TR 2008/6 - Petroleum resource rent tax and income tax: treatment of geosequestration expenditure and receipts

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Taxation Ruling

Petroleum resource rent tax and income tax: treatment of geosequestration expenditure and receipts

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What this Ruling is about

1. Geological sequestration (also known as geosequestration) refers to the long-term storage of material in underground geological formations such as oil and gas fields, unworkable coal beds and deep saline formations. The concept of 'storage' of material in this context is not limited to storing something that you own or to putting something away that you want back. In the context of geological sequestration, you may not own and will not generally want back what you geologically sequester. One example of geological sequestration is the long-term isolation from the earth's atmosphere of carbon dioxide or other greenhouse gases from industrial and energy related sources by means of storage of that gas in deep reservoirs beneath the surface of the earth. Such storage is an option in the portfolio of mitigation actions for stabilization of atmospheric greenhouse gas concentrations.[1]

[1] Intergovernmental Panel on Climate Change (IPCC) Special Report on Carbon Dioxide Capture and Storage, 'Summary for Policymakers', September 2005, at page 3.

2. The combined effect of sections 4 and 5 of the *Petroleum Resource Rent Tax Act 1987* is that petroleum resource rent tax (PRRT) is imposed at the rate of 40 per cent in respect of the taxable profit of a person of a year of tax in relation to a petroleum project. (The payment of the tax is deductible, and refunds, repayments or credits of the tax are assessable, for income tax purposes under section 40-750 of the *Income Tax Assessment Act 1997* (ITAA 1997).) The *Petroleum Resource Rent Tax Assessment Act 1987* (the PRRTAA)[2] relates to the assessment and collection of PRRT. Pursuant to section 22, the taxable profit of a person of a year of tax in relation to a petroleum project is the excess of the assessable receipts derived by that person over the sum of:

(a) the deductible expenditure incurred by the person;

(b) the total of any amounts transferred by the person to the project in relation to the year of tax under section 45A (that is, transfers of transferable exploration expenditure between the person's projects); and

(c) the total of any amounts transferred by another person to the person in relation to the project and the year of tax under section 45B (that is, transfers of transferable exploration expenditure between group companies).

3. This Ruling considers the circumstances when expenditure and receipts related to geological sequestration are deductible expenditure and assessable receipts respectively for the purposes of ascertaining taxable profit under the PRRTAA and so ascertaining liability for PRRT.

4. This Ruling also describes income tax consequences of expenditure on geological sequestration generally (that is, not just in relation to PRRT projects) under sections 8-1, 40-735 (mining site rehabilitation) and 40-755 (environmental protection activities) of the ITAA 1997.

Ruling

Petroleum resource rent tax

5. Terms used in this Ruling in discussing the operation of the petroleum resource rent tax that have a defined meaning for the purposes of the PRRTAA are used in that defined sense unless otherwise stated.

[2] All legislative references are to the PRRTAA unless otherwise indicated.

Geosequestration of something sourced from a petroleum project: exploration expenditure

6. Expenditure on geological sequestration may be exploration expenditure for PRRT purposes, and so may be deductible expenditure for PRRT purposes. You might geologically sequester something sourced from a petroleum project and do so in carrying on or providing the operations, facilities or other things of a kind referred to in subsection 37(1) in relation to the project. Broadly speaking, this will be for something sourced from exploration activities, or from exploration area production undertaken other than under an applicable production licence for the project.[3] The expenditure you incur in a financial year on that sequestration is exploration expenditure incurred by you in that financial year in relation to that project, provided that expenditure is not excluded expenditure.

7. An amount you pay someone else to do such geological sequestration for you in relation to a project (your project) is, pursuant to subsection 41(1), generally taken to be exploration expenditure incurred by you in relation to your project where that sequestration would have been an activity your own expenditure on which would have been your exploration expenditure had you done that sequestration yourself. This is not the case where the other person carries on or provides the operations, facilities or other things as part of the processing of external petroleum in relation to a different petroleum project.

8. In limited circumstances an amount you pay someone else to geologically sequester something sourced from your petroleum project can be exploration expenditure incurred by you in relation to your project even where the other person does that as part of the processing of external petroleum in relation to a different petroleum project. Where you pay someone else to geologically sequester petroleum recovered from the eligible exploration or recovery area (other than any production licence area) in relation to your project and that storage constitutes the processing of external petroleum in relation to a different petroleum project, your payment to that other person will, pursuant to paragraph 37(1)(c), be exploration expenditure you incur in relation to your project, provided that expenditure is not excluded expenditure.

[3] Miscellaneous Taxation Ruling MT 2004/1 explains that assessable receipts in relation to a PRRT project can arise before any relevant production licence has issued. Exploration expenditure under section 37 clearly arises other than at a time when there is any relevant production licence.

Geosequestration of something sourced from a petroleum project: general project expenditure

9. Expenditure on geological sequestration may be general project expenditure for PRRT purposes, and so may be deductible expenditure for PRRT purposes. You might geologically sequester something sourced from a petroleum project and do so in carrying on or providing the operations, facilities or other things of a kind referred to in section 38 in relation to the project. (Broadly speaking, this will be for something sourced from production activities undertaken under an applicable production licence for the project, or from preparatory operations and facilities directed towards those production facilities, or from the project's production activities in relation to the processing of external petroleum.) The expenditure you incur in a financial year on that sequestration is general project expenditure incurred by you in that financial year in relation to that project, provided that expenditure is not excluded expenditure, exploration expenditure or closing-down expenditure.

10. You might incur expenditure on geological sequestration of something sourced from your processing of external petroleum. (External petroleum is sourced from an area that is not the production licence area (or areas) for your own project.) If you process that external petroleum wholly or partly using the operations, facilities and other things comprising your own project, your expenditure in doing so is general project expenditure on your own project, provided that expenditure is not excluded expenditure, exploration expenditure or closing-down expenditure. (Processing external petroleum includes stabilising, transporting, storing or recovering it.) The expenditure you incur on geological sequestration of something sourced from such processing of external petroleum is itself general project expenditure, in the same way as if the thing were sourced from your other project activities, where the geological sequestration is done in carrying on or providing the operations, facilities or other things of a kind referred to in section 38, and provided that expenditure is not excluded expenditure, exploration expenditure or closing-down expenditure.

11. Any consideration receivable by a person in relation to the geological sequestration of something sourced from the processing of external petroleum in relation to a petroleum project is part of the assessable tolling receipts derived by the person in relation to that project and so is part of the assessable receipts derived by the person in relation to that project. Further, assessable tolling receipts derived by the person in relation to a petroleum project also include any consideration receivable by the person in relation to the geological sequestration of a constituent of petroleum that was separated from other constituents of petroleum recovered from an area or areas other than the production licence area or areas in relation to the project.

12. An amount you pay someone else to geologically sequester something sourced from your project is, pursuant to subsection 41(1), generally taken to be general project expenditure incurred by you in relation to your project where that sequestration would have been an activity your own expenditure on which would have been your general project expenditure had you done that sequestration yourself. This is not the case where the other person carries on or provides the operations, facilities or other things as part of the processing of external petroleum in relation to a different petroleum project.

13. Sometimes an amount you pay someone else to geologically sequester something sourced from your petroleum project can be general project expenditure incurred by you in relation to your project even where the other person does that as part of the processing of external petroleum in relation to a different petroleum project. As geological sequestration is a form of storage, where you pay someone else to geologically sequester petroleum recovered from the production licence area or areas in relation to your project and that storage constitutes the processing of external petroleum in relation to a different petroleum project, your payment to that other person will, pursuant to paragraph 38(1)(d), be general project expenditure you incur in relation to your project, provided that expenditure is not excluded expenditure, exploration expenditure or closing-down expenditure.

Geosequestration of something sourced from a petroleum project: closing-down expenditure

14. Expenditure on geological sequestration may be closing-down expenditure for PRRT purposes, and so may be deductible expenditure for PRRT purposes. Where your expenditure on geological sequestration is in carrying on operations involved in closing down your petroleum project, that expenditure will be closing-down expenditure under subsection 39(1), provided it is not excluded expenditure. This could include your expenditure on any geological sequestration done as part of environmental restoration involved in the project's closure.

15. An amount you pay someone else to do such geological sequestration for you in relation to your project is, pursuant to subsection 41(1), generally taken to be closing-down expenditure incurred by you in relation to your project where that sequestration would have been an activity your own expenditure on which would have been your closing-down expenditure had you done that sequestration yourself.

Geosequestration of something not sourced from a PRRT project

16. Geological sequestration of something that is not petroleum and is from a source other than a petroleum project is not generally part of the carrying on or providing of operations, facilities or other things of a kind referred to in sections 37, 38 or 39 even if the sequestration makes some use of petroleum project facilities. Therefore, expenditure on such geological sequestration is not generally deductible expenditure incurred in relation to a petroleum project.

17. However, where you geologically sequester something from a source other than a petroleum project because that is a legal requirement of the carrying on or providing of operations, facilities or other things of a kind referred to in sections 37, 38 or 39 in relation to a petroleum project, the expenditure you incur on that sequestration is deductible expenditure (of the class referred to in the relevant section among those three) incurred by you in relation to that project. If such expenditure is excluded expenditure it cannot be deductible expenditure even if incurring it is a legal requirement.

