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Evaluating Mining and Petroleum Joint Ventures in Australia

By

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A Revenue Law Perspective

Evaluating Mining and Petroleum Joint Ventures in Australia — A Revenue Law Perspective

Addendum

This thesis should be read subject to the amendments set out in this addendum.

- 1 On page xxv, replace the sentence commencing with the words "On 21 September 1999," with:

On 21 September 1999, the Commonwealth Government released the final report of the Review of Business Taxation (the *Ralph Committee* or *Committee*) on Australian business taxation reform—*A Tax System Redesigned*.

- 2 On page 13, insert the following sentence at the end of n 11:

Flow through taxation for trusts is subject to a distribution of income in the revenue year.

- 3 On page 34, replace the text of n 103 with:

A Tax System Redesigned, 550.

- 4 On page 34, insert a new paragraph after the sentence that ends with the words "an 'entity' is defined to mean any taxpayer":

It is noted that *Exposure Draft: A New Tax System (Income Tax Assessment) Bill 1999* (Cth), which accompanied *A Tax System Redesigned*, proposed a definition of 'tax entity' in s. 960-105(1). Broadly, that provision proposed that a tax entity means: a company; a trust; a person in the person's capacity as an executor administering a deceased estate; an arrangement or situation that is entered into outside Australia and does not give rise to a trust; and a limited partnership.

- 5 Add the following text and footnotes at the bottom of page 40:

Accordingly, a fractional interest approach generally applies to participants of unincorporated joint ventures.¹ That is, each participant separately accounts for its share of joint expenditures and, where relevant, the proceeds of disposal of shares of output.

The Committee has recommended the adoption of a 'comprehensive fractional interest' approach to unincorporated joint ventures.² Although specific details about this approach are yet to emerge, it appears the approach is intended to address specific problems of the current law, rather than cease the flow treatment of unincorporated joint ventures. If so, then new participants could benefit from lower compliance costs in two significant areas. First, if the comprehensive fractional interest the approach specifically allows participants to depreciate the cost of interests in jointly owned plant.³ Secondly, by making explicit in the balancing adjustment rollover provisions accessed by partnerships that they do not apply to participants whenever there is a disposal of an interest in an item of plant.

The Committee has indicated that suggestions have been received that 'another option would be to retain the current hybrid treatment (fractional interest for assets with capital gains and joint treatment for other assets) and address the

¹ *A Tax System Redesigned*, 552.

² *Ibid*, 552.

³ *Id.* See also recommendation 8.3.

problems with the balancing adjustment rollover provisions'.⁴ *A Tax System Redesigned* contains no statement that the hybrid approach will apply to participants of unincorporated joint ventures.

6 On page 47, insert the following sentence at the end of n 167:

In *A Tax System Redesigned*, 69, the Committee also said that 'Consolidation will allow a significant reduction in compliance costs for company groups while also reinforcing the integrity of the tax system'.

7 On page 69, add the following paragraphs and footnote at the end of the sentence that ends in the words "should be elective within the controlled group":

Under the proposed consolidation measures, dividends received from investments in non-wholly owned companies would cease to be eligible for the inter-corporate dividend rebate.⁵ If a consolidated group is in an overall current year loss position, the dividends will absorb current year losses. This will result in franking credit and current year loss wastage.

The Ralph Committee understood this issue. Recommendation 11.5 of *A Tax System Redesigned* proposes that current year losses be subject to an election as for prior year losses. The exposure draft legislation does not address this issue. The issue could significantly impact consolidated group taxpayers that receive dividends from equity participants of equity joint ventures.

8 On page 48, add the following text underneath the heading "Consequences of consolidated group regime":

Exposure Draft: New Business Tax System (Consolidation) Bill 2000 (Cth) sets out a procedure for determining the purchase price of a head entity of a consolidated group that is taken to have purchased each of the CGT assets of the joining entity.⁶ The procedure would apply to participants joining a consolidated group (the *joining participant*). The payment for the deemed purchase of the assets is determined by allocating the consolidated group's 'allocable cost amount' for the joining participant to the joining participant's assets.

The consolidated group's allocable cost amount for a joining participant is the amount used to determine the deemed purchase payments for the assets of the joining participant. One aspect of the proposed procedure for calculating prior distributions of pre-acquisition profits is unclear, and this uncertainty could arguably increase the compliance costs of a joining participant.

Section 168-245 of the exposure draft legislation sets out the consolidated group's 'allocable cost amount' for a joining entity. The 'allocable cost amount' is determined under seven steps.

⁴ Ibid, 554.

⁵ The provisions in Pt 4 of *Exposure Draft: New Business Tax System (Consolidation) Bill 2000* (Cth) propose the removal of the intercorporate dividend rebate for dividends paid after 30 June 2001.

⁶ Section 168-205 *Exposure Draft: New Business Tax System (Consolidation) Bill 2000* (Cth) defines a joining entity as an entity that becomes a subsidiary member of a consolidated group.

The first and second steps are to determine the cost base of membership interests in the joining participant⁷ and the liabilities of the joining participant.⁸ The third step is to add the sum of distributions of 'pre-joining time' profits⁹ made by the joining participant to members of the joined group in the period that starts at the joining time and ends when the joining participant lodges its income tax return for its income year ending at the joining time.¹⁰ The fourth step is to subtract distributions by the joining participant out of 'pre-acquisition' profits. The fifth step is to subtract an amount worked out in relation to certain losses of the joining participant.¹¹ The sixth step is to deduct an amount in relation to 'over-depreciated' assets of the joining participant.¹² The last step is to subtract an amount in relation to certain losses transferred to the head entity of the joined group by the joining participant.

Section 168-265(9) requires that a joining participant's profits that accrue in the period before realisation be determined on 'the most reasonable basis'. Whilst this 'reasonableness' test probably implies an objective assessment of all relevant factors, the issue is open to interpretation. In turn, the issue makes uncertain one aspect of determining the deemed purchase of the assets to the consolidated group, that could add to a joining participant's compliance costs.

Moreover, the proposed consolidation regime also creates significant difficulties for participants with substituted accounting periods (SAPs). The exposure draft legislation provides for the repeal of the loss transfer provisions in Subdivs 170-A, 170-B and 170-C of the ITAA 1997 with general effect from 1 July 2001, but provides transitional provisions for SAPs.

The object of the provisions is two-fold. First, to ensure that a company whose 2000-01 income year ends after 30 June 2001 can either transfer under Subdiv 170-A or 170-B of the ITAA 97 a loss it makes for that income year only so far as the loss is attributable to the part of the income year before 1 July 2001; or utilise a loss transferred under one of those subdivisions to reduce income or gains for that income year only so far as the income or gains are attributable to the part of the income year before 1 July 2001.¹³

Consolidated groups with one or more participants that utilise SAPs could be expected to incur significant costs to schedule and resource the additional work and reporting timetables that would be required to produce audited financial statements and income tax returns for a period to 30 June 2001.

⁷ See s. 168-250(1) and (2) *Exposure Draft: New Business Tax System (Consolidation) Bill 2000* (Cth).

⁸ See s. 168-255(1) and (2) *Exposure Draft: New Business Tax System (Consolidation) Bill 2000* (Cth).

⁹ 'Pre-joining time profits' are the distributable profits of the joining participant as at the joining time: s. 168-260(1) and (2) *Exposure Draft: New Business Tax System (Consolidation) Bill 2000* (Cth).

¹⁰ Or the time that return is required to be lodged, if the return is not lodged by then.

¹¹ Section 168-275(1) *Exposure Draft: New Business Tax System (Consolidation) Bill 2000* (Cth).

¹² Section 168-280(5) *Exposure Draft: New Business Tax System (Consolidation) Bill 2000* (Cth).

¹³ The rules are set out in Pt 5 of *Exposure Draft: New Business Tax System (Consolidation) Bill 2000* (Cth).

- 9 On pages 59-60, replace the paragraph commencing with the words "Despite the differences in ownership interests of unitholders in a trust to shareholders in a company," with this paragraph:

Unit trust joint ventures do not protect the unitholders entirely from liability to third parties, such as creditors. The settled general principle is that a trustee is entitled to an indemnity for liability incurred in carrying out the trust, and that right extends beyond the trust property and is enforceable in equity against a beneficiary who are *sui juris*.¹⁴ The policy rational for this principle is that a beneficiary who benefits from a trust should also bear its burdens unless the beneficiary can demonstrate a valid reason why the trustee should bear the burdens alone.¹⁵ Moreover, the effectiveness of an exclusion clause in a unit trust deed that exonerated the unitholders from liability to the trustee or manager was upheld recently.¹⁶

- 10 On page 129, add the following heading, text and footnotes immediately before the heading "TAXATION OF FINANCIAL ASSETS AND LIABILITIES – A NEW REGIME":

The proposed thin capitalisation rules

On 21 February 2001, the Government released *Exposure Draft: New Business Taxation (Thin Capitalisation) Bill 2001* (Cth).¹⁷ The exposure draft legislation proposes reforms to the thin capitalisation rules aimed at "improving both the integrity and fairness of the income tax law".¹⁸

Broadly, the new rules will apply to all of the debt of Australian joint venture taxpayers. The inclusion of all debt will strengthen the integrity of the rules. The maximum allowable debt to equity ratio allowed will be 3:1,¹⁹ compared with 2:1 under the current provisions. Concepts of debt and equity will continue to play a central role in the new rules. The prescribed debt to equity ratio may be exceeded in circumstances where the funding structure is still on an arm's length basis. In the joint venture context, the focus of the arm's length debt analysis is on the Australian joint venture operations of the foreign investor. The analysis looks to the assets of those operations as the source of cash flows to meet the debt repayments and the other liabilities of the operations.²⁰

Areas where the current thin capitalisation rules could increase compliance costs for joint venture taxpayers have been identified earlier in the chapter. The

¹⁴ *JW Eroomhead (Vic) Pty Ltd (In liq) v JW Broomhead Pty Ltd* [1985] VR 891, 939, per McGarvie J.

¹⁵ *Ibid*, 936, per McGarvie J.

¹⁶ Refer *McLean v Burns Philp Trustee Co Pty Ltd* (1985) 2 NSWLR 623.

¹⁷ Refer chapter 1 of *Explanatory Notes to Exposure Draft: New Business Taxation (Thin Capitalisation) Bill 2001* (Cth) for a general overview of the exposure draft legislation.

¹⁸ Paragraph 1.5 of *Explanatory Notes to Exposure Draft: New Business Taxation (Thin Capitalisation) Bill 2001* (Cth). The exposure draft legislation proposes to improve the integrity and fairness of tax laws by implementing recommendations 22.1 to 22.9, and 22.11 (b) and (c) of *A Tax System Redesigned*.

¹⁹ Refer s. 820-185(1) *Exposure Draft: New Business Taxation (Thin Capitalisation) Bill 2001* (Cth).

²⁰ Refer s. 820-215(1) *Exposure Draft: New Business Taxation (Thin Capitalisation) Bill 2001* (Cth). To sustain a high level of debt, the entity needs to consider what would have happened at arm's length under certain assumptions, and to demonstrate that continued sound operations under those assumptions could be reasonably expected.

approach in this section is to highlight three areas of the exposure draft legislation that, if enacted, could add fiscal complexity to the law, which in turn, could impose different compliance cost burdens on joint venture taxpayers.

The first significant issue is in the safe harbour calculation. A safe harbour calculation will be required to determine whether debt levels of an Australian resident participant or equity participant exceed a prescribed level. The definition of 'equity' is central to performing the calculation, and yet the term is not defined in the exposure draft legislation.²¹ Fiscal certainty would be promoted for joint venture taxpayers if the term were defined. For instance, in calculating the safe harbour debt in section 820-95 of the exposure draft legislation, 'associate entity equity' is excluded. 'Associate entity equity' means 'the total amount of equity that the entity holds ...'. However, there does not appear to be a definition of 'equity'.

The second significant issue is that the exposure draft legislation does not specify precisely what is required to 'demonstrate' in terms of documenting the calculation of the arm's length debt amount. Conceptually, the arm's length method provides additional flexibility. However, the test may not always be accessible because of the difficulties likely to be encountered in compiling the necessary data. The arm's length method might not be a practical alternative to the safe harbour test. The compliance costs associated with relying on the arm's length method could be prohibitive particularly since the amount has to be re-calculated at least annually. Some guidelines about the minimum level of documentation would be appropriate.

The third significant issue is that joint venture taxpayers with substituted accounting periods (SAPs) are not allowed to elect to apply div 820 for income years spanning 1 July 2001.²² Currently, they are required to apply div 16F for the part of the year before 1 July 2001 and div 820 for that part of the year after 30 June 2001. The start date of the thin capitalisation rules is 1 July 2001 regardless of whether or not the relevant joint venture taxpayer has a SAP. Therefore, joint venture taxpayers with SAPs will be required to do two calculations (one under div 16F for the part of the year before 1 July 2001 and one under div 820 for the part of the year after 30 June 2001). This could increase compliance costs and add complexity to reporting requirements. The potential cost to affected joint venture taxpayers could be reduced if a joint venture taxpayer with a SAP were allowed to elect to apply div 820 for the income year that spans 1 July 2001.

11 On page 56, add the following headings and text before the heading "UNIT TRUST JOINT VENTURES":

GST joint ventures

A New Tax System (Goods and Services Tax) Act 1999 (Cth) (the GST Act) makes provision for the registration of "GST Groupings".²³ Rather than requiring each participant to account for its share of supplies and acquisitions for GST purposes,

²¹ This is acknowledged explicitly in para 1.46 of *Explanatory Notes to Exposure Draft: New Business Taxation (Thin Capitalisation) Bill 2001 (Cth)*.

²² Sections 820-15 and 820-20 *Exposure Draft: New Business Taxation (Thin Capitalisation) Bill 2001 (Cth)*.

²³ See div 48 *A New Tax System (Goods and Services Tax) Act 1999 (Cth)*.

the participants²⁴ of the joint venture may apply to the Commissioner to be treated as a 'GST joint venture'.

Forming a GST joint venture will lower GST compliance costs for participants by simplifying GST accounting for the participants where there is a flow of supplies between participants to a joint venture. Significant aspects of the scheme are considered below.

'GST joint ventures' apply only where six conditions set out in s. 51-5 of the GST Act are satisfied. The first condition is that 'the joint venture is a joint venture for the exploration or exploitation of mineral deposits, or for a purpose specified in the regulations'. The second condition is that the joint venture is not a partnership. The third condition is that the entities apply, in the approved form, for approval of the joint venture as a GST joint venture. The fourth, fifth and sixth conditions are that each of the participants must satisfy the participation requirements for that GST joint venture, the application nominates one of the participants, or another entity, to be the joint venture operator for the purposes of the joint venture, and if the nominated joint venture operator is not a party to the joint venture agreement (the *JVA*) - the nominated joint venture operator satisfies the participation requirements of the GST joint venture.²⁵

Section 51-10 of the GST Act sets out the participation requirements for a GST joint venture, or a proposed GST joint venture. An entity must satisfy four requirements. First, the entity participates in, or intends to participate in, the joint venture. Secondly, the entity is a party to a JVA with all the other entities participating in, or intending to participate in, the joint venture. Thirdly, the entity is registered for GST. Fourthly, the entity accounts on the same basis as all those other participants. In the Australian minerals industry, the joint venture operator is often not a party to the JVA. The joint venture operator may fulfill this role for several joint ventures but not be a party to any of the JVAs.

Subdivision 51-B sets out the consequences of approval of a GST joint venture. The effect of forming a GST joint venture is that the joint venture operator pays the GST and is entitled to the input tax credits on supplies, acquisitions and importations it makes on behalf of the other participants for the purpose of the joint venture.²⁶ Supplies made by the joint venture operator to another participant in the GST joint venture for the purpose of the joint venture will not be subject to GST. For this reason, the operator is not required to fulfill all the participation requirements. The operator only needs to be registered for GST and account on the same basis as all the other participants. It will also be responsible for any adjustments relating to these supplies, acquisitions and importations (note that different rules apply when a participant leaves a GST joint venture).²⁷ The operator will submit a Business Activity Statement at the end of every tax period.²⁸ The Business Activity Statement will include a net amount of GST payable or input tax credits claimable as a result of transactions made on behalf of

²⁴ 'Participant' is defined by s. 195-1 *A New Tax System (Goods and Services Tax) Act 1999* (Cth) as an entity currently approved as one of the participants of the joint venture under s. 51-5 ('Approval of GST joint ventures') or para. 51-70(1)(a) ('Changing the participants etc. of GST joint ventures').

²⁵ Section 51-5(a) - (f) *A New Tax System (Goods and Services Tax) Act 1999* (Cth).

²⁶ Sections 51-30 and 51-35 *A New Tax System (Goods and Services Tax) Act 1999* (Cth).

²⁷ Section 51-40 *A New Tax System (Goods and Services Tax) Act 1999* (Cth).

²⁸ Section 51-50 *A New Tax System (Goods and Services Tax) Act 1999* (Cth).

the members of the GST joint venture. The net amount will include any adjustments relating to transactions made in previous tax periods.

When an entity ceases to be a member of a GST joint venture, it will be responsible for any subsequent adjustments relating to transactions made on its behalf by the entity that is (or was) the joint venture operator.²⁹

The joint venture operator can apply to the Commissioner to approve another company to join the joint venture, or remove participants from the GST joint venture, or approve another participant of the GST joint venture as the joint venture operator.³⁰

The Commissioner can also revoke the approval of a joint venture operator if that entity no longer satisfies the joint venture operator requirements.³¹

The Mining and Energy Issues Register

Before the introduction of the GST on 1 July 2000, the Australian Taxation Office (ATO) established an industry partnership with the mining and energy industries to discuss issues related to the interpretation of the GST law. The industry partnership aims to establish a 'consultative' forum where issues can be raised and discussed. The identification and supporting dialogue of these issues should assist participants in the mining and energy industries by providing speedy resolution to major matters under consideration.

The Mining and Energy Issues Register (the Register) was released in 2000 as an online document designed to provide guidance to taxpayers in the mining and energy community by publishing of resolved and unresolved GST mining and energy issues.³² It should mitigate participants' compliance costs in respect of technical GST questions.

The Register currently has 10 chapters. Chapters 3 and 4 are of particular relevance in the joint venture context. Chapter 3 provides the ATO view on three joint venture issues within the mining and energy industries. The first issue is whether or not to underlifts and overlifts within a GST joint venture are taxable supplies. The second issue relates to GST net amounts. The third issue concerns operators of multiple joint ventures. Similarly, chapter 4 provides the ATO view on four agency / principal issues that relate to joint ventures.

The guidance provided to joint venture participants in the mining and energy industries by the Register generally, and chapters 3 and 4 in particular, is a welcome step by the ATO to work more effectively with industry to resolve GST issues. The Register supports dialogue between joint venture participants in the mining and energy industries and the ATO on issues related to the interpretation of the GST law. That the Register is easily accessible (via the Internet), will enable the ATO to provide timely, accurate, and high quality written advice in

²⁹ Section 51-110 *A New Tax System (Goods and Services Tax) Act 1999* (Cth).

³⁰ See subdiv 51-C *A New Tax System (Goods and Services Tax) Act 1999* (Cth). This subdiv provides, broadly, that the Commissioner must approve: (1) another participant joining the GST joint venture if that company satisfies the participation requirements; (2) a request for the removal of a participant from the GST joint venture; (3) a change in GST joint venture operators, provided the new joint venture operator meets the joint venture operator requirements.

³¹ Section 51-75 *A New Tax System (Goods and Services Tax) Act 1999* (Cth).

³² Refer http://www.taxreform.ato.gov.au/ind_partner/mining/issues.htm to view the Mining and Energy Issues Register (20 July 2001).

relation to GST. The Register certainly has the potential to clarify technical GST issues for joint venture participants, and should continue to be used by the ATO and participants so that benefits continue into the medium term.

- 12 On page 154, add the following heading and text before the heading "Balancing adjustments add additional layer of fiscal complexity":

Is the supply of an interest in a tenement a supply of a going concern under the GST Act?

The Mining and Energy Issues Register was outlined in chapter 2. Chapter 10 of the Register indicates that there is some uncertainty about whether the supply of a tenement in a farmout situation is a supply of a going concern under Subdiv 38-J of the GST Act. This uncertainty could impose a GST compliance cost burden on affected farmees.

The Register reveals that industry groups have argued that because a farmer does not normally expend or receive any money for the farm out, the supply of an interest in a tenement is a going concern under Subdiv 38-J of the GST Act. It is understood that the ATO is evaluating industry arguments.³³

The ATO has recently released GSTR 2001/D2 ('When is the supply of a going concern GST-free?'). This draft ruling examines the GST-free treatment of the supply of going concerns. Under the concession provided for in Subdiv 38-J of the GST Act, the sale of a business or other enterprise is GST-free provided that four conditions are satisfied. First, the buyer is GST registered, or required to be registered. Secondly, the buyer and seller agree in writing that the sale is a supply of a going concern. Thirdly, the seller continues operating the enterprise until the sale is completed. Fourthly, the sale includes everything necessary for the enterprise to continue operating.³⁴

The author considers that GST-free treatment of the supply of a going concern primarily benefits the buyer. Where farmouts are concerned, the primary beneficiary would be the farmee. Subdivision 38-J avoids the farmee having to pay an extra 10 percent on the purchase price for entry into a farmout (albeit with a possible entitlement to input tax credits).

The draft ruling analyses the statutory requirements that apply before the going concern concession applies. It highlights the fact that a going concern is a statutory concept, not simply a 'going concern' in ordinary usage.³⁵ There must be a supply of an 'enterprise'. That includes an activity (or series of activities) done in the form of a business or on a regular or continuous basis in the form of a lease, licence or other grant of interest in property.³⁶ The enterprise may be part of a larger enterprise so long as it is capable of being operated independently.

Going concern status is not possible for the sale of an asset that is not an enterprise in its own right. For instance, where a farmer sells, as part of a farmout

³³ See the discussion under ch 10, http://www.taxreform.ato.gov.au/ind_partner/mining/issues.htm (20 July 2001).

³⁴ Section 38-325(1) and (2) *A New Tax System (Goods and Services Tax) Act 1999* (Cth).

³⁵ GSTR 2001/D2, para 15.

³⁶ GSTR 2001/D2, para 16.

agreement, a building that it has occupied as its own premises, there is no supply of a leasing activity or other enterprise. Therefore, there is no supply of a going concern and GST must be paid.³⁷

One issue that has caused some uncertainty for farmees to date is whether a going concern can be sold by more than one participant. Take, for instance, an unincorporated joint venture where three participants own fractional interests in the joint venture assets. Can the three participants collectively farmout all of the assets used in the joint venture and treat that sale as the supply of a going concern? The draft ruling states that such a sale cannot be a supply of a going concern because the GST Act requires 'an entity' to carry on an enterprise before the sale.³⁸ This would adversely affect some farmouts.

The ATO notes that the outcome is the same even where the multiple suppliers are members of the same GST group. While GST groups are treated as single entities for certain purposes, those purposes do not include the supply of a going concern. Therefore, even though participants may be members of a GST joint venture, the ruling indicates that the concession may not apply to them.³⁹

Another key aspect is that a sale must include 'all of the things that are necessary' for the continued operation of the enterprise. The draft ruling states that this does not refer to every conceivable thing that might be used in the relevant enterprise.⁴⁰ Farmees may experience difficulties in determining whether or not the farmor has met the required standard.

Another significant issue addressed by the ruling is whether a sale must include the premises in which the enterprise is carried on. Under the draft ruling, if an enterprise is 'necessarily conducted from premises' then the concession will only be available where the sale includes premises, or the right to occupy them. For example, if the relevant premises in a farmout is a drilling rig, then unless the farmor gives the farmee a right to occupy the rig, the agreement will be ineligible for concessional treatment.⁴¹ The ATO states that 'in limited circumstances, premises are not one of the things necessary for the continued operation of the enterprise'.⁴² However, the only examples given are the business of a personal fitness trainer and the business of a clairvoyant. These give no comfort to farmees. Ostensibly, this is a very restrictive reading of what is necessary to the carrying on of an enterprise. If the law is applied in this way by the ATO, many farmouts will not enjoy the going concern concession.

The draft ruling also provides that where statutory licences, permits, quotas and similar statutory authorisations cannot be sold, the concession will only apply where the seller makes all reasonable efforts to help the buyer become authorised, normal commercial practice means that the sale can only be effected in this way,

³⁷ GSTR 2001/D2, paras 30-32.

³⁸ GSTR 2001/D2, para 40.

³⁹ GSTR 2001/D2, para 42.

⁴⁰ GSTR 2001/D2, para 55.

⁴¹ GSTR 2001/D2, para 72.

⁴² GSTR 2001/D2, para 78.

and the authorisation is in fact given to the recipient.⁴³ This is potentially significant for farmees. A farmout agreement is a good mechanism to regulate these matters. This is a reasonable approach by the ATO. It recognises that some things necessary to a farmee to carry on business simply cannot be sold under a farmout agreement. The ATO accepts that this technical difficulty should not make the concession unavailable where the above requirements are satisfied.

