Exploration Expenditure of a Petroleum Company: Esso Australia Resources Ltd v Commissioner of Taxation (Cth)

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SUMMARY

This paper analyses a decision of the Federal Court concerning an exploration company's claims for deductions relating to certain exploration and prospecting activities and related matters.

Most importantly, the court held that the costs of reviewing and evaluating potential mineral deposits (essentially feasibility costs) were not deductible on the basis that the taxpayer was not actively involved in a business of mining or of exploration, and was not "committed" to commercial production of minerals if located.

The court also held that:

- *(a) expenditure incurred in exploring and prospecting for coal and oil shale were not deductible under s 124AH(1) of Div 10AA of the Income Tax Assessment Act 1936 (Cth) (the Act);*
- *(b) payments made by the taxpayer to secure its right to become the operator of a petroleum joint venture were not deductible under s 51(1) of the Act;*
- *(c) a payment received by the taxpayer from its co-venturer for the use of the taxpayer's drilling technology was assessable as income under s 25(1) of the Act; and*
- *(d) certain tenement acquisition costs such as professional service fees, licence fees, legal fees and taxes were deductible under s 122K of the Act for tenements which had been acquired by the taxpayer for exploration purposes but were later abandoned.*

The taxpayer in this case only succeeded against the Commissioner on one of the five issues examined by the court.

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THE MAIN ISSUES AND THE COURT'S DECISION

The case was that of *Esso Australia Resources Ltd v Commissioner of Taxation (Cth)* (the *Esso* case)[1] where the Federal Court rejected Esso's claims for deductions in respect of over $30 million worth of expenditure relating to exploring and prospecting for coal and oil shale. The court also held that a payment received by Esso from its co-venturer for the use of Esso's deep water drilling technology for the benefit of the joint venture was assessable as income.

The issues arose from Esso's years of income ended 31 December 1979 to 31 December 1984. During these years, Esso had significant petroleum operations in Australia, one of them being operating oil and gas fields in Bass Strait. The main issues and decisions of the court in the *Esso* case are summarised below:

1. Is expenditure incurred in exploring and prospecting for coal and oil shale deductible under s 124AH(1) of Div 10AA (Prospecting and Mining for Petroleum) of the Act? No, s 124AH relates to expenditure incurred in exploring and prospecting for petroleum. The definition of petroleum under the Act does not extend to include coal and oil shale.
2. Are review, evaluation and bidding costs incurred in relation to a potential coal, oil shale and mineral prospect deductible under the general deduction provision of the Act (s 51(1))?[2] No, unless the company is, first, in the business of mining for coal and oil shale and the expenditure is part of the cost of trading operations or, secondly, the company is in the business of exploration.
3. Is a payment received by a joint venturer from its joint venture partner in respect of deep water drilling technology assessable as income under the Act? Yes, where the payment is in the ordinary course of the company's business and/or the company has a profit-making purpose when entering into the transaction.
4. Is a payment which secures a joint venturer's right to become the operator of the joint venture deductible as an expense under s 51(1)? No, the payment is capital in nature if the payment forms a part of the consideration for the acquisition of an asset of lasting character for the benefit of the paying company. The payment would presumably be added to the taxpayer's cost base in that asset for capital gains tax purposes. (However, the court did not expressly address this issue.)
5. Can a company claim a deduction under s 122K of the Act for certain tenement acquisition costs, where the tenements acquired by the company for the purposes of exploring and prospecting coal, oil shale and other minerals are later abandoned? Yes.

[1] (1997) 97 ATC 4371, before Sundberg J.

[2] Incidental to this issue the court also examined whether Esso was entitled to a deduction under s 77 of the Act for amounts incurred in reviewing and evaluating potential gold tenements. This section has now been repealed as a redundant provision; accordingly, this paper will not deal specifically with the parts of the judgment relating to this provision.

Below is an analysis of each of the above five issues examined by the court. Two ancillary issues raised by the case are also discussed below. These issues relate to the deductibility of feasibility costs incurred in exploring and prospecting for minerals and petroleum, and the deductibility of tenement acquisition costs, under s 51(1) of the Act.

The tax law is in the process of being rewritten as part of a project known as the Tax Law Improvement Project (TLIP). As part of that project the provisions concerning deductions for mining and exploration expenditure and petroleum expenditure have been consolidated, effective 1 July 1997. However, the rewritten provisions reinforce the findings of the case. The implications of TLIP are considered in detail towards the end of the paper.

Legislative references are to the Act unless otherwise stated.