18. Similarly, where you geologically sequester something from a source other than a petroleum project so as to enhance the recovery of petroleum from your petroleum project, the expenditure you incur on that sequestration is either exploration expenditure or general project expenditure incurred by you in relation to that project, provided that the expenditure is not excluded expenditure. The type of expenditure will depend on whether it relates to enhancing production undertaken under an applicable exploration permit for the project, and so is exploration expenditure, or to enhancing production undertaken under an applicable production licence for the project, and so is general project expenditure.

Income tax

Section 8-1

19. Expenditure on geological sequestration may be deductible expenditure under section 8-1 of the ITAA 1997. A taxpayer's expenditure on geological sequestration will satisfy the positive limbs of section 8-1 where the expenditure has a sufficient connection with the operations or activities which more directly gain or produce the taxpayer's assessable income. This is provided that there is a genuine and not colourable relationship between the whole of the expenditure and the production of such income. If, however, after a practical weighing of all the circumstances it can be concluded that a portion of the expenditure has been outlaid in the independent pursuit of a non-income producing advantage, and not as a cost of undertaking the taxpayer's income earning activities or business, then to that extent the expenditure is not an allowable deduction under section 8-1. The expenditure will in any case be excluded from deduction under section 8-1 to the extent that it is capital expenditure, is private or domestic expenditure, is to gain exempt or non-assessable non-exempt income, or is expressly excluded by a provision of the law: subsection 8-1(2) of the ITAA 1997.

20. A taxpayer's expenditure on geological sequestration can have a sufficient connection with the operations or activities which more directly gain or produce the taxpayer's assessable income in a number of ways. First, the taxpayer could be deriving assessable income, or carrying on a business for the purpose of deriving assessable income, from carrying out geological sequestration. Second, a taxpayer could carry out geological sequestration in the course of its wider assessable income earning activity or business carried on for the purpose of deriving assessable income. In that case, geological sequestration would not have to produce assessable income directly or be carried on for the purpose of itself producing assessable income; but the wider activity itself or the business itself would have to meet those tests respectively.

21. A taxpayer's expenditure on geological sequestration that is done to ameliorate any adverse effects upon the environment of the taxpayer's mining or other industrial activity carried on for the purpose of deriving assessable income or in carrying on its business for the purpose of deriving assessable income is likely to have a revenue, rather than capital, character. However, expenditure on such things as the acquisition of land or the acquisition, construction or improvement of a depreciating asset is likely to be of a capital nature even if such expenditure is related to carrying out geological sequestration.

Section 40-735 (mining site rehabilitation)

22. Expenditure on geological sequestration may be on mining site rehabilitation, and so may be deductible under section 40-735 of the ITAA 1997. Section 40-735 can apply to expenditure on geological sequestration only where that sequestration is part of 'mining site rehabilitation' as defined in subsection 40-735(4) of the ITAA 1997. Therefore, generally, it can apply to expenditure on geological sequestration only where the material geologically sequestered would otherwise have an ongoing effect of changing the condition of a site from what it was before 'mining operations', 'exploration or prospecting' or 'ancillary mining activities' were first started on the site. So section 40-735 will rarely apply to geological sequestration given the gaseous nature of the material usually geologically sequestered.

Section 40-755 (environmental protection activities)

23. Expenditure on geological sequestration may be for the sole or dominant purpose of carrying on 'environmental protection activities', and so may be deductible under section 40-755 of the ITAA 1997, applicable to activities in preventing, fighting or remedying certain pollution or treating, cleaning up, removing or storing certain waste. The terms 'pollution' and 'waste' take their ordinary meanings in the context of section 40-755 and so are apt to include all material that might be geologically sequestered.

24. Geological sequestration will be 'environmental protection activities' as defined in subsection 40-755(2) of the ITAA 1997 where that sequestration is part of preventing, fighting or remedying pollution or treating, cleaning up, removing or storing waste and that pollution or waste:

- results or is likely to result from 'your earning activity' (as defined in subsection 40-755(3) of the ITAA 1997);
- is on or from the site of 'your earning activity'; or
- is on or from a site where an entity was carrying on any business that you have acquired and carry on substantially unchanged as 'your earning activity' (your predecessor business site).

25. Your environmental protection activities do not extend to preventing, fighting or remedying pollution from someone else's activities, or of or from someone else's site or predecessor business site even if such pollution is equivalent to the pollution from your earning activity, or of or from a site of your earning activity or your predecessor business site. Similarly, your environmental protection activities do not extend to treating, cleaning up, removing or storing waste from someone else's activities, from or on someone else's site or predecessor business site even if such waste is equivalent to the waste from your earning activity, or on or from a site of your earning activity or your predecessor business site.

26. However, the nature of the pollution resulting from your earning activity, or from a site of your earning activity, or from your predecessor business site, may be such that it becomes an indistinguishable part of a common pool of material of the same nature (for example, as may happen when a greenhouse gas such as carbon dioxide is released into the atmosphere). For the purposes of section 40-755 of the ITAA 1997 you (or someone else for you) can be 'fighting or remedying' such pollution by extracting from the common pool (to which the pollution resulting from your earning activity, or from a site of your earning activity, or from your predecessor business site was added) and geologically sequestering an amount of the polluting material, up to the amount that entered the common pool resulting from your earning activity, or from a site of your earning activity, or from your predecessor business site. To that extent, your expenditure on such geological sequestration can be deductible under section 40-755 (and applicable decline in value deductions for depreciating assets used for such geological sequestration may be available).

Date of effect

27. This Ruling applies to years of income commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a 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
27 August 2008

Appendix 1 – Explanation

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

Petroleum resource rent tax

28. As stated in paragraph 3, this Ruling considers the circumstances when expenditure and receipts related to geological sequestration are deductible expenditure and assessable receipts respectively for the purposes of ascertaining taxable profit under the PRRTAA and so ascertaining liability for PRRT.

29. Expenditure may be deductible expenditure for PRRT purposes although it is not deductible, or gives rise only to partial or to periodic deductions, for income tax purposes. Such a different result may occur because, unlike income tax which makes distinctions between the deductibility of expenditure of a revenue nature and that of a capital nature, the PRRT does not make such a distinction.

30. Expenditure may not be deductible expenditure for PRRT purposes although it is deductible for income tax purposes. Similarly, receipts may be assessable receipts for PRRT purposes although they are not part of assessable income for income tax purposes, are assessable income only in part, or are brought to account at a different time and on a different basis. Again, such a different result may occur because, unlike income tax which makes distinctions between the assessability of receipts of a revenue nature and those of a capital nature, the PRRT does not make such a distinction.

31. Receipts may not be assessable receipts for PRRT purposes although they are part of assessable income for income tax purposes.

32. Payments of PRRT are generally deductible in working out taxable income for income tax purposes, and certain refunds and credits of PRRT are included in assessable income for income tax purposes, by operation of section 40-750 of the ITAA 1997.

33. PRRT issues only arise when a petroleum project subject to PRRT is involved. There can be PRRT issues relating to geological sequestration if such a petroleum project is the source of the thing that is geologically sequestered or if such a petroleum project uses its project resources to carry out geological sequestration of something from a source other than a petroleum project.

Geosequestration of something sourced from a petroleum project

34. There are several general scenarios relating to the geological sequestration of something sourced from a petroleum project – that is, a petroleum project subject to PRRT. The thing sourced from a petroleum project could be geologically sequestered by the same project, by another petroleum project, or by a non-petroleum project. These general scenarios are respectively represented by figures 1, 2 and 3 below. Although those figures relate to greenhouse gas, it need not be greenhouse gas that is being geologically sequestered (for example, it could be contaminated water).

Figure 1: Greenhouse gas sourced from a PRRT project and geologically sequestered into the same PRRT project

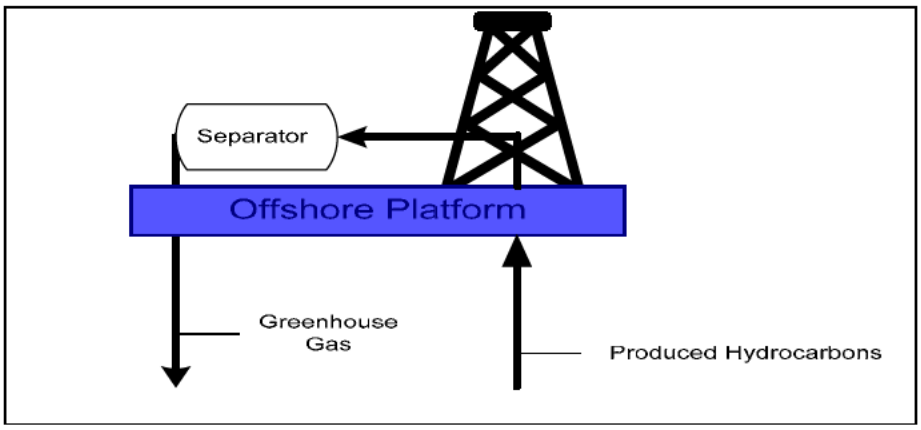


Figure 2: Greenhouse gas sourced from a PRRT project and geologically sequestered into a different PRRT project