The author considers that most of the analysis in the draft ruling is valid. At a practical level, it still remains important to ensure that the documentation for farmouts includes an appropriately worded GST clause that addresses the consequences if, contrary to the expectations of the farmor and farmee, a particular supply does not in fact qualify for the going concern concession.

- 13 **On page 45, add the following text at the end of n 159:**

Refer Abbey (2000), 103, '[Option 2] gives the same end result as the current system'.

- 14 **On page 46, add the following text at the end of n 160 and n 161:**

See also Boccabella (2000), 84.

- 15 **On page 45, add the following text at the end of n 159:**

Cooper (2000), 202 concurs with these observations.

- 16 **On page 45, add the following text at the end of n 158:**

Drum (2000), 60 notes that 'there is no additional revenue intended to be raised from [Option 2] and accordingly there is no budget imperative for the Government that there must be a 1 July start-up.'

- 17 **In the section of the Bibliography entitled "ARTICLES", insert the following references in the appropriate places:**

Abbey (2000)	Abbey, P (2000) 4 <i>Tax Specialist</i> 101.
Boccabella (2000)	Boccabella, D (2000) 3 <i>Journal of Australian Taxation</i> 82; (2000) 29 <i>Australian Tax Review</i> 81.
Cooper (2000)	Cooper, G (2000) 35 <i>Taxation in Australia</i> 201.
Drum (2000)	Drum, P (2000) 70 <i>Australian CPA</i> 60.

- 18 **In the Table of Cases, insert the following case citation in the appropriate place:**

JW Broomhead (Vic) Pty Ltd (In liq) v JW Broomhead Pty Ltd [1985] 60 VR 891.

⁴³ GSTR 2001/D2, para 88-90.

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MCNASH UNIVERSITY**FACULTY OF LAW****DOCTOR OF PHILOSOPHY****STATEMENT OF CANDIDATE**

- (a) This thesis contains no material which has previously been submitted or accepted for the award of any other degree in this or another University.
- (b) This thesis contains no material previously written or published by another person, except when due reference or acknowledgement is made.
- (c) No other person has collaborated in the preparation of this thesis.

Signed 

Date: 4 April 2007

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CONTENTS

<i>Statement of Candidate</i>	iii
<i>Acknowledgements</i>	iv
<i>Contents</i>	v
<i>Table of Figures</i>	vi
<i>Table of Cases</i>	vii
<i>Abbreviations and Citations</i>	xv
<i>Glossary of Terms</i>	xvi
<i>Introduction</i>	xxi

CHAPTERS

1	Compliance Costs and Income Tax In Australia	1
2	Nature of Mining and Petroleum Joint Ventures and Their Revenue Law Features	12
3	Taxation and Joint Venture Financing Costs	76
4	Farmouts	134
5	Dealings With The Ownership of Joint Ventures	179
6	Tolling Companies and Their Taxation Features	218
7	Conclusions	258
	<i>Bibliography</i>	268

TABLE OF FIGURES

<i>Figure 2.1 - Simplified Unincorporated Joint Venture Structure</i>	<i>16</i>
<i>Figure 2.2 - Calculation of Taxable Income Under The Cash Flow/Tax Value Methodology</i>	<i>44</i>
<i>Figure 2.3 – Simplified Unit Trust Joint Venture Structure</i>	<i>59</i>
<i>Figure 2.4 – Simplified Equity Joint Venture Structure</i>	<i>63</i>
<i>Figure 3.1 – Simplified Unincorporated Joint Venture Financing Structure</i>	<i>79</i>
<i>Figure 3.2 - Simplified Equity Joint Venture Financing Structure</i>	<i>81</i>
<i>Figure 3.3 - Channar Iron Ore Project - Financing Structure</i>	<i>93</i>
<i>Figure 3.4 - Bellinz Pty Ltd v FCT - Leveraged Lease Structure</i>	<i>96</i>
<i>Figure 3.5 - Interest Withholding Tax Example</i>	<i>121</i>
<i>Figure 6.1 - Simplified Organisation Structure of a Tolling Company</i>	<i>220</i>
<i>Figure 6.2 - Simplified Tolling Company Financing Structure</i>	<i>241</i>
<i>Figure 6.3 - Simplified Tolling Trust Structure</i>	<i>251</i>

TABLE OF CASES

A B v FCT (1998) 157 ALR 510; 98 ATC 5100; 40 ATR 65	33
AAT Case 10,103 (1995) 30 ATR 1238	240
AAT Case 10,999 (1997) 97 ATC 397; 36 ATR 1154	240
AAT Case 13,147 (1998) 98 ATC 209; 40 ATR 1001	188
AAT Case 13,192; Pierce & FCT, Re (1998) 98 ATC 2240; 39 ATR 1222	195
AAT Case 14/98 (1998) 98 ATC 201; 39 ATR 1105	85
AAT Case 5705 (1990) 21 ATR 3253	33
AAT Case 5789 (1990) 90 ATC 3323	254
AAT Case 6812; AAT Case Y18 (1991) 22 ATR 3116; 91 ATC 230	33
AAT Case 7529 (1991) 22 ATR 3532	210
AAT Case V64 (1988) 88 ATC 492	31
AGC (Advances) Ltd v FCT (1975) 132 CLR 175	87
AGC (Investments) Ltd v FCT (1991) 21 ATR 1379; 91 ATC 4180	188
Aktiebolaget Volvo v FCT (1978) 36 FLR 334	253
Alexander Adam & Robert Smith v William Newbigging & Walter Townend (1888) 18 ChD 698	26
Allgas Energy Ltd v Commissioner for Stamp Duties (Qld) (1979) 10 ATR 593	163
Amoco Minerals Australia Co v Commissioner of Stamp Duties (WA) (1978) 8 ATR 719	162
Aqua Max Pty Ltd & Sietel Pty Ltd v MT Associates Pty Ltd, Malz Nominees Pty Ltd & Trihey (19/6/98) SCVic 5966/93	29
ARM Constructions Pty Limited v FCT (1987) 19 ATR 337; 87 ATC 4790	22, 33
Atlas Realty Co v Galt (1927) 153 Md. 586	36, 37
Australasian Jam Co Pty Ltd v FCT (1953) 88 CLR 23	154
Australian and New Zealand Banking Group Ltd v FCT (1994) 48 FCR 268	233

Australian Machinery & Investment Co Ltd v FCT (1946) 180 CLR 9	189
Avondale Motors (Parts) Pty Ltd v FCT (1971) 124 CLR 97	206, 207
Bale v Bennett (1907) 28 NLR 361	14
Ball v FCT (1984) 15 ATR 1296	90
Ballantyne v Raphael (1889) 15 VLR 538	22
Ballarat Brewing Co Limited v FCT (1951) 82 CLR 364	240
Bank of Cedar Bluffs v Le Grand 254 NW 892 (1934)	36
Barnsdall v FCT (1988) 19 ATR 1352	210
Bell & Moir Corp Pty Ltd v FCT [1999] FCA 1009; BC 9904203; (1999) 99 ATC 4738; 42 ATR 421	87
Bell v Commissioner of Taxes (Queensland) (1920) 13 QJPR 17	xxi
Bellinz Pty Ltd v FCT (1998) 84 FCR 154	97, 98
Bennett v Ogston (1930) 15 Tax Cas 374	120
Berry v Commissioner of Taxation (NSW) (1932) 1 ATD 347	Xxiv
Blackburn v Industrial Equity Limited (1978) 78 CLC 40-324	129
Blockey v FCT (1923) 31 CLR 503	115, 150
Borland's Trustee v Steel Bros & Co Ltd [1901] 1 Ch 279	64
Bowater Sales Co Limited v IR Commissioners (1958) 38 TC 593	240
Brent v FCT (1971) 125 CLR 418	165, 240
Brisbane Water County Council v Commissioner of Stamp Duties (NSW) [1979] 1 NSWLR 320	172
Broken Hill Theatres Pty Ltd v FCT (1952) 85 CLR 423	233
Building and Civil Engineering Holidays Scheme Management Ltd v Post Office [1966] 1 QB 247	172
Burnett's Motors Ltd v Inland Revenue Commissioner (NZ) (1977) 8 ATR 620	194
Californian Copper Syndicate Ltd v Harris (1904) 5 TC 159	190
Californian Oil Products Ltd v FCT (1934) 52 CLR 28	189
Canny Gabriel Castle Jackson Advertising Pty Ltd v Volume Sales Finance Pty Ltd (1974) 131 CLR 321	26, 197
Carboneau v Peterson 95 P. 2d 1043 (1939) (Supreme Court of Washington)	23
Carter v Hyde (1923) 33 CLR 115	142
Case 27 (1956) 6 CTBR(NS)	191
Case 44 (19XX) 5 CTBR (NS)	31
Case 71 (19XX) 3 CTBR (NS)	31
Case 73 (1950) 1 CTBR(NS)	191
Case 89 (1985) 85 ATC 138	42
Case D67 (1972) 72 ATC 400	149
Case J11 (1977) 77 ATC 101	240
Case K9 (1978) 78 ATC 98	240

Case L1 (1979) 79 ATC 1	240
Case L22 (1979) 79 ATC 106	240
Case M50 (1980) 80 ATC 349	240
Case M67 (1980) 80 ATC 479	240
Case M93 (1980) 80 ATC 674	240
Case N 108 (1981) 81 ATC 600	42
Case N56 (1981) 81 ATC 277	31
Case No 17 (1950) 1 CTBR(NS)	191
Case No 28 (1954) 5 CTBR(NS) 181	191
Case No 32 (1954) 5 CTBR(NS)	191
Catlow v Accident Compensation Tribunal (1989) 167 CLR 543	90
Cecil Bros Pty Ltd v FCT (1964) 111 CLR 430	228
Central Mortgage & Housing Corporation v Graham (1974) 43 DLR(3d) 686	14
Chapman v Dwyer 40 F 2d 468 (1930)	36
Charles v FCT (1954) 90 CLR 598	57, 199
Chow Yoong Hong v Choong Fah Rubber Manufacturing [1962] AC 209	121
CMI Services Pty Ltd v FCT (1990) 90 ATC 4428	188
Coles Myer Finance Pty Ltd v FCT (1993) 93 ATC 4214; 112 ALR 322; 25 ATR 95; 67 ALJR 463	114
Commissioner of State Taxation (WA) v Nischu Pty Ltd (1991) 4 WAR 437	166
Commissioner of Succession Duties (SA) v Executor Trustee and Agency Co of South Australia Ltd (1947) 74 CLR 358	173
Commonwealth Aluminium Corporation Limited v FCT (1977) 32 FLR 210	241
Comptroller of Stamps (Vic) v Christian (1990) 21 ATR 1036	187
Connell v Lavender (1991) 7 WAR 9	253
Coope v Eyre (1788) 1 Hy Bl 37	22
Cummings v Lewis Unreported, Federal Court of Australia, 2 August 1991, Wilcox J	23
David Jones Finance and Investments Pty Ltd v FCT (1991) 28 FCR 484	263
Denny v Guyton (1931) 327 40 SW (2d) 562	36
Detachable Bit Co v Timken Roller Bearing Co 133 F 2d 632 (1943)	36
Eagle v Commissioner 677 F.2d 594 (1982)	261
Edwards v Bairstowe [1956] AC 14	193
Emerson v Custom Credit Corporation Ltd [1994] 1 QdR 516	166
Erichsen v Last (1881) 8 QBD 414	150
Esquire Nominees Ltd v FCT (1972) 72 ATC 4076; 46 ALJR 345; 3 ATR 105 (Gibbs J); (1973) 73 ATC 4114 (Full High Court)	253
Estate of Weinert v Comm'r 294 F 2d 750, 750 (1961)	143
Estrella v Suarez 134 P 2d 167 (1943)	36

Fairway Estates Pty Ltd v FCT (1970) 123 CLR 153	115, 149
Fanmac Ltd v FCT (1991) 91 ATC 4703; 22 ATR 413	189
FCT v Australian Gas Light Co & Anor (1983) 74 FLR 13	241
FCT v Australian Guarantee Corporation Ltd (1984) 2 FCR 483	242
FCT v Bill Wissler (Agencies) Pty Ltd (1985) 16 ATR 952	90
FCT v Brambles Holdings Ltd (1991) 28 FCR 451	153
FCT v Brown [1999] FCA 721; 99 ATC 4600	87, 88
FCT v Cainero (1988) 15 ALD 368; 19 ATR 1301; 88 ATC 4427	187
FCT v Citibank Limited & Ors (1993) 44 FCR 434	233
FCT v Clarke (1927) 40 CLR 246	240
FCT v Commonwealth Aluminium Corporation Ltd (1980) 143 CLR 646	253
FCT v Cooling (1990) 22 FCR 42	106
FCT v Email Ltd [1999] FCA 1177; 99 ATC 4868	87
FCT v Energy Resources of Australia Pty Ltd (1996) 185 CLR 66	85
FCT v Ilbery (1981) 81 ATC 4100; 50 ALR 219; 11 ATR 484; 34 ALR 237	101
FCT v James Flood Pty Ltd (1953) 88 CLR 492	114, 233, 241, 242
FCT v Maddalena (1971) 45 ALJR 426; 71 ATC 4161; 2 ATR 541	88
FCT v McDonald (1987) 15 FCR 172	35
FCT v Miller Anderson Ltd (1946) 73 CLR 341	128
FCT v Montgomery (1999) 198 CLR 639	106
FCT v Myer Emporium Ltd (1987) 163 CLR 199	189, 190, 191, 193
FCT v Radilo Enterprises Pty Ltd (1997) 72 FCR 300	112
FCT v Radnor Pty Ltd (1991) 91 ATC 4689; 102 ALR 187; 27 ATR 344	88
FCT v Slater Holdings Limited (No. 2) (1984) 156 CLR 447	128
FCT v Suttons Motors (Chullora) Wholesale Pty Ltd (1985) 59 ALJR 615	153, 187
FCT v Total Holdings (Australia) Pty Ltd (1979) 43 FLR 217	86
FCT v Whitfords Beach Pty Ltd (1982) 150 CLR 355	151
Fell v Goodwin (1884) 5 NLR 265	14
Ferguson v FCT (1979) 37 FLR 310	238, 239
Fielder Downs (WA) Pty Ltd v FCT (1979) 45 FLR 242	208
Fightvision Pty Ltd v Tszyu Unreported, (27/03/1998) SCNSW 50120/95	203
Fletcher v FCT (1991) 173 CLR 1	85, 86
Folks v Woolf [1933] VLR 403	27
Forwood Down & Co Ltd v Commissioner of Taxation (WA) (1935) 53 CLR 403	191
G K N Kwikform Services Pty Ltd v FCT (1990) 21 ATR 769; 90 ATC 4823	187
Gasparin v FCT (1993) 93 ATC 4479; 115 ALR 707; 26 ATR 41	241

General Construction Co Ltd v Minister of National Revenue (1959) 19 DLR (2d) 373	190
Geo W Cheverton Pty Ltd v FCT (1962) 8 ATR 497; 12 ATD 461	191
Glass v Commissioner 76 TC 949 (1981)	261
Goerig v Continental Casualty Co 167 F 2d 930 (1948)	37
GP International Pipecoaters Pty Ltd v FCT (1990) 170 CLR 124	86, 266
Grace v Smith (1775) 2 Black 998	22
Griffin v Pelton [1958] Ch 205	142
Griffiths v JP Harrison (Watford) Ltd [1963] AC 1	239
Guinea Airways Ltd v FCT (1950) 83 CLR 584	187
Hadley v Baxendale (1854) 2 CLR 517	182
Hoare v Dawes (1780) 1 Doug KB 371	22
Holderness v Shackels (1828) 8 B & C 612	22
Hooker Rex Pty Limited v FCT (1988) 88 ATC 4392; 79 ALR 181; 19 ATR 1241	233, 234
Home v Pollard and Anderson [1935] NZLR 125	26
Howell v FCT (1994) 28 ATR 105	240
Hugies v Fripp (1922) 30 CLR 508	Xxiv
ICI Australia Ltd v FCT (1994) 94 ATC 4600; 125 ALR 63; 29 ATR 233	19
Inland Revenue Commissioners v Rowntree & Co Ltd [1948] 1 All ER 482	121
IRC v Incorporated Council of Law Reporting (1888) 22 QBD 279	239
Ivans v FCT (1989) 89 ATC 4540; 20 ATR 922	238
J Rowe & Son Pty Ltd v FCT (1971) 124 CLR 421	240
JJ Savage & Sons Pty Ltd v Blakney (1970) 19 CLR 435	242
John Bridge & Co Ltd v Magrath (1904) 4 SR(NSW) 441	145
John v FCT (1989) 166 CLR 417	187, 239
Johnson v Lion Oil Co (1950) 227 S.W.2d 162	37
Johnstone v Commissioner of Inland Revenue (NZ) [1966] NZLR 833	64
Jolley v FCT (1989) 20 ATR 335; 86 ALR 297; 17 ALD 643; 89 ATC 4197	33
JV (Crows Nest) v Commissioner of Stamp Duties (NSW) (1985) 85 ATC 4198; 16 ATR 372	158
K D Morris & Sons Pty Ltd (in Liq) v Bank of Queensland Ltd (1980) 146 CLR 165	121
Kahn v Massler 140 F Supp 629 (1956,	36
Kasishke v Baker 146 F 2d 113 (1944)	36
Keyes v Nims 184 P 695 (1919)	37
Kinhult-Ng v Tay Unreported, (3/10/97) SCWA CIV2184/93	29
Lang v James Morrison & Co Ltd (1911) 13 CLR 1	24
Langerman v Carper [1905] TH 251	14

Laybutt v Amoco Australia Pty Limited (1974) 132 CLR 57	202
Leonard v FCT (1919) 26 CLR 175	Xxiv
Little Olympian Each Ways Ltd, In re [1995] 1 WLR 560	253
Lodge v FCT (1972) 128 CLR 171	88
London Australia Investment Ltd v FCT (1977) 138 CLR 106	150, 199
Loxton v Moir (1914) 18 CLR 360	19
MacFarlane v FCT (1986) 13 FCR 356	128, 129
Mackay v Wilson (1947) 47 SR(NSW) 315	202
Madigan v FCT (1996) 68 FCR 19	85
Magna Alloys & Research Pty Ltd v FCT (1980) 49 FLR 183	Xxiii
Malayan Shipping Co Ltd v FCT (1946) 71 CLR 156	253
Marra Developments Limited v BW Rofe Pty Ltd (1977) 2 NSWLR 616	128, 129
Meinhard v Salmon 164 NE 545 (1928)	36, 37
Memorex Pty Ltd v FCT (1987) 87 ATC 5034; 77 ALR 299; 19 ATR 553; 13 ALD 685	187
Mendelsohn v Leather Manufacturing Corporation 93 NE 2d 537 (1949)	36
Mengden v Peninsula Prod. Co 544 S.W.2d 643 (1978)	140
Mitler v Friedeberg 222 NYS 2d 480 (1961)	36
Mollwo March & Co v Court of Wards (1872) LR 4 PC 419	78
Moncrief v Martin Oil Service, Inc, 658 F.2d 768 (1981)	135, 140
Mooney v Commissioner of Taxation (NSW) (1905) 3 CLR 221	193
Mount Isa Mines Ltd v Seltrust Mining Corporation Pty Ltd Unreported, SCWA, No.1614 of 1985, 5 July 1985	22, 184
News Ltd v Australian Rugby Football League Ltd (1996) 58 FCR 447	29
Newton v Pyke (1908) 25 TLR 127	115, 150
Nicholson v Gander (1910) 8 CLR 648	27
Nilsen Development Laboratories Pty Ltd & Ors v FCT (1981) 144 CLR 616	114, 242
Nischu Pty Ltd v Commissioner of State Taxation (WA) (1990) 90 ATC 4391; 21 ATR 391	166
Norman v FCT (1963) 109 CLR 9	64
Oracal International Pty Ltd v International Professional Traders Pty Ltd [1999] NSWSC 753	23
Pancontinental Mining Ltd v Commissioner of Stamp Duties (Qld) [1989] 1 QdR 310	158, 165
Parfew Nominees Pty Ltd v FCT (1986) 86 ATC 4673	153, 154
Pata Nominees v Durnsford [1988] WAR 365	203
Pawsey v Armstrong (1991) 18 ChD 698	26
Permanent Trustee Co of NSW Ltd v FCT (1940) 2 ATR 109	240
Petroleum Financial Corp v Cockburn 241 F.2d 312 (1957)	136, 140
Phillip Morris Limited v FCT (1979) 79 ATC 4352; 38 FLR 370	154
Pine Creek Goldfields Ltd v FCT [1999] FCA 326; 99 ATC 4382; 41	87

ATR 471	
Placer Pacific Management Pty Ltd v FCT (1995) 95 ATC 4459; 31 ATR 253	87
Pooley v Driver (1876) 5 Ch D 458	78
Producers & Citizens Co-op Assurance Co Ltd v FCT (1956) 95 CLR 26	191
Prosser v Commissioner of Inland Revenue (NZ) (1973) 73 ATC 6006	239
Quinn v Recreation Park Association 46 P 2d 144 (1935)	36
RACV Insurance Pty Ltd v FCT (1974) 22 FLR 385	242
Rae v Cameron 114 P 2d 1060 (1941)	37
Re Abenheim; Ex parte Abenheim (1913) 109 LTR (KBD) 219	27
Re Beard & Co [1915] Hansell Bank Rep 191	78
Re Butchart; Ex parte Jones (1865) 2 WW & AB (IE & M) 8	145
Re Negative Instruments Pty Ltd v FCT (1994) 94 ATC 4809; 29 ATR 423; 30 AustLawyer (No.1) 43k [note]	115
Re Securitibank Ltd (No.2) (1978) 2 NZLR 136	121
Re Yorkshire WoolCombers' Association Ltd [1903] 2 Ch 284	67
Re Young (1876) 5 Ch D 458	78
Read v Commonwealth of Australia (1988) 167 CLR 57	128
Reynolds v Searle 174 NYS 137 (1919)	36
Richardson & Wrench (Holdings) Pty Ltd v Ligon No 174 Pty Ltd (1994) 123 ALR 681; ATPR(Digest) 46-133	128
Ridgway v DFCT (1937) 40 WALR 43; 1 AITR 236; 4 ATD 439	191
RMC Holdings (Delaware) Inc v Newcrest Mining (WA) Ltd Unreported, 24/6/1994, SCWA, 1102 of 1994	18
Robert Coldstream Partnership v FCT (1943) 68 CLR 391	Xxiv
Rose v FCT (1951) 84 CLR 118	187, xxiv
Sample v Romine 8 So 2d 257 (1942)	36
Sarich v FCT (1978) 46 FLR 326	26
Shearer v Wilding (1915) 15 SR(NSW) 283	142
Shell Australia Ltd v Newcrest Mining (WA) Ltd Unreported, 24/6/1994, SCWA, 1276 of 1994	18
Shell Oil Co v Prestidge 249 F 2d 413 (1957)	37
Softwood Pulp and Paper Ltd v FCT (1976) 7 ATR 101; 76 ATC 4439	88
South Australian Battery Makers Pty Ltd v FCT (1978) 140 CLR 645	101
Spencer v The Commonwealth (1907) 5 CLR 418	171, 269
St Hubert's Island Pty Ltd v FCT (1978) 138 CLR 210	153
Stainer's Executors v Purchase [1952] AC 280	120
State v Quintana Petroleum Corp 134 Tex. 179, 133 S.W.2d 112 (1939)	144
State; Ex rel Crane Co of Minnesota v Stokke 272 NW 811 (1937)	36
Steele v FCT (1999) 197 CLR 459	85, 86, 87, 266
Sun Newspapers v FCT (1938) 61 CLR 337	85

Tax Case K23 (1978) 78 ATC 209	19
Taxation Case L57 (1979) 79 ATC 429	253
Tennant v Dunn 130 Tex. 285, 110 S.W.2d 53 (1937)	144
Thomas v FCT (1972) 72 ATC 4094; [1972-73] ALR 368; 46 ALJR 397; 3 ATR 165	115, 149
Thomas Well Service, Inc. v Williams Natural Gas 873 F. Supp. 474, 477, 130 O&GR 286 (D. Kan 1994)	227
Thorpe Nominees Pty Ltd v FCT (1988) 88 ATC 4886; 19 ATR 1834	149
Tivka Investments Pty Ltd v FCT (1972) 128 CLR 158	30
Torkington v Magee [1902] 2 KB 427	19
Trevisan v FCT (1991) 91 ATC 4416	89
Trimble v Goldberg [1906] TS 1002	14
Tweedle v FCT (1942) 180 CLR 1	239, xxiii
Unit Construction Co Ltd v Bullock (1959) 38 TC 712	253
United Dominions Corporation Ltd v Brian Pty Ltd (1985) 157 CLR 1	29, 46
United States v Cocke 399 F.2d 433, 436-37 (1968)	143
United States v Kintner 216 F.2d 418 (1954)	38
Ure v FCT (1981) 81 ATC 4100; 50 ALR 219; 11 ATR 484; 34 ALR 237	101
Uys v Le Roux [1906] TS 429	14
Van den Berghs Ltd v Clark (1935) 19 TC 390	190
W Nevill & Co Ltd v FCT (1937) 56 CLR 290	241
Weiner v Harris [1910] 1 KB 285	26
Werle & Co v Colquhoun (1888) 20 QBD 753	115, 150
West London Syndicate v IRC [1898] QB 228	163
Western Gold Mines NL v Commissioner of Taxation (WA) (1938) 59 CLR 729	191
Wiley N Jackson Co v Norfolk 87 SE 2d 781 (1955)	37
Williams v Commissioner of Inland Revenue (NZ) [1964] NZLR 996	64
Williamson v Elf Aquitaine 925 F. Supp. 1163 (1996)	227
Wiltshire v Kuenzli (1945) 63 WN(NSW) 47	26
Yeung v FCT (1988) 19 ATR 1006	32

ABBREVIATIONS AND CITATIONS

See also Author's Notes at the bottom of this page

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Author's Notes

A footnote reference in a chapter citing the name of a journal article that does not cite a specific page number means that the relevant page is the first page of that article. For example, a footnote pointing to page 153 of Cage E M, 'Anatomy of a Farmout' (1970) 21 *Oil and Gas Institute* 153, will be referenced as Cage (1970).