ANALYSIS OF ISSUES

Petroleum exploration and prospecting expenditure: section 124AH(1)

At the time the claims were made, s 124AH(1) provided that:

> "expenditure incurred by the taxpayer ... on exploration or prospecting in Australia for the purpose of discovering petroleum is an allowable deduction."[3]

The issue was whether Esso's exploration activities for coal and oil shale were exploration for "petroleum" as defined in the Act. The Act defines petroleum in s 6(1) as:

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

Extensive expert evidence was tendered as to whether or not coal and oil shale are naturally occurring hydrocarbons and consequently whether coal and oil shale fell within the definition of petroleum under the Act. The evidence established that coal and oil shale are not themselves hydrocarbons, even though hydrocarbons could be extracted from coal and oil shale by the application of heat (pyrolysis) or chemical process (hydrogenation). The experts agreed that only those substances which occurred naturally, without the intervention of humans, could be regarded

[3] Section 124AH now provides "for petroleum obtainable by prescribed petroleum operations" instead of "for the purpose of discovering petroleum".

as "naturally occurring". Thus, even if the transformation of coal and oil shale into hydrocarbon products could be regarded as relevant in determining the nature of the coal and oil shale for the purpose of these provisions (which is by no means evident), those products could not be described as "naturally occurring". The court accepted the evidence and concluded that coal and oil shale are not *naturally* occurring hydrocarbons.

Curiously, it appears that no evidence was led that Esso was in fact engaging in exploration and prospecting for coal and oil shale for the purpose of transforming them into hydrocarbons. If, in fact, no such evidence was led, it is submitted that the subsequent use or transformation of the coal or oil shale into hydrocarbons was not relevant in determining the nature of the expenditure for the purposes of Div 10AA.

The court also examined the history of the Act to determine whether coal and oil shale were now impliedly included within the definition of petroleum in the Act. The *Income Tax Social Services Contribution Act (No 2)* 1963 (Cth), which inserted Div 10AA (which dealt with the taxation of enterprises prospecting or mining for petroleum), defined "petroleum" as:

> "a naturally occurring hydrocarbon ... *but does not include coal or shale* or any substance that may be extracted from coal, shale or other rock by application of heat or by chemical process."[4]

However, the court[5] did not accept that the removal of the (above italicised) words in the current definition of petroleum impliedly included coal and oil shale within the concept of petroleum.

Whilst the court did not examine the definitions of petroleum in the various State Petroleum Acts, it would have found that coal, shale and any substance from which oil may be derived by application of heat or by chemical process are expressly excluded from the definition of petroleum in some of those Acts.[6]

It was therefore well accepted, prior to the *Esso* case, that even though the definition of petroleum no longer expressly excludes coal and oil shale, these commodities are to be considered (for tax purposes) to be minerals rather than petroleum.[7] As is explained further below, the new provisions remove this distinction.

[4] In 1986 the Act adopted the definition of "petroleum" contained in the *Petroleum (Submerged Lands) Act* 1967 (Cth) (PSLA). The current definition of petroleum in the Act is derived from the definition found in the PSLA. The petroleum exploration provision of the 1968 Act was described in the Explanatory Memorandum as being complementary to the PSLA. It was intended that the definition of petroleum was to have the same meaning in the two Acts. Although the definition of petroleum in the PSLA does not contain an express exclusion of hydrocarbons that can be extracted from coal or shale, the provisions of the PSLA makes it quite clear that petroleum is limited to substances found in petroleum pools and capable of being produced through a well head controlled by a valve. Accordingly, his Honour concluded that the definition of petroleum did not include coal or shale. The definitions of petroleum are identical in *Petroleum Act* 1967 (WA), s 5(1); *Petroleum Act* 1955 (NSW), s 3; *Petroleum Act* 1958 (Vic), s 3(1).

[5] (1997) 97 ATC 4371 at 4379.

[6] Forbes and Lang, *Australian Mining and Petroleum Laws* (2nd ed, 1987), p 286 referring to *Petroleum Act* 1923 (Qld), s 3; *Petroleum Act* 1940 (SA), s 3; *Petroleum Act* 1984 (NT), s 5.

[7] Nicholls and Oser, "Taxation Implications of Developing and Operating a Mining or Oil and Gas Venture", seminar paper of the NSW Branch of AMPLA, April 1983, pp 24-27.

Since Esso was exploring or prospecting for coal and oil shale (which are not naturally occurring hydrocarbons) it was not exploring or prospecting for petroleum as defined in the Act. Accordingly, the court denied the deductions sought by Esso under s 124AH.

Esso's claim for a deduction under s 124AH may have stemmed from the fact that prior to 21 August 1984, expenditure on exploration for coal and oil shale could only be deducted against general mining income and not petroleum income. At the relevant time it appears that Esso was deriving its business income from petroleum refining and marketing activities. Section 122J has since been amended to allow companies to deduct exploration and prospecting expenditure incurred on mining tenements against a taxpayer's income from mining and non-mining activities.[8] Accordingly, a company incurring the expenditure described above after 21 August 1984 could claim expenditure for exploring and prospecting for coal and oil shale on mining tenements under s 122J. This result also arises under the new provisions, as explained below.