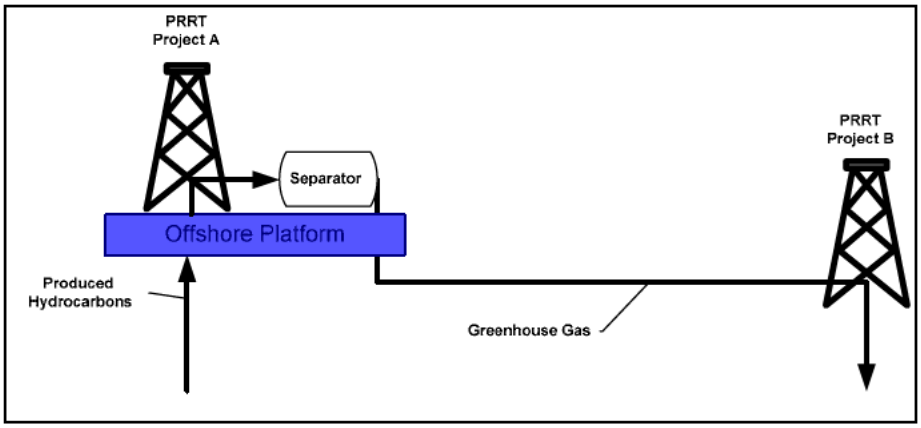
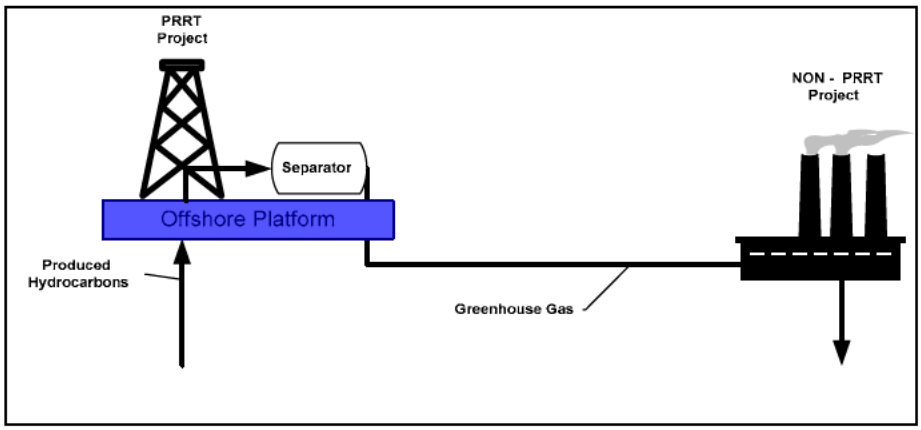


Figure 3: Greenhouse gas sourced from a PRRT project and geologically sequestered into a non-PRRT project



35. Section 32 sets out the classes of expenditure that are added together to form the deductible expenditure incurred by a particular person in a financial year in relation to a petroleum project. Those classes of expenditure are, in turn, defined in sections 33 to 39. A common element of those definitions is that each is calculated based on amounts of 'exploration expenditure', 'general project expenditure' or 'closing-down expenditure' as defined in sections 37, 38 and 39 respectively. In other words, an amount of expenditure must satisfy one of those three definitions to be taken into account in the calculation of deductible expenditure for PRRT purposes.

Geosequestration of something sourced from a petroleum project: exploration expenditure

36. Subsection 37(1) relevantly provides:

> For the purposes of this Act, a reference to exploration expenditure incurred by a person in relation to a petroleum project is a reference to payments (not being excluded expenditure), whether of a capital or revenue nature, liable to be made by the person:
>
> (a) 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 project; and
>
> (b) in carrying on or providing such of the following as are or have been carried on or provided:
>
> (i) operations and facilities involved in the recovery of any petroleum from the eligible exploration or recovery area (other than any production licence area) in relation to the project;
>
> (ii) operations and facilities involved in moving any petroleum so recovered to or between any storage or processing facilities prior to the production of any marketable petroleum commodity from the petroleum;

(iii) operations and facilities involved in the storage, processing or treating of any petroleum so recovered to produce any marketable petroleum commodity from the petroleum;

(iv) operations and facilities involved in the moving or storage of any such marketable petroleum commodity before it becomes an excluded commodity;

(v) services, or facilities for the provision of services, in connection with the operations, facilities, amenities and services referred to in this section;

(vi) employee amenities in connection with the operations, facilities and services referred to in this section; and

(c) 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 external petroleum in relation to another petroleum project;

and includes any exploration permit, retention lease or other fee (not being an excluded fee) liable to be paid by the person in relation to the carrying on or providing of any operations, facilities or other things referred to in this section.

37. Although that definition does not specifically mention waste management and pollution control, when waste management or pollution control measures apply to operations or facilities 'involved in' doing a certain thing, they are themselves part of the operations or facilities 'involved in' doing that thing. So provided you geologically sequester something sourced from a petroleum project and do so in carrying on or providing the operations, facilities or other things of a kind referred to in subsection 37(1) in relation to the project, the expenditure you incur in a financial year on that sequestration is exploration expenditure incurred by you in that financial year in relation to that project, provided that expenditure is not also excluded expenditure.[4]

38. An amount you pay someone else to do such geological sequestration for you in relation to your project is, pursuant to subsection 41(1), generally taken to be exploration expenditure incurred by you in relation to your project where that sequestration would have been an activity your own expenditure on which would have been your exploration expenditure had you done that sequestration yourself.

[4] 'Excluded expenditure' is defined in section 44.

Example 1

39. You process a petroleum stream with a high proportion of carbon dioxide from your exploration well and send the resulting stream of carbon dioxide which is separated during processing to another PRRT project for geological sequestration, paying a fee for that. The cost of sequestering the carbon dioxide would have been exploration expenditure had you done it. The carbon dioxide is not itself petroleum and the fee you pay is exploration expenditure of yours, if not excluded expenditure.

40. However, subsection 41(1) does not apply where the other person carries on or provides the operations, facilities or other things as part of the processing of external petroleum in relation to a different petroleum project.[5]

41. In limited circumstances an amount you pay someone else to geologically sequester something sourced from your petroleum project can be exploration expenditure incurred by you in relation to your project even where the other person does that as part of the processing of external petroleum in relation to a different petroleum project. Paragraph 37(1)(c) includes as exploration expenditure payments liable to be made 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, etcetera, constitutes the processing of external petroleum in relation to another petroleum project.

42. The result of the combination of the definitions of 'external petroleum' and 'processing of external petroleum' is that 'processing of external petroleum' includes the stabilisation, transportation, storage or recovery of petroleum, or constituents of petroleum, recovered from an area or areas other than the production licence area or production licence areas in relation to the project. So provided the thing you pay someone else to geologically sequester is petroleum[6] recovered from the eligible exploration or recovery area (other than any production licence area) in relation to your project and that storage constitutes the processing of external petroleum in relation to a different petroleum project, your payment to that other person will be exploration expenditure you incur in relation to your project.

[5] Subsection 41(2).
[6] The definition of 'petroleum' is given in paragraph 67 of this Ruling.

43. If you pay someone else to stabilise, transport, recover or process petroleum recovered from the eligible exploration or recovery area in relation to your project in circumstances where their activities in doing that constitute the processing of external petroleum in relation to a different project, and they geologically sequester something sourced from that processing of external petroleum, their expenditure on that sequestration is, *in effect,* recognised in the exploration expenditure you incur in relation to your project through the recognition under paragraph 37(1)(c) of your payment to them (for processing what is external petroleum in relation to their project) as exploration expenditure you have incurred in relation to your project. This comes about effectively because the amount they charge you for that activity ordinarily takes into account their various costs, including the cost of the geological sequestration of the thing sourced from those activities.

Example 2

44. You send a petroleum stream from your exploration well to another PRRT project for processing into marketable petroleum commodities of yours for a fee (referred to as a tolling fee). If that processing facility geologically sequesters some component of the stream, such as carbon dioxide, that processing facility's expenditure on that sequestration is in effect recognised in your exploration expenditure through the recognition of your payment to them for processing your petroleum as exploration expenditure in relation to your project. Such a tolling fee will be an assessable tolling receipt of the recipient in relation to their PRRT project (see paragraph 53 of this Ruling for more details).

Geosequestration of something sourced from a petroleum project: general project expenditure

45. Section 38 provides:

> (1) For the purposes of this Act, a reference to general project expenditure incurred by a person in relation to a petroleum project is a reference to payments (not being excluded expenditure, exploration expenditure or closing-down expenditure), whether of a capital or revenue nature, liable to be made by the person:
>
> (a) in carrying on or providing operations and facilities preparatory to the activities referred to in paragraph (b), including in carrying out any feasibility or environmental study; and
>
> (b) in carrying on or providing the operations, facilities and other things comprising the project; and
>
> (c) in purchasing, as part of the project, external petroleum in relation to the project; and

(d) in procuring another person to stabilise, transport, store, recover or process petroleum recovered from the production licence area or areas in relation to the project, if that stabilisation, transportation, storage, recovery or processing constitutes the processing of external petroleum in relation to another petroleum project;

and includes any production licence or other fee (not being an excluded fee) liable to be paid by the person in relation to the carrying on or providing of any operations, facilities or other things referred to in this section.