A footnote reference in a chapter to a book or government publication, will be referenced by citing the author's name, then the title of the work (or abbreviated title, as appropriate), followed by the year of publication, and page or paragraph number. For example, a footnote citing Pope J, Fayle R and Duncanson M, *The Compliance Costs of Personal Income Taxation in Australia* (Australian Tax Research Foundation, Sydney, 1990), will be referenced as Pope, *The Compliance Costs of Personal Income Taxation in Australia*, (1990).

GLOSSARY OF TERMS

Term	Meaning of Term
<i>Administrative costs</i>	The public sector costs incurred in administering an existing tax code (including advice on its modification)
<i>Accelerated depreciation</i>	Depreciation calculated at a faster rate than would otherwise be expected
<i>Canadian royalty trust</i>	A conduit entity for taxpayers with significant investments in mining and petroleum assets, such as mature oil and natural gas properties, producing oil facilities, pipelines and gas processing facilities
<i>Carried interest agreement</i>	The farmee carries the farmor's costs. The farmee is obligated to perform specific work, not limited or calculated by reference to dollars
<i>Characterisation risk</i>	The risk or probability that a particular joint venture structure is characterised as either a general law partnership or tax partnership
<i>Compliance costs</i>	Those costs incurred by taxpayers, or third parties, such as businesses, in meeting the requirements laid upon them in complying with a given tax structure. For a business, the compliance costs include the cost of collecting, remitting and accounting for tax on the products or profits of the business and on the wages and salaries of its employees together with the costs of acquiring the knowledge to enable this work to be done including knowledge of their legal obligations and penalties
<i>Consenting participant</i>	A participant which votes in favour of a non-consent programme
<i>Deferred transfer farmout</i>	A type of farmout agreement pursuant to which the farmee agrees to undertake certain financial obligations or work commitments, following which it will be entitled to take an interest in the exploration entitlement
<i>Drilling fund</i>	A type of vehicle established to attract venture capital to oil and gas exploration and development
<i>Earning obligation</i>	An earning obligation might involve a farmor agreeing to spend a certain percentage of future exploration costs up to a defined dollar limit at which time an undivided percentage interest in the prospecting entitlement and information will be farmed out to the farmee
<i>Earning obligation</i>	An agreement pursuant to which the farmee earns a right to acquire

Term	Meaning of Term
<i>agreement</i>	an <i>earning obligation</i> in the prospecting entitlement
<i>Effective complexity (of laws)</i>	A tax which is not determinable for a taxpayer from a few readily ascertainable facts
<i>Effective life</i>	The effective life of plant is an estimate of how long the plant can be used for income producing purposes. A lessee participant has a choice of calculating its own effective life or using the Commissioner of Taxation's published recommended periods of effective life (see SubDiv 42-C ITAA 97)
<i>Equalisation agreement</i>	An agreement between a farmee and farmor pursuant to which the farmee is required to spend a specific sum of money until it has equalised that incurred by the farmor
<i>Equity joint venture</i>	A company jointly controlled by <i>equity participants</i> . Also known as an incorporated joint venture
<i>Equity participant</i>	A shareholder of an SPV
<i>Farmout</i>	For <i>unincorporated joint ventures</i> , farmouts involve a <i>participant</i> (the <i>farmor</i>) agreeing to assign rights to all or part of its percentage interest under a <i>prospecting entitlement</i> to another participant of the same <i>unincorporated joint venture</i> or to some other party (the <i>farmee</i>), in exchange for value
<i>Fiscal complexity</i>	Fiscal complexity could be caused by fiscal uncertainty. Fiscal complexity involves <i>legal complexity</i> and <i>effective complexity</i>
<i>Fiscal uncertainty</i>	Fiscal uncertainty arises from either the interpretation, operation or application of tax laws and could involve retrospective adverse tax consequences
<i>Immediate transfer farmout</i>	A type of farmout agreement pursuant to which there is an immediate transfer of an interest in the exploration entitlement to the farmee, subject to an obligation to re-convey in the event of default in the performance of the farmin obligations
<i>Independent operations</i>	<i>Non-consent</i> and <i>sole risk operations</i>
<i>IWT</i>	Interest withholding tax
<i>JVA</i>	Joint venture agreement
<i>Joint venture agreement</i>	Constituent document of an <i>unincorporated joint venture</i>

Term	Meaning of Term
<i>agreement</i>	
<i>Legal complexity (of laws)</i>	Laws which are complex to read or understand
<i>Lessee participant</i>	The lessee of an asset the subject of a leveraged lease. It could be a <i>participant</i> , <i>SPFC</i> or <i>SPV</i> (as appropriate)
<i>Leveraged lease</i>	A form of tax effective financing used to finance the cost of significant capital items such as co-generation plants, power stations, mining infrastructure, pipelines and manufacturing plants
<i>Long term purchase contract</i>	A contract between the participants of a <i>tolling company</i> and a tolling company to purchase the product processed by the <i>tolling company</i> with a long term, say, of up to 20 years duration. Often structured as a <i>take-or-pay contract</i>
<i>Minority participant</i>	A <i>participant</i> which elects not to participate in an <i>independent operation</i>
<i>Non-consent operations</i>	An operation of a joint venture which will proceed as a joint venture activity notwithstanding that it has received the affirmative vote of less than all the <i>participants</i>
<i>Non-resource loan</i>	Repayment of the borrowed money is secured against the subject matter of the loan (i.e. plant or equipment) without recourse to the borrower personally
<i>Non-sole risk participant</i>	A <i>participant</i> which elects not to proceed with a <i>sole risk operation</i>
<i>Participant</i>	<p>A party that owns, as a tenant in common, an undivided fractional interest of a percentage of the assets of an <i>unincorporated joint venture</i>. A <i>participant</i> is a party to a <i>JVA</i></p> <p>It is also used to describe a taxpayer which is a party to a <i>tolling agreement</i></p>
<i>Pipeline throughput contract</i>	A contract dealing with the terms and conditions on which a gas supplier will supply gas to its customer
<i>Preference share</i>	A preference share carries a fixed-rate dividend obligation, at a rate lower than that which applies to non-convertible securities of the issuing participant. The holder is entitled to convert the share into ordinary shares, at a price or prices – in the case of a staged conversion privilege – above current market prices.

Term	Meaning of Term
<i>Production payment agreement</i>	A production payment describes a share of the oil produced from a described tract of land, free of the costs of production at the surface, terminating when a specified sum from the sale of such oil has been realised. Oil payments may be reserved by a farmor. Also known as oil payments
<i>Overriding royalty</i>	A farmor grants to a farmee a right to acquire a percentage interest in future production of a <i>prospecting entitlement</i> for a fixed monetary amount. However, the future production assigned is expressed as a fixed percentage of the gross production appropriate to the farmor's interest, rather than being fixed in quantity or value terms
<i>Prospecting entitlement</i>	Exploration and prospecting right, permit or entitlement issued by an Australian state or territory government department
<i>Recent commercial transactions valuation method</i>	A methodology of valuing <i>prospecting entitlements</i> based on the value attributable to the market value of neighbouring <i>prospecting entitlements</i> recently disposed of
<i>Shareholders' agreement</i>	Constituent document of an <i>equity joint venture</i>
<i>Sole risk operations</i>	Usually an exploration operation with which a <i>participant</i> proceeds when the other <i>participants</i> elect not to participate. The <i>sole risk</i> party carries out the exploration at its own cost and risk
<i>Sole risk participant</i>	A <i>participant</i> which proceeds with a <i>sole risk operation</i>
SPFC	A special purpose finance company. Incorporated by <i>participants</i> to finance a project
SPV	Special purpose vehicle. Incorporated by <i>equity participants</i> of an <i>equity joint venture</i>
<i>Take or pay contract</i>	A contract between a buyer and a seller of an asset-based service under which the buyer undertakes to pay regularly to the seller a fixed minimum sum, regardless of the actual level of consumption of the service by the buyer
<i>Tolling agreement</i>	An agreement prescribing the rights and obligations of <i>participants</i> relating to tolling (i.e. processing) of basic raw material into finished product
<i>Tolling company</i>	A company usually established to build, own and operate production facilities at which the raw materials owned by the <i>participants</i> in the joint venture will be processed into finished product for use or

Term	Meaning of Term
	disposal by the <i>participants</i> individually
<i>Throughput contract</i>	A contract often used to finance the construction of pipelines. The operator of the pipeline charges a 'throughput' or 'tolling' fee to the <i>participants</i> for the carriage of goods (eg gas) through the pipeline
<i>Transferee equity participant</i>	The purchaser of an interest in an <i>equity joint venture</i>
<i>Transferee participant</i>	The purchaser of an interest in an <i>unincorporated joint venture</i>
<i>Transferor equity participant</i>	An <i>equity participant</i> who sells its interest in an <i>equity joint venture</i> in one of four ways: (1) by selling some or all of the shares in the <i>SPV</i> ; (2) by selling shares in the special purpose subsidiary; (3) by selling shares in the Australian holding company which owns the shares in the special purpose subsidiary; or (4) by some combination of those methodologies
<i>Transferor participant</i>	A <i>participant</i> who sells its interest in an <i>unincorporated joint venture</i> in one of four ways: (1) by selling the assets of the <i>unincorporated joint venture</i> ; (2) by selling the shares in the special purpose subsidiary which owns an interest in those assets; (3) by selling the shares in the Australian holding company which owns the shares in the special purpose subsidiary; or (4) by selling its interest in some assets and selling shares in either the special purpose subsidiary or the Australian holding company
<i>Turn key contract</i>	A contract in which an independent contractor undertakes to furnish all materials and labour and do all the work required to complete a project in a workmanlike manner, place it in production and turn it on ready to 'turn the key' and start production running
<i>Unincorporated joint venture</i>	An association of two or more participants that is not a general law partnership or a tax partnership. Also known as a contractual joint venture
<i>Unitised agreement</i>	An agreement between a farmor and farmee to unitise a proven petroleum field that straddles two or more blocks. All the parties concerned agree to operate the field as a unit and agree on their respective interests in the field as a whole. Costs are reallocated to each <i>prospecting entitlement</i> holder in accordance with their revised percentage interests, and balancing payments are made (as appropriate)

INTRODUCTION

This thesis evaluates the taxation of mining and petroleum joint ventures. The framework examined is applicable to the various stakeholders involved in joint ventures—participants, equity participants, farmees, farmors, financiers and governments. It uses the data of the compliance costs of taxing expected returns and recognising expenditures associated with the returns as key determinants of the choice of joint venture structure.

FACTORS IN JOINT VENTURE ANALYSIS

General taxation framework in Australia

The compliance cost issues to be considered in evaluating the taxation of mining and petroleum joint venture structures are the same as those encountered in any taxation analysis where a present outlay is made to obtain future returns. The trade-off generally involves an analysis of the compliance costs of taxing returns and recognising expenditures.

The critical elements of this operation are four-fold. First, using compliance costs as a model to assess the taxation of future returns. Secondly, using compliance costs as a model to assess the recognition of expenditures associated with those returns. Thirdly, determining, based on that risk assessment, the compliance costs inherent in using one joint venture structure compared to other structures. Fourthly, determining if the net benefits of one joint venture structure exceed the net benefits of other structures.

The first and second elements, *using compliance costs as a model to assess the taxation of future returns and the recognition of expenditures associated with these returns*, require extensive analysis on the part of the taxpayer involving considerable judgement and often a number of assumptions about the costs of complying with tax laws.

The third element, *determining the compliance costs inherent in using one joint venture structure compared to other structures*, requires a determination of the impact of compliance costs associated with key factors on the outcome of a particular joint venture structure. Typically, compliance costs will be referenced in terms of their causes: *fiscal uncertainty*, *characterisation risk* and *fiscal complexity*. Fiscal uncertainty arises from either the interpretation, operation or application of tax laws and could involve retrospective adverse tax consequences. Characterisation risk refers to the risk or probability that a particular joint

venture structure is characterised as either a general law partnership or tax partnership. Characterisation risk is an example of fiscal uncertainty. Fiscal complexity may impose an onerous compliance burden and a cost disadvantage on a taxpayer. Fiscal complexity could be caused by fiscal uncertainty. Fiscal complexity is itself complex, as a substantial literature has shown;¹ it is 'not a concept that can be easily defined, measured or agreed upon.'² Its antithesis—fiscal simplicity—has been described as 'simplicity of rules'.³ Fiscal complexity involves *legal complexity* and *effective complexity*.⁴ Legal complexity describes the difficulty (ease) with which a particular tax law can be read and understood.⁵ Effective simplicity is 'the characteristic of a tax which makes the tax determinable for each taxpayer from a few readily ascertainable facts':⁶ effective complexity (simplicity) can be measured by reference to the value of resources expended by the society in raising some amount of tax revenue.⁷ The level of fiscal uncertainty, characterisation risk and fiscal complexity imposed on taxpayers will affect the compliance cost burden on taxpayers to comply with tax laws. The extent of fiscal uncertainty, characterisation risk and fiscal complexity may vary between joint venture structures.

The evaluation of one joint venture structure compared to other structures does not involve a simple accept/reject decision but rather a choice among a wide range of alternative physical, legal and financial combinations. The value of a superior joint venture structure reflects

¹ See generally Blum (1954), Eustice (1989), McDaniel (1978), Roberts (1978), Sawyer (1996), White (1990), Zelinsky (1990).

² Tran-Nam (1999), 505.

³ Boucher (1991), 278. Fiscal simplicity is understood by the Ralph Committee to mean: 'remov[ing] anomalies and inequities between the treatment of economically similar transactions...', 'drafting of the tax legislation on the basis of a set of consistent principles...', 'consolidation of company groups, while involving significant transitional costs...' and 'a much clearer and shorter statement of the law': *A Tax System Redesigned*, Overview, 16-17.

⁴ Tran-Nam (1999), 505.

⁵ Ibid, 506. This proposition raises two questions: how is readability of tax law to be determined, and who are the readers of the tax law? The degree of complexity in the tax law is a function of two factors.

⁶ Surrey and Brannon (1968), 915.

⁷ Tran-Nam (1999), 507. Tran-Nam argues, 508, that there are five determinants of effective simplicity of a particular tax: (1) legal simplicity; (2) the number of taxpayers and tax administrators; (3) the size distribution of taxpayers (some components of operating costs such as tax compliance costs are known to be regressive in taxpayer size); (4) business cycle (changing macroeconomic conditions affect the tax base); and (5) the general level of tax avoidance and tax evasion in the economy and government's commitment to combat these.

elements of the compliance costs of taxing expected profits, but also of the compliance costs of expenditures involved. The greater the compliance costs of a particular structure, the less attractive that structure will be compared to others.

The fourth element, *determining if the net benefits of one joint venture structure exceed the net benefits of other structures*, is largely a question of financial modelling and can thus be ignored in this thesis.

Characteristics of a particular joint venture structure

To return to the most basic level, for taxation purposes, an investment is often made using a particular structure if it is determined that the compliance costs of using that structure are lower than those of using other structures.⁸ The factors in this profitability equation ought to be known with certainty, to eliminate the risk of utilising a sub-optimal joint venture structure. The main component of risk and return identified under this heading is the *flow-through capability* of the joint venture structure. The flow-through capability of a joint venture structure describes its fiscal transparency.

STRUCTURE

This thesis is divided into seven chapters. Chapter 1 raises a taxonomy of compliance costs relevant to joint venture structures. Chapter 2 examines the nature of different legal structures of joint ventures (unincorporated, unit trust and equity joint ventures), introduces hybrid joint venture structures (tolling companies and farmouts) and critically analyses the extent and significance of characterisation risk for unincorporated joint ventures by reference to current and proposed tax laws. Chapter 3 studies the costs of financing joint venture structures. Chapter 4 is concerned with taxing farmout arrangements. Chapter 5 uses compliance costs as a model for the assessment of the taxation of dealings in the ownership of participants and equity participants. Chapter 6 critically compares the nature of and taxation features of tolling companies to unincorporated joint ventures and equity joint ventures, and considers the case for the use of a 'tolling' trust as a development or extension of existing concepts. Chapter 6 concludes with a comparison of Canadian royalty trusts and U.S. oil and gas royalty trusts.

⁸ For the Australian judicial approach to overcoming taxpayers' choice of advantageous structures, see *Tweddle v FCT* (1942) 180 CLR 1, per Williams J in a passage adopted by Brennan J and by Deane and Fisher JJ in *Magna Alloys & Research Pty Ltd v FCT* (1980) 49 FLR 183; *FCT v Orica Ltd* (1998) 194 CLR 500, 531.

Chapter 7 concludes this thesis with a summary of major findings.

METHODOLOGY

The methodology will be to use compliance costs as a model for the assessment of tax regimes based on assumptions about fiscal complexity, fiscal uncertainty, and characterisation risk as determinants of the choice of mining or petroleum joint venture structure. Legal structures of mining or petroleum joint ventures in Australia range from the unincorporated joint venture, to unit trust and equity joint ventures, to farmouts and tolling company arrangements. The compliance costs of the taxation of partnerships are not considered in any detail in this thesis. The taxation of partnership income has been considered extensively by the courts.⁹ With respect to each structure, the approach of this thesis is to look to the compliance costs of income and capital gains tax implications. Except where noted, the taxpayer under consideration in this thesis is an Australian resident corporation.

The methodology involves a consideration of a number of taxation factors for each joint venture structure. First, the object is to understand the compliance cost effect of current and proposed tax laws in evaluating the taxation of mining and petroleum joint ventures. Secondly, to identify the precise nature of the ownership interests of taxpayers operating under each joint venture structure and to consider the general features or characteristics of each structure. It will be demonstrated that each structure has different compliance costs associated with it, but there are similarities as well. The tax advantages and disadvantages of any given structure will be identified and evaluated. Certain of the opportunity costs of a given structure will be established through an examination of the relative or comparative compliance costs and benefits of choosing a particular structure. Compliance costs will be used as a model for the assessment of the taxation of financing costs to determine the nature and extent to which they influence and shape joint venture structures. Next, we will explore the compliance costs of taxing returns and recognising expenditures for dealings in ownership of unincorporated joint ventures and equity joint ventures, first in the context of farmouts, then by the withdrawal of a participant from the venture in the ordinary course, or because of a buy-out,

⁹ See *Berry v Commissioner of Taxation (NSW)* (1932) 1 ATD 347 (existence of a partnership); *Bell v Commissioner of Taxes (Queensland)* (1920) 13 QJPR 17 (existence of a partnership); *Leonard v FCT* (1919) 26 CLR 175 (assessment of income); *Robert Coldstream Partnership v FCT* (1943) 68 CLR 391 (payment of tax); *Rose v FCT* (1951) 84 CLR 118 (effects of disposal of assets on dissolution or on assignment); *Hughes v Fripp* (1922) 30 CLR 508 (tax on income due to a deceased partner's estate if the partnership is dissolved).

dilution or forfeiture of a taxpayer's interest and then by operation of non-consent or sole risk provisions under a contract to which the relevant taxpayer is bound. The structural efficiency of tolling companies is then examined.

TAXATION REFORM

On 21 September 1999, the Review of Business Taxation Committee (the *Ralph Committee* or *Committee*) released its final report on Australian business taxation reform—*A Tax System Redesigned*. This is the Ralph Committee's blueprint for Australia's business taxation system for 2000 and beyond. The Australian Federal Government has adopted certain of its recommendations to change Australia's tax laws and it is expected that further changes will arise from the recommendations contained in *A Tax System Redesigned*. Accordingly, the conclusions reached in this thesis will need to be considered in light of any developments arising from the Government's review process as well as any future legislation.

The redesigned tax system is intended to significantly reduce fiscal uncertainty and fiscal complexity and to make the system more consistent, transparent and sustainable.¹⁰ Compliance costs should reduce as a result of these improvements. The Simplified Tax System for small business and the cash flow approach described in *A Tax System Redesigned* will not apply to mining or petroleum joint ventures.

Mining and petroleum joint venture projects undertaken in Australia often require capital investments of hundreds of million or even billions of dollars.¹¹ Annual turnovers of companies involved are in many cases well in excess of \$1 million.¹² 'Accruals' taxation for

¹⁰ J Ralph, 'Ralph: A tax system by design rather than accident', www.brw.com.au/stories/19990924/3622.htm (28/9/99).

¹¹ An example of the costs of major projects is the Laminaria oil field in the Timor Sea, owned 50 percent by Woodside Petroleum Limited and 25 percent each by Shell Australia and BHP Petroleum, cost \$1.37 billion to develop and is designed to produce 140,000 barrels of oil a day: B Hextall, 'Woodside surges as Timor Sea field performs', *The Australian Financial Review*, 21 January 2000.

¹² See chapter 17, *A Tax System Redesigned*. A company must have an annual turnover of less than \$1 to be eligible for the Simplified Tax System. Two good illustrations of size of revenues are: (1) United Energy Limited which, through its 58 per cent shareholder - a joint venture between Utilicorp and AMP earned total revenue for the year ended 31 December 1999 of \$764.8 million: Caruana L, 'Energised United boots profits sixfold', *The Australian*, 3 February 2000, 23; (2) Centrica, the UK gas energy supply and services group, and Essent, the Dutch multi-utility, on 17 February 2000 said they had formed an 50:50 joint venture to develop wholesale energy trading in the Netherlands, Belgium and Germany. The venture, to be called Access Energy, will offer both gas and electricity trading. It will operate from Essent's headquarters in Amsterdam from the end of March 2000 and is expected to generate incremental revenues of E500m (approx. \$800m) in the first year of trading: Jones M,

these joint ventures will continue after 1 July 2000, requiring traditional computation of income and deductions, unless the proposed cash flow/tax value approach of calculating taxable income becomes law.¹³ Where applicable, this thesis also includes the possible taxation implications of certain recommendations of *A Tax System Redesigned*.¹⁴

Except where noted, this thesis does not address the issues of the competitiveness of Australia's business taxation system under the proposed regime, nor the extent to which the recommendations of the Committee will create additional jobs. Nor does it address the equity issues arising from the Federal Government's response to the recommendations, except to the extent that taxpayers investing or proposing to invest in unincorporated joint ventures, equity joint ventures, farmouts or tolling companies in Australia will be or could be affected specifically by them. The principal objective of analysing the proposed business tax reforms is to predict shifts in the compliance costs of Australia's tax laws for business taxpayers using joint venture structures and comment, where appropriate, on the potential impact this may have on the perceived desirability of one form of joint venture structure over another.

'Centrica, Essent in joint venture', *FT.com Financial Times*, 18 February 2000, <http://news.ft.com/ft/gx.cgi/ftc?pagename=View&c=Article&cid=FT56U0M6S4C&live=true&useoverride=IXLZHNNP94C> (21/2/00).

¹³ See Treasurer, *The New Business Tax System: Stage 2 Response*, Press Release no. 74, 11 November 1999, where he stated: 'A major recommendation of the Ralph Review was... Option 2. ... The Government sees considerable merit in the high level reforms proposed by the Review and has given *in principle support* to their introduction. However it recognises the importance of developing a workable system that can be implemented with minimum disruption.' [emphasis added]

¹⁴ Many writers have commented on these reforms, including Cooper (1999), 232; Dirks (1999), 241; Hiou (1999), 242; Spence (1999), 244; Lockie (1999), 245; Conwell (1999), 246; Cussen (1999), 248; Barton (1999), 249; Moshinsky (1999), 254; Cathro (1999).

