


***Commissioner of Taxation v Shell Energy Holdings
Australia Limited -***

Decision impact statement

Commissioner of Taxation v Shell Energy Holdings Australia Limited

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| Court citations: | HCATrans [2022] 151 (special leave application) [2022] FCAFC 2 [2021] FCA 496 |
| Venues: | High Court of Australia (special leave application) Full Federal Court of Australia Federal Court of Australia |
| Venue reference numbers: | P4 of 2022 (special leave application) WAD146 of 2021 WAD391 of 2019 |
| Judge names: | Gageler, Gordon and Gleeson JJ (special leave application) Allsop CJ, Davies and Thawley JJ Colvin J |
| Judgment dates: | 9 September 2022 (special leave application decision) 25 January 2022 12 May 2021 |
| Appeals on foot: | No |
| Decision outcome: | Mostly unfavourable to the Commissioner |

Impacted advice

 The ATO is reviewing the impact of this decision on related advice and guidance products.

Taxation Ruling TR 2017/1 *Income tax: deductions for mining and petroleum exploration expenditure*

Taxation Determination TD 2019/1 *Income tax: what constitutes 'use' (and potentially first use) of a mining, quarrying or prospecting right, that is a depreciating asset, for the purposes of subsection 40-80(1) of the Income Tax Assessment Act 1997?*

Miscellaneous Taxation Ruling MT 2012/1 *Miscellaneous taxes: application of the income tax and GST laws to immediate transfer farm-out arrangements*

Miscellaneous Taxation Ruling MT 2012/2 *Miscellaneous taxes: application of the income tax and GST laws to deferred transfer farm-out arrangements*

Précis

This Decision impact statement outlines the ATO's response to this case, which concerned whether the amount of the deduction available under section 40-25 of the *Income Tax Assessment Act 1997* (ITAA 1997) for the decline in value of a depreciating asset acquired by Shell Energy Holdings Australia Limited (Shell) was the cost of that asset by virtue of the operation of section 40-80 of the ITAA 1997.

All legislative references in this Decision impact statement are to the ITAA 1997, unless otherwise indicated.

Brief summary of facts

In 2012, Shell and Chevron Australia Pty Ltd (Chevron) were both participants, with other parties, in a petroleum venture known as the Browse Project. Relevantly, the participants in the Browse Project were together the legal holders of an exploration permit and 6 retention leases (Statutory Titles) which gave a permission or authority to the holders to explore for petroleum. One of the Statutory Titles was acquired by Shell prior to 1 July 2001 and the remaining Statutory Titles were derived from exploration permits that were held by Shell prior to 1 July 2001.

In August 2012, Shell entered into an asset exchange agreement (AEA) with Chevron to purchase Chevron's participating interest in the Browse Project.

Shell claimed a deduction of approximately \$2.3 billion under sections 40-80 and 40-25 for the cost of acquiring 'mining, quarrying or prospecting rights'¹ (MQPRs) in the form of 'an additional proportional interest' in the Statutory Titles (commensurate with its additional proportional interest in the Browse Project after the dealing with Chevron), on the basis of it first using those MQPRs for 'exploration or prospecting'.

Under the terms of the AEA, once the dealing between Shell and Chevron had been approved and registered under the relevant petroleum legislation that governed the Statutory Titles, the AEA was to have retrospective effect from 1 June 2012. Approval and registration under the relevant petroleum legislation occurred in early November 2012.

Certain activities were carried out in the areas governed by the Statutory Titles prior to the approval and registration of the dealing between Shell and Chevron in November 2012. However, a geotechnical study, a geophysical survey and an ultra-high resolution seismic survey were also carried out after the relevant approval and registration.

Following an audit, the Commissioner disallowed Shell's claimed deductions and imposed administrative penalties. Shell objected to the Commissioner's decision and its objections were disallowed. The Commissioner's decision was appealed to the Federal Court.²

On 12 May 2021, Colvin J handed down a partly unfavourable decision against the Commissioner, who then appealed his Honour's decision to the Full Federal Court.³ Shell also filed a cross appeal against part of his Honour's decision.

