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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TREASURY LAWS AMENDMENT (MEASURES FOR CONSULTATION) BILL
2023: CAPITAL ALLOWANCES FOR MINING, QUARRYING OR
PROSPECTING RIGHTS AND CLARIFYING THE MEANING OF
EXPLORATION FOR PETROLEUM

EXPOSURE DRAFT EXPLANATORY MATERIALS

Consultation preamble

Treasury seeks feedback on the effectiveness of this exposure draft explanatory material in explaining the policy context and operation of the proposed new law, including, but not limited to:

- how the new law is intended to operate;
- whether the background and policy context is sufficiently comprehensive to support understanding of the policy intent and outcomes of the new law;
- the use of relevant examples, illustrations or diagrams as explanatory aids; and
- any other matters affecting the readability or presentation of the explanatory material.

Feedback on these matters will assist to ensure the Explanatory Memoranda for the Bill aids the Parliament's consideration of the proposed new law and the needs of other users.

Treasury and the ATO work closely to identify aspects of new tax laws which may benefit from ATO public advice and guidance (PAG). Feedback is also sought on any aspects of the new law where ATO PAG should be considered, to support stakeholders' understanding and application of the new law. Stakeholder feedback will be shared with the ATO.

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Glossary

This Explanatory Memorandum uses the following abbreviations and acronyms.

Abbreviation	Definition
ATO	Australian Taxation Office
Bill	<i>Treasury Laws Amendment (Measures for Consultation) Bill 2023: Capital allowances for mining, quarrying or prospecting rights and clarifying the meaning of exploration for petroleum</i>
Commissioner	Commissioner of Taxation
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
MQPR	Mining, quarrying or prospecting right
PRRTAA	<i>Petroleum Resource Rent Tax Assessment Act 1987</i>
PRRT	<i>Petroleum Resource Rent Tax</i>

Chapter 1: Clarifying the tax treatment of ‘exploration’ and ‘mining, quarrying and prospecting rights

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Outline of chapter

- 1.1 The Bill amends the PRRTAA to clarify the meaning of ‘exploration for petroleum’.
- 1.2 Additionally, amendments to the ITAA 1997 clarify:
 - that MQPRs cannot be depreciated for income tax purposes until they are used, not merely held, and
 - the circumstances in which the issue of new rights over areas covered by existing rights lead to tax adjustments.
- 1.3 All legislative references in this Chapter are to the ITAA 1997 unless otherwise stated. Further, all references to the ‘decision’ are references to the decision of the Full Federal Court in *Commissioner of Taxation v Shell Energy Holdings Australia Limited* [2022] FCAFC 2.

Context of amendments

- 1.4 Following the decision, clarification was required to the PRRTAA and ITAA 1997. The decision was, amongst other things, in relation to whether the taxpayer in that case was entitled to deduct an amount equal to the cost of the asset under subsection 40-80(1) which provides that the decline in value of a

depreciating asset that a taxpayer holds is the asset's cost, provided the taxpayer first uses the asset for 'exploration'.

- 1.5 The activities in question in the decision were activities conducted for the purpose of evaluating the feasibility of recovering petroleum on a commercial basis. The outcome of the case raised three issues:
- Firstly, the ordinary meaning of the term 'exploration' was determined to not have a precise or rigid meaning, could be wider than previously understood since 2014 and can be extended beyond searching for petroleum to assessing the commercial viability of a project where the context allows. Although it was also determined that the meaning of the term 'exploration' will depend on the relevant statutory context and legislative history, there may have been ambiguity raised by the decision, which could potentially make a greater range of expenses eligible for the concessional treatment afforded to exploration expenditure.
 - Secondly, taxpayers may have begun depreciating intangible assets such as MQPRs from when they acquired them, rather than when they began undertaking activities authorised by the rights, potentially bringing forward the intended start time for decline in value deductions.
 - Thirdly, taxpayers may have been required to make more frequent balancing adjustments for income tax purposes due to routine conversion of MQPRs, increasing administrative burden and prematurely crystallising gains or losses. There may also have been inadvertent impacts on the effective life of an MQPR if a balancing adjustment occurred in such circumstances.

'Exploration for petroleum'

- 1.6 Although the decision was concerned with income tax (including section 40-80) and did not consider the meaning of 'exploration' in the PRRTAA, there may have been ambiguity raised by the decision which could have resulted in an expanded meaning of 'exploration' in a PRRT context. These amendments clarify the interpretation of 'exploration for petroleum' in the PRRTAA consistent with established practice and policy intent.
- 1.7 The 2023-24 Budget announcement outlined the Government's policy that PRRT legislation will be amended to clarify that 'exploration for petroleum' is limited to the 'discovery and identification of the existence, extent and nature of the petroleum resource' and does not extend to 'activities and feasibility studies directed at evaluating whether the resource is commercially recoverable'. These amendments give effect to the Government's policy intent and the Commissioner's administrative treatment and written binding advice as set out in TR 2014/9, which applied from 21 August 2013.