(2) To avoid doubt, carrying on or providing the operations, facilities and other things comprising the project referred to in paragraph (1)(b) includes carrying on or providing the operations, facilities and other things in relation to the processing of external petroleum in relation to the project.

46. The meaning of paragraph 38(1)(b) is expanded upon in subsection 19(4), which provides:

For the purposes of this Act, a reference to the operations, facilities and other things comprising a petroleum project is a reference to:

(a) operations and facilities for the recovery of petroleum from the production licence area or production licence areas in relation to the project; and

(b) such of the following as are carried on or provided:

(i) operations and facilities involved in moving petroleum so recovered between any storage or processing facilities prior to the production of any marketable petroleum commodity from the petroleum;

(ii) operations and facilities involved in the storage, processing or treatment of petroleum so recovered to produce any marketable petroleum commodity from the petroleum;

(iii) operations and facilities involved in the moving or storage of any such marketable petroleum commodity before it becomes an excluded commodity;

(iv) services, or facilities for the provision of services, in connection with the operations, facilities, amenities and services referred to in this section;

(v) employee amenities in connection with the operations, facilities and services referred to in this section.

47. Subsection 19(2B) also relevantly provides:

> For the purposes of this Act, there shall be taken to be included, as part of any petroleum project within the meaning of subsection (1) or (2), the carrying on of any processing of external petroleum wholly or partly using the operations, facilities and other things comprising the project:
>
> (a) in the case of an eligible production licence referred to in subsection (1) – while that licence is in force; or
>
> (b) in the case of 2 or more eligible production licences referred to in subsection (2) – while any of those licences are in force.
>
> Note: under subsection (4), the operations, facilities and other things comprising the project are limited to those used in relation to petroleum recovered from the one or more production licence areas in relation to the project.

48. The combined result of subsections 38(1) and 19(4) is that the scope of the general project expenditure you may incur in relation to a petroleum project is very similar to the scope of the exploration expenditure you may incur in relation to that project. Differences relate to the fact that with exploration expenditure the relevant area from which petroleum may be recovered is the eligible exploration or recovery area in relation to the project, excluding any production licence area, where with general project expenditure the relevant area is the production licence area or areas in relation to the project.

49. So, just as with exploration expenditure, where you geologically sequester something sourced from a petroleum project and do so in carrying on or providing the operations, facilities or other things of a kind referred to in section 38, the expenditure you incur in a financial year on that sequestration is general project expenditure incurred by you in that financial year in relation to that project, provided that expenditure is not excluded expenditure, exploration expenditure or closing-down expenditure.

50. Further, the effect of subsection 19(2B) is that the carrying on of any processing of external petroleum wholly or partly using 'the operations, facilities and other things comprising the project' (as that phrase is expansively defined in subsection 19(4)) is taken to be part of the project. That produces the result, as evidenced in subsection 38(2), that paragraph 38(1)(b) includes expenditure incurred in carrying on or providing the operations, facilities and other things in relation to the processing of external petroleum in relation to the project.

51. So, if you stabilise, transport, store, recover or process petroleum, or constituents of petroleum, recovered from an area or areas other than the production licence area or production licence areas in relation to your project, wholly or partly using the operations, facilities and other things comprising your project, the expenditure you incur in carrying on those operations, facilities and other things in relation to that processing of that external petroleum is general project expenditure you incur in relation to your project, provided that expenditure is not excluded expenditure, exploration expenditure or closing-down expenditure. This would include expenditure you incur on geological sequestration of something sourced from that processing of external petroleum.

Example 3

52. You acquire a petroleum stream from some other project's well and add it to the petroleum stream from your PRRT project's recovery of petroleum under an applicable production licence. You stabilise it with the stream from your project, store it in common tanks, and process it in the same facilities as the stream from your project. As part of these operations you geologically sequester something that came from the stream from the other project's well. The expenditure you incur on that geological sequestration is general project expenditure (if not excluded expenditure).

53. Any consideration[7] receivable by a person in relation to the processing of external petroleum in relation to a project is assessable tolling receipts derived by the person in relation to the project and so is in included in the assessable receipts derived by the person in relation to the project.[8] This would include any consideration receivable by a person in relation to the geological sequestration of something sourced from the processing of external petroleum in relation to the project. (If the external petroleum is not tolled for another person, but is part of your own stock of petroleum, then you will get the assessable receipts in relation to that petroleum, which is part of the 'petroleum from the project'[9] for which you derive assessable petroleum receipts.)

54. Further, assessable tolling receipts derived by the person in relation to a petroleum project also include any consideration receivable by the person in relation to the geological sequestration of a constituent of petroleum that was separated from other constituents of petroleum recovered from an area or areas other than the production licence area or areas in relation to the project.

[7] 'Consideration' includes the money value of consideration by way of the provision of property other than money: section 8.
[8] See sections 23 and 24A.
[9] See the definition of ***petroleum from the project*** in subsection 24(2).

55. For example, although carbon dioxide once separated from hydrocarbons is no longer 'petroleum' or part of 'petroleum' as defined for the purposes of the PRTAA,[10] such carbon dioxide is a 'constituent of petroleum' for the purposes of the definition of 'external petroleum' in section 2. Therefore, we consider that the geological sequestration of such carbon dioxide can be the 'processing of external petroleum' in relation to a petroleum project (which includes the stabilisation, transportation, storage or recovery of external petroleum in relation to the project) as defined in section 2.

56. Therefore, consideration receivable to geologically sequester carbon dioxide separated from other constituents of 'petroleum' (as defined) recovered from an area or areas other than the production licence area or areas in relation to the project is 'consideration receivable by the person in relation to the processing of external petroleum in relation to the project' for the purposes of section 24A.

57. Therefore, such consideration is assessable tolling receipts derived by the person in relation to the petroleum project and so is included in the assessable receipts derived by the person in relation to the project: see sections 23 and 24A.

58. As in relation to exploration expenditure, an amount you pay someone else to geologically sequester something sourced from your project is, pursuant to subsection 41(1), generally taken to be general project expenditure incurred by you in relation to your project where that sequestration would have been an activity your own expenditure on which would have been your general project expenditure had you done that sequestration yourself. Again, this is not the case where the other person carries on or provides the operations, facilities or other things as part of the processing of external petroleum in relation to a different petroleum project.

59. As in relation to exploration expenditure, an amount you pay someone else to geologically sequester something sourced from your petroleum project can be general project expenditure incurred by you in relation to your project even where the other person does that as part of the processing of external petroleum in relation to a different petroleum project. Paragraph 38(1)(d) includes as general project expenditure, 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 project, if that stabilisation, etcetera, constitutes the processing of external petroleum in relation to another petroleum project.

[10] As per section 2 of the PRTAA, for the purposes of the PRRTAA 'petroleum' has the same meaning as in the *Offshore Petroleum Act 2006*. (Refer to paragraph 67 of this Ruling for further details).

60. So where the thing you pay someone else to geologically sequester is petroleum recovered from the production licence area or areas in relation to your project and that storage constitutes the processing of external petroleum in relation to a different petroleum project, your payment to that other person will be general project expenditure you incur in relation to your project, provided that expenditure is not excluded expenditure, exploration expenditure or closing-down expenditure.

61. If you pay someone else to stabilise, transport, recover or process petroleum recovered from the production licence area or areas in relation to your project in circumstances where their activities doing so constitute the processing of external petroleum in relation to a different petroleum project, and they geologically sequester something sourced from that processing of external petroleum, their expenditure on that sequestration is *in effect* recognised in general project expenditure you incur in relation to your project through the recognition under paragraph 38(1)(d) of your payment to them (for processing what is external petroleum in relation to their project) as general project expenditure you have incurred in relation to your project. This comes about effectively because the amount they charge you for that activity ordinarily takes into account their various costs, including the cost of the geological sequestration of the thing sourced from those activities.

Example 4

62. You send a petroleum stream from your PRRT project's production well to another PRRT project for processing into marketable petroleum commodities of yours for a fee (referred to as a tolling fee). If that processing facility geologically sequesters some component of the stream, such as carbon dioxide, that processing facility's expenditure on that sequestration is in effect recognised in your general project expenditure through the recognition of your payment to them for processing your petroleum as general project expenditure in relation to your project. Such a tolling fee will be an assessable tolling receipt of the recipient in relation to their PRRT project (see paragraph 53 of this Ruling for more details).

Geosequestration of something sourced from a petroleum project: closing-down expenditure

63. Subsection 39(1) provides:

> For the purposes of this Act, a reference to closing-down expenditure incurred by a person in relation to a petroleum project is a reference to payments (not being excluded expenditure), whether of a capital or revenue nature, liable to be made by the person in carrying on operations involved in closing down the project, including in any environmental restoration as a consequence of closing down the project.