On 25 January 2022, the Full Federal Court dismissed the Commissioner's appeal and allowed Shell's cross-appeal. Davies J's decision was agreed with by Thawley J

¹ As defined in subsection 995-1.

² *Shell Energy Holdings Australia Limited v Commissioner of Taxation* [2021] FCA 496 (*Shell at first instance*).

³ *Commissioner of Taxation v Shell Energy Holdings Australia Limited* [2022] FCAFC 2 (*Shell FFC*).

and Allsop CJ, with the Chief Justice also making some additional comments in a separate decision.

On 9 September 2022, the High Court dismissed the Commissioner's special leave application against the Full Federal Court's decision.

Issues decided by the Courts

The following 4 issues were decided:

- What were the relevant depreciating assets and whether section 40-77 of the *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A) operated to disapply Division 40 to the relevant depreciating assets?
- When did Shell begin to hold the relevant depreciating assets?
- Whether certain activities conducted by the joint venture were activities of exploration?
- When did Shell first use the relevant depreciating assets for the purposes of section 40-80?

The MQRs and Transitional Provisions issue

Both Courts proceeded on the basis that by acquiring Chevron's participating interest in the Browse Project, Shell had acquired a commensurate additional proportional interest in the Statutory Titles and these interests were MQRs and the relevant depreciating assets.⁴

It was then held that subsections 40-77(1) and (1A) of the IT(TP)A did not apply because Shell only 'started to hold' these rights in November 2012, as a consequence of acquiring Chevron's participating interest in the Browse Project.⁵ Further, it was held that subsection 40-77(1B) of the IT(TP)A did not apply because the rights were not a replacement for, or the successor to, a right that had ended, on the basis that Shell's proportional interest in the Statutory Titles which it held prior to the acquisition of Chevron's interest had not come to an end.⁶

In addition, the Full Federal Court held that the criterion in paragraph 40-77(1B)(c) of the IT(TP)A that the rights 'relate to the same area' was not satisfied.⁷ This was held despite the area governed by the Statutory Titles being a subset of the area covered by earlier titles held by Shell. In particular, it was concluded that the word 'same' in paragraph 40-77(1B)(c) of the IT(TP)A means 'identical' and that a right does not cover the same area as another right if the area is different in size. However, neither of the Courts went on to consider whether the alternative condition in paragraph 40-77(1B)(c) of the IT(TP)A, that 'any difference in area is not significant', was met.

The 'hold' issue

At first instance, Colvin J rejected Shell's submission that it began to hold the additional proportional interest in the Statutory Titles from the retrospective effective date of the AEA of 1 June 2012.

His Honour agreed with the Commissioner's contention that because the relevant Petroleum Acts governing the Statutory Titles provide that a dealing which creates or assigns an interest in an existing statutory title is of 'no force' *until* it is approved and

⁴ See [39] of *Shell at first instance* and [12] of *Shell FFC*.

⁵ See [71] of *Shell FFC*, which also endorses [360–362] of *Shell at first instance*.

⁶ See [72] of *Shell FFC*, which also endorses [346], [350] and [352] of *Shell at first instance*.

⁷ See [72] of *Shell FFC*.

registered, Shell could only come to hold its additional proportional interest in the Statutory Titles from when the dealings by which that interest was transferred was approved and registered under the relevant Petroleum Acts, being in early November 2012.⁸

His Honour's conclusion on this issue was not part of Shell's cross appeal and this issue was therefore not considered by the Full Federal Court.

The 'exploration' issue

The Courts did not construe the meaning of the term 'exploration or prospecting' contained in subsection 40-730(4). The Commissioner contended, at first instance, that there could be no exploration for the purposes of the ITAA 1997 unless there was exploration for the purposes of the relevant Petroleum Acts.⁹ Therefore, the issue considered by the Courts was the construction of the terms 'explore' and 'exploration' as used in the relevant Petroleum Acts.