MQPRs 'first use' and balancing adjustments

- 1.8 Under Subdivision 40-D;
- a taxpayer may have to make an adjustment to their taxable income if they stop holding a depreciating asset; and
 - the adjustment is generally based on the difference between the 'termination value' of the asset when they stop holding it and its 'adjustable value'.
- 1.9 The decision meant that 'first use', in relation to an MQPR, may have been interpreted as when a taxpayer acquired the MQPR rather than when they began undertaking activities under the right. This may have resulted in unintended consequences, by potentially bringing forward the start time for decline in value deductions.
- 1.10 Further, it is common for one type of mining right to convert to a different type of mining right or rights, for example a retention lease converts to a production licence or licences. As a consequence of the decision, taxpayers may have been required to make more frequent balancing adjustments for income tax purposes where a new right or rights were issued over part of the areas covered by an existing right or rights.

Summary of new law

- 1.11 These amendments provide for the following:
- For the purposes of the meaning of the phrase 'exploration for petroleum' in the PRRTAA, excludes activities engaged in for the purpose of determining how to recover petroleum or whether the recovery of petroleum is commercially viable, economically feasible or technically feasible.
 - Limit when the 'first use' of an MQPR occurs, by specifying that 'first use' starts when an activity that is authorised by the mining right is undertaken, and not just when the MQPR begins to be held.
 - Clarify that an income tax balancing adjustment does not occur in relation to a new MQPR in circumstances where the new right or rights are granted over an area that is merely a subset of the area governed by an existing MQPR.

Detailed explanation of new law

Clarifying 'exploration for petroleum' in the PRRTAA legislation

- 1.12 The amendments in the Bill clarify that the meaning of the phrase 'exploration for petroleum' in paragraph 37(1)(a) of the PRRTAA is limited to the discovery and identification of the existence, extent and nature of petroleum. Generally, this will include searching to discover petroleum and the process of ascertaining the size of the discovery and appraising its physical characteristics.
- 1.13 The clarification does not define what 'exploration for petroleum' is. Rather, activities engaged in for the purpose of determining how to recover petroleum or whether the recovery of petroleum is commercially, economically, or technically viable are excluded for the purpose of paragraph 37(1)(a) of the PRRTAA.
- 1.14 'Commercially viable', 'economically viable' and 'technically viable' are not defined terms, they take on their ordinary meaning within the context of the PRRTAA. However, the policy intention is to ensure that 'exploration for petroleum' does not extend to activities and feasibility studies directed at evaluating whether the resource is 'commercially viable', or 'economically feasible', or 'technically feasible', or how to recover petroleum. These activities are not part of, or in connection with, the discovery and identification of the existence, extent, and nature of petroleum.
- 1.15 For the avoidance of doubt, feasibility and environmental studies and other preparatory activities may be 'in connection with exploration for petroleum' and therefore fall within paragraph 37(1)(a) of the PRRTAA where there is a reasonably direct relationship between those things and 'exploration for petroleum'.
[Schedule #, Part 2, item 7, subsections 37(4)-(5) of the PRRTAA]

Clarifying 'first use' of 'mining, quarrying and prospecting rights'

- 1.16 The amendments clarify that MQPRs that are depreciating assets start to decline in value from the time when the holder of the right engages in an activity that involves exercising one or more rights conferred by the asset. For the purposes of the 'days held' requirement in paragraph 40-70(1)(b), where an MQPR has been first used by the holder exercising the rights conferred by the asset, then the decline in value is not paused merely because authorised activities are not undertaken on a daily basis.
- 1.17 The amendments achieve the policy intent by deeming all provisions in Division 40 that rely on the concept of "use", when referring to using an MQPR, are a reference to engaging in activity that involves exercising rights conferred by the asset.

- 1.18 The policy outcome sought from these amendments is that the mere holding of an MQPR without commencing activities authorised by the right (for example, relevant mining, quarrying and prospecting activities that are authorised by the right) is not enough to constitute ‘first use’ for the purpose of section 40-80.
- 1.19 The activity that triggers the start time may not necessarily be conducted in the area to which the MQPR relates, however, that will often be the case. Whether there is activity that involves exercising rights conferred by the asset will depend on the relevant facts and circumstances. Activities that are not permitted nor authorised by the MQPR, or that you could legally be undertake without holding the MQPR, are not an intended to be a use of the MQPR. Additionally, activities that are merely incidental, accidental, or irrelevant to other activities that are permitted by the MQPR will ordinarily be of a de minimis or trivial nature, and thus not a ‘use’ of the MQPR.¹
[Schedule #, Part 1, item 2, subsection 40-42(1) of the ITAA 1997]
- 1.20 The amendments in subsection 40-42(1) relate to assets that are interests described in paragraphs (a), (b) or (d) of the definition of MQPR in subsection 995-1(1). If the asset is an interest covered by paragraph (c) of that definition, then under subsection 40-42(1) the relevant rights conferred by the assets are the rights conferred by the authority, licence, permit, right or lease referred in paragraph (c) of that definition. Such exercise of rights does not include the exercise of rights under any joint venture agreement in relation to the MQPR.
[Schedule #, Part 1, item 2, subsection 40-42(2) of the ITAA 1997]
- 1.21 Further, the definition of ‘installed ready for use’ in subsection 995-1(1) is clarified as it applies to MQPR and these amendments make it clear that an MQPR cannot be ‘installed ready for use’.
[Schedule #, Part 1, item 5, subsection 995-1(1) of the ITAA 1997]