Esso did not attempt to argue, as an alternative ground of appeal, that the above expenditure was deductible under s 51(1). Any such ground would be likely to have failed on the basis that the expenditure was of a capital nature.

Review, evaluation and bidding costs for coal/oil shale prospects

Esso also incurred expenditure in investigating the acquisition of interests in potential joint ventures for the exploration and mining of coal, oil shale and minerals and claimed a deduction under s 51(1) of the Act. Esso did not acquire any tenements. The issue was whether the costs were necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income. Esso relied on the second limb of s 51(1). The costs that Esso incurred included:

(a) investigating an area that had potential for exploration;
(b) preparing tender documents;
(c) in-house review of geological information;
(d) on-site work and geological review and mine planning;
(e) marketing studies;
(f) full economic appraisals;
(g) hiring outside consultants involved in geological studies and mine planning; and
(h) general costs incurred to ascertain the feasibility of potential ventures for mining of coal, oil shale and minerals.

Critical to the resolution of the issue was the scope of Esso's business activities at the time of its claim. The court had found that the exploration was outside the scope of Esso's normal business operations and was incurred with a view to diversifying its operations. The court denied the deductions claimed under s 51(1) for a number of reasons.

[8] See *Australian Tax Practice* (looseleaf service, 1996), Vol 6, p 2470.4.

First, the court found that while Esso was engaged in exploration activities for coal and oil shale, it had not *committed* itself to the commercial production of these commodities, nor did it commence to conduct a mining business. Rather, the taxpayer's business at the relevant time was that of producing and selling oil and gas.[9] Accordingly, the expenditure incurred failed the second limb requirement that the expenditure be incurred in carrying on a business (of mining for coal, oil shale and minerals). The expenditure was therefore not "part of the cost of trading operations" of Esso's existing business: *John Fairfax & Sons Pty Ltd v Commissioner of Taxation (Cth)*.[10]

Esso submitted an alternative argument that it was conducting a business of exploration. Unlike the facts in *Commissioner of Taxation (Cth) v Ampol Exploration Ltd* (the *Ampolex* case),[11] Esso did not sell any of its exploration information or otherwise earn fees for its exploration activities. In the absence of any discrete plan or commitment to conduct exploration for reward, it was held that Esso was not conducting such a business.

The court's decision to deny Esso's expenditure on this ground would surprise many in the mining and petroleum industry. If one accepts Sundberg J's view that the expenditure was not incurred in relation to any business being carried on by Esso, it is understandable that Esso could not rely on the second limb of s 51(1) to support its deduction. However, it appears that it was not argued, and his Honour did not address the issue of whether the expenditure would, in these circumstances, be deductible under the first limb of s 51(1). That limb provides that losses and outgoings will be deductible to the extent that they are incurred "in gaining or producing assessable income", which are not, among other things, of a capital nature. It is well established that a business taxpayer may rely on this limb (*Snowden & Willson Pty Ltd v Commissioner of Taxation (Cth)*)[12] and that in certain circumstances a taxpayer may obtain a deduction under this limb notwithstanding that the expenses are not productive of assessable income. For example, in *Fletcher v Commissioner of Taxation (Cth)*,[13] the High Court of Australia held that expenditure will be deductible notwithstanding that no relevant assessable income is derived as a result of the outgoing, where a commonsense or practical weighing of the various aspects of the whole set of circumstances, including direct and indirect objects and advantages which the taxpayer sought in making the outgoing, indicates that the whole outgoing is properly to be characterised as genuinely and not colourably incurred for the purpose of gaining or producing assessable income (unless, of course, it is of a capital nature).

The availability of a deduction in circumstances where no income was produced was more recently confirmed by the Federal Court's decision in *Commissioner of Taxation (Cth) v Brand*,[14] in which a taxpayer was held to be

[9] (1997) 97 ATC 4371 at 4381.
[10] (1959) 101 CLR 30 at 49.
[11] (1986) 13 FCR 545.
[12] (1958) 99 CLR 438 at 443 per Fullager.
[13] (1991) 91 ATC 4950.
[14] (1995) 31 ATC 326.

entitled to a deduction for a prepayment of licence fees for a seven-year period, notwithstanding that the prawn farming business intended to be conducted pursuant to the licence never actually commenced and therefore no income was ever derived.

However, it would appear that the implicit reasoning of the court on this issue was that Esso was not "committed" to producing coal and therefore to producing income, so as not to have the requisite purpose of deriving income when incurring the expenditure. With respect, this reasoning makes little sense from a business or practical point of view, since the obvious purpose for which businesses incur expenditure on mentioned evaluating expansion opportunities is to expand its income base. However, such reasoning would be consistent with the outcome of the *Griffin Coal Mining Company* case discussed below. In that case, the availability of both limbs of s 51(1) were discussed extensively. Consequently, the unsatisfactory result arises that the decision is consistent with previous judicial authority and, with respect, appears to be at odds with business reality.