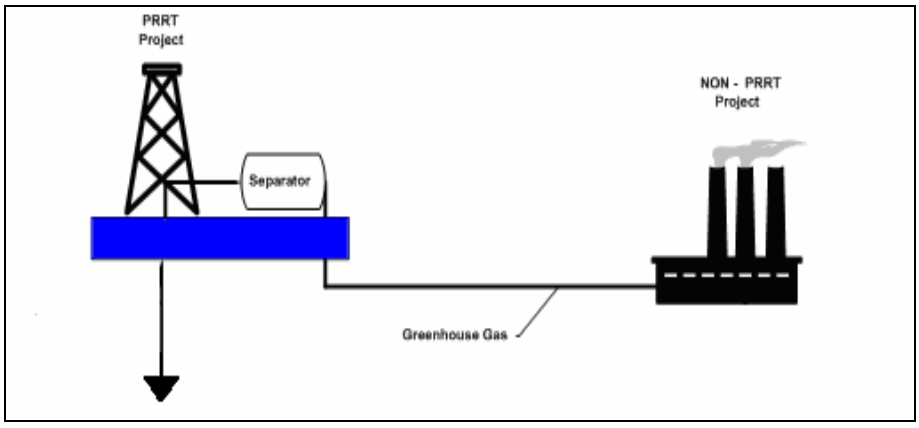
64. Where your expenditure on geological sequestration is in carrying on operations involved in closing down your project, that expenditure will be closing-down expenditure under subsection 39(1), provided it is not excluded expenditure. Specifically included as closing-down expenditure are environmental restoration payments liable to be made by you as a consequence of (that is, made necessary by)[11] the project's closure. This could include your geological sequestration expenditure made necessary as part of environmental restoration forming part of the project's closure.

65. An amount you pay someone else to do such geological sequestration for you in relation to your project is, pursuant to subsection 41(1), generally taken to be closing-down expenditure incurred by you in relation to your project where that sequestration would have been an activity your own expenditure on which would have been your closing-down expenditure had you done that sequestration yourself.

Geosequestration of something not sourced from a PRRT project

66. This general scenario is represented by Figure 4 below.

Figure 4: Greenhouse gas sourced from a non-PRRT project and geologically sequestered into a PRRT project.



[11] See the notes on clause 39 of the Petroleum Resource Rent Tax Assessment Bill 1987.

67. Geological sequestration of something that is not petroleum and is from a source other than a petroleum project is not generally part of the carrying on or providing of operations, facilities or other things of a kind referred to in sections 37, 38 or 39 of the PRRTAA even if the sequestration makes some use of petroleum project facilities. Therefore, expenditure on such geological sequestration is not generally deductible expenditure incurred in relation to a petroleum project. Further, any receipt from such sequestration is not generally an assessable receipt derived in relation to a petroleum project. (If what is geologically sequestered is 'petroleum', under the extended definition of that term in the *Offshore Petroleum Act 2006*, which by section 6 of that Act relevantly means:

> (a) any naturally occurring hydrocarbon, whether in a gaseous, liquid or solid state; or
>
> (b) any naturally occurring mixture of hydrocarbons, whether in a gaseous, liquid or solid state; or
>
> (c) any naturally occurring mixture of:
>
> (i) one or more hydrocarbons, whether in a gaseous, liquid or solid state: and
>
> (ii) one or more of the following, that is to say, hydrogen sulphide, nitrogen, helium and carbon dioxide;
>
> and:
>
> (d) includes any petroleum as defined by paragraph (a), (b) or (c) that has been returned to a natural reservoir;
>
> …

then it is dealt with as external petroleum[12] and not as something other than part of a petroleum project.)

Example 5

68. You receive carbon dioxide produced by a nearby fossil fuel based electricity generator and, for a fee, geologically sequester it (along with the carbon dioxide produced in the course of your petroleum project) using the facilities of your project. The expenditure you incur in sequestering the carbon dioxide from the generator is not deductible expenditure of your petroleum project (requiring you to apportion the overall cost of sequestering carbon dioxide, because some of that carbon dioxide comes from your petroleum project), and the fee is not an assessable receipt of your petroleum project.

[12] See the definition of *external petroleum* in section 2.

69. However, where you geologically sequester something that is not petroleum and is from a source other than a petroleum project and do so because that is a legal requirement of the carrying on or providing of operations, facilities or other things of a kind referred to in sections 37, 38 or 39 in relation to a petroleum project, the expenditure you incur on that sequestration is deductible expenditure (of the class referred to in the relevant section among those three) incurred by you in relation to that project. If such expenditure is excluded expenditure it cannot be deductible expenditure even if it is a legal requirement.

70. In other words, the fact that such geological sequestration is a legal requirement of the carrying on or providing of operations, facilities or other things of a kind referred to in sections 37, 38 or 39 in relation to a petroleum project, means that your expenditure on such geological sequestration is not merely connected with, but rather is actually in, the carrying on or providing of operations, facilities or other things of a kind referred to in sections 37, 38 or 39 in relation to a petroleum project.

71. Similarly, where you geologically sequester something that is not petroleum and is from a source other than a petroleum project and do so to enhance the recovery of petroleum from a petroleum project, the expenditure you incur on that sequestration is either exploration expenditure or general project expenditure incurred by you in relation to that project, provided that expenditure is not excluded expenditure. Such expenditure is, in terms of subparagraph 37(1)(b)(i) or paragraph 38(1)(b) in conjunction with paragraph 19(4)(a), liable to be made in carrying on or providing operations and facilities involved in [or for] the recovery of petroleum from the relevant eligible exploration or recovery area or production licence area in relation to the project depending on whether it is in relation to production under a production licence or not.

Example 6

72. You receive carbon dioxide produced by a nearby fossil fuel based electricity generator and geologically sequester it into part of a petroleum reservoir to increase flows of petroleum from one of your production wells that recovers petroleum from the reservoir under a production licence for your petroleum project. Your expenditure on the geosequestration is general project expenditure, if not excluded expenditure.

Income tax

73. As stated in paragraph 4 of this Ruling, this Ruling also describes income tax consequences of expenditure on geological sequestration generally (that is, not just in relation to PRRT projects) under sections 8-1, 40-735 (mining site rehabilitation) and 40-755 (environmental protection activities) of the ITAA 1997. Income tax deductibility does not depend on whether expenditure is 'deductible expenditure' for the purposes of the PRRT. In the income tax context, the distinction between capital expenditure and expenditure of a revenue character is usually material to the treatment of the expenditure, where the same distinction is usually not significant to the treatment of expenditure in the PRRT context.

Section 8-1

74. Taxation Ruling TR 2006/2 sets out general principles concerning the application of 'the positive limbs' of section 8-1 (contained in subsection 8-1(1)) of the ITAA 1997 as follows at paragraphs 18 to 30:

> 18. Expenditure will satisfy the positive limbs of section 8-1 of the ITAA 1997 if its essential character is that of expenditure that has a sufficient connection with the operations or activities which more directly gain or produce the taxpayer's assessable income: *Lunney v. Commissioner of Taxation* (1958) 100 CLR 478; (1958) 11 ATD 404 at CLR 498-499; ATD 412-413.
>
> 19. The characterisation of particular expenditure is by its nature a question of fact. It involves an enquiry about what the expenditure was for and what it was intended to achieve in relation to the taxpayer's income earning activities or business from a practical and business point of view: *Magna Alloys & Research Pty Ltd v. Federal Commissioner of Taxation* (1980) 49 FLR 183; 80 ATC 4542; (1980) 11 ATR 276 (*Magna Alloys*) at ATC 4549 and 4551; ATR 284 and 287 and *Hallstroms Pty Ltd v. Federal Commissioner of Taxation* (1946) 72 CLR 634; (1946) 8 ATD 190 at CLR 648; ATD 196.
>
> 20. Ordinarily, the objective circumstances that gave rise to the expenditure would be expected to provide a clear explanation of the benefit intended to be achieved by the expenditure and thereby its essential character. As Dixon J pointed out in *Robert G Nall Ltd v. Federal Commissioner of Taxation* (1936) 57 CLR 695; (1936) 4 ATD 335 (*Robert G Nall*) at CLR 712; ATD 342,[13] '…the circumstances of the transaction must give it the complexion of money laid out in furtherance of a purpose of gaining income'. In the context of the ITAA 1936 this has been interpreted as meaning that the expenditure must be incurred in circumstances where it is 'conducive to the gaining or producing of assessable income or to the carrying on of a business by the taxpayer' (*Magna Alloys* at ATC 4549; ATR 284).

[13] *Robert G Nall* was decided under the predecessor of the *Income Tax Assessment Act 1936* (ITAA 1936), but related to the deductibility of expenses incurred by a company in the course of conducting a business.

21. Expenditure is 'conducive' to the production of assessable income or the conduct of a business to produce such income where it is 'incidental and relevant' to the gaining of the income or reasonably capable of being seen as 'desirable or appropriate' in the pursuit of the business ends of the business (*Ronpibon Tin NL & Tongkah Compound NL v. Federal Commissioner of Taxation* (1949) 78 CLR 47; (1949) 8 ATD 431 (*Ronpibon*) at CLR 56-57; ATD 435; *Magna Alloys* at ATC 4560-4561; ATR 296-297).