COMPLIANCE COSTS AND INCOME TAX IN AUSTRALIA

In this chapter, we seek to erect a body of assumptions relating to income tax compliance costs. In particular, a distinction is made between private and public sector compliance costs. The remainder of this chapter outlines the results of a recent Australian survey of the income tax compliance costs of business taxpayers in Australia and their causes. It is argued that compliance costs of income tax for large businesses in Australia are high. This chapter is pivotal to understand the role of compliance costs in evaluating different mining and petroleum joint venture structures in subsequent chapters of this thesis.

The international context

Concern about taxation compliance costs is growing in the international arena:

[t]he level of this concern cannot be attributed only to taxation and taxation systems. There is an increased awareness of the intrusiveness of modern government and sensitivity to the burdens which regulations of all sorts impose. The consequence of big government, which is needed to meet the demands of the people in western liberal communities for more benefits from government, can be intrusive and demanding government regulation. The reaction to such intrusion and to the demands of government in meeting the demands of citizens for greater benefits of government (such as safety laws, gun laws, labour laws, regulation of corporations, regulation of monopolistic practices and so on) has manifested itself, in recent times, in a number of ways.¹

The world trend is towards regulatory reform, whether this comprises deregulation or better regulation, and this has affected the evaluation of taxation laws as well as other areas of government. It has been observed that:

[c]oncern about the amount, quality and cost of regulation has been shared by governments in industrialised countries... Some have adopted explicit deregulatory policies; others have sought rather to improve the quality of regulation and to see that it is well targeted. Whatever the focus, most

¹ Evans and Walpole, *Compliance Cost Control – A Review of Tax Impact Statements in the OECD, Research Study No.27*, (1999), 10.

have introduced administrative procedures designed to guide and discipline public officers and others in devising regulatory policy and drafting legislation.²

Clearly an integral part of that process is the identification of the likely compliance cost effect on taxpayers of particular tax legislative changes, and, for the purposes of this thesis, the most critical issues are the compliance cost effect of the current and proposed income tax laws on taxpayers involved in business activities where a joint venture is the preferred structure and how the compliance cost effect differs for each joint venture structure. It is therefore now appropriate to consider the awareness of and concern for compliance costs of income tax in Australia.

The Australian context

In recent years, there has been a growing awareness and concern among politicians, public servants, business leaders and tax researchers throughout the world about the effect of compliance costs of income tax on taxpayers. In Australia, that concern has been expressed in a number of ways. In 1993, the Joint Committee of Public Accounts noted that:

[a]s the law has been adjusted on a piecemeal basis, compliance costs have not been viewed as a necessary concern for the revenue. To the extent that the Commonwealth does not pay tax, compliance costs have not been a major consideration in making legislative change. However, compliance costs do affect the capacity of business to function profitably. Moreover, the greater the cost of compliance the greater the incentive for taxpayers not to comply. Compliance costs can therefore be considered to include the additional cost arising from obscure, complex or uncertain law. While it is difficult to calculate the cost of complying to any given law for any given taxpayer, it is reasonable to consider compliance costs as a factor in the efficiency of an economy - though not necessarily one which of itself is critical.³

In 1996, the Australian Chamber of Commerce and Industry said that:

[i]t is not just the cost of the tax which matters but the requirements involved in complying. The painstaking detail and effort required in adhering to the provisions of the tax act are a major impediment to the

² Boden, *Controlling the Regulators*, (1998), 9.

³ PJCPA, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office*, (1993), xxvii.

efficient operation of the economy.⁴

The Chamber considered that the compliance costs of Australia's business tax system undermined Australia's international competitiveness:

[b]usiness is concerned at Australia's continuing failure to develop an internationally competitive tax system. The current system diverts managerial time away from dealing with matters which would stimulate productivity and growth, and redirects effort into dealing with the utterly non-productive area of tax payment.⁵

In November 1997, the then Commissioner of Taxation noted the importance of compliance costs:

[c]osts borne by taxpayers in complying with our tax laws have rightly achieved an increasing profile in recent years. Keeping compliance costs to the minimum necessary to achieve policy objectives of a country's taxation laws is an important objective of any tax system.⁶

In 1999, the Ralph Committee recognised the burden of compliance costs when it recommended that a Charter of Business Taxation 'be adopted in order to establish an acceptable framework within which Australian taxation laws affecting business can be consistently developed and maintained',⁷ which would be regulated by the following taxation principle:

[t]ax laws should be designed from the perspective of those who must comply with and administer them. Taxation laws should be as clear and concise, and provide as much certainty, as possible. They should be framed in plain English and based upon a consistent set of stated design principles. Their structure should be able to accommodate change.

Further, the objective of equity cannot be realised if some sectors of business, or of the community generally, bear disproportionately the costs of complying with the nation's tax laws. Compliance costs should be minimised in total and distributed fairly.⁸

⁴ ACCI, *What Business Seeks from the Next Government of Australia: ACCI Review No. 18*, (1996), 4.

⁵ Id.

⁶ Evans, *A Report into Taxpayer Costs of Compliance*, (1997), iii (Foreword by Michael Carmody).

⁷ *A Tax System Redesigned*, 102.

⁸ Ibid, 106-107.

Given the very clear level of concern about compliance costs of income tax in Australia, it is now appropriate to review their nature and then the evidence about the magnitude and incidence of compliance costs of income tax in Australia.

Nature of taxation compliance costs

There has been some uncertainty and controversy⁹ about the nature of and measurement of taxation compliance costs. This is probably a topic in which there will always be some debate. It is possible to identify a number of costs that definitely comprise the costs of complying with income taxation requirements. A commentator has defined compliance costs in these terms:

...compliance costs are defined as those costs incurred by taxpayers, or third parties, such as businesses, in meeting the requirements laid upon them in complying with a given tax structure... For a business, the compliance costs include the cost of collecting, remitting and accounting for tax on the products or profits of the business and on the wages and salaries of its employees together with the costs of acquiring the knowledge to enable this work to be done including knowledge of their legal obligations and penalties. These costs include associated overhead costs including the costs of storing records as required by the tax authorities.¹⁰

A corollary of this definition is that offsets to compliance costs should be deducted from the cost burden. The tax deductible status of expenditure incurred by a joint venture taxpayer on compliance activities would be an example of an offset:

[i]t is also necessary to recognise and measure (where possible) identifiable offsets to compliance costs. Such offsets include the cash flow benefits that certain taxpayers enjoy as a result of the operation of the tax system (eg accelerated depreciation offered tax deferral benefits),¹¹ and the managerial benefits that arise from complying with tax obligations. Additionally, various of the monetary compliance costs that taxpayers suffer are deductible for tax purposes. When such offsets are taken into account, it is possible to identify changes in net compliance costs as well as changes in compliance costs measured at a societal level.¹²

⁹ Evans, *A Report into Taxpayer Costs of Compliance*, (1997), 2.

¹⁰ Sandford and Godwin, *Administrative and Compliance Costs of Taxation*, (1989), 10. See generally Sandford, *Tax Compliance Costs Measurement and Policy*, (1995).

¹¹ It is noted that accelerated depreciation was abolished on 30 September 1999 and to that extent, the quotation is inaccurate.

¹² Evans and Walpole *Compliance Cost Control – A Review of Tax Impact Statements in the OECD*, Research Study No.27, (1999), 12.

On this basis, it follows that the Australian government's policy focus should be on minimising compliance costs to taxpayers:

[i]f equity considerations are taken into account, the argument for minimising compliance costs is stronger than that for minimising administrative costs. As administrative costs are paid for by tax revenue, it can reasonably be assumed that these costs are distributed across the taxpaying population on the basis of some principle of ability to pay. Compliance costs, on the other hand, have been shown to be inequitable in their incidence, with business costs in particular falling with disproportionate severity on small firms; compliance costs have been shown to generate more taxpayer resentment than administrative costs. Thus, within any total of tax operating costs, where possible, the balance should be shifted towards more administrative costs and less compliance costs. Where a switch between administrative and compliance costs would reduce operating costs but raise compliance costs, there may be a difficult trade-off between efficiency and equity.¹³

Administrative costs are the 'public sector costs incurred in administering an existing tax code (including advice on its modification).'¹⁴ The Australian government bears the direct costs of these. Tran-Nam considers that the costs of five activities comprise total administrative costs: tax policy design and planning costs, tax law drafting and enactment costs, tax system administering costs, public sector compliance costs with the tax structure and tax dispute resolution costs.¹⁵ An important problem that obviously arises in studying administrative costs is the limitation on available information. Many countries do not, as a matter of routine, record the detailed components of expenditure or allocate that expenditure to particular taxes.¹⁶

An appreciation of the relationship between administrative costs and compliance costs is required in this thesis. Some government policy measures, such as those to simplify the tax system, may have the effect of reducing both administrative and compliance costs. But there is also a degree of transferability between the two. For instance, business tax reform measures may conceivably be adopted which reduce administrative costs but increase compliance costs. 'A move to a system of self assessment will usually have that effect, and putting more reporting work on employers or banks may similarly effect a saving in administrative costs but increase

¹³ Sandford and Hasseldine, *The Compliance Costs of Business Taxes in New Zealand*, (1992), 12.

¹⁴ Sandford and Godwin, *Administrative and Compliance Costs of Taxation*, (1989), xi.

¹⁵ Tran-Nam (1999), 511.

¹⁶ IFA, *Cahiers de droit fiscal international, administrative and compliance costs of taxation*, (1989).

compliance costs.¹⁷

Another commentator argues for a definition of compliance costs taken at a societal level:

[a]t a social level, they are the costs to the economy that arise as a result of taxpayers complying with taxation, and are measured before any offsetting benefits are taken into account [called social compliance costs]... But taxpayers are able to obtain a tax deduction for many of their compliance costs, and also derive certain cash flow benefits (which are sometimes negative and called cash flow costs). When these are netted off against the social compliance costs, the result is a measure of the aggregate compliance costs faced by taxpayers.¹⁸

According to this view, the narrower measure of cost set out on page 4 of this thesis:

does not clearly distinguish between societal compliance costs (ie costs to the economy) and private sector compliance costs (ie costs legally and initially borne by personal and business taxpayers).¹⁹

It has been argued that 'it is more useful to view operating costs from the societal perspective as the compliance costs, for example, consist of both the private sector and public sector costs.'²⁰ An example of this is the cash-flow advantage, which arises when taxpayers have the use of tax revenues for a period before they must be remitted to tax authorities.²¹ 'The cash-flow benefits enjoyed by taxpayers may be thought of as interest-free loans to taxpayers and thus viewed as costs to tax authorities.'²² 'This means that cash-flow benefits to taxpayers represent a transfer within the economy, which do not reduce the compliance costs to the economy, only to taxpayers (assuming taxpayers and tax authorities have the same interest rate).'²³ Other benefits to taxpayers disappear at the societal level, such as 'the tax deductibility of compliance

¹⁷ Sandford and Hasseldine, *The Compliance Costs of Business Taxes in New Zealand*, (1997), 12

¹⁸ Evans, *A Report into Taxpayer Costs of Compliance*, (1997), vii.

¹⁹ Tran-Nam (2000), 3.

²⁰ Tran-Nam (1999), 510.

²¹ Sandford and Godwin, *Administrative and Compliance Costs of Taxation*, (1989), 13-14.

²² Tran-Nam (1999), 510.

²³ Id.

costs to taxpayers and government subsidies to taxpayers as a result of a tax change'.²⁴

The societal model offers a compelling reason for identifying and accounting for wider economic costs in the measurement of compliance costs, however vaguely. Relevant costs might include welfare costs, opportunity costs, psychic costs (ie a measure of the anxiety/worry that complying with tax laws imposes on taxpayers),²⁵ administration costs,²⁶ and other social costs. These costs will usually involve wider policy issues which are not readily or easily brought to account in this thesis. Notwithstanding that there may be other costs resulting from the operation of and amendments to tax laws, it will often be difficult and speculative to accurately determine these. The overriding consideration will usually be to establish the costs incurred by taxpayers in meeting the requirements of the tax law. These will occur in certain major areas of cost applicable to taxation compliance activities undertaken by taxpayers. The major areas will usually be: labour/time consumed in completion of tax activities, external advice to assist with completion of tax activities and incidental expenses incurred in completion of tax activities.²⁷

This thesis does not recommend one definition of cost over another definition. It is sufficient to recognise that the task of a government seeking to reform the business tax system is to promote the efficient use of resources in the economy by seeking to minimise compliance costs to both the public and private sectors, rather than simply seeking to minimise administrative costs. Wherever possible, this thesis will attempt to identify instances where business tax reform measures could potentially transfer administrative costs and compliance costs: either by reducing administrative costs but increasing compliance costs, or reducing compliance costs but increasing administrative costs. To the extent that a business tax reform measure affects joint venture structures differently, this will be identified, as well, because it will further the evaluation of the taxation of mining and petroleum joint ventures in Australia.

There are a number of other features of compliance costs. First, they may be characterised as

²⁴ Id. The tax deductibility benefits of tax compliance to taxpayers are considered in some detail in Johnson, *Corporations' Federal Income Tax Compliance Costs*, (1961) and Johnson, *Corporations' Federal Income Tax Compliance Costs: A Study of Small, Medium-size and Large Corporations*, (1963).

²⁵ For a review of psychic costs in Australia, see generally Woellner (2000).

²⁶ Evans, *A Report into Taxpayer Costs of Compliance*, (1997), 3.

²⁷ Id.

commencement costs and regular costs. Therefore, the measurement of compliance costs must take account of the fact that the introduction of a new tax or tax change could involve initial costs in learning and training, whilst most taxes, once in place, involve only regular costs. Secondly, they may be unavoidable or avoidable compliance costs.²⁸ An issue is whether tax planning costs should fall within the definition of compliance costs: the argument being that 'planning costs do not constitute costs that a taxpayer is obliged to incur in complying with tax obligations and that therefore they are not part of compliance costs'.²⁹ The author does not share that view. Given the size and complexity of the activities of many of the taxpayers who use joint ventures as a business structure, the line between avoidable and unavoidable compliance costs will almost always be blurred and it would be extremely difficult to consistently distinguish activities and costs related to tax planning from those related to satisfying the compliance demands of the tax system. In accordance with research on compliance costs, in this thesis avoidable compliance costs of taxpayers are included in the definition of compliance costs.

Level of tax compliance costs in Australia

A review of the literature on compliance costs will reveal the complexities and difficulties of measuring the level of tax compliance costs generally.³⁰ Surveys conducted in the late 1980s and 1990s indicate that Australian tax compliance costs are high.³¹

In 1997, a study was conducted into tax compliance costs of taxpayers in Australia in the 1994-95 year of income.³² The study concludes the following. First, the social compliance cost of

²⁸ Id.

²⁹ Id.

³⁰ It must be recognised at the outset that complexities and measurement techniques and definitions make it difficult if not impossible to define the various costs with absolute precision or in a neat, mutually exclusive way; moreover operational definitions must be read subject to the data available.

³¹ See generally, Pope, *The Compliance Costs of Personal Income Taxation in Australia*, (1990); Pope, *The Compliance Costs of Personal Income Taxation in Australia 1986/87*, (1991), Pope, *The Compliance Costs of Employment Related Taxation in Australia*, (1992), Pope, *The Compliance Costs of Wholesale Sales Tax in Australia*, (1993) and Pope, *The Compliance Costs of Companies' Income Taxation in Australia*, (1994).

³² The following assumptions underlie the calculations: the appropriate average to use for all calculations is the mean; disaggregation on the basis of three levels of turnover (ie, small, medium and large) is appropriate; further disaggregation, on the basis of the legal form of the business entity, may also be appropriate; the value of employees' time should be based on the before tax wage rate appropriate to different types of personnel in firms of different sizes (factoring in employees' on-costs, as appropriate);

tax compliance for business taxpayers in Australia were estimated to be \$8,574 million for the 1994-95 year of income.³³ Large taxpayers (i.e. annual turnover in excess of \$50 million) were estimated to incur 11 percent of these costs. Almost 37 percent of the costs were estimated to be borne by small taxpayers (i.e. annual turnovers less than \$500,000).³⁴ In the relevant year, there were 8,896 large business taxpayers and 277,472 small business taxpayers.³⁵

The value of tax deductibility of compliance costs for business taxpayers was estimated for the 1994-95 year of income to be \$2,446 million and cash flow benefits accruing to them were about \$1,781 million. Taking into account these offsets, and business taxpayer compliance costs were estimated to be \$9,667 million. That figure represented 9.4% of business tax revenues in that year and over 1 percent of gross domestic product for Australia.³⁶

External tax advisor costs were estimated in the 1994-95 year of income to be 0.45 percent of the turnover of large companies and 0.854 percent of the turnover of small companies.³⁷ These costs include tax agents/accountants, lawyers, financial consultants and others. By contrast, internal labour costs spent on business tax affairs were significantly higher for the same year of income. For example, large companies were estimated to have spent \$69,941 on internal labour costs on business tax affairs compared to a low \$980 for small companies.³⁸

It is clear that the concern felt by many about the level of compliance costs of tax compliance is justified by reference to the existing evidence about the incidence and burden of such costs in Australia.

the value of imputed overtime for small businesses should be based on the before-tax reservation wage for medium income personal taxpayers \$19 per hour, and the midpoint reservation wage for medium and high income personal taxpayers \$29 per hour in medium sized businesses; the value of unpaid overtime should be based on the overall average of personal taxpayer's own valuations \$12 per hour; the tax deductibility of compliance costs for those businesses which pay tax or obtain a tax deduction must be taken into account; and the cash flow benefits/costs that accrued to business taxpayers must also be taken into account. Evans, *A Report into Taxpayer Costs of Compliance* (1997), 14.

³³ Evans, *A Report into Taxpayer Costs of Compliance* (1997), vii.

³⁴ *Ibid.* 33 and 55.

³⁵ *Ibid.* table 4.1.

³⁶ *Ibid.* viii.

³⁷ *Ibid.* 33; table 4.2. It is assumed that the annual turnover of large and small companies is \$50M and \$500,000 respectively.

Causes of compliance costs in Australia

Compliance costs may derive from the 'paper burden' or administrative costs to taxpayers associated with complying with and/or reporting on particular regulatory requirements:

[i]t is not just the tax which matters but the requirements involved in complying. The painstaking detail and effort required in adhering to the provisions of the tax act are a major impediment to the efficient operation of the economy.³⁹

Fiscal uncertainty contributes to the level of compliance costs of business taxpayers in Australia:

[c]ompliance costs can therefore be considered to include the additional cost arising from obscure, complex or uncertain law.⁴⁰

Taxpayers and administrators need guidance where the law is unclear. Lawmakers respond to uncertainty by producing new authorities that clarify but sometimes complicate the law (eg amending legislation, tax rulings and determinations, court and tribunal judgements).⁴¹ The pace of complication depends on the revenue. In theory, a new legal authority is produced when the amount of revenue at stake in resolving an uncertainty exceeds the transaction costs necessary to produce the authority.

Complexity arises because policy ideals are insufficiently tractable to administer, but practical second-best solutions are also complex by virtue of being second-best.⁴² Complexity is a by-product of fiscal uncertainty in Australia's tax system. Fiscal uncertainty is caused by difficulty in interpreting or applying tax laws or because of the way tax laws operate. Characterisation risk is an example of fiscal uncertainty. Fiscal complexity is 'not a concept that can be easily defined, measured or agreed upon.'⁴³ Laws may be complex to read or understand (*legal*

³⁸ Woellner and Coleman, *Once More into the Breach*, (1998), table 4.5.

³⁹ ACCI, *What Business Seeks from the Next Government of Australia: ACCI Review No.18*, (1996), 4.

⁴⁰ PJCPA, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office*, (1993), xxvii.

⁴¹ In this context, a 'lawmaker' is defined to mean the Commonwealth Parliament, the Australian Taxation Office and the Australian courts and tribunals that make judgements on tax matters.

⁴² Complexity is itself complex as substantial literature has shown: see generally Blum (1954), Eustice (1989), McDaniel (1978), Roberts (1978), Sawyer (1996), White (1990), Zelinsky (1990).

⁴³ Tran-Nam (1999), 505.

complexity).⁴⁴ A tax may not be 'determinable for each taxpayer from a few readily ascertainable facts':⁴⁵ (*effective complexity*). Effective complexity can be measured by reference to the value of resources expended by the society in raising some amount of tax revenue.⁴⁶ The level of fiscal uncertainty, characterisation risk and fiscal complexity imposed on taxpayers will affect the compliance costs borne by taxpayers of complying with tax laws. The extent of fiscal uncertainty, characterisation risk and fiscal complexity could vary from one joint venture structure to another. Compliance costs of tax laws could differ depending on the particular joint venture structure used by a taxpayer.

The evaluation of the taxation of mining and petroleum joint ventures in subsequent chapters attempts to take into account factors that bear on the level of compliance costs. Relevant factors are fourfold. First, the major differences in the compliance cost burden faced by joint venturers with different levels of turnover. Secondly, the fact that some of the compliance costs faced by joint venturers do not involve explicit costs in a conventional sense, involving a monetary outgoing, but rather involve labour time or other costs which introduce uncertainty and subjectivity when attempts are made at their measurement. Thirdly, the fact that joint venturers, to varying degrees, may be entitled to a tax deduction in respect of compliance costs that have been incurred, which reduces that cost to them. Fourthly, the fact that certain joint venturers derive cash flow benefits and costs from the tax system that have the effect of reducing or increasing the compliance cost burden on them.

The identification in this chapter of the income tax compliance costs of business taxpayers in Australia will serve to advance the analysis in subsequent chapters of the fiscal risks inherent in one joint venture structure compared to other structures.

⁴⁴ Ibid, 506. This proposition raises two questions: how is readability of tax law to be determined, and who are the readers of the tax law? The degree of complexity in the tax law is a function of two factors.

⁴⁵ Surrey and Brannon (1968), 915.

⁴⁶ Tran-Nam (1999) 507. Tran-Nam argues, 508, that there are five determinants of effective complexity (simplicity) of a particular tax: (1) legal simplicity; (2) the number of taxpayers and tax administrators; (3) the size distribution of taxpayers (some components of operating costs such as tax compliance costs are known to be regressive in taxpayer size); (4) business cycle (changing macroeconomic conditions affect the tax base); and (5) the general level of tax avoidance and tax evasion in the economy and government's commitment to combatting these.

NATURE OF MINING AND PETROLEUM JOINT VENTURES AND THEIR REVENUE LAW FEATURES

This chapter commences by first of all attempting to clearly define the concept being examined. This chapter appraises the nature of a joint venture in Australia by outlining the main types and features of mining and petroleum joint ventures and a number of indicia of the income tax aspects relevant to each type examined by reference to the ITAA 97 and the proposals of the Ralph Committee in *A Tax System Redesigned*. The extent and significance of characterisation risk is also examined by distinguishing unincorporated joint ventures from partnerships for the purposes of the ITAA 36 and the proposals of the Ralph Committee.

Joint ventures can be classified by reference to their legal forms into three main types: unincorporated joint ventures,¹ unit trust joint ventures² and equity joint ventures,³ although some joint ventures may be a combination of these. The parties to a joint venture may be government agencies or from industry.⁴ An unincorporated joint venture is distinct from a general law partnership and a tax partnership. A general law partnership is the relation that subsists between persons carrying on business in common with a view to profit.⁵ An

¹ Also known as contractual joint ventures, non-equity joint ventures or simply joint ventures: Bean, *Fiduciary Obligations and Joint Ventures*, (1995), 5-6. For example, Portman Mining—an Australian coal producer—was considering entering into a unincorporated joint venture with Germany's conglomerate Ruhr Coal (also known as the RAG Group): R Sproull and D Frith, 'Portman coalition tipped', *The Australian*, 15 September 1999, 25.

² Komesaroff (1999), 5.

³ Also known as incorporated joint ventures: Bean, *Fiduciary Obligations and Joint Ventures*, (1995), 5.

⁴ An example of a joint venture involving the government is the Australian Co-Operative Research Centre for Renewable Energy (ACRE). ACRE was established in 1996 under the Commonwealth Co-Operative Research Centre Program. It is an incorporated joint venture with 21 equity participants - eight from industry, four power utilities, a government agency and eight universities from throughout Australia. Murdoch University committed \$1.3 million to developing the ACRE centre: Anon, *Power Industry News*, National Electricity Market Management Company Limited, Edition 192, 8 May 2000, 15-16.

⁵ Section 5(1) *Partnership Act 1958* (Vic), s. 1 *Partnership Act 1892* (NSW), s. 1 *Partnership Act 1891* (SA), s. 5 *Partnership Act 1891* (Qld), s. 7(1) *Partnership Act 1895* (WA), s. 6 *Partnership Act 1891* (Tas), s. 6 *Partnership Act 1963* (ACT).

association of persons in receipt of income jointly is a tax partnership.⁶ The participants⁷ will not be jointly and severally liable.⁸ A unit trust joint venture is constituted by the vesting of property in a trustee who is bound by a trust deed to deal with it in accordance with directions and for the benefit of the unitholders. An equity joint venture involves the incorporation of a separate and distinct corporation usually with limited liability.