It should also be noted that IT 2642 provides that preliminary expenditure consisting of reconnaissance costs and surveys, including geophysical studies incurred before the acquisition of exploration or prospecting rights, is not deductible under s 122J, as that section requires expenditure to be made on "any mining tenements". The ruling states that such expenditure incurred by mining companies would normally be capital in nature and not deductible under s 51(1). On the other hand, such expenditure incurred by a petroleum company would be deductible under s 124AH(1) since this section does not require expenditure to be incurred specifically on mining tenements; however, the expenditure must be on an activity which comes within the definition of "exploration or prospecting" under s 124AH(7) and must be expenditure relating to the discovery of petroleum.

The *Esso* case raises two ancillary issues relating to expenses incurred by exploration and prospecting and companies, namely:

(a) the deductibility of feasibility studies before mining commences; and

(b) the deductibility of tenement acquisition costs.

Deductibility of the costs of feasibility studies under section 51(1)

In IT 2642, the Australian Tax Office (ATO) states that expenditure incurred on feasibility studies before mining operations commence should be deductible under s 122J (relating to exploration or prospecting for minerals other than petroleum) or under s 124AH (exploration or prospecting for petroleum) where studies "relate to evaluating the economic feasibility of the mining project". Examples of such qualifying expenditure include test drilling, sample crushing and costs of a pilot plant.[15] However, the following do not qualify as exploration or prospecting expenditure:

[15] IT 2642, para 25.

(a) expenditure incurred on feasibility studies relating to aspects of the venture that are outside the scope of the economics of the mining project; and

(b) surveys and evaluations relating to infrastructure.

However, if the costs are revenue in nature, IT 2642 provides that certain feasibility costs may be deductible under s 51(1); for example, where the taxpayer is presently engaged in the existing business of mining or exploration of particular minerals and does not extend its business activities to a new line of trade.

The following cases demonstrate the difficulties exploration and prospecting companies face in obtaining deductions for expenditure on feasibility studies under s 51(1).

The courts will not allow a deduction in circumstances where feasibility study costs are incurred for the purpose of acquiring an asset to be used in a completely new line of business to produce a new source of income: *Griffin Coal Mining Company Ltd v Commissioner of Taxation (Cth)*.[16] In that case, a coal mining company formed a consortium to construct and operate an aluminium smelter and conducted a feasibility study in relation to the project. Griffin Coal spent approximately $1.4 million on the feasibility study and was denied a deduction on the basis that:

> "the relevant expenditure was not necessarily incurred in carrying on the business of extraction and sale of coal, but rather, it was seeking to acquire an asset to be used in an expanded business of the company or a business to be conducted by another member of the group ... the outgoings were not necessarily incurred in carrying on the existing business of Griffin Coal."[17]

Accordingly, the feasibility study expenditure was characterised as being capital expenditure.

A similar conclusion was reached in *Case 62/94*.[18] In that case, the taxpayer was a company carrying on a business of mining and mineral processing of mineral sands in Western Australia. The company in question was required under an agreement to investigate the technical economic feasibility of establishing a plant for secondary processing of its mineral products. No plant was ever built. The company's claim for a deduction of feasibility study expenses incurred under s 51(1) was denied. It was held that the company's feasibility study expenditure was not necessarily incurred in carrying on its business. It was neither incidental nor relevant to, nor dictated by, the business end to which the company was directed, that being the sale of mineral sands from its deposits. The costs relating to diversifying into an entirely new business were of a capital nature.

Where feasibility studies relate to the proposed acquisition of a new capital asset, then the expense will be of a capital nature. It is the ATO's view that a mining or petroleum company will be restricted from obtaining

16 (1990) 90 ATC 4870.
17 Ibid at 4888 per Lee J.
18 (1994) 94 ATC 520.

a deduction under s 51(1) for feasibility study costs unless it intends to make its profit not by mining but by assigning or selling its rights to mine should the area prove profitable.[19] Such a company derives assessable income from the sale of its rights and the cost of acquiring exploration or prospecting rights is deductible under s 51(1). This is supported by the *Ampolex* case where it is suggested that expenditure incurred by an exploration or prospecting company in carrying on the kinds of activities ordinarily involved in exploration or prospecting often constitute expenditure of a revenue nature.[20]

In the *Ampolex* case, Ampol Exploration Ltd (Ampolex) was engaged in the exploration for hydrocarbons and incurred exploration expenses in relation to a search for hydrocarbons overseas. Ampolex acquired an interest in a prospect and assigned its rights to a related company in which Ampolex was the major shareholder. In return, Ampolex was to receive an agreed fee for the assignment from the related company, which was basically a recoupment of its costs plus an extra payment if the prospect was found to be commercially feasible. The deduction was allowed as the expenditure was incurred in the course of the carrying on of Ampolex's business of petroleum exploration.[21]

Deductibility of tenement acquisition costs

Are expenditures relating to the acquisition of exploration or prospecting rights deductible under the Act, or are they of a capital nature?