22. Consistent with this, expenditure incurred in obtaining the supply of goods or services from another party under a contract will ordinarily be characterised by reference to both the contractual benefits passing to the taxpayer under the contract and the relationship that those benefits have to the taxpayer's income earning activities or business: *Magna Alloys* at ATC 4548 & 4559; ATR 283 & 295, *Federal Commissioner of Taxation v. The Midland Railway Co of Western Australia Ltd* (1952) 85 CLR 306; (1952) 9 ATD 372 at CLR 313; ATD 377.[14]

23. Where, however, the relationship between the contractual benefits and the taxpayer's income earning activities or business is inadequate to explain objectively the whole of the expenditure then the contract alone will not suffice, without more, to characterise the whole expenditure as one which can truly be said to have been incurred in gaining or producing assessable income (*Fletcher & Ors v. Commissioner of Taxation of the Commonwealth of Australia* (1991) 173 CLR 1; 91 ATC 4950; (1991) 22 ATR 613 (*Fletcher*) at CLR 18-19; ATC 4958; ATR 622-623, *Ure v. Federal Commissioner of Taxation* (1981) 50 FLR 219; 81 ATC 4100; (1981) 11 ATR 484 (*Ure*) at ATC 4109-4110; ATR 494-495), or in pursuing the commercial ends of the business.[15]

[14] Note, however, if, the contractual arrangements constitute a sham then characterisation of the expenditure will not be determined by reference to the purported contract but by reference to the actual legal rights and obligations which the parties intended to create.

[15] This will be particularly true of arrangements between associates where the connection between the expenditure and the taxpayer's income earning activities or business cannot be 'inferred' but must be 'positively established' (see *Spassked Pty Limited v. Commissioner of Taxation* (2003) 136 FCR 441; 2003 ATC 5099; (2003) 54 ATR 546 at ATC 5130; ATR 583).

24. Problems arise where the parties are not dealing with each other at arm's length and the charges are grossly excessive (see *Steele v. Deputy Commissioner of Taxation* (1999) 197 CLR 459; 99 ATC 4242; (1999) 41 ATR 139 at CLR 470; ATC 4248; ATR 147, *Federal Commissioner of Taxation v. Firth* (2002) 120 FCR 450; 2002 ATC 4346; (2002) 50 ATR 1 (*Firth*) at ATC 4350; ATR 5 and *Hart v. Commissioner of Taxation* (2002) 121 FCR 206; 2002 ATC 4608; (2002) 50 ATR 369 at ATC 4616; ATR 377); and/or where the expenditure is disproportionate to the benefits passing to the taxpayer under the contract (see *Robert G Nall* at CLR 706, 708-709, 712-713; ATD 338, 340, 342-343; and *WD & HO Wills (Australia) Pty Ltd v. Federal Commissioner of Taxation* (1996) 65 FCR 298; 96 ATC 4223; (1996) 32 ATR 168 at ATC 4248; ATR 193).[16] To adopt the language of the Federal Court in *Ure*, in cases such as these the circumstances of the expenditure will not 'offer an obvious commercial explanation for incurring it'.[17]

25. It should be noted that whether a payment is grossly excessive will depend on all of the circumstances in the case. In this context the nature of the connection between the parties is of particular relevance. A payment that might be considered acceptable if made between two unrelated parties acting at arm's length may be considered grossly excessive when made between related parties, particularly if there is a single controlling mind, or group of minds, in respect of both parties. The former may simply be the result of a 'bad' business deal, while the latter may indicate the existence of another objective purpose for making the payment.

26. If the relationship between the contractual benefits and the taxpayer's income earning activities or business is inadequate to explain the whole of the expenditure, then the characterisation of the expenditure cannot be confined to a 'juristic classification of the legal rights, if any, secured, employed or exhausted in the process': *Firth* at ATC 4348-4349; ATR 4. Characterisation of the expenditure must be resolved by a 'commonsense' or 'practical' weighing' of 'the whole set of objects and advantages which the taxpayer sought in making the outgoing', including the direct and indirect objects and advantages sought by the taxpayer: *Fletcher* at CLR 18-19; ATC 4958; ATR 623.

[16] It is unclear whether these cases should be viewed as separate lines of authority or whether they simply represent different expressions of the same legal principle. Either way, the Commissioner takes the view that they have the same practical consequences when considering the deductibility of expenditure incurred under service arrangements.
[17] 81 ATC at 4109; 11 ATR at 494.

27. If, after conducting a broader inquiry into all the circumstances surrounding the expenditure, including the direct and indirect objects and advantages sought by the taxpayer, it can be fairly concluded that the whole expenditure is properly to be characterised as genuinely, and not colourably, incurred in the pursuit of the taxpayer's income earning activities or business, then the entire expenditure will be deductible, subject to the exclusory provisions within section 8-1 of the ITAA 1997: *Fletcher* at CLR 19; ATC 4958; ATR 623. This would be the position even if the taxpayer could have acquired the same contractual benefits by incurring a lesser amount of expenditure. It 'is not for the Court or the Commissioner to say how much a taxpayer ought to spend in obtaining his income, but only how much he has spent': *Ronpibon* at CLR 60; ATD 437. Nor is it for the Commissioner to tell a taxpayer 'how to run his business profitably or economically': *Tweddle v. Federal Commissioner of Taxation* (1942) 180 CLR 1; (1942) 7 ATD 186 at CLR 7; ATD 190. The Commissioner must take the results of the taxpayer's activities as he finds them, regardless of whether those activities give rise to good or bad commercial outcomes.

28. If, however, after a practical weighing of all the circumstances it can be concluded that a portion of the expenditure has been outlaid in the independent pursuit of a non-income producing advantage, and not as a cost of undertaking the taxpayer's income earning activities or business, then to that extent the expenditure is not an allowable deduction: *Fletcher* at CLR 19; ATC 4958; ATR 623, *Ure* ATC 4110-4111; ATR 495-496 and *Robert G Nall* at CLR 706, 708-709, 712-713; ATD 338, 340, 342-343.

29. Depending on the individual circumstances, an independent advantage could be, amongst other things, the 'distribution of income gained' (see *Robert G Nall* at CLR 713; ATD 343), the making of a 'gift' (see Deane J in *Federal Commissioner of Taxation v. Isherwood & Dreyfus Pty Ltd* (1979) 9 ATR 473; 79 ATC 4031 at ATR 474; ATC 4032), or the creation of a fund for the provision of financial benefits to family members or associates (see *Ure* at ATC 4104 and 4110; ATR 488 and 495).

30. In such cases it will be necessary to undertake a fair and reasonable apportionment of the expenditure having regard to all the relevant circumstances: *Ronpibon*.

75. A taxpayer's expenditure on geological sequestration will satisfy the positive limbs of section 8-1 of the ITAA 1997 where the expenditure has a sufficient connection with the operations or activities which more directly gain or produce the taxpayer's assessable income, provided that there is 'a genuine and not colourable relationship between the whole of the expenditure and the production of such income.'[18] 'If, however, after a practical weighing of all the circumstances it can be concluded that a portion of the expenditure has been outlaid in the independent pursuit of a non-income producing advantage, and not as a cost of undertaking the taxpayer's income earning activities or business, then to that extent the expenditure is not an allowable deduction'[19] under section 8-1. The expenditure will in any case be excluded from deduction under section 8-1 to the extent that it is capital expenditure, is private or domestic expenditure, is to gain exempt or non-assessable non-exempt income, or is expressly excluded by a provision of the law: subsection 8-1(2) of the ITAA 1997.

76. A taxpayer's expenditure on geological sequestration can have a 'sufficient connection with the operations or activities which more directly gain or produce the taxpayer's assessable income'[20] in a number of ways.

77. First, the taxpayer could be deriving assessable income, or carrying on a business for the purpose of deriving assessable income, from carrying out geological sequestration. A likely context would be a taxpayer with the capacity to use its facilities to carry out geological sequestration of some particular material. Such a taxpayer might decide to carry out geological sequestration of other people's material for reward.

[18] *Fletcher & Ors v. Federal Commissioner of Taxation* (1991) 173 CLR 1; 91 ATC 4950; (1991) 22 ATR 613 at CLR 18; ATC 4957; ATR 622. See paragraph 24 of TR 2006/2 for examples of situations that give rise to consideration as to whether there is a colourable relationship between the expenditure and assessable income production.
[19] See paragraph 28 of TR 2006/2.
[20] See paragraph 18 of TR 2006/2, set out at paragraph 74 of this Ruling.

78. Second, a taxpayer could carry out geological sequestration in the course of, and for the purposes of, its wider assessable income earning activity or business carried on for the purpose of deriving assessable income. In that case, geological sequestration would not have to produce assessable income directly or be carried on for the purpose of itself producing assessable income; but the wider activity itself or the business itself would have to meet those tests respectively. A likely context would be that the material being geologically sequestered is an unwanted by-product of other processes carried out in the taxpayer's wider business or wider activity. Indeed, expenditure on geological sequestration can have a sufficient connection with the operations or activities which more directly gain or produce the taxpayer's assessable income even where the geological sequestration is carried out for reasons related relatively indirectly to assessable income production. For example, geological sequestration could be carried out by a taxpayer with the capacity to do it, so as to create a favourable impression of the taxpayer's assessable income earning activity or business carried on for the purpose of deriving assessable income.