Unincorporated joint ventures are the dominant structure adopted in the Australian mining and petroleum industries primarily because of the commercial and taxation flexibility they offer the participants.⁹ The two main advantages of an unincorporated joint venture are favourable treatment for income tax purposes and a greater degree of flexibility than the unit trust joint venture or equity joint venture.¹⁰ Two areas of uncertainty for taxpayers of unincorporated joint ventures are the potential impact of the abolition of accelerated depreciation and the extent and significance of characterisation risk under current tax laws and under the Ralph proposals. The main benefit of unit trusts relates to their conduit tax treatment.¹¹ Most equity joint ventures will fall outside the consolidated group regime and because of this, they will be denied the benefits of the consolidation regime.

UNINCORPORATED JOINT VENTURES

This section of the chapter commences by outlining some preliminary matters about unincorporated joint ventures (their nature, joint venture agreements, the interests of

⁶ Section 6(1) ITAA 36.

⁷ The term 'participant' must be used with care because it could refer to (1) an affiliate or associate entitled to an economic interest under the relevant entitlement pursuant to illustrative agreements; or (2) a third party who does not hold an undivided fractional interest in the assets of the joint venture. Unless otherwise stated, in this thesis a 'participant' means a participant of an unincorporated joint venture.

⁸ Milliner (1988), 12 notes 'as a general observation, ... involvement [by participants of an unincorporated joint venture] in joint financing will lead to a presumption of partnership rather than the existence of a joint venture relationship'; Komesaroff (1999), 10.

⁹ Komesaroff (1999), 3-4.

¹⁰ Joint ventures are still subject to other government approvals and government policy. These risks can cause participants to withdraw from a joint venture: G West, 'One US Giant quits as another expands', *The Australian Financial Review*, 9 September 1999, 7; Komesaroff (1999), 19.

¹¹ It is noted that *Exposure Draft: New Business Tax System (Entity Taxation) Bill 2000* (Cth), proposed that conduit tax treatment would continue for 'fixed trusts' (ie, those trusts in which entities have fixed entitlements to all of the income and capital of the trust). On 27 February 2001, the Treasurer announced that 'the Government is withdrawing the draft legislation [on entity taxation] and will not be legislating it': *Entity Taxation*, Press Release no. 008, 27 February 2001.

participants, obligations of participants, role of the operator, sharing of product in kind, and liability to third parties). It is then argued that unincorporated joint ventures will be subject to characterisation risk to a greater or lesser degree, which places a compliance cost burden on taxpayers using this structure. Tax features of unincorporated joint ventures are explored. It is argued that their tax advantages involve their flow-through capabilities, the ability of each participant to make its own elections, separate accounting, ability to separately claim deductions and flexibility in financing. But there are potential compliance costs arising from uncertainty about the cash flow/tax value approach and the operation of the consolidation regime. At a general level, unincorporated joint ventures will be affected by the abolition of accelerated depreciation and the new capital allowances regime.

Nature of unincorporated joint ventures

The term 'unincorporated joint venture' is not known to the Australian common law,¹² although there are provisions relating to joint ventures in Australian legislation¹³ and elsewhere.¹⁴ An unincorporated joint venture has been inclusively defined as 'an enterprise carried on by two or more persons in common, otherwise than as partners'.¹⁵

In *United Dominions Corporation Ltd v Brian Pty Ltd*¹⁶ (Brian's case), the High Court considered the meaning of the term 'joint venture'. The case concerned an association of

¹² Crommelin (1986), 65.

¹³ See s. 4J *Trade Practices Act 1974* (Cth); Div 51 ('GST Joint Ventures') *A New Tax System (Goods and Services Tax) Act 1999* (Cth).

¹⁴ English law does not recognise a separate concept of joint venture: Ryan (1982), 105. Despite its separate origin in Scots law, the legal concept of joint venture in Scotland has merged with that of partnership: Ryan (1982), 107-108; Merralls (1988), 907; Miller, *The Law of Partnership in Scotland*, (1973), 607. There is judicial recognition of a separate legal concept of joint venture in Canada, but many of the principles of the law of partnership apply: *Central Mortgage & Housing Corporation v Graham* (1974) 43 DLR(3d) 686. A range of views to joint ventures can be discerned in South African law, from which it cannot be concluded that a distinct legal concept has emerged: *Trimble v Goldberg* [1906] TS 1002 (SC Transvaal); *Uys v Le Roux* [1906] TS 429 (SC Transvaal); *Fell v Goodwin* (1884) 5 NLR 265 (SC Natal); *Bale v Bennett* (1907) 28 NLR 361 (SC Natal), *Langerman v Carper* [1905] TH 251 (HC Witwatersrand), Bamford, *Bamford on the Law of Partnerships and Voluntary Associations in South Africa*, (1971), 11-12. Moreover, *Ruling* TR 94/14, para. 459, defines a joint venture as an unincorporated contractual association, other than a partnership or a trust, between two or more parties to undertake a specific business project in which the joint venturers meet the costs of the project and receive a share of any resulting output; see also the definition of 'joint venture' in AASB 1006, *Accounting for Interests in Joint Ventures*, para. 6: 'a joint venture means an unincorporated contractual association, other than a partnership or a trust, between two or more parties to undertake a specific business project in which the "venturers" meet the costs of the project and receive a share of any resulting output'.

¹⁵ Goddard (1985), 36.

¹⁶ (1985) 157 CLR 1.

companies described as a 'joint venture' for the purpose of land development. The question before the High Court was whether United Dominions Corporation had breached a fiduciary duty owed to Brian.

Justices Mason, Brennan and Deane in *Brian's* case said of the term 'joint venture':

As a matter of ordinary language, it connotes an association of persons for the purposes of a particular trading, commercial, mining or other financial undertaking or endeavour *with a view to mutual profit*, with each participant usually (but not necessarily) contributing money, property or skill. Such a joint venture (or, under Scots' law, "adventure") will often be a partnership. The term is, however, apposite to refer to a joint undertaking or activity carried out through a medium other than a partnership such as a company, a trust, an agency or joint ownership. The borderline between what can properly be described as a "joint venture" and what should more properly be seen as no more than a simple contractual relationship may on occasion be blurred.¹⁷ [Emphasis added]

The author adopts the view that the High Court's description of an unincorporated joint venture contains disturbing implications for the mining and petroleum industries in Australia. As a matter of ordinary language, unincorporated joint ventures connote an association of persons with a view to *mutual* profit. Unincorporated joint ventures are formed just so that there is *no* mutual profit.¹⁸ If this fiscal uncertainty causes prospective participants to incur costs to acquire the knowledge to determine the legal characterisation of their business structure, including the knowledge of their legal obligations and penalties, then additional compliance costs for participants may result. The High Court's decision does nothing to mitigate the characterisation risk inherent in incorporated joint ventures: it exacerbates the uncertainty.¹⁹ It is argued later in this chapter that the Ralph Committee's proposals for unincorporated joint ventures blur the distinction even more.

While the ITAA 97 contains no general definition of a joint venture, there is a definition for the purposes of s. 128A(1) of the ITAA 36: 'an enterprise carried on by 2 or more persons in common otherwise than as partners'. That section concerns the taxation of interest paid to

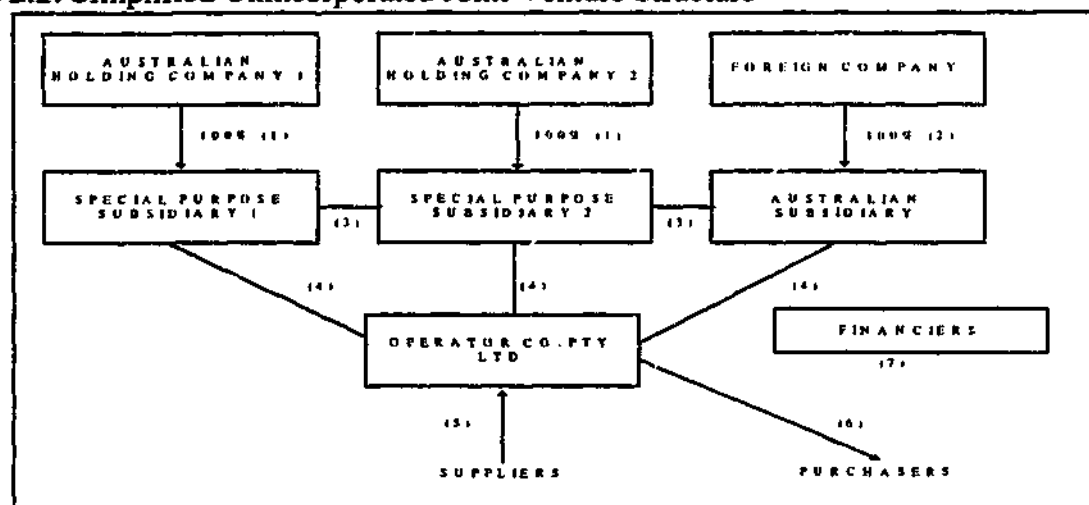
¹⁷ Ibid, 10, *per* Mason, Brennan and Deane JJ.

¹⁸ Crommelin (1986), 67.

¹⁹ Cf. Justice Dawson in the same case recognised that unincorporated joint ventures are formed so that there is *no* mutual profit. His Honour said that the term joint venture referred to an association of persons with a common undertaking 'to generate a product to be shared among the participants'.

non-residents and to certain other persons. In *A Tax System Redesigned*, the Committee defined joint ventures as 'associations of persons or entities jointly carrying on a business activity or jointly owning assets for business use, which do not receive income jointly'.²⁰ A simplified diagram of an unincorporated joint venture structure is set out in Figure 2.1.

Figure 2.1: Simplified Unincorporated Joint Venture Structure



Notes:

- (1) 100% ownership enables group relief to be utilised while protecting the assets of the Holding Companies from claims against the participants.
- (2) Subsidiary generally preferred to branch for taxation and commercial reasons.
- (3) Joint Venture Agreement which specifically negates the existence of a partnership relationship.
- (4) Agency Agreement.
- (5) Operator Co. Pty Ltd deals with suppliers on behalf of the participants.
- (6) Sale of product to purchasers.
- (7) Finance documents.

A number of other agreements are in practice likely to be in place between the participants, which are not identified in the structure set out above.

The unincorporated joint venture in Figure 2.1 has three participants: two are wholly owned Australian resident companies; the third is an Australian subsidiary of a foreign company. The unincorporated joint venture is operated through an operating company—Operator Co. Pty Ltd. The participants usually enter into a number of agreements: the joint venture agreement, an agency agreement, a sale agreement (for the product) as well as finance documents.

The joint venture agreement is not particularly complex

The constituent document of an unincorporated joint venture is the joint venture agreement

(the JVA).²¹ Subject to the legal risk that an unincorporated joint venture could be characterised as either a general law or a tax partnership, there is no insurmountable obstacle or particularly onerous drafting required to complete a JVA.

The law of contract primarily regulates the unincorporated joint venture structure, although equity and fiduciary duties are relevant as well.²² The parties to a JVA are the participants. A JVA states the purpose and scope of the relationship between them. Assets that participants commit to the undertaking and interests that individual participants have in the JVA are described and quantified. A JVA provides for a number of matters, including the management and control of the operations of the undertaking (eg expenditure of funds, apportionment of liability, consequences of default and so on) and the use and disposal of the joint venture product obtained.²³ As well, participants each have the opportunity to separately transfer losses and outgoings from the joint venture project between wholly owned companies that are resident in Australia and are members of the same corporate group.²⁴ In general, this is not possible with an equity joint venture because the taxable entity is the joint venture corporation, not the equity participants as shareholders.²⁵ The shareholders could not in general offset tax losses carried by or deductions incurred by the joint venture corporation against the income of the shareholders. It follows that an unincorporated joint venture, unlike a corporation, does not enjoy legal personality.²⁶ Therefore, an unincorporated joint venture is fiscally transparent, so that income and deductions flow-through to the participants.

The cost of this benefit could be measured in terms of the compliance costs incurred by a taxpayer to mitigate characterisation risk. Notwithstanding that on one view it could be argued that costs incurred to mitigate characterisation risk do not constitute costs that a participant must incur to comply with tax obligations and therefore they are not part of a

²¹ Komesaroff (1999), 6; Sullivan, *Financing Transnational Projects*, (1988), 8-5[2].

²² Id. See also Finn (1984), Gallimore (1984) and Wiese (1984).

²³ Merralls (1988), 912; Komesaroff (1999), 6.

²⁴ Ahrens (1986), 460. This proposed consolidated group regime will be discussed later in this chapter.

²⁵ Ryan (1982), 127. But see Armstrong (1982), 409-410.

²⁶ Crommelin (1986), 65.

participant's compliance costs,²⁷ the author prefers a different view. The author considers that the sophistication of the participants involved in mining and petroleum unincorporated joint ventures blurs the line between avoidable and unavoidable compliance costs, so it would be extremely difficult to consistently distinguish activities and costs related to mitigating characterisation risk from those related to satisfying the compliance demands of the tax system. Consistent with research on compliance costs, therefore, avoidable compliance costs of participants to mitigate characterisation risk are compliance costs.²⁸

Equity joint ventures lack this fiscal transparency and equity participants have no characterisation risk, although the use of a tolling company will generate the same tax outcome as for unincorporated joint ventures, but compliance costs will be borne.²⁹

JVAs in most cases regulate the ability of the participants bound by them to sell, transfer, assign or otherwise dispose of all or part of their interests in the JVA and the assets subject to it. Common provisions for this purpose include a requirement on a participant seeking to dispose of its interest to first obtain the other participants' consent to the sale, transfer, assignment or disposition (or to follow the provisions dealing with rights of pre-emption that the other participants may have) before offering the same to third parties.³⁰

Nature of interests of participants

It is argued that the taxation of dealings by participants in their interests in an unincorporated joint venture generally is more complex and costly (in compliance terms) than the taxation of dealings by equity participants in their shares in an equity joint venture. This is due to the complex laws for taxing the interests of a participant in an unincorporated joint venture. This theme is developed later in this thesis, particularly in chapters 4 and 5.

A participant's interests in an unincorporated joint venture consist of a complex hybrid of

²⁷ See Evans, *A Report into Taxpayer Costs of Compliance*, (1997), 3.

²⁸ Id.

²⁹ See chapter 6.

³⁰ See Manning (1986), 119-121. Transferor participants may be obliged to require third parties to agree to be bound by the same assignment provisions which bound them; cf Fletcher (1988), 291. For a detailed analysis of assignment by a participant, see *RMC Holdings (Delaware) Inc v Newcrest Mining (WA) Ltd* (Unreported 24/6/1994, SC WA Ipp J, 1102 of 1994); *Shell Australia Ltd v Newcrest Mining (WA) Ltd* (Unreported, 24/6/1994, SC WA Ipp J, 1276 of 1994).

contractual rights or choses in action, contractual obligations and proprietary interests (some of which may be reducible or determinable in certain instances under the provisions of the JVA).³¹ Two aspects about the interests of a participant are:

[f]irst it has an ownership interest as a tenant in common in the mining tenements and other assets which are acquired, constructed or used for the development of the project. Secondly, it has certain rights or choses in action represented by the joint venture agreement and related agreements.³²

It is therefore usual for the assets committed to the unincorporated joint venture to be held by the participants as tenants in common in proportion to their respective shares.³³

The contractual rights, or choses in action, would include the right to take a share of the production in kind, the right to enforce the obligation of the other participants to contribute their proportion of the costs and expenses of joint venture operations in a proper and businesslike manner with the usual standards of care, to maintain the tenements and to take out and maintain insurance policies or to procure the operator to do this.³⁴ In order to fully appreciate the rights conferred on a participant by a JVA, the meaning of a chose in action must be clearly understood.

The meaning of 'chose in action' has been judicially considered on several occasions. According to Channell J in *Torkington v Magee*,³⁵ a chose in action is a known legal expression used to describe all personal rights of property which can only be claimed or enforced by action, and not by taking physical possession. According to Rich J in the decision of the High Court in *Loxton v Moir*,³⁶ the primary sense of a chose in action is:

... a right enforceable by action. It can also be used to describe the right of action itself, when considered as part of the property of the person entitled to sue. A right to sue for a sum of money is a chose in action, and is a

³¹ Crommelin (1986), 70; Carson (1988), 1-2. McCann (1990).

³² Ladbury (1981), 275; Komesaroff (1999), 3 refers to ownership by the participants as 'tenants in common'.

³³ Komesaroff (1999), 3.

³⁴ Manning (1986), 122.

³⁵ [1902] 2 KB 427, 430; cited in *ICI Australia Ltd v FCT* (1994) 94 ATC 4600; 125 ALR 63; 29 ATR 233; *Tax Case K23* (1978) 78 ATC 209; see also Raphael (1998).

³⁶ (1914) 18 CLR 360.

proprietary right.³⁷

The rights and benefits under a JVA fall within the definition of a chose in action. Legal title may be held by one participant, or by the operator, on behalf of all participants³⁸ in trust,³⁹ but usually each participant holds legal title in the assets of the joint venture in the same proportion as it holds rights under the JVA. In this way, each participant holds 'a direct interest in the venture instead of participating indirectly through a shareholding in a single jointly held ... company' as in equity joint ventures.⁴⁰ It will become evident from the analysis in subsequent chapters, particularly chapters 4 and 5, that this feature of unincorporated joint ventures is determinative of their flow-through capabilities, but also of the fiscal complexity and compliance costs of transactions involving dealings of interests in unincorporated joint ventures.

Several not joint obligations

Unincorporated joint ventures involve *several not joint* obligations.⁴¹ The position of partners in a partnership is different from this:

[p]artners are liable jointly on obligations arising ex contractu and the estate of a deceased partner is liable severally on such obligations, which were incurred before her or his death; on liabilities arising out of torts the partners are jointly and severally liable.⁴²

Rules concerning joint and several liability are largely derived from law which has developed in relation to deeds.⁴³ A promise in an instrument made by two or more persons must be construed as a promise made jointly and severally (unless a contrary intention appears). Apart from that presumption, the extent to which an obligation is joint or several depends upon the intention of the parties evidenced by the JVA. Several liability means that the parties make

³⁷ Ibid, at 379.

³⁸ Pritchard (1986), 508.

³⁹ Komesaroff (1999), 3.

⁴⁰ Daintith, *United Kingdom Oil & Gas Law*, (1984), 1087.

⁴¹ See, for example, Standen (1988), para. 14,012; Merralls (1988), 910; Komesaroff (1999), 10.

⁴² Fletcher and Higgins, *The Law of Partnership in Australia and New Zealand*, 22.

⁴³ Section 81 of the *Property Law Act 1958* (Vic).

separate promises to each other: each participant is liable only for its share of joint venture liabilities being a proportion equal to its percentage interest in the unincorporated joint venture.⁴⁴ Several promises can be made in the same terms and in the same document⁴⁵ and need not necessarily be cumulative. It is not to be presumed from a provision in a JVA whereby each participant separately promises to appoint the operator agent to sell a participant's share of product, that the participants intend joint and several liability between them.⁴⁶

Sharing of product in kind

It is said that participants receive the product of the undertaking separately and in kind.⁴⁷ Judicial support for this notion is contained in the judgment of Dawson J in *Brian's* case:⁴⁸

[p]erhaps in this country, the important distinction between a partnership and a joint venture is, for practical purposes, the distinction between an association of persons who engage in a common undertaking for profit and an association of those who do so in order to generate a profit to be shared among the participants. Enterprises of the latter kind are common enough in the exploration for and exploitation of mineral resources and the feature which is most likely to distinguish them from partnerships is the *sharing of product* rather than profit. It is, however, unnecessary to pursue that matter here.⁴⁹ [emphasis added]

And in *Mount Isa Mines Ltd v Seltrust Mining Corporation Pty Ltd*,⁵⁰ Rowland J said:

[m]any of the indicia of partnership are missing, in particular the ultimate

⁴⁴ Komesaroff (1999), 10.

⁴⁵ Williams, *Joint Obligations*, (1949), 33.

⁴⁶ The question of joint and several liability between the participants is developed further in chapter 3 in the context of tax law aspects of financing joint ventures.

⁴⁷ Fletcher (1988), 291; Industry Commission, *Study into the Australian Gas Industry*, (1995), xxviii; Komesaroff (1999), 3.

⁴⁸ (1985) 157 CLR 1, 15. In *Mount Isa Mines Ltd v Seltrust Mining Corp* (Unreported, Supreme Court of Western Australia, No.1614 of 1985, 5 July 1985, Rowland J) a mining joint venture was found not to be a partnership on the same basis: 'At the end of the day each of the parties takes in kind the object of the joint venture i.e. nickel concentrate and there is no express restriction on the way in which each deals with that product.' The Western Australia Full Court dismissed an appeal from the judgment on 27 September 1985.

⁴⁹ (1985) 157 CLR 1, 15-16.

⁵⁰ Supreme Court of Western Australia, No.1614 of 1985, 5 July 1985 (unreported).

equitable interest in the whole of the assets referred to in [...]. At the end of the day each of the parties takes in kind the object of the venture i.e. nickel concentrate and there is no express restriction on the way in which each deals with that product.

That is not to say that commentators have not questioned the efficacy of the product-sharing approach to recognising unincorporated joint ventures. One writer⁵¹ does this by relying on *Holderness v Shackels*.⁵² In that case, a product-sharing venture did not escape treatment as a partnership. However, early English cases point to the product-sharing aspect as a distinguishing feature of unincorporated joint ventures.⁵³

Further, in *ARM Constructions Pty Limited v FCT (ARM Constructions)*,⁵⁴ the Commissioner of Taxation had claimed that a property undertaking near Bankstown in Sydney, New South Wales, between two of the applicants was a partnership. Yeldham J held that the agreement between them was merely to construct buildings capable of partition so that each could construct a building, in contrast to an agreement to make profits for sharing among themselves.⁵⁵ In an early Victorian case, *Ballantyne v Raphael*,⁵⁶ a syndicate to buy, subdivide and sell land was held to be neither a partnership nor an illegal association for gain in excess of twenty members because the members had intended to form a unit trust to develop the land.⁵⁷

A recent unreported case sheds light on a different aspect to product-sharing; namely, the

⁵¹ McPherson (1987), 19, 21.

⁵² (1828) 8 B & C 612 (where a whaling ship product sharing joint venture was treated by the court as a partnership). Admittedly, the case was decided before the enactment of the *Partnership Act 1890* (UK).

⁵³ Additional support for the product sharing approach is found in early English cases of *Hoare v Dawes* (1780) 1 Doug KB 371; *Coope v Eyre* (1788) 1 Hy Bl 37; *Grace v Smith* (1775) 2 Black 998 (cited in Case J40 (1977) 77 ATC 377). These cases distinguished joint purchases of goods for resale jointly by the participants that might give rise to partnership, and joint purchase for division and separate sale by the individual adventurers that did not.

⁵⁴ (1987) 19 ATR 337; 87 ATC 4790; see also *Determination TD 92/161* - Land acquired before 20 September 1985.

⁵⁵ *Ibid.*, 354; 4805.

⁵⁶ (1889) 15 VLR 538.

⁵⁷ *Ibid.*, 556-557.

sharing of benefits. In *Cummings v Lewis*,⁵⁸ Wilcox J found an unincorporated joint venture between a famous Australian racehorse trainer and a firm of accountants to market a racehorse syndicate to taxation clients. According to Wilcox J, the concept underlying the joint venture was mutual but differing benefits to the two parties. Each was to share an entrepreneurial role but each was to take a share of the overall benefits of the syndication in his own way. Such a joint venture was not a partnership, the profits were entirely distinct and were not shared. An essential aspect of the notion of partnership was the sharing of jointly derived profits. The benefits to the accountants were held to be distinct from the benefits intended for Cummings.

Product-sharing will not be commercially feasible in every instance. The alternative is profit-sharing.⁵⁹ Where the parties do not product-share, the inference of a partnership may be easier to find.⁶⁰

Role of the operator

Participants employ a manager or operator to conduct many (if not all) of the activities of the unincorporated joint venture.⁶¹ An operator usually conducts the joint operation as the agent of all the participants.⁶² The operator can be either one of the participants or a third party.⁶³ If

⁵⁸ Unreported, Federal Court of Australia, 2 August 1991, Wilcox J. But cf. on appeal (1993) 41 FCR 559, 589 where the Full Federal Court upheld the judgment of Wilcox J by following the approach of Steinert J in *Carboneau v Peterson* 95 P. 2d 1043 (1939) (Supreme Court of Washington). Cooper J (with whom Sheppard and Neaves JJ agreed) found that the arrangement fell 'within the category of arrangements not constituting joint ventures for want of a community of interest'.

⁵⁹ For an example of a profit sharing joint venture, see *Oraca! International Pty Ltd v International Professional Traders Pty Ltd* [1999] NSWSC 753, per Bryson J.

⁶⁰ Fletcher (1988), 291.

⁶¹ The author has referred to the 'manager / operator' because both terms are frequently used. In the remainder of this thesis the author will refer simply to the operator but that comprehends parties who are also described as a manager or by some other term. See also Industry Commission, *Study into the Australian Gas Industry*, (1995), xxviii; Komesaroff (1999), 6.