Examples of acquisition costs are set out in IT 2642 and include:

(a) survey fees to check the mineral claim areas;
(b) advertisements to comply with mining regulations;
(c) attending court hearings;
(d) payment to holders of tenements for abortive options;
(e) buying in and compensation payments to landlords for rights to enter property;
(f) application fees for exploration licences;
(g) legal costs in connection with compensation payments and application fees; and
(h) costs incurred in negotiating and effecting farmout arrangements.

Expenses relating to the acquisition of exploration or prospecting rights are not deductible under ss 122J, 124AH or 51(1) and are of a capital nature in the case of a mining company having an intention of developing any discoveries made.

19 IT 2642, para 13.
20 Ibid.
21 Whilst the court dismissed the Commissioner's argument under the former anti-avoidance provision (s 260 of the Act) that the assignment by Ampolex to a related party was intended to avoid tax, it is possible that in the future the Commissioner could succeed in denying a claim for a deduction in these circumstances under the current anti-avoidance provisions contained in Pt IVA of the Act. Part IVA replaced s 260 which was the general anti-avoidance provision.

However, as stated above, the *Ampolex* case supports the view that a company which is in the business of petroleum exploring could claim the acquisition costs as a deduction under s 51(1).

Deep water technology payments under a joint venture agreement

The third issue examined by the court related to a joint venture agreement to explore for petroleum between Esso and Hematite Petroleum Pty Ltd (Hematite). Both parties had a 50 per cent interest in the joint venture. Under the joint venture agreement, Esso, through its affiliate, agreed to contribute deep water drilling technology. In recognition of Esso's contribution of such technology, Hematite agreed to pay an increased proportion of drilling costs and forego a proportion of production as specified in the joint venture agreement. However, the joint venture agreement also provided that in lieu of paying an increased proportion of the costs and in lieu of foregoing part of the production, Hematite had an option to pay Esso a certain amount of money referable to those amounts.

In 1979, Hematite elected to exercise the option and paid US$1.66 million to Esso. Esso treated this sum as a capital payment, a "Receipt in Respect of Sale of Technology". The Commissioner, on the other hand, argued that the technology payment was income under s 25(1).

The court referred to the principles enunciated in *Commissioner of Taxation (Cth) v Myer Emporium Ltd*[22] and *Commissioner of Taxation (Cth) v Cooling*[23] and held that the technology payment was assessable as income under s 25(1) on three alternative grounds. Those grounds were as follows:

1. Entering into the joint venture agreement with Hematite was part of the ordinary course of Esso's business. The technology payment was derived under that agreement and was accordingly made from a transaction forming part of the ordinary course of its business.
2. In the alternative, the amount was income because the use of the technology and payment for its use was incidental to Esso's business as an explorer and producer and Esso entered into the transaction with a profit-making purpose.
3. Further, and in the alternative, the technology payment was an income receipt because it was realised in a commercial transaction in circumstances where Esso had the intention or purpose of making a gain. It did not matter that Esso's primary purpose in entering into the agreement was to discover petroleum and exploit it for profit. The court inferred that Esso also wanted to turn to profitable account the drilling technology available to it. The monetary gain to be derived from the technology payment was "clearly not an insignificant [purpose]"[24] of entering into the contract and this was sufficient to characterise the gain as income.

[22] (1987) 163 CLR 199.
[23] (1990) 22 FCR 42.
[24] *Esso Australia Resources Ltd v Commissioner of Taxation (Cth)* (1997) 97 ATC 4371 at 4384.

In relation to the first categorisation of the transaction in (1), above, it is difficult to see how the one-off technology payment to Esso formed a part of its ordinary course of business of "producing and selling oil and gas".[25] In relation to the second categorisation of the transaction, the court held that the transaction relating to the technology payment was a transaction which was entered into by Esso with a profit-making purpose; however, it appears that no express evidence was led on this point.

On the third categorisation of the transaction, the court was of the view that even if Esso had not entered into the transaction for the sole purpose of making a profit, it was sufficient that Esso's purpose of obtaining a profit was "not insignificant". This conclusion was based on the fact that Hematite had an option to pay a sum of money instead of paying more than half of the outgoings and receiving less than half of the production profits.