Section 8-1 of the ITAA 1997 (capital exclusion)

79. Even though a loss or outgoing satisfies either or both the positive limbs of section 8-1 of the ITAA 1997, subsection 8-1(2) of the ITAA 1997 provides that it is not deductible under section 8-1 to the extent that:

(a) it is a loss or outgoing of capital, or of a capital nature; or

(b) it is a loss or outgoing of a private or domestic nature; or

(c) it is incurred in relation to gaining or producing the taxpayer's *exempt income or *non-assessable non-exempt income; or

(d) a provision of this Act prevents you from deducting it.

80. In *Associated Minerals Consolidated Ltd v. Commissioner of Taxation* (1994) 53 FCR 115; 94 ATC 4499; (1994) 29 ATR 147 the Full Federal Court made some statements that are relevant to whether, and to what extent, a taxpayer's expenditure on geological sequestration is likely to be excluded from deductibility under section 8-1 of the ITAA 1997 as a 'loss or outgoing of capital, or of a capital nature' pursuant to paragraph 8-1(2)(a) of the ITAA 1997.

81. The taxpayer carried on the business of mining and processing minerals sands which resulted in the production of large quantities of tailings, which were subsequently used as land fill by individuals in the local area. These tailings included monazite – a radioactive by-product of the mining. The Commissioner allowed a deduction under section 51 of the ITAA 1936 for the taxpayer's expenditure on removal of monazite from land which had been mined, but denied the taxpayer a deduction under that section in respect of the taxpayer's contribution towards the cost of removing monazite from land on which the tailings had been used as land fill.

82. In holding that the expenditure towards removing monazite from land-fill land was deductible under section 51 of the ITAA 1936, Northrop, Spender and Burchett J stated at FCR 123; ATC 4506; ATR 154:

> In the late 20th century, part of the recurring costs of mining businesses is expenditure upon the amelioration of any adverse effects upon the environment of the mining activity. If it were not so, the community would be most concerned about the activity itself. Because the issue *is* one in which the community takes a strong interest, it is necessary to the conduct of the business of mining, not only that this additional work be done, but also that the doing of it be made known and, in some cases, something extra be done to make up for past neglect or oversight. None of this is properly to be seen as unrelated to the ongoing cost of the mining activity. Nor does it procure for the mining company, once and for all, some enduring benefit; any public credit gained will prove ephemeral unless regularly renewed by constant effort.
>
> …
>
> This expenditure was 'incurred in attempting to vindicate the business methods of the taxpayer, overcoming the obstacle to its trading' which was perceived by its directors: *Magna Alloys & Research Pty Ltd v. Commissioner of Taxation (Cth)* (1980) 49 FLR 183 at 201, per Brennan J. In the same passage, Brennan J made it clear that the fact that an expenditure 'protected the reputation and goodwill' of the taxpayer's business would not deny it the character of expenditure on revenue account where 'it was the business purpose of vindicating the methods by which [the business] was conducted' which was involved. See also *Putnin v. Commissioner of Taxation* (1991) 27 FCR 508 at 513.

83. The Commissioner considers that those statements apply to give a likely revenue, rather than capital, character to a taxpayer's expenditure on geological sequestration that is done to ameliorate any adverse effects upon the environment of the taxpayer's mining activity itself carried on for the purpose of deriving assessable income or in carrying on its business for the purpose of deriving assessable income. Further, the Commissioner considers that those statements apply (by analogy) to industrial activities generally, that is, to give a likely revenue, rather than capital, character to a taxpayer's expenditure on geological sequestration where that is done to ameliorate any adverse effects upon the environment of the taxpayer's industrial activity itself carried on for the purpose of deriving assessable income or in carrying on its business for the purpose of deriving assessable income. However, expenditure on such things as the acquisition of land or the acquisition, construction or improvement of a depreciating asset is likely to be of a capital nature even if such expenditure is related to carrying out geological sequestration.

84. Where a taxpayer pays someone else to carry out geological sequestration, those payments are deductible (or not) under section 8-1 of the ITAA 1997 in the same way and on the same tests as if the taxpayer themselves carried out the geological sequestration of the same material and in the same income-earning context.

Section 40-735 (mining site rehabilitation)

85. Section 40-735 of the ITAA 1997 provides an immediate deduction for expenditure, whether capital or not, on rehabilitating mining or quarrying sites, sites of exploration or prospecting activities, and sites of 'ancillary mining activities'. 'Mining site rehabilitation' 'is an act of restoring or rehabilitating a site or part of a site to, or to a reasonable approximation of, the condition it was in before mining operations, exploration or prospecting or ancillary mining activities were first started on the site'.[21] Such rehabilitation need not be complete. It may be, and may be intended to be, only partial.[22]

86. Section 40-735 of the ITAA 1997 can apply to expenditure on geological sequestration only where that sequestration is part of such mining site rehabilitation. Therefore, generally, it can apply to expenditure on geological sequestration only where the material geologically sequestered would otherwise have an ongoing effect of changing the condition of a site from what it was before 'mining operations', 'exploration or prospecting' or 'ancillary mining activities' were first started on the site. As such section 40-735 will rarely apply to geological sequestration in practice given the gaseous nature of the material (generally greenhouse gases) usually geologically sequestered. Such gaseous material generally does not remain on the site or change the condition of the site in any material way. An example of geological sequestration that is part of mining site rehabilitation is the geological sequestration of contaminated water from your mining operations that would otherwise pond on the site on which you carried on mining operations and materially change the pre-mining condition of the site.

[21] See subsection 40-735(4) of the ITAA 1997.
[22] See subsection 40-735(5) of the ITAA 1997.

87. Section 40-745 and section 40-735 of the ITAA 1997 itself place limitations on the expenditure that can be deducted under section 40-735. (The deductible expenditure is not limited by a general exclusion of expenditure of a capital nature.) Section 40-745 excludes a deduction under section 40-735 for expenditure on the following things:

(a) acquiring land or an interest in land or a right, power or privilege to do with land;

(b) a bond or security, however described, for performing *mining site rehabilitation;

(c) *housing and welfare.[23]

88. Subsection 40-735(3) of the ITAA 1997 excludes a deduction under section 40-735 of the ITAA 1997 to the extent that the expenditure forms part of the cost of a depreciating asset. 'Depreciating asset' is expansively defined in section 40-30 of the ITAA 1997. Although a deduction under section 40-735 is not available for expenditure to the extent that it forms part of the cost of a depreciating asset, a decline in value deduction under Division 40 of the ITAA 1997 may be available for such a depreciating asset. That is likely to be the case for many depreciating assets related to mining site rehabilitation given the expansive definition of a 'taxable purpose' in subsection 40-25(7) of the ITAA 1997 (which includes, among other things, the purpose of mining site rehabilitation and environmental protection activities). The extent to which a depreciating asset is used, or installed ready for use, for a taxable purpose is generally a key element in the calculation of the asset's decline in value deduction.

89. Further, subsection 40-735(2) of the ITAA 1997 provides that provisions of the income tax law that expressly prevent or restrict the operation of Division 8 of the ITAA 1997 (except for provisions in Division 8 itself) apply in the same way to section 40-735 of the ITAA 1997 so as to prevent or restrict a deduction under that section.

90. Finally, section 40-765 of the ITAA 1997, which applies across Subdivision 40-H of the ITAA 1997 and therefore to deductions under section 40-735 of the ITAA 1997, provides that an amount of expenditure is limited to the market value of what the expenditure was for where the taxpayer incurred the expenditure under an arrangement in respect of which there was at least one other party to the arrangement with whom the taxpayer did not deal at arm's length and the amount of the expenditure would otherwise be more than that market value.

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[23] Housing and welfare is defined in subsection 995-1(1) of the ITAA 1997 to mean:
(a) residential accommodation; or
(b) health, education, recreation or similar facilities, or facilities for meals; or
(c) works carried out directly in connection with such accommodation or facilities, including works for providing water, light, power, access or communications.

Section 40-755 (environmental protection activities)

91. Section 40-755 provides an immediate deduction for expenditure, whether capital or not, incurred for the sole or dominant purpose of carrying on 'environmental protection activities'.

92. 'Environmental protection activities' are comprehensively defined through the combination of subsections 40-755(2), (3) and (4) of the ITAA 1997 as follows:

> (2) ***Environmental protection activities*** are any of the following activities that are carried on by or for you:
>
> (a) preventing, fighting or remedying:
>
> (i) pollution resulting, or likely to result, from *your earning activity; or
>
> (ii) pollution of or from the site of your earning activity; or
>
> (iii) pollution of or from a site where an entity was carrying on any *business that you have acquired and carry on substantially unchanged as your earning activity;
>
> (b) treating, cleaning up, removing or storing:
>
> (i) waste resulting, or likely to result, from your earning activity; or
>
> (ii) waste that is on or from the site of *your earning activity; or
>
> (iii) waste that is on or from a site where an entity was carrying on any business that you have acquired and carry on substantially unchanged as your earning activity.
>
> No other activities are environmental protection activities.
>
> (3) ***Your earning activity*** is an activity you carried on, carry on, or propose to carry on:
>
> (a) for the *purpose of producing assessable income for an income year (except a *net capital gain); or
>
> (b) for the purpose of *exploration or prospecting; or
>
> (c) for the purpose of *mining site rehabilitation; or
>
> (d) for purposes that include one or more of those purposes.
>
> (4) If *your earning activity is:
>
> (a) leasing a site you own; or
>
> (b) granting a right to use a site you own or control; or
>
> (c) a similar activity involving a site;
>
> that site is taken to be the site of your earning activity.
>
> **Note:** This means you can deduct your expenditure on environmental protection activities relating to the site, even if the pollution or waste is caused by another entity that uses the site.