The Full Federal Court agreed with Colvin J that, having regard to the statutory context and legislative history of the relevant Petroleum Acts, the terms 'explore' and 'exploration' were not confined to activities directed only to the discovery of petroleum but also included activities undertaken within the relevant area to ascertain the worth and extent of the resource and to assess the commercial feasibility for exploitation of the petroleum resource.¹⁰

Accordingly, the geotechnical study, the geophysical survey and the ultra-high resolution seismic survey, carried out after the approval and registration of the relevant dealing, were held to be activities that constituted exploration for the purposes of the relevant Petroleum Acts. These activities were undertaken after early November 2012 when Shell was found to have held new MQPRs as a result of its dealing with Chevron.¹¹

The 'first use' issue

In allowing Shell's cross appeal against Colvin J's decision on this issue¹², the Full Federal Court considered the meaning of 'first use' in section 40-80 and held that:

- the first use of an asset to which section 40-80 can apply corresponds with the 'start time' for that asset as that term is defined in subsection 40-60(2), and
- as the 'start time' of a depreciating asset is defined to include when that asset is first used or is held installed ready for use for any purpose, in practice that means that a bundle of rights, such as an MQPR, is installed ready for use once held for use.¹³

⁸ See [107–108], [113] and [116–118] of *Shell at first instance*.

⁹ See [194] of *Shell at first instance*.

¹⁰ See [5] and [51–52] of *Shell FFC*, which endorse [233–237] of *Shell at first instance*.

¹¹ As stated in [194] of *Shell at first instance*, the Commissioner did not argue in this case that there might be activities that would be exploration for the purposes of the relevant Petroleum Acts but not 'exploration or prospecting' for the purposes of the ITAA 1997.

¹² See [131] of *Shell at first instance* for his Honour's conclusion on the 'first use' issue.

¹³ See [64–66] of *Shell FFC*.

ATO view of decision

The MQPRs and Transitional Provisions issue

The Commissioner accepts the Full Federal Court's decision that the word 'same' in paragraph 40-77(1B)(c) of the IT(TP)A means 'identical' and that a right does not cover the same area as another right if the area is different in size, even where the area covered by one right is merely a subset of the area covered by the other right.

However, as no argument was advanced before the Courts that any difference in area was not significant for the purposes of paragraph 40-77(1B)(c) of the IT(TP)A, neither decision provides authority for the meaning of the phrase 'any difference in area is not significant' as it appears in paragraph 40-77(1B)(c) of the IT(TP)A.

In relation to the MQPRs issue, the Commissioner's first ground in the special leave application was that it was incorrect for the Courts below to assume that Shell had acquired a commensurate additional proportional interest in the Statutory Titles merely because it had acquired Chevron's participating interest in the Browse Project. The Commissioner posited that a proper construction of the relevant Joint Venture Agreement demonstrated that no such additional proportional interest in the Statutory Titles arose despite Shell's acquisition of Chevron's participating interest in the Browse Project. The High Court's reasons for refusing leave were that the procedural history of the case made it an inappropriate vehicle to consider this issue.

Accordingly, whether or not an interest in joint venture property arises merely by virtue of the acquisition of a participating interest in the joint venture remains an open question. The Commissioner's view on this issue is that whether, and to what extent, a venturer has an interest in joint venture property and the nature of any such interest will depend on the facts and circumstances of each case (and may be affected by the joint venture agreement or by statute).

The 'hold' issue

Colvin J's decision on the 'hold' issue is consistent with the Commissioner's view on the operation of the relevant Petroleum Acts and their requirements for certain dealings to be approved and registered and otherwise having 'no force' until such approval and registration has been completed.

However, certain statements in MT 2012/1 and MT 2012/2 about when a farmee may begin to hold an interest in a mining tenement in accordance with section 40-40 will be updated to include further context to make it clear that the effect of the relevant regulatory regime needs to be considered in each case including, in particular, the operation of any 'no force' provisions.