It is arguable that the element of "a profit-making purpose" was absent in this case. If this was the case, the technology payment to Esso would have been outside the scope of the definition of income. It is arguable that Esso did not have a profit-making purpose in entering into the transaction or a purpose of making a profit from the use of its drilling technology in the joint venture, as its main interest was exploring for petroleum and "exploiting any commercially viable reserves discovered".[26] However, if the payment for the use of technology was categorised as a capital receipt, the receipt would not have been taxed in 1979. The issue today, more importantly, is whether such a payment would have been taxed as a capital gain under Pt IIIA of the Act.

Esso described the technology payment as a receipt for the sale of technology, but the court correctly concluded that there was no parting with a capital asset in exchange for the payment. The interesting issue, as to whether this was a disposal or a deemed disposal of an asset under the capital gains tax provisions of the Act, was therefore apparently answered in the negative; however it is clear that rights over information and know-how (as opposed to information itself) comprise assets for capital gains tax purposes, as that term is defined in s 160A of the Act.[27]

Operatorship assumption payment

Two companies known as the Rundell Twins[28] held an authority to prospect a deposit of oil shale in the Rundell area. In 1980 Esso submitted a proposal to acquire an interest in the Rundell deposit and was selected as the successful bidder. Esso's bid provided for it to acquire a 25 per cent equity in the resource which could be increased up to 50 per cent

[25] Ibid at 4381.
[26] Ibid at 4382; see also *Westfield Ltd v Commissioner of Taxation (Cth)* (1991) 21 ATR 1398.
[27] There is strong support for the view that "know-how" is an asset for the purpose of Pt IIIA: Lehman and Coleman, *Taxation Law in Australia* (4th ed, 1996), p 224. Further details of Esso's technology would be required in order to determine whether the technology would have been classified as an asset under Pt IIIA of the Act.
[28] South Pacific Petroleum and Central Pacific Minerals are the two companies known as the Rundell Twins.

depending on the amount of costs it incurred. Negotiations of the formal agreements continued over a number of months. As part of these negotiations, Esso made known its desire to become operator of the joint venture upon execution of the heads of agreement. The position of the operator is said to be "a prestigious one and, for better or for worse, the operator is the heart and soul of the joint venture".[29]

In June 1980, the negotiations were completed when Esso agreed to make 10 annual payments of $25 million each and an additional payment of $27.5 million known as an "operatorship assumption payment".

On the signing of the heads of agreement and pursuant to its terms, Esso became the operator of the joint venture. Shortly afterwards, Esso paid the first instalment of the operatorship assumption payment of US$10 million. Later, the parties agreed to amend the heads of agreement. In substance, Esso's obligations with respect to the balance of the operatorship assumption payment would be satisfied by the payment of a further US$5 million after the effective date of the joint venture agreement.

Esso claimed that the two instalments were deductible under s 51(1). The Commissioner contended that the payment was part of the price paid for the purchase of a participating interest in the joint venture and other rights accorded to Esso by the heads of agreement.

Evidence was given by one of Esso's negotiators that Esso would not have had a joint venture agreement or a heads of agreement without the operatorship assumption payment being made. The evidence was to the effect that the payments benefitted the project for its entire duration, were really part of the cost of acquisition, were made to entice the Rundell Twins to sign the heads of agreement and were made in order to entice the Rundell Twins to agree to turn over the operatorship of the project to Esso immediately upon the signing of the heads of agreement.

The court concluded that the two payments were made to secure the Rundell Twins' agreement to execute the heads of agreement. One of the provisions was that Esso would become operator upon execution of the document. It was held that the payments were consideration for the acquisition of an asset of lasting character for the benefit of Esso's organisation. As a result, the court concluded that payments were capital in nature and not deductible under s 51(1). The true character of the payment could be described as the consideration for the acquisition of a capital asset: *Poole; Dwight v Commissioner of Taxation (Cth)*.[30]

Tenement acquisition costs

Esso also claimed deductions for expenditure for the acquisition of tenements to conduct exploration and prospecting activities. The tenements were acquired by Esso for the purpose of conducting exploration and prospecting activities. The tenements in question were abandoned during

[29] Forbes, op cit n 6, p 351 and McDonald, "Comment on the Role of the Operator Under a Joint Venture Agreement" (1982) 4 AMPLJ 270.

[30] (1970) 122 CLR 427 at 436 per Walsh J.

the relevant year, without any consideration being received. The expenses were for professional services, options, rentals, legal fees, taxes, stamp duty and licence fees. The deductions were claimed under s 122K so far as the costs related to coal, oil shale and minerals.[31]

Section 122K(1) provided:

> "This section applies where deductions have been allowed or are allowable, under this Division or under provisions of a previous law of the Commonwealth relating to the taxation of income derived from mining operations, in respect of expenditure of a capital nature by the taxpayer in respect of property of the taxpayer which, in the year of income, has been disposed of, lost or destroyed, or the use of which by the taxpayer for prescribed purposes has, in the year of income, been otherwise terminated."