⁶² McCafferty (1981), 34; Merralls (1981), 9; Ryan, 280, 282; McCann (1982), 257-258; Williamson (1982), 277; Crommelin (1986), 66; Dowsett (1987), 269-270; Smith (1987), 290; Fewster (1987), 285; Ryan (1990), 380; Barrymore (1994), 159.

⁶³ For example, Portman Mining has a strategic alliance with Thiess Contractors, which is in turn owned by Leighton Holdings. Thiess operates the Burton coal mine in Queensland: D Frith, 'Portman sells to RAG for riches', *The Australian*, 15 September 1999, www.news.com.au/news/content/aus/4361076.htm. Santos is the operator of the Bentu and adjoining Korine-Bareu blocks. It has a 61 percent interest, while Petrox has 39 percent: B Rough, 'Strong Sumatra gas flow fails to ignite the market', *The Australian Financial Review*, 1 October 1999, 47; Woodside Petroleum owns 50 percent and is the operator of the Laminaria/Corallina project in the

it is a third party, it is very often a company formed expressly for the undertaking and owned by the participants jointly. If an operator is appointed, it is often the case that the participants retain an involvement in the activities of the JVA through a joint operating committee. Even if the operator is the participants' agent, then the operator will never be appointed the mutual agent of the participants. The risk of characterisation as a general law partnership would be too great.⁶⁴ Most JVAs will make provision for a committee comprised of representatives of each participant who meet and make decisions concerning the operation of the undertaking on a regular basis. The powers and duties of the operator and the committee are usually set out in some detail. The operator may be obliged to divide up and deliver the completed product to each participant or its agent.⁶⁵ Very often there is a separate management agreement, which defines the rights and duties of the operator at length. Those provisions will contain the powers of the operator, set out limits on the operator's powers as well as setting out its duties. The operator may also be required to contract with third parties on behalf of the participants.

Liability to third parties

Generally, the participants are liable to third parties in contract and in tort for the authorised acts of their operator.⁶⁶ Some JVAs provide that the operator's dealings with third parties are as principal only. Forbes and Lang suggest that 'it is unlikely that such a denial of agency can be wholly and *per se* effective' and that 'it is difficult to avoid the conclusion that the relationship of principal and agent does arise between joint venturers and their operator'.⁶⁷

Timor Sea (other participants are Shell Australia and BHP Petroleum): I Horwarth, 'Timor sea crude flows to northern endeavour', *The Australian Financial Review*, 9 November 1999, 26.

⁶⁴ See Griffith CJ's comments in *Lang v James Morrison & Co Ltd* (1911) 13 CLR 1, 11; Lord Cranworth's comments in *Cox v Hickman* (1860) 8 HL Cas 268, 302. The risk for participants is that one participant can be bound by the others. For example, in a matter decided by the vote of the joint operating committee, the dissenting participant is bound by the action of the operator on the matter, and in so acting, the operator is, agent for, the participants who through their representatives on the joint operating committee, voted in favour of the action. Changing the role of the operator from one of agent to trustee could mitigate this risk.

⁶⁵ Komesaroff (1999), 6.

⁶⁶ Forbes and Lang, *Australian Mining and Petroleum Laws*, (1987), 1908; Reynolds, *Bowstead on Agency*, (1985), 50; Crommelin (1986), 78; Ryan (1990), 377. The participants usually require the manager to indemnify them in respect of liabilities incurred in excess of authority: see McCann (1982), 266.

⁶⁷ *Id.*, [emphasis added].

Extent and significance of characterisation risk for unincorporated joint ventures

The extent and significance of characterisation risk for unincorporated joint ventures will be examined by reference to the present law and the Ralph Committee's proposals.

Currently, it is difficult to be sure that an unincorporated joint venture does not constitute a partnership for the purposes of the ITAA 36. That is, *characterisation risk* will exist. A sub-contractor, for example, may work with an information technology company, supplying her own personal computer and other tools, without any real question of partnership arising. But an unincorporated joint venture may so closely resemble a partnership that the true position is at best unclear. An assessment of the degree of characterisation risk for a given situation is a complex matter and could cause fiscal uncertainty. Additionally, if prospective participants incur temporary costs, either as start up costs or pre-implementation costs (ie fees to tax lawyers), to assess the degree of characterisation risk associated with their proposed unincorporated joint venture structure, then participants' tax compliance costs will increase as a result. Such participants may also incur periodic costs of tax lawyer's fees during the term of the unincorporated joint venture to ensure that characterisation risk is managed throughout the project. For example, the participants might incur regular costs in administering the sales contracts to ensure that there is no joint sale of product.

The substance of a relationship between participants depends upon their intention, manifested by the JVA. Judicial construction of what is in substance agreed may override a particular inconsistent term. Notwithstanding that a JVA may expressly state that the relationship subsisting between the participants is not one of partnership and that the participants are not in receipt of income jointly, a court may still construe these to be so. One writer considers that parties who are in fact partners cannot avoid the relationship of partnership by calling themselves something else.⁶⁸ Accordingly, notwithstanding that a JVA is entitled 'Joint Venture Agreement' and describes the parties to it as participants, joint venturers or co-venturers (as the case may be), the label will not be determinative.⁶⁹ Probably the best Australian example of this is in *Canny Gabriel Castle Jackson Advertising Pty Ltd v Volume*

⁶⁸ Ryan (1982), 129.

⁶⁹ *Alexander Adam & Robert Smith v William Newbigging & Walter Townend* (1888) 18 ChD 698; *Weiner v Harris* [1910] 1 KB 285; *Horne v Pollard and Anderson* [1935] NZLR 125; *Wiltshire v Kuenzli* (1945) 63 WN(NSW) 47; *Pawsey v Armstrong* (1991) 18 ChD 698.

Sales Finance Pty Ltd,⁷⁰ where the High Court held that there was a partnership, even though the parties in their agreement sought to avoid the creation of a partnership and described their relation as a joint venture.⁷¹

Partnership is defined by s. 6(1) of the ITAA 36 as 'an association of persons carrying on business as partners or in receipt of ordinary income or statutory income jointly, but does not including a company.' Under current tax laws, participants of unincorporated joint ventures are liable to be assessed individually for income tax on the basis that the undertaking is not an association of persons carrying on business as partners and they are not in receipt of income jointly. Relevant factors to make a determination about whether an unincorporated joint venture constitutes a general law partnership or tax partnership will now be examined.

General law partnerships

There are various methods by which it is argued that the unincorporated joint venture relationship is not a general law partnership. These have been extensively discussed in the literature on the subject.⁷²

The arguments usually involve negating the existence of one of the elements in s. 5(1) of the *Partnership Act 1958* (Vic) which provides 'Partnership is the relation which subsists between persons carrying on business in common with a view of profit'. This definition predicates that a partnership involves the carrying on of a business, in common, and with a view of profit. While the *Partnership Act 1958* is not a complete code of the law of partnership⁷³ it would be difficult to argue that a general law partnership may exist outside its operation.

It could be argued that participants are not carrying on a business because an unincorporated joint venture is for a single undertaking. There is a distinct lack of continuity or repetition of the profit-making activities (eg derivation of sales revenue), which are characteristic of the conduct of a business. However, the limited scope of a JVA will not prevent the relationship

⁷⁰ (1974) 131 CLR 321; appld *FCT v McDonald* (1987) 15 FCR 172; *Sarich v FCT* (1978) 46 FLR 326.

⁷¹ Ibid, 327.

⁷² Including: Merralls (1988); Ryan (1982); Standen (1988); Davis, *Unincorporated Joint Ventures*, (1983); Fletcher and Higgins, *The Law of Partnership in Australia and New Zealand*, 31-33; Ladbury (1984), 37.

⁷³ Lindley and Banks, *Lindley and Banks on Partnership*, 2.

between the participants from being characterised as a general law partnership because the former usually involves a project spanning over a period of time involving a number of transactions and is accordingly able to fall within the concept of carrying on a business.⁷⁴

To determine whether the activity being carried on under a JVA is within the concept of 'carrying on a business', it is necessary to first define the nature of the business. The business conducted under a JVA may be that of development of a mine which would involve different acts and transactions from that of mineral processing, but each involves carrying on a business. However, if the undertaking carried on by the participants is limited solely to exploring for minerals, then the object of the JVA concerns the acquisition of a capital asset (eg a mine), which is not readily seen as an activity performed with a view of profit.⁷⁵ The contrary view is that underlying the search for a capital asset is the consideration that the capital asset, if found, will ultimately be used by the participants to produce a profit and, therefore there is a view of profit. Notwithstanding the latter view, it seems that little emphasis will be placed on this element when seeking to distinguish a joint venture from a partnership.⁷⁶

Another argument that a JVA is not a general law partnership relates to the use of the words 'in common' in s. 5(1). Because participants hold their interests in the assets of the JVA severally as tenants in common, it is argued that unincorporated joint ventures are cost-sharing relationships comprising merely a number of several distinct businesses with only some aspects being undertaken in common.⁷⁷ The only common aspects in a joint venture are the sharing of the joint venture assets and the co-ordination of joint venture activities through an

⁷⁴ In this connection, in *Re Abenheim; Ex parte Abenheim* (1913) 109 LTR (KBD) 219, 220 Phillimore J said: 'It has been suggested to me that "business" does not mean an isolated adventure, but that it means the regular trade of people even though they may have two or three separate trades. I see no reasons for construing it in this way'.

⁷⁵ Merralls (1938), 909; Ladbury (1984), 320; Ryan (1982), 131-35. *Nicholson v Gander* (1910) 8 CLR 648, 670, per Higgins J.

⁷⁶ See Chetwin (1991), 262. Further, in *Folks v Woolf* [1933] VLR 403, the plaintiff and the defendant formed what was called a 'mining syndicate' for the purpose of mining 15 acres of land near Donnybrook, Victoria. It appears they agreed to divide costs and revenues. Lowe J held that notwithstanding that there was only one mining project, the parties were carrying on a business and were a partnership.

⁷⁷ Merralls (1988), 909-10; Crommelin (1986), 68-69; Ladbury, 41; Ladbury (1985).

operating committee and jointly appointed operator;⁷⁸ all other aspects of a joint venture are several.⁷⁹ Moreover, carrying on the separate businesses at the same time is not a separate business in itself.⁸⁰

It has been argued that an unincorporated joint venture is not a partnership because there is no joint profit, only a sharing of product in kind.⁸¹ Partnership requires there to be an activity with a view of profit. The participants of an unincorporated joint venture taking their minerals or other asset in kind obtain no profit at that stage. However, it is not beyond argument that product-sharing is mutually exclusive with general law partnerships. Commentators have argued that although Australian courts would probably not regard the product or output itself as constituting 'profit' for the purposes of the *Partnership Acts*,⁸² there is a debate among academicians about whether a 'view to joint profit' is a necessary prerequisite for a finding of partnership.⁸³ One commentator asserts that the resolution of the latter question depends on the method of interpretation of the statutory definition of partnership under the *Partnership Acts*. If viewed as three separate elements, the definition may be construed as requiring only that each participant in the joint venture has a (separate) view to profit.⁸⁴ If the definition is treated as a composite expression, it leads to the conclusion that the profit motive must attach to the participants as a group in the conduct of their common business.⁸⁵ On this approach, which is supported by Dawson J in *Brian's case*,⁸⁶ the statutory definition of partnership under the *Partnership Acts* must be read as requiring profit to be gained jointly, which is not the case

⁷⁸ Ladbury, 41; Ryan (1983-84), 260, n 6.

⁷⁹ Refer Ladbury, 41; Crommelin (1986), 68.

⁸⁰ Merralls (1988), 909.

⁸¹ See Ryan (1982), 139; Chate (1969), 2; Beeny (1980), 8.

⁸² Ryan (1982), 140-41; cf Chetwin (1991), 263; Crommelin (1986), 68.

⁸³ Chetwin (1991), 263; Ryan (1982), 139-41.

⁸⁴ Chetwin (1991), 263: 'It is not clear whether or not sharing of profits is essential for a partnership... The implication of this approach is that the "in common" refers to the mode of conducting business and not with the disposal of the profit.'

⁸⁵ See Crommelin (1986), 68.

⁸⁶ *United Dominions Corporation Ltd v Brian Pty Ltd* (1985) 157 CLR 1, 15-16 per Dawson J.

in a typical unincorporated joint venture.⁸⁷

No Australian court has been asked to consider whether unincorporated joint ventures are separate and distinct from partnerships at law. It is not possible to conclude with absolute certainty that they are not. Therefore, characterisation risk will be a feature of all unincorporated joint ventures. To a greater or lesser degree, a prospective participant would be likely to incur compliance costs to make an assessment of the level of characterisation risk in a given case. It is contended that *Canny Gabriel's case* does not stand for the antithetical proposition. That case concerned a contract entered into by the plaintiff engaging Elton John and Cilla Black to appear at concerts in Australia and the defendant agreed to provide finance for the tour. The High Court held that the 'joint venture' was a partnership on grounds that the parties had become 'joint venturers' with a view to profit, the parties intended on sharing the profits, the policy of the joint venture required agreement by both parties, otherwise matters were to be resolved by arbitration. An assignment of a half interest in the interests for the appearances by Elton John and Cilla Black was attempted but failed. There was concern for the financial stability of one and other in a way which the court considered is common among partners. Conversely, in *Brian's case*,⁸⁸ Dawson J considered that the sharing of product, not profit, among the participants was the discriminant between unincorporated joint ventures and partnerships.⁸⁹

Tax partnerships

There is a risk that an unincorporated joint venture may be classified as a tax partnership. As stated earlier, s. 6(1) of the ITAA 36 defines 'partnership' to mean an association of persons carrying on business as partners or in receipt of income jointly but does not include a company. Accordingly, the terms 'partnership' and 'company' are mutually exclusive. But one commentator has stated that a typical unincorporated joint venture does not provide for the joint receipt of income by the participants, and therefore is effectively only a partnership for the purposes of the ITAA 36 if it comes within the definition of partnership as provided

⁸⁷ Crommelin (1986), 68.

⁸⁸ (1985) 157 CLR 1; *applied Aqua Max Pty Ltd & Sietel Pty Ltd v MT Associates Pty Ltd, Malz Nominees Pty Ltd & Trihey* (19/6/98) SCVic 5966/93; *Kinhult-Ng v Tay* (3/10/97) SCWA CIV2184/93; *News Ltd v Australian Rugby Football League Ltd* (1996) 58 FCR 447; *FCT v McDonald* (1987) 15 FCR 172; Griggs (1997).

⁸⁹ *Ibid*, 15.

under the *Partnership Acts*.⁹⁰ The author considers that there is no 'typical' JVA because the terms of each one will turn on the particular project. If the commentator's point is that most JVAs do not provide for the joint receipt of income by the participants, then the author agrees with the commentator.

Participants do not want their JVA to fall foul of the definition of 'partnership' contained in s. 6(1) by reason only that the participants are in receipt of ordinary income or statutory income jointly. It is generally accepted that the second limb of the definition (in receipt of income jointly) is wider than the meaning of partnership at general law and has the effect of including associations that would not constitute partnerships under the general law.⁹¹

If an unincorporated joint venture is to be characterised as a tax partnership, then all of the perceived tax advantages of being taxed on the basis that the relationship is an unincorporated joint venture will be lost. Therefore, participants of unincorporated joint ventures must not be in receipt of income jointly. They must receive their income from the venture separately. As a practical matter, this may mean that JVAs always include a provision expressly negating the relation of partnership between the parties,⁹² to which substance is given by the participants putting in place policies and procedures to preserve the integrity of the provisions of the JVA for the life of the venture. But in the end, the question could be one for a court to decide. If each participant has separate sales contracts with the operator, sends separate invoices to customers for the sale of product and the operator conducts separate bank accounts for each participant, then characterisation risk will be reduced. These activities will surely come at a cost to the participant—a cost not incurred by equity participants. Participants separately authorise the operator to dispose of their share of the product as their agent. The risk for a participant that holds its assets in the joint venture as a joint tenant is that the disposal of those assets may be treated for ITAA 97 purposes as being a receipt of income jointly and therefore, a tax partnership. According to one commentator, the words 'in receipt of income jointly'

⁹⁰ Crommelin (1986), 68.

⁹¹ *Tivka Investments Pty Ltd v FCT* (1972) 128 CLR 158; *Jolley v FCT* (1989) 20 ATR 335; 86 ALR 297; 17 ALD 643; 89 ATC 4197; *FCT v McDonald* (1987) 15 FCR 172.

⁹² See *Ruling* TR 94/8 for the view that a written partnership agreement is not conclusive proof of the existence of a partnership; Komesaroff (1999), 5.

may be inappropriate where income is generated by a business activity.⁹³

Tax partnership and tenancy in common not mutually exclusive

It is contended that joint ownership of property is not a prerequisite for an association of persons to be in receipt of income jointly. For persons to be in receipt of income jointly they must be beneficially entitled to the income. In *Case 91*,⁹⁴ the trustee of a trust established by a settlor carried on a business pursuant to the terms of the trust deed. The Commissioner of Taxation contended that the trustee was carrying on the business in partnership. This contention was unanimously rejected by the Board of Review which held that a trustee is not a 'partner' within the meaning of the definition merely because it is in receipt of income jointly. The board considered that the definition refers to beneficial receipt of income and it is the beneficiary and not the trustee who has the beneficial entitlement. The trustee has a bare legal interest which is conferred upon it merely for the purpose of administering the trust according to its terms.⁹⁵

In *Case 24*,⁹⁶ it was suggested that the *conduct of business* by the partnership and not merely by one of the partners is necessary for the joint receipt of income. It is not unusual for the participants of an unincorporated joint venture to be involved in the activities of the JVA. In this case, the taxpayer (an individual) purchased a truck for the purpose of recommencing a carrying business. Prior to this he had entered into a carrying business and his wife had made a contribution towards the cost of a truck. In the intervening period the taxpayer's business income was received by the taxpayer by cheque made payable to him personally and banked by him in his and his wife's joint account. Three years later the taxpayer requested the company for which he was operating to make payments by cheque made payable to his wife and himself jointly. The taxpayer's wife participated in the business to a very minor extent. He claimed that half of the income derived from the carrying business was income derived by

⁹³ Parsons, *Income Taxation in Australia*, (1985), para. 13.81.

⁹⁴ (1973) 18 CTBR (NS).

⁹⁵ See also *Case N56* (1981) 81 ATC 277; *apld AAT Case V64* (1988) 88 ATC 492; *Case 71* 3 CTBR (NS); *Case 44* 5 CTBR (NS) and *Case 69* 6 CTBR (NS) in each of these cases it was held that there was a joint receipt of business income within the definition of partnership in s. 6(1) of the ITAA 36, whether or not the persons concerned carried on business as partners.

⁹⁶ (1965) 12 CTBR (NS) 14.

his wife from a general law partnership or alternatively, it was submitted that the taxpayer and his wife were in receipt of income jointly and were therefore to be treated as partners for income tax purposes. The Board of Review held that there was no binding agreement between the taxpayer and his wife and that there was no factual sharing of profits between them and they were not in receipt of income jointly. It was held that the ordinary test of partnership (ie whether the business is carried on by one person or several persons) should be applied to ascertain whether income is derived by one person or several persons jointly and that this principle was not altered by the definition of partnership in s. 6(1) of the ITAA 36. The Board of Review stated that '[t]o put it another way, where income is derived from a business carried on with a view to profit, it is necessary to apply the ordinary tests of partnership in order to ascertain whether the income is derived by one person or by two or more persons jointly.'⁹⁷

The fact that participants hold their interest in the property of the venture as tenants in common does not prevent a finding that the venture is a tax partnership. In *Yeung v FCT*,⁹⁸ a husband and wife in their own names and in the names of their four young children as tenants in common used several properties to derive rental income. The Federal Court held that it was sufficient for the existence of a partnership as defined in s. 6(1) of the ITAA 36 that the properties were owned by the six members of the family as tenants in common, that the leases were in the names of the six and, therefore, that the rents were derived by the six, although in the years in question none of the children had a one-sixth or any other beneficial interest in the net income of the partnership.

Absence of written agreement

The absence of a written agreement between participants of an unincorporated joint venture does not preclude the existence of a partnership. Arguably, very few if any of the joint ventures under consideration in this thesis would operate on the basis of an oral agreement only. In *Jolley v FCT*,⁹⁹ the Full Federal Court did not determine whether a partnership existed between the taxpayer and his wife but held that the AAT had erred in law in failing to

⁹⁷ Ibid, 14.

⁹⁸ (1988) 19 ATR 1006.

⁹⁹ (1989) 20 ATR 335; 86 ALR 297; 17 ALD 643; 89 ATC 4197; appld *A B v FCT* (1998) 157 ALR 510; 98 ATC 5100; 40 ATR 65; *AAT Case 6812*; *AAT Case Y18* (1991) 22 ATR 3116; 91 ATC 230. Refer Hill (1995).

assess oral evidence that the taxpayer and his wife had discussed the formation of a partnership and had agreed to carry on a business in partnership. Accordingly, the case was remitted to the tribunal for determination according to law. Subsequently the AAT held that a partnership existed within the meaning of s. 6(1) of the ITAA 36.¹⁰⁰

In *ARM Constructions*,¹⁰¹ the Commissioner treated the two parties as a partnership and increased their assessable incomes in the relevant years of income by their share of net income from the projects. The court held that until such time as a deed of partition had been entered into between the parties, in relation to property which was situated at one location a tax partnership had existed between the parties for their rental property income. However, since that time and for the duration of the venture in relation to the properties situated at the other location, the parties were participants in an unincorporated joint venture and no tax partnership existed. Yeldham J said that 'the parties associated together to produce a product, a building of units capable of partition between them, so that each could thereafter go their own respective ways. Their expressed intention so to do was duly manifested in what they thereafter did and achieved, and their agreement constituted in law something in the nature of a joint venture to construct a building, in contrast to an agreement to make profits for sharing, *inter se*.'¹⁰²

Characterisation risk under the Ralph proposals

The extent and significance of characterisation risk for unincorporated joint ventures must also be examined in light of the Ralph Committee's proposals for unincorporated joint ventures. It is argued that—in their current form—the Committee's proposals do not reduce the extent and significance of characterisation risk for unincorporated joint ventures but add to it.

The Committee has recommended that unincorporated joint ventures have the option to apply a 'joint' approach to some or all of their transactions and assets in calculating members' shares of the taxable income or loss of the joint venture and gains or losses on the disposal of

¹⁰⁰ AAT Case 5705 (1990) 21 ATR 3253.

¹⁰¹ *ARM Constructions Pty Limited v FCT* (1987) 19 ATR 337; 87 ATC 4790. See also *Determination TD 92/161 - Land Acquired Before 20 September 1985*.

¹⁰² *Ibid*, 354.

interests in the joint venture.¹⁰³ The Committee also proposes that further consultation on design issues accompany implementation of these recommendations for the 2001-02 year of income.¹⁰⁴ At this stage, the government has not responded to this.

The 'joint' approach is significant for participants in two respects. First, for the Ralph Committee to describe a participant as a 'member' of a joint venture is inconsistent with the definition of a 'member' in *A Tax System Redesigned*. For the purposes of *A Tax System Redesigned*, a member includes 'people with an interest in either the income or capital of an entity, and objects of discretionary trusts.'¹⁰⁵ In turn, an 'entity' is defined to mean any taxpayer.¹⁰⁶ But unincorporated joint ventures are not taxpayers.¹⁰⁷ Even if it was argued that because *A Tax System Redesigned* does not expressly exclude unincorporated joint ventures from the definition of 'member', they impliedly fall within the definition, the problem would be that the interpreter of *A Tax System Redesigned* would be making an assumption and there is no reason for making such an assumption.

Secondly, it is unclear whether unincorporated joint ventures will be taxed like partnerships if participants adopt the 'joint' approach. The risk to participants from applying the joint approach in relation to calculating participants' shares of the taxable income or disposing of interests in a joint venture, is that they could be taxed as partners in a tax partnership pursuant to s. 6(1) of the ITAA 97. That is, characterisation risk could exist. If participants, by reason of the joint receipt of income, are in a tax partnership, then they cannot rely on the general principles of partnership to assert a division of profits or losses that would otherwise be available to them as participants of an unincorporated joint venture. For example, in the Federal Court case of *FCT v McDonald*,¹⁰⁸ the taxpayer claimed a deduction for the whole of the loss incurred in connection with a property business. Prior to the commencement of the business, the taxpayer and his wife had signed a record of discussion recording their intention

¹⁰³ Id.

¹⁰⁴ Id.

¹⁰⁵ Ibid, 790. [Emphasis added]

¹⁰⁶ Ibid, 783. [Emphasis added]

¹⁰⁷ Tang (1999), 6; *Ruling* TR 94/14, para. 459.

