans and other accommodation such as exploration camps provided for exploration or prospecting crews are also included.

17. Interest and financing charges on moneys borrowed to finance exploration and prospecting are not deductible under sections 122J or 124AH as the amounts do not represent expenditure incurred "on exploration or prospecting" in Australia. The use of the phrase "expenditure incurred ... on exploration or prospecting" in subsections 122J(1) and 124AH(1) suggests that there must be a direct relationship between the expenditure and the operations before the expenditure is deductible under those provisions. This view is supported by the decision of the Federal Court in Robe River Mining Co. Pty Ltd v. F. C. of T. (1989) 20 ATR 768 where it was held that exchange losses made on borrowed funds which were used to finance the company's mining operations were not allowable capital expenditure. Instead, interest and other financing costs that represent revenue outgoings incurred by the taxpayer in obtaining finance for its operations are deductible under subsection 51(1).

18. Sections 122J and 124AH extend to other administrative costs incurred by mining or exploration and prospecting entities in the course of carrying out exploration or prospecting activities (e.g. the administration cost incurred in searching for minerals, the cost of renting and maintaining an office, salaries of office staff, etc.). This differs from the treatment of similar administrative costs incurred at an early stage of exploration or prospecting venture when actual exploration or prospecting activity has yet to commence. As mentioned in paragraph 6 of this Ruling, Taxation Ruling IT 2208 deals with that situation.

Development Expenditure

19. It is important to remember that the various deductions provided by Divisions 10 and 10AA depend not so much on the point in time at which a particular stage commences or ceases as on whether the expenditure falls within one of the classes of expenditure specified for deduction. The purpose and nature of the expenditure are important factors in identifying the class of expenditure. To determine the class of expenditure specified for deduction, it is first necessary to have regard to the definitions of "exploration or prospecting" contained in subsections 122J(6) and 124AH(7) and "allowable capital expenditure" in sections 122A and 124AA.

20. It is understood that once an ore body or a petroleum field has been discovered and delineated, generally two types of expenditure will be incurred. The first relates to project evaluation expenditure such as feasibility studies, pilot plant

and environmental impact studies. The second relates to the establishment of access facilities and other infrastructure to properly carry out the mining project. Often the latter type of infrastructure put in place during this stage is of such a scale that it is far in excess of that required to complete the project evaluation and essentially has an enduring benefit to the mine. And yet, the nature and purpose of the expenditure may be such that it could be viewed as both exploration or prospecting expenditure and allowable capital expenditure.

21. In these circumstances, it is important to first determine the predominant purpose of establishing the infrastructure. In doing so, regard could also be had to the scale of the operations undertaken. If the establishment of infrastructure is to such a degree as to be commensurate with preparing the site for prescribed mining or petroleum operations, or the work done is more concerned with how to best mine the ore rather than with whether to mine, then the expenditure incurred would more properly be classified as allowable capital expenditure rather than exploration or prospecting expenditure.

22. There is no hiatus between the exploration and development stages of a mining operation, but the exploration stage generally continues until a decision is taken to undertake the development stage of the mining operation. The development stage is part of the prescribed mining or petroleum operations in terms of sections 122A and 124AA respectively, and does not embrace exploration or prospecting work undertaken antecedently to any decision to establish a mine - Mount Isa Mines Limited v. F.C. of T (1954) 92 CLR 483; F.C. of T. v. Broken Hill Proprietary Company (1969) 120 CLR 240.

23. The question of when the decision to mine is made is a question of fact which needs to be determined on a case by case basis. However, as a general proposition, a decision to mine is taken when it is established that there exists a sufficient commercial quantity of mineral resources and that it would be economically feasible to carry out the mining operation. In determining the economic viability of a project, it is necessary to weigh the market for the resource which is to be won and the price obtainable for it against all the costs which will be incurred in winning and marketing the commodity. Clearly, one of the costs to be quantified in balancing that equation is the cost of financing the project, with the taxpayer likely to determine a range within which the project remains viable. Presumably, this process would also entail some estimation of the likelihood of obtaining the relevant finance. However, if having reached that point and bearing in mind its likelihood of obtaining the relevant finance, a taxpayer undertakes further expense the purpose of which is essentially development in nature, the fact that actual financial or government approval has not been received, or a formal commitment has not been documented cannot alter the nature of the undertaking or its expense.