Section 122K(2) and (3) provides as follows:

> "(2) Where the aggregate of:
> (a) the sum of the deductions so allowed or allowable; and
> (b) the consideration receivable in respect of the disposal, loss or destruction or, in the case of other termination of the use of property, the value of the property at the date of termination of use,
>
> exceeds the total expenditure of a capital nature of the taxpayer in respect of that property, so much of the amount of the excess as does not exceed the sum of those deductions shall be included in the assessable income.
>
> (3) Where the total expenditure exceeds that aggregate, the excess shall be an allowable deduction."

In this case, Esso claimed that the total expenditure on the tenements of a capital nature exceeded the sum of the deductions allowed on the value of the property at the date of termination of use. As a result, Esso claimed the excess was deductible under s 122K(3).

The issue was whether the tenement acquisition costs were expenditure of a capital nature for the purposes of s 122K(3).

The court allowed the deductions under s 122K for the tenement acquisition costs in relation to the coal, oil, shale and other minerals and the Commissioner's argument that the costs were not "expenditure of a capital nature" within the meaning of s 122K(3). The Commissioner argued that the phrase "expenditure of a capital nature" was confined to capital expenditure otherwise deductible under the Act. It was common ground that tenement acquisition costs were not deductions allowed by Div 10 of the Act.

However, the court examined the legislative history of the provisions and found that it was the intention of Parliament to ensure that mine owners would be "allowed the *full amount* of the difference between the cost price of the asset and the amount received on its sale or disposal".[32]

[31] In the alternative, the taxpayer made a claim under s 124AM so far as they related to coal and oil shale and under s 77 so far as they related to gold.

[32] *Esso Australia Resources Ltd v Commissioner of Taxation (Cth)* (1997) 97 ATC 4371 at 4389, where Sundberg J referred to the Explanatory Notes to the Bill which became the 1951 Act. The emphasis is Sundberg J's.

The court held that the phrase "total expenditure of a capital nature" in s 122K(2) and (3) was not restricted to mean "total expenditure of a capital nature allowable as a deduction under this Division". If this was the case, Esso would not have been entitled to the deductions for the tenement acquisition costs. The court applied the natural meaning of the phrase "total expenditure of a capital nature" and accordingly allowed Esso the deduction. It was the court's view that:

> "The intention to be discerned from Division 10 as a whole, is that the amount which is to be amortised during the period the property is used does not include all capital expenditure on the property (s 122A(1) and (2)), but when the property ceases to be used, *all* capital expenditure is to be taken into account (s 122K(3))."

Of the five issues dealt with by the court, this was the only ground on which Esso succeeded. The court allowed Esso the deductions relating to the tenement acquisition costs where it had hoped to mine for coal or oil shale and other minerals.[33]

TAX LAW REWRITE

The existing tax law concerning deductions for mining quarrying activities is contained in Div 10 (Mining Quarrying), Div 10AAA (transport of minerals and quarry materials, Div 10AA (prospecting and mining for petroleum) and Div 10AB (rehabilitation and restoration of mining quarrying and petroleum sites) of Pt III of the Act. Those Divisions now only apply in respect of expenditure up to 30 June 1997. Any expenditure after that date is governed by Div 330 of Pt 3-45 of the new *Income Tax Assessment Act* 1997 (Cth) (the new Act).

It is beyond the scope of this paper to provide a comprehensive analysis of the new provisions and the ways in which the new Division differs from the old law. However, the following points are noted due to their relevance on the continuing applicability of the Esso decision.

First, with few exceptions, the new Division is not intended to provide any change to the substantive law dealing deductions for mining and quarrying. Rather, the aim of consolidating the provisions is to remove unnecessary duplication and thereby simplify the law.

Secondly, s 330-15 represents the effective consolidation of s 124AH (exploration of prospecting expenditure for petroleum) and s 122J (exploration of prospecting expenditure for minerals). The provision states that expenditure, whether of a capital nature or not incurred from the 1997-1998 income year, on exploration or prospecting for minerals or quarrying minerals obtainable by eligible mining or quarrying operations is deductible from that year.

[33] In the alternative, the taxpayer made a claim under s 124AM so far as they related to coal and oil shale and under s 77 so far as they related to gold.

Thirdly, the concept of mining has been expanded so that it includes mining for petroleum (s 330-5(2)). The concept of "minerals" also includes petroleum (s 330-25(1)). The new Act adopts a definition of petroleum that is identical to that contained in s 6(1) as described above (s 330-25(2)).

The concept of exploration or prospecting in now not defined exhaustively. The Explanatory Memorandum to the new Division indicates that the definition is intended to have flexibility to take in, over time, comparable activities that evolve from technological and other changes. The Explanatory Memorandum acknowledges that the existing law is inconsistent in its treatment of activities that can be regarded as exploration and prospecting, in that the definition for general mining and quarrying was much more restrictive than the definition for petroleum.