¹⁰⁸ (1987) 15 FCR 172.

to invest in the property business on terms which included that the property would be held by them as joint tenants, that any net profits would be divided as to three-quarters to the wife and the remainder to the husband and that the husband would bear all losses. The Commissioner allowed only half the amount of the loss claimed by the taxpayer. The Administrative Appeals Tribunal (AAT) upheld the taxpayer's objection. The Federal Court upheld the Commissioner's appeal finding that the taxpayer and his wife were partners for the purposes of the ITAA 36 by virtue of the joint receipt of income derived from property which they jointly owned but that no general law partnership subsisted between the taxpayer and his wife. Accordingly it did not follow from their 'notional' partnership that the taxpayer was entitled to deduct the whole of the loss incurred.

Absence of clarity as to how unincorporated joint ventures will be taxed could increase the costs for participants in meeting the requirements laid on them in complying with tax laws. For a participant, this might include the cost of collecting, remitting and accounting for tax together with the costs of acquiring the knowledge to enable this work to be done (eg tax lawyer's fees), including knowledge of their legal obligations and penalties for non-compliance.

Since compliance costs are incurred by participants whenever changes are made to the tax system which affect them,¹⁰⁹ it is important for Parliament (if it accepts the joint approach), to get things right first time, or as near right as is reasonably possible. The greater the number of amendments to the tax system, the higher compliance costs will be. Parliament is more likely to get the law right first time if the Committee has got it right. The Committee is more likely to get the design of the joint approach right if it looks closely at what other tax jurisdictions have done (ie, what other tax jurisdictions have got right and wrong) and to consult with and obtain the input of interested taxpayers. It is imperative that the compliance cost implications of tax legislative changes are brought to the attention of Parliament at the time that the change is considered. Indeed, it will not be possible for Parliament to consider legislative amendments without that analysis having been undertaken.

For example, in the United States, most joint ventures fall within the definition of a

¹⁰⁹ Evans, *A Report into Taxpayer Costs of Compliance*, (1997), 29-34. As well, Warburton Committee, *The Tax Value Method, Discussion Paper* (2000), para. 6.2 says: 'The implementation of the Government's tax reforms will place a high compliance cost burden on the accounting profession and business taxpayers over the next couple of years'.

partnership, but participants can elect for the partnership provisions not to apply to them. To date, the Committee has not stated that participants of unincorporated joint ventures can elect out of the partnership provisions where, by adopting the joint approach, the partnership provisions would ordinarily apply. If the Committee proposes an election system that is not complex, uncertain or too costly to apply, then the system has more chance of improving on the current situation.

A comparative note - the United States elective system

The common law in the United States recognises a separate legal concept of joint venture,¹¹⁰ but its nature differs from the concept of unincorporated joint venture as it is understood in Australia. The principal distinction between partnership and a joint venture under United States law appears to be that while:

a copartnership is ordinarily formed for the transaction of a general business of a particular kind, a joint venture is usually, but not necessarily, limited to a single transaction.¹¹¹

The sharing of profits and losses is a key requirement of the U.S. joint venture:¹¹²

[t]he right to share in profits is an indispensable characteristic of the joint adventure just as in partnership.¹¹³

While a joint adventure may be distinguished from a partnership, nevertheless they are both so much alike that it is very difficult to differentiate them, and to establish either it is necessary to do more than show that the persons said to be so associated are to share in the profits of a transaction.¹¹⁴

¹¹⁰ See *State; Ex re! Crane Co of Minnesota v Stokke*, 272 NW 811 (1937), 817; *Meinhard v Salmon*, 164 NE 545 (1928); *Mendelsohn v Leather Manufacturing Corporation*, 93 NE 2d 537 (1949); *Sample v Romine*, 8 So 2d 257 (1942) (SC Miss); *Chapman v Dwyer*, 40 F 2d 468 (1930); *Kasishke v Baker*, 146 F 2d 113 (1944). Discussed in Merralls (1988), 907; Ryan (1982), 108-12.

¹¹¹ *Denny v Guyton* (1931) 327 40 SW (2d) 562, 570 per Atwood J.

¹¹² *Detachable Bit Co v Timken Roller Bearing Co*, 133 F 2d 632 (1943); *Kahn v Massler*, 140 F Supp 629 (1956); *Estrella v Suarez*, 134 P 2d 167 (1943); *Quinn v Recreation Park Association*, 46 P 2d 144 (1935); *Bank of Cedar Bluffs v Le Grand*, 254 NW 892 (1934); *Atlas Realty Co v Galt* (1927) 153 Md. 586; *Mitler v Friedeberg*, 222 NYS 2d 480 (1961); *Reynolds v Searle*, 174 NYS 137 (1919), 138, per Lambert J.

¹¹³ Menwick (1936), 300.

¹¹⁴ *Atlas Realty Co v Galt* (1927) 153 Md. 586, 590. See also *Johnson v Lion Oil Co* (1950) 227 S.W.2d 162; Robberson (1968), 339; Robberson and Van Bebber (1972), 428-9.

The incidents of a joint venture under U.S. law closely resemble those of partnership.¹¹⁵ The joint exploration and production of oil and gas is frequently conducted pursuant to a joint operating agreement (a JOA). It is the vehicle which is created in the U.S. pursuant to a JOA which is most analogous to the unincorporated joint venture under Australian law:

[t]he joint exploration and production of oil and gas in the United States is also frequently conducted through a form of unincorporated business association. Generally speaking, this association is not a 'partnership' under State law, nor is it classified as a 'joint venture', which in some States (including Texas) is defined as a partnership for a particular purpose. Rather, exploration is conducted pursuant to a Joint Exploration Agreement under which the parties agree to acquire *undivided interests as co-tenants* in oil and gas leases in specified areas and to share the costs and expenses of conducting seismic and geological work, drilling the initial test well for a prospect or prospects with such lease acreage and conducting other exploratory activities. The Joint Exploration Agreement typically provides that one participant shall conduct exploratory drilling operations on behalf of all participants in the program with respect to the initial test well on each prospect. If such initial test well and any future wells, is generally governed by the terms of a Joint Operating Agreement (the form of which is sometimes incorporated into the Joint Exploration Agreement), under which one of the participants is designated as the operator on behalf of all participants.¹¹⁶ [emphasis added]

For federal income tax purposes, the term 'partnership' includes 'a syndicate, group, pool, joint venture, or other unincorporated organisation, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of [the tax laws], a trust or estate or a corporation ...'.¹¹⁷ Therefore, if parties intend to share profits from the business venture, the venture will likely be characterised as a partnership for federal income tax purposes; that is, there is less uncertainty about assessing characterisation

¹¹⁵ Participants owe fiduciary obligations to each other in the same way as partners: *Meinhard v Salmon*, 164 NE 545 (1928). Participants can bind each other in contract as can partners: *Goerig v Continental Casualty Co*, 167 F 2d 930 (1948); *Rae v Cameron*, 114 P 2d 1060 (1941); *Wiley N Jackson Co v Norfolk*, 87 SE 2d 781 (1955); cf *Keyes v Nims*, 184 P 695 (1919) (SC Calif). Participants may be liable in tort for the actions of one of them: *Shell Oil Co v Prestidge*, 249 F 2d 413 (1957); Rowley, *Rowley on Partnership: Including a Full Consideration of Joint Adventures*, (1960), 543. U.S. courts maintain, however, that the relationship between participants differs from that between partners: *Rae v Cameron*, 114 P 2d 1060 (1941).

¹¹⁶ Barrett (1981), 319.

¹¹⁷ Section 761(a) Internal Revenue Code.

risk in the United States than in Australia.¹¹⁸

For U.S. tax purposes, a partnership is treated as a flow-through entity. Tax on the income of the partnership is assessed not at the level of the partnership, but at the level of the partners, and the income retains the characteristics (eg income from a business, interest, dividends etc.) that it has in the hands of the partnership.¹¹⁹ However, the partnership is a tax-reporting entity that must file an annual partnership return. To be classified as a partnership, a business entity must possess no more than two of the following four corporate characteristics: continuity of life, centralisation of management, limited liability and free transferability of interest.¹²⁰

The typical oil and gas working interest owner or joint venture is a member of a partnership although the owner may account for income and expenses separately. Section 761(a) of the *Internal Revenue Code* and IT Regs. 1.761-2(a)(3) permit participants in the joint production, extraction, or use of property to be excluded from the partnership code sections in Subchapter K, by virtue of the Check-the-Box entity classification regime.¹²¹

On 18 December 1996, the Internal Revenue Service (Service) published the 'check-the-box' entity classification regulations¹²² which became effective 1 January 1997.¹²³ The check-the-box regulations replaced the traditional Kintner regulations,¹²⁴ which spanned four decades of confusion, inconsistencies, and frustration, with the 'corporate resemblances' methodology,

¹¹⁸ IT Reg. 1.761-1(a) and 301.7701-3(a).

¹¹⁹ See Subchapter K, and particularly s. 701, Internal Revenue Code. See also Carson (1998), 33.

¹²⁰ Reg. 301.7701-2(a).

¹²¹ For a comprehensive discussion of the operation of Subchapter K, see Melone (1998).

¹²² The Internal Revenue Code prescribes certain categories into which various organisations fall for purposes of taxation in Treas. Reg. s. 301.7701-1(b) (as amended by 61 Fed. Reg. 66,584 (1996)). These categories, or classes, include associations (which are taxable as corporations), partnerships, and trusts. The tests, or standards, which are to be applied in determining the classification in which an organisation belongs (whether it is an association, a partnership, a trust, or other taxable entity) are determined under the Internal Revenue Code. Sections 301.7701-2 to 4 of the Treasury Regulations set forth these tests, or standards, which are to be applied in determining whether an organization is (1) an association (see s. 301.7701-2), (2) a partnership (see s. 301.7701-3), or (3) a trust (see s. 301.7701-4).

¹²³ Treas. Reg. s. 301.7701 (as amended by 61 Fed. Reg. 66,584 (1996)).

¹²⁴ The decision in *United States v Kintner*, 216 F.2d 418 (9th Cir. 1954), resulted in the promulgation of the four-factor corporate resemblance test: (1) continuity of life, (2) centralisation of management, (3) limited liability, and (4) free transferability of interest.

which allows unincorporated business entities to freely elect to be a corporation or a partnership for federal tax purposes.¹²⁵ The new regulations allow eligible entities to elect their classification status for federal tax purposes, unless the entity is identified as a per se corporation.¹²⁶

The check-the-box sections have been described as complex and uncertain.¹²⁷ This election is made by attaching a statement to a partnership return and can be made in any year in the life of a partnership. However, until the election is made, a partnership return must be filed and the joint venture will be subject to the partnership provisions in the Code.¹²⁸

The introduction of an appropriate election system under Australian law as part of the joint approach would, provided it was introduced by a comprehensive education and training program, either reduce or eliminate characterisation risk in respect of tax partnerships and compliance costs on participants arising therefrom would reduce or disappear also. However, to fully eliminate characterisation risk, the election system would also need to apply to general law partnerships.

Main tax features of the unincorporated joint venture

Now that the basic nature of an unincorporated joint venture is understood and how it differs from a partnership, the main tax features of an unincorporated joint venture will be outlined. There are two reasons for doing this. First, by doing the same for unit trust joint ventures and equity joint ventures, a comparison of the tax features of each joint venture structure can be readily made and secondly, it will assist in an analysis of whether the tax reform measures will alter the current position. For the reasons stated in this section of the chapter, the author

¹²⁵ Treas. Reg. s. 301.7701-2(a), -(3)(a).

¹²⁶ Treas. Reg. s. 301.7701-2 (as amended by 61 Fed. Reg. 66,584 (1996)) defines "corporations," for federal tax purposes, to include corporations denominated as such under applicable law, as well as associations, joint-stock companies, insurance companies, organisations that conduct certain banking activities, organisations wholly-owned by a state, organisations that are taxable as corporations under provisions of the Code other than s. 7701(a)(3), and certain organisations formed under the laws of a foreign jurisdiction.

¹²⁷ Bybee and Laurence (1998), 3.

¹²⁸ Oil and Gas Handbook (1999), Internal Revenue Manual, 'Handbook 4.4.1 Oil and Gas Industry Handbook - Chapter 5 Types of Organisations', 4 July 1999, www.irs.ustreas.gov/prod/bus_info/tax_pro/irm-part-new/section/35075.html, [5.3.1]; Turner (1996), 315.

considers that the main advantages of an unincorporated joint venture are its flow-through capability, participants' flexibility to make their own elections and to establish and administer separate accounting systems, participants' ability to separately claim deductions and the flexibility in financing. The disadvantage is the extent and significance of characterisation risk.

Flow-through capability

Presently, Australian tax laws do not treat unincorporated joint ventures as taxpayers in their own right.¹²⁹ The Committee has not explicitly recommended that an unincorporated joint venture be treated as a separate taxpayer, although the author's concerns about the proposed joint approach are noted.¹³⁰ The draft legislation prepared by the Committee does not contemplate the entry of unincorporated joint ventures into the entity regime.¹³¹ It is therefore a flow-through vehicle for taxation purposes. It neither derives assessable income nor claims allowable deductions. It does not pay tax at the applicable corporate tax rate on any resultant taxable income (less any applicable rebates) on its own account.¹³² A properly constituted unincorporated joint venture is not a tax reporting entity under the ITAA 97.¹³³ It does not enjoy the protection of limited liability and lacks the right to sue and be sued in its own name.

Any tax payable on assessable income generated through the conduct of the unincorporated joint venture is therefore taxable to each participant individually based on the sales they make (individually) less their proportionate share of common expenses.¹³⁴ The Committee supports the continuation of this approach.¹³⁵ Therefore, each participant includes in its own income tax return the assessable income derived from the sale of its share of joint venture product and claims allowable deductions for its proportionate share of costs incurred by the operator.

¹²⁹ Tang (1999), 6; *Ruling* TR 94/14, para. 459.

¹³⁰ See also *A Tax System Redesigned*, 551.

¹³¹ Notice that the definition of a 'tax entity' in section 150-15 of draft *A New Tax System (Income Tax Assessment) Bill 1999* (Cth) does not refer to unincorporated joint ventures.

¹³² Cf SPVs of equity joint ventures: Tang (1999), 1.

¹³³ Davies (1983), 6, 8 acknowledges the point but in relation to the ITAA 36; Burrell and Caradus (1997), 186.

¹³⁴ Tang (1999), 7.

Flexibility to make elections

By making appropriate elections under the ITAA 97, each participant has flexibility to maximise the cash flows from the undertaking. Participants are free to make elections for income tax purposes in line with their own internal tax policies.¹³⁶ This flexibility can be particularly attractive to participants who are required to follow the tax policy of the parent company.¹³⁷ By way of illustration, a participant in receipt of assessable income derived from joint venture activities and with other mining income, may currently elect to claim the full deduction on expenditure available under Div 330 of the ITAA 97 in the year it is incurred, whilst another participant with *no* other mining income may elect to claim a deduction by way of depreciation over that period under the general depreciation provisions of the ITAA 97.¹³⁸ However, the reform of the capital allowance provisions of the ITAA 97 will reduce the degree of significance that participants attach to this feature.

Separate accounting

There is no joint accounting in unincorporated joint ventures. Each participant's accounts are kept separately so that individual participants can adopt their own accounting procedures in relation to costs (eg depreciation, write-offs etc) and revenues.¹³⁹ Therefore, the total costs of an item of joint venture equipment can potentially be treated in several different ways in the income tax returns of each participant. This is because each participant has proprietary rights in the assets of the venture as a tenant in common.¹⁴⁰ For example, if the joint venture between U.S. Duke Energy and Australian electricity distributor—Energy Australia—is probably characterised as an unincorporated joint venture,¹⁴¹ then Duke Energy and Energy Australia could depreciate joint venture equipment in different ways. Reforms to the capital

¹³⁵ *A Tax System Redesigned*, 551.

¹³⁶ Burrell and Caradus (1997), 186.

¹³⁷ *Id.*

¹³⁸ *Id.*

¹³⁹ Burrell and Caradus (1997), 186.

¹⁴⁰ Section 42-15(a) ITAA 97 provides that *owners* of plant and articles are entitled to claim depreciation deductions.

¹⁴¹ J Macleay, 'Gas deal on front-burner', *The Australian*, 23 September 1999, 21.

allowance provisions of the ITAA 97 will alter this position. In a jointly-owned company, the company itself must take all taxation actions or elections. This may not be to the immediate or maximum advantage of all of the shareholders.¹⁴²

Separate deduction claims

Each participant separately claims allowable deductions for its share of expenditure from the venture. This often affords the taxpayer 'significant financial relief.'¹⁴³ If the joint venture were incorporated, then the expenditures of the joint venture company would be generally deductible only from the income of that company.¹⁴⁴ Moreover, since unincorporated joint ventures do not derive any income or capital gains, there is no need to set a dividend policy. Each participant generally receives the full share of (its proceeds of) the product at the time it is earned.¹⁴⁵ Participants may be able to treat their share of tax losses¹⁴⁶ that arise in earlier income years from the joint venture as an allowable deduction against assessable income derived by them severally in the current year of income.¹⁴⁷ Some participants may have other taxpaying entities within the same wholly owned group that could benefit from grouping losses.

Some flexibility in financing

Further, as each participant has an undivided fractional interest in the assets of the JVA and its output, each is able to adopt its own method of financing.¹⁴⁸

¹⁴² Davis, *Unincorporated Joint Ventures*, (1983), 9. The abolition of accelerated depreciation is noted, and will be considered shortly.

¹⁴³ Forbes and Lang, *Australian Mining and Petroleum Laws*, (1987), (n 35), para. 1915.

¹⁴⁴ *Case N 108* (1981) 81 ATC 600; cited in *Case 89* (1985) 85 ATC 138. The exception to this is tolling companies: see chapter 6.

¹⁴⁵ Burrell and Caradus (1997), 186.

¹⁴⁶ The method for calculating a tax loss is prescribed in s. 36-10 ITAA 97. See generally subdivision. 36-A ITAA 97.

¹⁴⁷ Section 36-15 ITAA 97.

¹⁴⁸ *Id.* Chapter 3 is devoted to the revenue law considerations of financing unincorporated joint ventures and equity joint ventures.

Uncertain impact of cash flow/tax value approach

The Ralph Committee has examined ways of aligning taxation law with accounting concepts. The cash flow/tax value approach (also known as Option 2) is to imply a comparison of beginning and end of year balance sheets and will involve adjustments between the profit and loss account and taxable income.¹⁴⁹ The Federal Government has given in-principle support to this methodology.¹⁵⁰ If this reform is enacted, then it will affect all taxpayers.

The need for reform arises because the:

existing law is based on legal concepts of income that have built up over time. Centrally it involves the concepts of ordinary income, statutory income including capital gains and expenses, and losses of either a revenue or capital nature.

As a consequence of the evolution of the existing law, assets may be taxed in a variety of ways depending on the purpose for which they are held. This creates uncertainty and complexity in the law.

To distinguish expenses consumed in a tax year from expenses that essentially involve a conversion from one type of asset to another asset, the existing tax system uses the concept of capital expenditure. The absence of statutory principles has resulted in uncertainty and led to the mischaracterisation of expenses.¹⁵¹

The cash flow/tax value approach is based on the need to achieve a more robust and durable tax system and is driven by the need to improve the structural integrity of the present system, to reduce fiscal complexity and fiscal uncertainty, to provide a basis for ongoing simplification and to align more closely taxation law with accounting principles wherever possible.¹⁵² Ralph proposes abandoning many of the fundamental principles underlying

¹⁴⁹ Ibid, recommendation 4.1.

¹⁵⁰ In the Treasurer's response, *The New Business Tax System: Stage 2 Response*, Press Release no. 74, 11 November 1999, 5, the Treasurer states: 'The Government sees considerable merit in the high level reforms proposed by the Review and has given in principle support to their introduction. However, it recognises the importance of developing a workable system that can be implemented with minimum disruption.'

¹⁵¹ *A Tax System Redesigned*, Overview, 37.

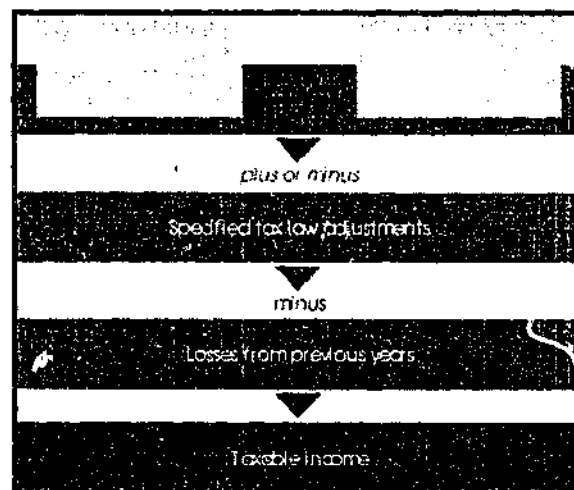
¹⁵² Id. However, F Buffini, 'Black hole open for tax avoidance', *The Australian Financial Review*, 29 October 1999, 16 states that fiscal uncertainty would arise because: 'A deduction would be triggered by a debit bank account with no requirement to match the timing of expenses with income'.

Australia's tax laws, including the capital / income dichotomy.¹⁵³ We saw in chapter 1 that the compliance costs of income tax in Australia for business taxpayers are high. If the cash flow/tax value approach is introduced, then it is clearly desirable to use the change in the tax laws as an opportunity to minimise these compliance costs, subject to other objectives such as safeguarding the revenue and ensuring equity of treatment between taxpayers.

In subsequent chapters, it is argued that some current tax laws are fiscally uncertain and complex for participants when calculating their taxable income¹⁵⁴ and that the cash flow/tax value approach may promote fiscal certainty and reduce fiscal complexity but questions of the potential compliance costs for participants due to the cash flow / tax value approach remain. What follows is an outline of the potential benefits accruing to participants from the introduction of the cash flow/tax value approach.

Under the proposed rules, taxable income will be determined for all taxpayers as shown in Figure 2.2.

Figure 2.2: Calculation of Taxable Income Under the Cash Flow/Tax Value Methodology¹⁵⁵



The cash flow/tax value calculation derives taxable income from receipts less payments plus or minus changes in the tax value of assets and liabilities.¹⁵⁶ It is not a comprehensive

¹⁵³ Cathro (1999).

¹⁵⁴ See, in particular, chapters 4 and 5.

¹⁵⁵ *A Tax System Redesigned*, reproduced from Figure 4.3. See also page 43 of the Explanatory Notes to the draft *New Business Tax System (Integrity and other Measures) Bill 1999* (Cth).

¹⁵⁶ *Ibid*, Overview, 37.

accruals calculation of income. For instance, if assets such as shares are taxed on a realisation basis, the tax value is treated at cost so that when a participant purchases a share, the negative amount arising from the payment for the share is offset by the value of the asset on hand (valued at cost). This position remains until the participant sells the share when the difference between the receipt and tax value (cost or indexed cost) is brought to account as part of taxable income.

Extensive adjustments are then made to the basic calculation for cases where policy produces variations. For example, the 125 percent research and development tax concession which the Ralph Committee recommends be retained would be treated as a payment as to the full amount of the research and development (except for spending on plant or buildings) not offset by any asset plus a further downward adjustment of 25 percent of the payment, giving a total 'deduction' of 125 percent.¹⁵⁷

What is of significance to participants is the detail of what constitutes a receipt, payment, asset or liability and the special rules that apply to various categories of case. Apart from the specific areas covered in subsequent chapters, there is a myriad of changes encompassed within the discussion of the cash flow/tax value approach. To allay fears of the unknown, the Report recommends that the approach reflect current law except so far as specific recommendations require departure from current law.¹⁵⁸ The problem with this type of comfort is the possibility of disagreement about what current law is and whether or not a change has been recommended. Then there is the concern that the temporary costs to taxpayers in acquiring the knowledge about the new rules, and the once-off costs that may be required to make information technology changes to accommodate the new law as well as the recurrent costs of complying with the new approach (both from the perspective of industry and the public sector), may imply that the compliance costs of this approach will be so high that the cash flow/tax value approach is not justified, particularly if all that those new measures do is to substitute one set of complex principles for another set.¹⁵⁹

The Report recommends that a clear reconciliation between tax and accounting principles be

¹⁵⁷ *A Tax System Redesigned*, chapter 4 read with recommendation 8.19.

¹⁵⁸ *A Tax System Redesigned*, 156, where the Ralph Committee stated 'Of itself, it will not imply a broadening of the tax base: variations to the base should occur only by express intention'.

¹⁵⁹ Cathro (1999).

developed and that the justification for differences be carefully considered so that greater convergence can be achieved. The closest that the Report comes to accounting principles is in the proposed definition of asset as 'something that embodies future economic benefits'.¹⁶⁰ The definition of liability, however, does not follow accounting principles being 'a present obligation to provide future economic benefits'.¹⁶¹ The reference to a *present* obligation will have the effect of excluding most provisions in financial accounts.