24. Expenditure incurred in developing the site for prescribed mining or petroleum operations, i.e., after a decision to mine has been made, is clearly not deductible under sections 122J and 124AH. Development expenditure in general is deductible as "allowable capital expenditure" under sections 122A or 124AA. Development expenditure incurred in preparing a site for carrying on prescribed mining or petroleum operations and the cost of providing for water, light and power for use on the mining site for future mining operations are examples of allowable capital expenditure.

Feasibility Studies

Divisions 10, 10AA and 10AAA

25. Feasibility studies considered under this heading are studies carried out before the mining operations commence. These studies usually include activities such as test drilling, appraisal drilling, sample crushing, the cost of pilot plant, assaying and studies to evaluate the economic feasibility of mining the ore or petroleum. The deductibility of expenses incurred on those activities depends upon the particular circumstances. As is implied above those expenses will, generally speaking, come within exploration or prospecting expenditure.

26. Expenditure on feasibility studies, surveys, evaluations, etc. relating to aspects of the venture that are outside the scope of the economics of the mining project or treatment of the ore or petroleum will not qualify as exploration or prospecting expenditure. Feasibility studies, surveys, etc. relating to a port or harbour, or a possible railway, water, power, roads and housing would fall within this class and thus not qualify as exploration or prospecting expenditure.

27. Expenditure on feasibility studies relating to a road, railway, port or harbour or other mineral transport facilities outside the site of prescribed mining or petroleum operations will be deductible under Division 10AAA if the mining project proceeds and the facility is built. Expenditure on feasibility studies relating to roads and housing within the site of prescribed mining or petroleum operations and the same expenditure on water, light or power either within or outside the site will be deductible under Divisions 10 or 10AA as "allowable capital expenditure".

Subsection 51(1)

28. Where feasibility studies relate to the proposed acquisition or construction of a new capital asset, then the expense would be of a capital nature. In the decision of the full Federal Court in The Griffin Coal Mining Company Limited v. F.C. of T. (1990) 20 ATR 1038, the taxpayer, a coal mining company, and two others formed a consortium to construct and operate an aluminium smelter and to conduct a feasibility study to determine the construction and operation costs. The taxpayer

incurred approximately $1.4 million on "smelter feasibility study costs". The project was then deferred indefinitely. The Court held that no deduction was allowable under subsection 51(1). The feasibility study costs were incurred for the purpose of acquiring an asset to be used in a completely new line of business and to produce a new source of income. Accordingly, it was capital expenditure. The Court further indicated that the costs of the feasibility study in the same situation to investigate the possibility of sales to the proposed smelter would be of the same nature as the smelter feasibility study cost, and thus not deductible. While this Office had previously accepted the deduction claim in respect of similar expenditure on the feasibility study into the possibility of sales, the Commissioner accedes to the Court's view that such expenditure is of a capital nature.

29. Certain feasibility study costs, however, may be deductible under subsection 51(1) where the taxpayer is presently engaged in an existing business of mining or exploration of particular minerals and does not extend its business activities to a new line of trade. For example, the cost of the feasibility study as to the market for minerals when they are won is deductible under subsection 51(1) and not under sections 122J or 124AH. Such an expense does not result in the acquisition of any asset and thus is not of a capital nature.

Continuing Exploration or Prospecting after a Decision to Mine is Made

30. This Office accepts that there may be circumstances where exploration or prospecting can continue after a decision to mine has been made. For example, where a mining right is granted and exploration is still proceeding in those areas covered by the mining right but which have not yet been explored, it would be possible that the taxpayer may continue to claim exploration or prospecting expenditure after the decision to mine has been made. In that situation, it will be necessary for the taxpayer to separate the exploration expenditure from other mining expenditure.

31. If, however, the taxpayer continues to expand exploration or prospecting activities over the areas where no mining tenement exists, the same principles as set out in paragraphs 7 to 9 of this Ruling would apply. In addition, as indicated in paragraph 19 of this Ruling, it would also be necessary to have regard to the definitions of "exploration or prospecting" and "allowable capital expenditure" in Divisions 10 and 10AA.

COMMISSIONER OF TAXATION
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