On 28 October 2015, the Australian Taxation Office (ATO) released a long-awaited draft taxation ruling (TR 2015/D4) to provide principle-based guidance on what constitutes exploration for income tax purposes and the application of income tax deduction rules to exploration expenditure.

The draft ruling is the product of an extensive confidential consultation process that involved key industry stakeholders. In our opinion, it provides a sensible outcome for taxpayers and demonstrates the benefits of taking a positive and collaborative approach to this particular issue.

Prior to this draft ruling, the ATO’s published view was stated in Taxation Ruling TR 98/23, which was issued almost two decades ago. There has in recent years been increasing uncertainty over the exact scope of eligible exploration expenditure for income tax purposes, particularly in the context of front end engineering and design (FEED) and economic feasibility study costs due to the growing scale and complexity of resources projects (especially LNG projects) which have a long lead time before final investment decisions (FID) are made.

Key outcomes in the new draft ruling released by the ATO include:

- The exploration deduction provision under section 40-730 of the Income Tax Assessment Act 1997 does not constitute a code for exploration expenditure deductions. For resources companies with an existing mining or exploration business, an immediate deduction may be available under the general deduction provision (section 8-1) in respect of exploration expenditure incurred in the context of that business.

- There is no ‘bright line’ test in determining the character or nature of expenditure for the purposes of section 8-1 or subsection 40-730(1). This means a FID or Decision to Mine (DtM) cannot be used for the purposes of classifying expenditure. In particular, the draft ruling notes that the following expenditure will not qualify for an immediate deduction under section 8-1 or subsection 40-730(1):
  - Long-lead items; and
  - Early development and execution costs which may become regret costs if the project does not proceed to development.
Other key items covered by the ATO in the draft ruling include:

- There is no assumption that exploration expenditure is capital in nature, even if information is produced from this exploration activity. Instead, the nature or character of the advantage sought by the taxpayer is relevant in determining whether expenditure is capital in nature.
- Expenditure incurred, after a DtM, in assessing whether or not a mine extension or expansion would be economically feasible can constitute exploration expenditure, where it can be distinguished from activities directed towards ‘getting at’ or ‘getting out’ minerals in relation to an existing mine. Similar principles apply in an oil and gas context.
- Although the wording of subsection 40-730(1) does not allow apportionment of expenditure (similar to the former Petroleum Resource Rent Tax provisions, and unlike general deductions under section 8-1), the Commissioner accepts that apportionment may be made under this subsection on a ‘fair and reasonable’ basis.
- The ATO also provides more guidance on the scope of the exclusions under subsection 40-730(2), including the relevant facts that need to be taken into account in considering the application of that subsection.
- Although the ruling addresses some aspects of section 40-80 (which allows a deduction for the cost of certain depreciating assets first used for exploration), it does not address the meaning of ‘use’ or ‘first use for exploration or prospecting’.

In particular, the ATO provides the following examples of expenditure that can fall within the definition of exploration (and be deductible under subsection 40-730(1)):

- FEED work undertaken for the selected ‘basis of design’ up to the point where the ‘project schedule, cost estimates, and risks can be understood...to a sufficient level of certainty in order to ascertain whether a decision to mine should be made’
- FEED work in respect of supporting infrastructure, including accommodation, supply bases, roads and material receiving facilities, as well as social infrastructure, such as airports, roads, hospitals, schools etc. which will be handed to a government agency on completion
- Environmental impact studies
- Costs of re-examining feasibility of abandoned projects under an alternative basis of design
- Feasibility costs in respect of downstream infrastructure
- Drilling costs undertaken after a DtM but before any development activities take place

By contrast, the ATO provides that the following would not normally constitute exploration:

- Early execution activities which may become regret costs if the project does not proceed
- Long-lead items which are required to be purchased early so as to not delay the project
- Detailed engineering and design works, procurement of assets and construction works
- Acquisition of land prior to a DtM

Extensive list of examples

The draft ruling provides an extensive list of examples which illustrate the ATO’s view on the application of subsection 40-730(1). These examples cover broad types of expenditure, including feasibility, FEED and early execution costs. Extensive input from the resources industry was sought during the consultation process and the examples should assist relevant taxpayers in understanding the ATO’s view of how subsection 40-730(1) should be applied.
Our initial observations

Whilst the outcomes in this draft ruling are sensible, caution is required in the following areas:

- The draft ruling indicates that exploration expenditure, in some cases, can be deductible under either section 8-1, subsection 40-730(1) or section 40-80 (e.g. any information or tangible assets created from exploration activities). Taxpayers who seek to claim a deduction for exploration expenditure must be mindful of the different requirements under each of these sections. Under section 8-1, expenditure needs to have a necessary connection with income earning operations or be incidental and relevant to those operations. On the other hand, to be deductible under subsection 40-730(1), exploration expenditure must be incurred ‘on’ exploration or prospecting activities for minerals (including petroleum). For expenditure to be ‘on’ exploration or prospecting activities for minerals, there must be a direct or close link between the two. Under section 40-80, an asset must be first used for exploration.

- The draft ruling also indicates that the information created as a result of undertaking an economic feasibility study is not ‘mining, quarrying or prospecting information’ and therefore it is not a depreciating asset. Taxpayers may need to revisit previous positions adopted, for example with respect to acquisition scenarios and allocations to ‘assets’ under the income tax consolidation rules.

Date of application

When issued in final, the ATO proposes to apply the ruling to expenditure incurred both before and after its date of issue. Taxation Ruling TR 98/23 has been withdrawn from the date of issue of the new draft ruling, being 28 October 2015.

In this regard, the ATO has noted that it expects the draft ruling to provide taxpayers with at least as favourable an outcome as under TR 98/23. If circumstances arise where the new ruling provides a less favourable outcome, they are encouraged to approach the ATO to discuss possible actions in this regard.

Submissions invited

The ATO has invited submissions about the draft ruling, including its proposed date of effect. Submissions are due by 11 December 2015.

ATO compliance approach

The ATO has indicated in the draft ruling that it is developing a ‘practical compliance approach’, and will consult upon this approach before its release.

We understand the ATO is considering issuing ‘practical guidance’ on the ruling’s application when the draft ruling is finalised. We expect this ‘practical guidance’ to:

- Assist taxpayers in assessing and documenting their exploration claims; and
- Assist the ATO in undertaking risk assessment and compliance activities.

What this means for you

Companies engaged in resources exploration or development should review their historical and current expenditure classification approaches to confirm they adhere to the guidance issued by the ATO in the draft ruling, as the draft ruling may impact on income tax and deferred tax accounting positions previously taken.

EY can assist with reviewing internal policies in this regard, and can also draft submissions to the ATO about this draft ruling on behalf of clients.
For more information please contact:

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