93. Geological sequestration activities can be 'environmental protection activities', which as defined in section 40-755 of the ITAA 1997 include preventing, fighting or remedying certain pollution and treating, cleaning up, removing or storing certain waste. The terms 'pollution' and 'waste' are not defined and take their ordinary meanings in the context of section 40-755 and so are apt to include all material that might be geologically sequestered.[24]

94. However, not all geological sequestration activities will be 'environmental protection activities' due to the limitations inherent in the definition of 'environmental protection activities' that the pollution or waste must:

- result, or be likely to result, from 'your earning activity';
- be on or from the site of your earning activity; or
- be on or from a site where an entity was carrying on any business that you have acquired and carry on substantially unchanged as your earning activity (your predecessor business site).

95. Your environmental protection activities do not extend to preventing, fighting or remedying pollution from someone else's activities, or of or from someone else's site or predecessor business site even if such pollution is equivalent to the pollution from your earning activity, or of or from a site of your earning activity or your predecessor business site. Similarly, your environmental protection activities do not extend to treating, cleaning up, removing or storing waste from someone else's activities, from or on someone else's site or predecessor business site even if such waste is equivalent to the waste from your earning activity, or on or from a site of your earning activity or your predecessor business site.

[24] See, for instance, the *Shorter Oxford English Dictionary Fifth Edition 2002, Oxford University Press, Oxford*: *waste* – refuse matter; the useless by-products of any industrial process… *pollution* – the action of polluting, or condition of being polluted…uncleanness or impurity… *pollute* – to make physically impure, foul, or filthy; to dirty, stain, taint, befoul.

96. However, the nature of the pollution resulting from your earning activity, or from a site of your earning activity, or from your predecessor business site, may be such that it becomes an indistinguishable part of a common pool of material of the same nature (for example, as may happen when a greenhouse gas such as carbon dioxide is released into the atmosphere). For the purposes of section 40-755 of the ITAA 1997 you (or someone else for you) can be 'fighting or remedying' such pollution by extracting from the common pool (to which the pollution resulting from your earning activity, or from a site of your earning activity, or from your predecessor business site was added) and geologically sequestering an amount of the polluting material, up to the amount that entered the common pool resulting from your earning activity, or from a site of your earning activity, or from your predecessor business site. To that extent, your expenditure on such geological sequestration can be deductible under section 40-755 (and applicable decline in value deductions for depreciating assets used for such geological sequestration can be available).

97. To be eligible for a deduction under section 40-755 of the ITAA 1997 the geological sequestration activities must not only be 'environmental protection activities'; the expenditure on geological sequestration must be incurred for the sole or dominant purpose of carrying on 'environmental protection activities'.[25] Further, sections 40-760 and 40-765 of the ITAA 1997 place limitations on the expenditure that can be deducted under section 40-755. (The deductible expenditure is not limited by a general exclusion of expenditure of a capital nature.) Section 40-760 excludes a deduction under section 40-755 for:

(a) expenditure for acquiring land;

(b) capital expenditure for constructing a building, structure or structural improvement;

(c) capital expenditure for constructing an extension, alteration or improvement to a building, structure or structural improvement;

(d) a bond or security (however described) for performing *environmental protection activities;

(e) expenditure to the extent that you can deduct an amount for it under a provision of this Act outside Subdivision 40-H of the ITAA 1997;[26] and

(f) expenditure to the extent that it is incurred on carrying out an activity for environmental impact assessment of your project.

[25] See subsection 40-755(1) of the ITAA 1997.
[26] Even where sections 40-735 and 40-755 of the ITAA 1997 both allow you a deduction in respect of the same expenditure, you can deduct that expenditure only under the provision that is most appropriate: section 8-10 of the ITAA 1997.

98. Paragraph 40-760(1)(e) of the ITAA 1997 would, for example, apply to expenditure to the extent that it forms part of the cost of a depreciating asset for which you can deduct an amount for its decline in value under Subdivision 40-B of the ITAA 1997. That is likely to be many depreciating assets related to environmental protection activities given the expansive definition of a 'taxable purpose' in subsection 40-25(7) of the ITAA 1997 (which includes, among other things, the purpose of mining site rehabilitation and environmental protection activities). The extent to which a depreciating asset is used, or installed ready for use, for a taxable purpose is generally a key element in the calculation of the asset's decline in value deduction.

99. Further, subsection 40-760(3) of the ITAA 1997 provides that provisions of the income tax law that expressly prevent or restrict the operation of Division 8 of the ITAA 1997 (except for provisions in Division 8 itself) apply in the same way to section 40-755 of the ITAA 1997 so as to prevent or restrict a deduction under that section.

100. Finally, section 40-765 of the ITAA 1997, which applies across Subdivision 40-H of the ITAA 1997 and therefore to deductions under section 40-755 of the ITAA 1997, provides that an amount of expenditure is limited to the market value of what the expenditure was for where the taxpayer incurred the expenditure under an arrangement in respect of which there was at least one other party to the arrangement with whom the taxpayer did not deal at arm's length and the amount of the expenditure would otherwise be more than that market value.

Appendix 2 – Detailed contents list

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

References

Previous draft:

Previously issued as TR 2008/D2

Related Rulings/Determinations:

MT 2004/1; TR 2006/2;
TR 2006/10

Subject references:

- assessable tolling receipts
- environmental protection activities
- petroleum exploration expenditure
- geological sequestration
- mining site rehabilitation
- petroleum
- petroleum project
- petroleum resource rent tax
- processing of external petroleum
- PRRT closing-down expenditure
- PRRT general project expenditure
- taxable purpose

Legislative references:

- ITAA 1936
- ITAA 1936 51
- ITAA 1997 Div 8
- ITAA 1997 8-1
- ITAA 1997 8-1(1)
- ITAA 1997 8-1(2)
- ITAA 1997 8-1(2)(a)
- ITAA 1997 8-10
- ITAA 1997 Div 40
- ITAA 1997 Subdiv 40-B
- ITAA 1997 Subdiv 40-H
- ITAA 1997 40-25(7)
- ITAA 1997 40-30
- ITAA 1997 40-735
- ITAA 1997 40-735(2)
- ITAA 1997 40-735(3)
- ITAA 1997 40-735(4)
- ITAA 1997 40-735(5)
- ITAA 1997 40-745
- ITAA 1997 40-750
- ITAA 1997 40-755
- ITAA 1997 40-755(1)
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- ITAA 1997 40-755(3)
- ITAA 1997 40-755(4)
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- ITAA 1997 40-760(1)(e)
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- PRRTAA 1987 2
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- PRRTAA 1987 38(1)(b)
- PRRTAA 1987 38(1)(d)
- PRRTAA 1987 38(2)
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- PRRTAA 1987 39(1)
- PRRTAA 1987 41(1)
- PRRTAA 1987 41(2)
- PRRTAA 1987 44
- PRRTAA 1987 45A
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Case references:

- Associated Minerals Consolidated Ltd v. Commissioner of Taxation (1994) 53 FCR 115; 94 ATC 4499; (1994) 29 ATR 147
- Federal Commissioner of Taxation v. Firth (2002) 120 FCR 450; 2002 ATC 4346; (2002) 50 ATR 1

- Federal Commissioner of Taxation v. Isherwood & Dreyfus Pty Ltd (1979) 9 ATR 473; 79 ATC 4031
- Federal Commissioner of Taxation v. The Midland Railway Co of Western Australia Ltd (1952) 85 CLR 306; (1952) 9 ATD 372
- Fletcher & Ors v. Commissioner of Taxation of the Commonwealth of Australia (1991) 173 CLR 1; 91 ATC 4950; (1991) 22 ATR 613
- Hallstroms Pty Ltd v. Federal Commissioner of Taxation (1946) 72 CLR 634; (1946) 8 ATD 190
- Hart v. Commissioner of Taxation (2002) 121 FCR 206; 2002 ATC 4608; (2002) 50 ATR 369
- Lunney v. Commissioner of Taxation (1958) 100 CLR 478; (1958) 11 ATD 404
- Magna Alloys & Research Pty Ltd v. Federal Commissioner of Taxation (1980) 49 FLR 183; 80 ATC 4542; (1980) 11 ATR 276
- Putnin v. Commissioner of Taxation (1991) 27 FCR 508; 91 ATC 4097; (1991) 21 ATR 1245
- Robert G Nall Ltd v. Federal Commissioner of Taxation (1936) 57 CLR 695; (1936) 4 ATD 335
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- Spassked Pty Limited v. Commissioner of Taxation (2003) 136 FCR 441; 2003 ATC 5099; (2003) 54 ATR 546
- Steele v. Deputy Commissioner of Taxation (1999) 197 CLR 459; 99 ATC 4242; (1999) 41 ATR 139
- Tweddle v. Federal Commissioner of Taxation (1942) 180 CLR 1; (1942) 7 ATD 186
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ATO references

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