The increased flexibility of the new definition of exploration or prospecting, contained in s 330-20 of the new Division, is to be welcomed. The term includes the traditional exploration or prospecting processes of geological mapping, geophysical surveys and a search by drilling or other means for minerals. The term also now expressly includes feasibility studies to evaluate the economic feasibility of mining minerals or quarry minerals, once they have been discovered, within the concept of exploration or prospecting. This change aligns the law with established practice which was not reflected in the old provisions.

A deduction for exploration or prospecting expenditure is subject to "deductibility tests" specified in s 330-15(2), which differ according to whether the expenditure is incurred in relation to minerals other than petroleum, quarry materials or for petroleum itself.

Clearly, as a result of the *Esso* case, exploration and prospecting expenditure for coal and oil shale will be subject to the tests for applying to "minerals other than petroleum".

The tests imposed on such expenditure, one of which must be satisfied, are that:

(a) the taxpayer must be carrying on eligible mining operations other than petroleum mining;

(b) it must be reasonable to conclude that the taxpayer proposed to carry on such operations; or

(c) the taxpayer carried on the business of, or a business that included, explorational prospecting for minerals other than petroleum obtainable by such operations, and the expenditure was necessarily incurred in carrying on that business.

It is evident that these tests replicate the existing tests under the current mining and exploration Divisions and under s 51(1).

Significantly, eligible mining operations are defined in s 330-30(2) to mean:

(a) mining operations on a mining property for extracting minerals other than petroleum on the natural site for the purpose of producing assessable income; or

(b) mining operations for the purpose of obtaining petroleum for the purpose of producing assessable income.

If the facts giving rise to the *Esso* case arose today, the central issue would be whether it would be reasonable to conclude that Esso proposed to carry on eligible mining operations other than petroleum mining. Again, it would therefore appear that the issue of deductibility of this amount would turn on whether the company was "committed" to conducting coal and oil shale mining operations. On the basis of the reasoning in the *Esso* case, the court would have found that this requirement was not satisfied here.

It therefore appears that the *Esso* case would not have decided differently on the first issue if the issue was determined under the new provisions. The Division itself does not expressly state whether it is to be a code for the deduction of such expenditure. Whilst the Division states that it applies to expenditure, whether of a capital or revenue nature, the general aim of the new Act is, as stated above, not to change the existing law unless expressly stated. Mining expenditure may therefore still be deductible under s 51(1) where the tests set out in that provision are met.

It is noteworthy that the new Division replaces a number of discretions given to the Commissioner under the old law within an objective test, generally based on reasonableness. For example, the ability of the Commissioner to disallow deductions for s 124AH expenditure unless the Commissioner is satisfied that the taxpayer carried on or proposed to carry on prescribed petroleum operations or prospecting for petroleum obtainable by prescribed petroleum operations (in s 124AH(4C)) has been replaced with the objective tests set out above.

In summary, the new law simply consolidates the existing provisions. Generally, the requirements to be satisfied before a deduction can be granted under this Division are the same as those that existed under the old law, save that some uncertainties which arose under the old law have been clarified.

CONCLUSION

The *Esso* case has the following ramifications for petroleum and mineral exploration companies:

1. Expenditure incurred in exploring and prospecting for coal and oil shale is not deductible under s 124AH(1). In order to obtain such a deduction a company exploring for these commodities should make a claim for a deduction under s 122J.
2. Preliminary exploration costs, such as reviewing, evaluation and bidding costs, are not deductible as an expense under s 51(1) unless the company exploring for the particular commodities is committed to the commercial production of those commodities. Alternatively, such expenditure will only be deductible if the exploration or prospecting company intends to make a profit, not by mining, but by selling its rights to mine, should the area prove profitable.

3. Payments received by a joint venturer for contributing mining technology to the joint venture may be assessable as income according to ordinary concepts if the court finds that there is "not an insignificant profit-making purpose" in entering into the transaction.
4. Payments made to secure the right to become an operator of a joint venture cannot be deducted under s 51(1) if the payment is held to be an acquisition of an asset of a lasting character for the benefit of the paying organisation.
5. Companies may be able to claim a deduction under s 122K for tenement acquisition costs where the tenements are abandoned at a later stage. The intention of Div 10 is that the amount to be amortised during the period the property is used does not include capital expenditure on the property (s 122A(1) and (2)), but when the property ceases to be used all capital expenditure is to be taken into account (s 122K(3)).

Whilst the business community could object that the government has missed an opportunity to provide greater incentives for the mining community to conduct mineral and petroleum exploration by not amending the new tax provisions in more substantive detail, it is the express purpose of the TLIP to simplify and clarify the law, rather than introduce substantive or material amendment.