The 'exploration' issue

Davies J stated that the ordinary meaning of 'explore' or 'exploration' can include activities conducted for the purposes of evaluating the feasibility of recovering petroleum. However, her Honour also noted that ultimately the natural and ordinary meanings of the terms did not assist the Court to favour one construction over the other for the purposes of the interpretative task and the statutory context and legislative history were of more probative assistance.¹⁴

The Commissioner accepts that, having regard to the statutory context and legislative history of the relevant Petroleum Acts, it was open for the Full Federal Court to conclude that the terms 'explore' and 'exploration' had a wider meaning in the context of those Acts than that contended by the Commissioner. The activities directed

¹⁴ See [31] of *Shell FFC*.

towards ascertaining the characteristics of the petroleum field or whether the identified resource was commercially recoverable were therefore found to have met the definition of 'explore' or 'exploration' under the relevant Petroleum Acts.

The Commissioner is of the view that the statutory context and legislative history of the defined term 'exploration or prospecting' contained in subsection 40-730(4) suggest that (except for the particular express additions contained in paragraphs 40-730(4)(a) to (d)) a more limited meaning of those words was intended for the purposes of the ITAA 1997. This view is consistent with TR 2017/1 but the Commissioner will update certain statements in TR 2017/1 that refer to the ordinary meaning of 'exploration' in a more limited manner than was considered possible by the Full Federal Court.¹⁵

The 'first use' issue

The Commissioner accepts the Full Federal Court's decision that the 'first use' and 'start time' for an MQPR correspond with when the MQPR is taken to be held by an entity.

Whether Davies J's comments that 'a bundle of rights is installed ready for use once held for use'¹⁶ can apply to other intangible assets listed in subsection 40-30(2) will depend on the nature of the relevant intangible asset and the operation of any relevant legislation that governs the use of the intangible asset. Further, whether or not the 'taxable purpose' requirement in subsection 40-30(2) is satisfied will depend on the facts and circumstances of each case.

For completeness, the Commissioner does not consider that 'mining, quarrying or prospecting information' is a bundle of rights and will continue to apply their view in Taxation Ruling TR 2019/4 *Income tax: capital allowances: expenditure incurred by an entity that collects, processes and provides multi-client seismic data*.

Implications for impacted advice or guidance

TD 2019/1 will be withdrawn with effect from 2 February 2023.

TR 2017/1, MT 2012/1 and MT 2012/2 will be updated in accordance with the comments made in this Decision impact statement.

Comments

We invite you to advise us if you feel this decision has consequences we have not identified. Please forward your comments to the contact officer.

Date issued: 31 January 2023

Due date: 3 March 2023

Contact officer details have been removed as the comments period has expired.

Legislative references

ITAA 1997 Div 40

ITAA 1997 40-25

ITAA 1997 40-30(2)

¹⁵ In this case, on the facts as ultimately found by the Court, the activities determined to have been conducted for evaluating the commercial feasibility of recovering petroleum would likely have satisfied one or more of the express additions listed in paragraphs 40-730(4)(a) to (d).

¹⁶ See [66] of *Shell FFC*.

ITAA 1997 40-40
ITAA 1997 40-60(2)
ITAA 1997 40-80
ITAA 1997 40-730(4)
ITAA 1997 40-730(4)(a)
ITAA 1997 40-730(4)(b)
ITAA 1997 40-730(4)(c)
ITAA 1997 40-730(4)(d)
ITAA 1997 995-1

IT(TP)A 40-77
IT(TP)A 40-77(1)
IT(TP)A 40-77(1A)
IT(TP)A 40-77(1B)
IT(TP)A 40-77(1B)(c)

Related Rulings/Determinations

MT 2012/1
MT 2012/2
TD 2019/1
TR 2017/1
TR 2019/4

ATO references

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