Clarifying when income tax balancing adjustments occur to ‘mining, quarrying and prospecting rights’

- 1.22 The Bill amends subsection 40-30(6) so that a balancing adjustment event does not occur in relation to a new MQPR and that the new MQPR is treated for the purposes of Division 40 as being a continuation of the old MQPR, in relation to cases where a new right or rights are granted over an area that is merely a subset of the area governed by an old MQPR.
- 1.23 The purpose of subsection 40-30(6) is to deal with conversion cases, for example, the conversion of an area covered by an exploration permit to a Production License. However, depending on the circumstances, the area

¹ This is consistent with the established legal principle that, unless the contrary intention appears, the law disregards certain things as de minimis (see, for example, *Farnell Electronic Components Pty Ltd v. Collector of Customs* ((1996) 72 FCR 125; 1996142 ALR 322 per Hill J at 324-327).

covered by the new right or rights may not necessarily be the same area covered by the old right and any difference in area could be significant. These amendments to subsection 40-30(6) ensure that the subsection applies to those cases as intended and a balancing adjustment event does not occur to the old right, and the new right or rights have the same effective life of the old right.

[Schedule #, Part 1, item 1, paragraph 40-30(6)(b) of the ITAA 1997]

1.24 Amendments are also made to make clear the treatment of partial conversions of MQPRs. If:

- an MQPR (the 'old right') relates to an area; and
- the taxpayer begins holds another MQPR (the 'partial new MQPR') that relates to an area that is part of the area that the old right relates to; and
- the old right does not end when you begin to hold the partial new right;

then, for the purposes of Division 40, the old right is taken to have split into an asset that is the partial new right an asset that is the old right. The time of the split is just before the time when the partial new MQPR begins to be held.

[Schedule #, Part 1, item 1, note to paragraph 40-30(6)(b) and item 3, section 40-122 of the ITAA 1997]

1.25 The occurrence of this split allows section 40-205 to set the cost of the continuing old right and the new right based on the adjustable value of the old right just before the time of the split. A balancing adjustment does not occur for the old right merely because of the split (per subsection 40-295(3)).

1.26 Where the new right only relates to part of the area covered by the other right, then, to ensure appropriate outcomes are achieved, there is a proportionate continuation of the other right. Where sub-paragraph 40-30(6)(b)(ii) applies, then the first element of the cost of new right is a reasonable proportion of the adjustable value of the other right just before the other right ended. This ensures that the full cost of the other right is not carried over to each new right, leading to inappropriate outcomes. All other things substantially equal, a reasonable proportion could be worked out based on the respective areas of the new rights compared to the area of the other right just before the other right ended. The adjustable value of the other right is then zero.

[Schedule #, Part 1, item 4, section 40-217 of the ITAA 1997]

Commencement, application, and transitional provisions

1.27 The Bill commences on the first 1 January, 1 April, 1 July or 1 April to occur after the day the Bill receives Royal Assent.

[Table item 1 in the Commencement information table]

- 1.28 As announced in the 2023-24 Budget, the amendments related to the meaning of ‘exploration for petroleum’ will apply to all expenditure incurred from 21 August 2013. This impacts PRRT years starting on or after 1 July 2013.
- 1.29 The retrospective application ensures that ‘exploration expenditure’ within the meaning of the PRRTAA is not affected by the decision and aligns with date of effect of the ATO’s views on the application of the law as set out in taxation ruling TR 2014/9 and administrative treatment set out in the decision impact statement issued by the ATO following the Administrative Appeals Tribunal decision in *ZZGN v Commissioner of Taxation* [2013] AATA 351. This application provision provides certainty for taxpayers from the ambiguity created by the decision from the 2014 year of tax.
[Schedule #, Part 2, item 8]
- 1.30 The amendments relating to the capital allowance provisions dealing with MQPRs apply in respect of an MQPR that an entity started to hold after the date of announcement (7:30PM (AEST) on 9 May 2023 (Budget night)).
[Schedule #, Part 1, item 6]