The consolidation regime will apply at the participant level

The Ralph Committee proposes treating wholly owned groups of Australian resident companies as single taxpayers for Australian taxation purposes. Consolidation will be optional via an irrevocable choice, but to consolidate, a group of entities must have an 'Australian resident head'.¹⁶² An Australian head entity will be 'an Australian resident entity that directly or indirectly owns one or more other entities and which is not itself wholly owned by an Australian resident entity'.¹⁶³ Certain categories of ownership interests (e.g. certain employee share schemes and finance shares) will be disregarded when determining whether a group wholly owns an entity.¹⁶⁴

The consolidation regime will not apply directly to unincorporated joint ventures, because this joint venture structure is not recognised by the ITAA 97 as a taxpayer in its own right or as a tax reporting entity. Unincorporated joint ventures will not be eligible to join the consolidated

¹⁶⁰ A Tax System Redesign, 159; SAC 4, *Definition and Recognition of the Elements of Financial Statements*, (1995), para. 14 defines an 'asset' as 'future economic benefits controlled by the entity as a result of past transactions or other past events' and 'control of an asset' means 'the capacity of the entity to benefit from the asset in the pursuit of the entity's objectives and to deny or regulate the access of others to that benefit'.

¹⁶¹ Id; SAC 4, *Definition and Recognition of the Elements of Financial Statements*, (1995), para. 48 defines 'liabilities' as 'the future sacrifices of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events'.

¹⁶² A Tax System Redesign, recommendation 15.1. See also 2 A Platform for Consultation, para. 26.3. See also Div 168 *Exposure Draft: New Business Tax System (Consolidation) Bill 2000* (Cth).

¹⁶³ Ibid, 778. *Exposure Draft: New Business Tax System (Consolidation) Bill 2000* (Cth), proposes to define a 'head entity' as an Australian corporate tax entity that is not a 100% Australian subsidiary of another Australian corporate tax entity.

¹⁶⁴ Ibid, 518. See also s. 168-90(2) and (3) *Exposure Draft: New Business Tax System (Consolidation) Bill 2000* (Cth).

regime.¹⁶⁵ Therefore, for unincorporated joint ventures, the consolidation regime will only ever operate at the participant level.

The precise form of all these reforms remains unclear, as legislation has not been enacted. The Government released Exposure Draft *New Business Tax System (Consolidation) Bill 2000* (Cth) in 2000. The Treasurer's Press Release states only that the Federal Government:

will implement, with improvements, reforms to achieve a unified entity regime [including]... providing a system of consolidation for groups of companies and trusts, while addressing value shifting.¹⁶⁶

Against this background, the possible implications of the consolidation regime for participants will now be analysed. It is argued that participants which qualify for the consolidation regime and who elect for that regime to apply to them will have greater flexibility under the ITAA 97 than participants who do not, but they may not necessarily save on their tax compliance costs.

Perceived benefits of consolidation

According to the Ralph Committee, consolidation will lower compliance costs and high tax revenue costs (and concomitant complex anti-avoidance provisions) associated with the current tax treatment of corporate groups.¹⁶⁷ The problem with this unsubstantiated statement is that it fails to clearly show the cause and effect relationship between the perceived benefits of consolidation and a reduction in compliance costs for taxpayers. The Ralph Committee has provided no data to support its claims. Moreover, no data is available at this point from the various compliance cost studies that have been conducted in Australia.

To measure whether the consolidation regime will in fact lower compliance costs will involve a comparison between the current costs of complying with applicable tax laws and the costs of complying with the consolidation regime. In respect to the latter, the measurement of commencement costs and regular costs of complying will be relevant. The measurement of commencement compliance costs must take account of the fact that the introduction of the consolidation regime will involve initial costs for taxpayers in learning and training, whilst

¹⁶⁵ Ibid, chapter 15. Section 168-65(1) *Exposure Draft: New Business Tax System (Consolidation) Bill 2000* (Cth), states that the consolidation regime only applies to 'consolidatable groups'.

¹⁶⁶ Treasurer, *The New Business Tax System*, Press Release no. 58, 21 September 1999.

¹⁶⁷ *A Tax System Redesigned*, 517.

most taxes, once in place, involve only regular costs. It is true to say that for unincorporated joint ventures, these costs will be incurred at the level of the participant. It would be surprising, however, if participants would benefit from any substantial reduction in recurrent costs because, absent a change in accounting principles, they must still account for all transactions to properly record the financial position of the company at year end. At any rate, given the size and complexity of the activities of many of the taxpayers who use joint ventures as a business structure, measurement of this would be a difficult task.

To illustrate, take the case of taxpayer A—the parent of four wholly owned subsidiaries, each of which is a participant in a petroleum unincorporated joint venture, a company group with significant intra group transactions. Presently, each of these taxpayers would incur costs of collecting, remitting and accounting for income tax together with maintaining the knowledge to enable this work to be done, including the knowledge of the legal obligations and penalties. In a consolidated group context, the company group would be treated as a single taxpayer and intra group transactions would be ignored for tax purposes. By ignoring intra group transactions for tax purposes, the Committee says that complexity will reduce and flexibility will increase.¹⁶⁸ It is difficult to accept that any sizable reduction in compliance costs will flow from ignoring intra-group transactions. Taxpayer A would surely continue to incur costs in recording and accounting for intra-group transactions.

Consequences of consolidated group regime

On enactment of consolidation, current grouping provisions will be repealed because 'the availability of a consolidated taxation regime removes the need to retain the grouping provisions'.¹⁶⁹ The exception is for group rollovers of assets between non-resident entities or between a non-resident entity and the head entity of a consolidated group.

Losses will be brought into a consolidated group but the group will be able to choose the rate at which it uses up losses (to prevent problems with intercorporate dividends).¹⁷⁰ Retention of

¹⁶⁸ Ibid, 518.

¹⁶⁹ Ibid, para. 26.69. *Exposure Draft: New Business Tax System (Consolidation) Bill 2000* (Cth) proposes repealing Subdiv 170-A ITAA 1997 (transfer of tax losses within a wholly-owned group); Subdiv 170-B (transfer of net capital losses within a wholly-owned group); and Subdiv 170-C (provisions which apply to transfers under Subdivisions 170-A and 170-B).

¹⁷⁰ Broadly, s. 168-550 *Exposure Draft: New Business Tax System (Consolidation) Bill 2000* (Cth) proposes that a loss may only be transferred to the head entity of a consolidated group if the loss could

the same business test will require several special rules for losses entering the consolidated group.¹⁷¹ Losses will remain in the group on exit of the member that brought them in.¹⁷²

Franking account balances will be brought into the consolidated group by its members and retained there when a member exists the group. Transactions within consolidated groups will be ignored for tax purposes.¹⁷³ For example, if participant A and participant B—both wholly owned subsidiaries of the same Australian head entity—have entered into an unincorporated joint venture, and participant A pays participant B to acquire participant B's share of product obtained from the undertaking, that payment would not be deductible and the payment would not be assessable to participant B for income tax purposes.¹⁷⁴

If assets (including equity in group members) of a participant who has elected for the consolidation regime to apply are disposed of outside the group, the asset based model will be used to determine the cost base on sale.¹⁷⁵ This model aligns the cost of equity and assets on entering consolidation. The alternative entity based model will be available on a short term basis for groups that elect to consolidate before 1 July 2002.¹⁷⁶

Members would lose their separate income tax identity on entry into the consolidated group and regain it on exit. Further, the proposed regime could result in a loss of entitlement for a participant to claim allowable deductions and excessive tax applied to a profit stream because franking account credits would not accompany an entity's exit from the consolidated group.

Clearly, taxpayers involved in unincorporated joint ventures would be affected by these

have been used outside the group by the entity seeking to transfer it (the joining entity). That is, if the joining entity could have deducted or applied the loss in the period immediately before transfer assuming it had sufficient income or gains of the relevant kind. Losses are tested for this purpose at the time the joining entity becomes a member of a group (the joining time).

¹⁷¹ *A Tax System Redesigned*, 523-524.

¹⁷² *Id.*

¹⁷³ *Ibid*, 518.

¹⁷⁴ *2 A Platform for Consultation*, para. 26.41. However, to the extent that quarantining provisions currently apply (eg. quarantining of foreign losses), those provisions would also apply in the consolidated group: para. 26.42.

¹⁷⁵ *A Tax System Redesigned*, 527-528.

¹⁷⁶ *Ibid*, 527.

reforms to some extent. Participants owning interests in pre-capital gains assets would be keen to preserve the pre-capital gains status of their assets. The Committee proposes that the existing majority underlying ownership rules would apply to a consolidated group so that any pre-capital gains assets held in the group would lose their exempt status if there were a 'substantial change in the majority underlying ownership of the group'.¹⁷⁷ This would create a similar compliance burden for participants who have to incur expenditure on ss. 149-30 and 104-230 issues.

Australia's tax laws incorporate capital gains tax value shifting rules relating to both assets and shares. There are two generic types of capital gains tax value shifting: at a direct (asset) level and at an indirect (interest in participant) level.¹⁷⁸ Value shifting at an asset level is where the value of an asset—which can include an interest in a participant—is directly altered otherwise than by a change in participant value (eg share value shifting caused by a change in share rights, or an alteration in the rights attaching to trust interests).¹⁷⁹ Value shifting out of, or between, participants is said to impact on the value of interests held directly (or indirectly) in them. 'Interests' for these purposes include equity interests (shares and other equity interests in companies, and units and other interests in trusts) and debt interests as well as direct and indirect interests in participants.¹⁸⁰ Rather than focussing on value shifting as a structural CGT problem requiring a systematic solution, 'existing responses to CGT value shifting have focused on the tax avoidance effect of particular value shifting transactions'.¹⁸¹

Abolition of accelerated depreciation

Will the abolition of accelerated depreciation promote the use of unincorporated joint ventures or not? The abolition of accelerated depreciation will be unlikely to promote the use of unincorporated joint ventures.

¹⁷⁷ 2 *A Platform for Consultation*, para. 26.63.

¹⁷⁸ *Ibid*, para. 29.4-29.8.

¹⁷⁹ *Ibid*, 29.4.

¹⁸⁰ *Ibid*, para. 29.9.

¹⁸¹ *Ibid*, para. 29.12.

The Ralph Committee recommended that the entity tax rate be reduced to 34 percent in the 2000-01 year of income, and 30 percent thereafter. This rate will apply to all companies, co-operatives, limited partnerships, and other entities currently taxed as companies, and also to trusts proposed to fall into the corporate tax regime.¹⁸² To meet the 'revenue neutrality' restriction placed on the Committee, the Committee also recommended the removal of the accelerated depreciation system.¹⁸³ The Australian Federal Government has accepted the reduction in the company tax rate, to be funded in part by moving to effective life depreciation by removing balancing charge rollover relief.¹⁸⁴

The new system is based on one that calculates the rate of depreciation based on the effective lifetime of the business asset.¹⁸⁵ It will apply to plant and equipment assets covered by Div 42 of the ITAA 97 except for assets acquired or commenced to be constructed before the time of effect (11:45am AEST 21 September 1999).¹⁸⁶ The carve-out for assets acquired or commenced to be constructed before 21 September 1999 is significant in four respects. First, participants acquiring or commencing to construct assets in which they hold an interest on or after 22 September 1999 can only depreciate those assets on an effective life basis. Secondly, participants who have acquired or commenced to construct assets before 21 September 1999 will be unaffected by the change, but only to the extent that an asset in which they hold an interest was acquired or commenced to be constructed before 21 September 1999. Thirdly, if a participant sells its interest in an asset acquired or commenced to be constructed before 21 September 1999 after that date, the purchaser will only be entitled to depreciate the asset on an effective life basis. Fourthly, if a participant chooses to dispose of its shares in the company (rather than its interest in the underlying assets) holding an interest in assets acquired or commenced to be constructed before 21 September 1999, then the purchaser will be entitled to

¹⁸² *A Tax System Redesigned*, Overview, paras. 89-93. For the convenience of discussion, it is assumed that *participants* and *SPVs* are Australian resident corporations.

¹⁸³ *Ibid*, recommendation 8.1.

¹⁸⁴ Treasurer, *The New Business Tax System*, Press Release no. 58, 21 September 1999; Cooper (1999), 233; Barton (1999), 249.

¹⁸⁵ It is noted that this will not apply to small businesses with three-year average turnovers of less than \$1 million per annum, who have in effect been granted accelerated depreciation in advance. This thesis is not concerned with small businesses.

¹⁸⁶ *Inquiry into Business Taxation Reform*, 33. Taxpayers will be able to reassess the effective life of their assets, having regard to changing market or technology developments.

depreciate those assets on an accelerated basis. The author considers that the different tax treatment afforded to direct sales of assets and indirect sales of assets will promote share sales and reduce the incidence of asset sales.

The term 'accelerated depreciation' describes the situation where the cost of an asset is deducted over a shorter period than its effective life. Accelerated depreciation is the allowance of deductions for declines in the value of an asset at higher rates than are expected to occur than if effective rates are used. Accelerated depreciation did not increase the nominal entitlement of participants to taxation depreciation over the life of an asset; it brought forward deductions. The consequence was one of tax deferral during the early years of an asset's useful life and of increased tax in the later years.¹⁸⁷

Sectoral effects

Industries that have traditionally relied on the use of unincorporated joint ventures are most affected by this reform. In after-tax terms, accelerated depreciation increased the net present value of an investment, or its rate of return above what it would be in the absence of accelerated depreciation.¹⁸⁸ Therefore, the abolition of accelerated depreciation decreases the net present value of an investment. However, this will be partially offset by a reduction in the company tax rate. It could influence an assessment about the choice of optimum joint venture structure.

It is well known that capital intensive industries, such as mining, petroleum and manufacturing benefited the most from accelerated depreciation. These industries have therefore lost the most from its abolition. Their *loss* can be measured in terms of the negative effect on the net present value of an investment (see illustration below). It is arguable that the abolition of accelerated depreciation will cause a diversion of scarce resources away from industries which have traditionally relied on unincorporated joint ventures as a preferred business structure; that is, away from capital intensive industries particularly in the case of foreign-owned companies, towards investments in industries not affected or affected less by

¹⁸⁷ Current Issues Brief 9, *Proposed Reforms to Business Taxation: A Critical Assessment of Some Budgetary and Sectoral Impacts*, (1999-2000), 20.

¹⁸⁸ *Ibid*, 21.

the reform.¹⁸⁹ The Ralph Committee recognised this when it stated that:

there is a possibility that if accelerated depreciation were not available, or it was made less generous in regard to long-life assets, *significant prospective investments may be located in other countries* in preference to Australia.¹⁹⁰ [emphasis added]

The removal of accelerated depreciation is a 'genuine penalty for companies with depreciating assets'.¹⁹¹ Participants of unincorporated joint ventures operating gas fields have large investments in depreciating assets.¹⁹² It is difficult to accept that the abolition of accelerated depreciation will achieve the objective of revenue neutrality over the longer term:

[i]n the absence of growth in the investment base, removing accelerated depreciation would yield only a temporary gain to revenue, though the peak in revenue would be around five years from the time of implementation of the effective life regime and the subsequent decline in revenue only gradual. In contrast, underlying growth in the nominal value of investment in plant and equipment averaging around six per cent per year is sufficient to prevent the revenue profile from declining significantly over the medium to long term.¹⁹³

A commentator has stated that the abolition of accelerated depreciation:

has the effect of bringing forward tax collections without increasing the overall revenue proceeds over the life of the particular asset subject to depreciation. *Hence the revenue gain from the abolition of accelerated depreciation will gradually fall to zero.* In 20 years time there will be no increased revenue. This is because the maximum assumed life of an asset for depreciation purposes is 40 years in the case of rental and office buildings. Hence these would be still getting the last benefits of accelerated depreciation in 20 years time in the absence of the planned

¹⁸⁹ For example, in S Lewis, 'Ralph Plan will reduce investment in Australia', *The Australian Financial Review*, 13-14 November 1999, 3, quoted Professor Peter Dixon from the Centre of Policy Studies at Monash University stated: 'Plans to reduce the company tax rate and abolish accelerated depreciation for major projects would "reduce the attractiveness of investments in Australia"'.

¹⁹⁰ 1 *A Platform for Consultation*, para. 2.19.

¹⁹¹ Current Issues Brief 9, *Proposed Reforms to Business Taxation: A Critical Assessment of Some Budgetary and Sectoral Impacts*, (1999-2000), 18.

¹⁹² For instance, the North West Shelf natural gas project alone generates more than \$3 billion annually in export income for Australia, requires \$300 million in maintenance and supports some 60,000 jobs: Prospect (1999), 23.

¹⁹³ *A Tax System Redesigned*, 703.

measure.¹⁹⁴ [emphasis added]

Effects on major projects

Accelerated depreciation has provided significant benefits to capital intensive industries such as mining, petroleum and manufacturing and it is possible that some projects may not proceed without it:

[i]t would be more efficient to subsidise directly projects of major national significance, if such projects would not otherwise proceed, as a budget expenditure than to maintain accelerated depreciation generally – at the cost of forgoing a lower company tax rate.¹⁹⁵

To illustrate the issues involved, the Papua New Guinea—Queensland gas pipeline is threatened by the proposed business tax changes, and in particular the abolition of accelerated depreciation. The consortium behind the PNG—Queensland gas pipeline—Australia's biggest eastern seaboard project since the Snowy River scheme – has described the reform as follows:

AGL, chosen along with Malaysia's Petronas by project operator Chevron to build and operate the pipeline, wants out of the federal government's new lower business tax regime, claiming that without the accelerated depreciation of the old tax system the \$1.5bn pipeline and its \$4bn in spin-off industry development could be in jeopardy.¹⁹⁶

The key problem for this project is reportedly the 6 percent price rise to customers caused by the reduction in the corporate tax rate after the removal of accelerated depreciation has been taken into account.¹⁹⁷

The North-West Shelf liquid natural gas project—one of Australia's major export industries—could also lose its competitive edge to potential Alaskan gas producers because of business

¹⁹⁴ Current Issues Brief 9, *Proposed Reforms to Business Taxation: A Critical Assessment of Some Budgetary and Sectoral Impacts*, (1999-2000), 21. Of course, these benefits would be countered by the declining value of money over the period.

¹⁹⁵ *A Tax System Redesigned*, 306.

¹⁹⁶ Brenchley (1999), 55.

¹⁹⁷ Id; see also S Strutt, 'Qld pipeline project in doubt', *The Australian Financial Review*, 26 November 1999, 61, which reports The Honourable Mr P Beattie (Queensland's Premier) as having said 'I am concerned about the removal of accelerated depreciation because that will make major projects, like the PNG gas pipeline, more difficult'.

tax changes.¹⁹⁸ The Federal Government recognises this by promising that major long-life projects may be considered under an expanded strategic investment process, but no details have emerged.¹⁹⁹

Capital allowances

The capital allowance tax laws are complex because there are detailed sets of provisions to deal with the treatment of over thirty-seven types of capital expenditure. The pre-21 September 1999 scheme was introduced in 1992 in an era of high inflation.²⁰⁰ From 1 July 2001 the uniform capital allowance provisions recommended by the Ralph Committee will be implemented.²⁰¹ This will simplify the capital allowance tax laws for participants by reducing the current thirty seven regimes so far as possible down to one regime. Capital allowances will be available to the participant who incurs the expense, not necessarily the legal owner, but the tax benefits of leasing will largely be preserved.²⁰² Cost will be determined on full absorption cost principles, but this will exclude finance charges.²⁰³ Allowances will be based on effective life in accordance with revised tables to be produced by the Australian Taxation Office (ATO) or self assessed by the taxpayer (including reassessment over time). The Federal Government has accepted this for plant and equipment, effective 21 September 1999.²⁰⁴ Straight line or declining balance depreciation will remain as options but for a broader class of assets including buildings, mining and intellectual property, which will generally be subject to the new wasting assets regime.

Pooling and the declining balance method, which automatically goes with pooling, will apply

¹⁹⁸ Nick Hordern and Dow Jones, 'Tax changes hit shelf companies', *The Australian Financial Review*, 11 December 1999, 6.

¹⁹⁹ Treasurer, *The New Business Tax System*, 'Benefits of Tax Reform for the Mining Sector', 21 September 1999.

²⁰⁰ Inquiry into Business Taxation Reform, para. 5.5.

²⁰¹ Treasurer, *The New Business Tax System: Stage 2 Response*, Press Release no. 74, 11 November 1999, 3.

²⁰² *A Tax System Redesigned*, Overview, para. 232.

²⁰³ Ibid, 310. Note that the principles to determine the cost of an asset for tax purposes are discussed in recommendation 4.18 of *A Tax System Redesigned*.

²⁰⁴ Treasurer, *The New Business Tax System*, Press Release no. 58, 21 September 1999, Attachment B.

to project development costs not included in other wasting assets, over the life of a project. Pooling will also be available by election on an all or nothing basis for other assets costing \$1,000 or less with a rate of 37 percent. The pool can also include other assets when their declining balance written down value falls below \$1,000. This regime will replace the \$300 immediate write-off from 1 July 2000.²⁰⁵

The Federal Government has accepted that capital gains treatment will no longer be available from 21 September 1999²⁰⁶ for wasting assets but this makes little positive difference to participants of unincorporated joint ventures especially with the abolition of indexation of cost bases of assets from 30 September 1999.

UNIT TRUST JOINT VENTURES

This section of the chapter commences by outlining some preliminary matters about unit trust joint ventures (their nature and liability to third parties). It is then argued that the main benefit of unit trusts is their conduit treatment for tax purposes.

Nature of unit trust joint ventures

In a unit trust joint venture, the participants conduct their project through a trust structure. A well-known Australian example is the Central Queensland Coal Associates and Gregory Joint Venture Agreements of the Queensland Coal Trust.²⁰⁷ A unit trust is a device that enables the separation of the legal and beneficial ownership of assets and entitlement to income derived on those assets to the beneficiaries (see discussion below). By comparison, a discretionary trust involves using entitlements which are not predetermined or fixed in the trust instrument, but are determined according to the discretion of the trustee or some other person nominated as appointor in the trust instrument.²⁰⁸ In the joint venture context, it is submitted that a fixed trust (ie a unit trust) is the most appropriate *trust structure* because a discretionary trust by its nature involves uncertainty as to beneficial ownership of assets and entitlements to income and corpus of the trust estate.

²⁰⁵ Treasurer, *The New Business Tax System: Stage 2 Response*, Press Release no. 74, 11 November 1999, Attachment L.

²⁰⁶ Treasurer, *The New Business Tax System*, Press Release no. 58, 21 September 1999, Attachment B.

²⁰⁷ Ladbury (1984), 329.

²⁰⁸ Australian Tax Practice, CD-ROM, June 1999, [95/0105].

A unit in a unit trust is not a tangible asset in the same sense as an interest in an asset of an unincorporated joint venture or a share in a company. It is merely a method of describing the quantum of a unitholder's interest in the trust. It is not property distinct from the underlying assets of the trust, as opposed to shares in a company, but:

the view is untenable, for a unit held under this trust deed is fundamentally different from a share in a company. A share confers upon the holder no legal or equitable interest in the assets of the company; it is a separate piece of property ... But a unit under the trust deed before us confers a proprietary interest in all the property which for the time being is subject to the trust of the deed.²⁰⁹

Thus, entitlements of a beneficiary under a unit trust joint venture are not attached to units in the same sense as rights attach to a share, they are merely measured in quantum terms by the number of units held. Nor does income flow from a unit in the same way as a dividend can be said to flow from a share as a separate item of income-producing property. Therefore, whereas a dividend may be income according to ordinary concepts (notwithstanding specific assessability under s. 44 of the ITAA 36), distributions or allocations under unit trust deeds do not become income of the unitholder through the application of any tests such as being flows of a periodic nature from an investment. Rather, the nature of such distributions or allocations as income or otherwise is determined by the nature which the funds distributed or allocated have in the hands of the trustee. The beneficiary merely takes a proportionate entitlement to the funds measured by the number of units held and the total number of units on issue.²¹⁰

The trustee owns all the assets for the benefit of the unitholders and is bound by the interests imposed by the trust deed on those assets.²¹¹ As with unincorporated joint ventures, a unit trust is not a separate legal entity and it must operate through a trustee. The trustee will often be a company incorporated by the unitholders and will in many cases have the dual roles of both trustee and manager (through its board of directors and executives) of the joint venture.²¹² The participants are unitholders.²¹³ The shareholding in the trustee company will

²⁰⁹ *Charles v FCT* (1954) 90 CLR 598, 609, *per* Dixon CJ, Kitto and Taylor JJ.

²¹⁰ This is subject to any statutory modifications in Div 6 (eg s. 99B ITAA 36) or elsewhere (eg Div 6AAA ITAA 36) and the application of the capital gains tax provisions.

²¹¹ Komesaroff (1999), 5.

²¹² *Id.*

²¹³ Rigney, *Australian Business Taxation*, (1990), 174.

generally (but not as a legal requirement) mirror the respective unitholding of each participant in the trust.²¹⁴ Unitholders are entitled to receive income derived by the trust, capital distributions (which may be made from time to time) and a proportionate share of surplus assets on the winding up of the trust.²¹⁵

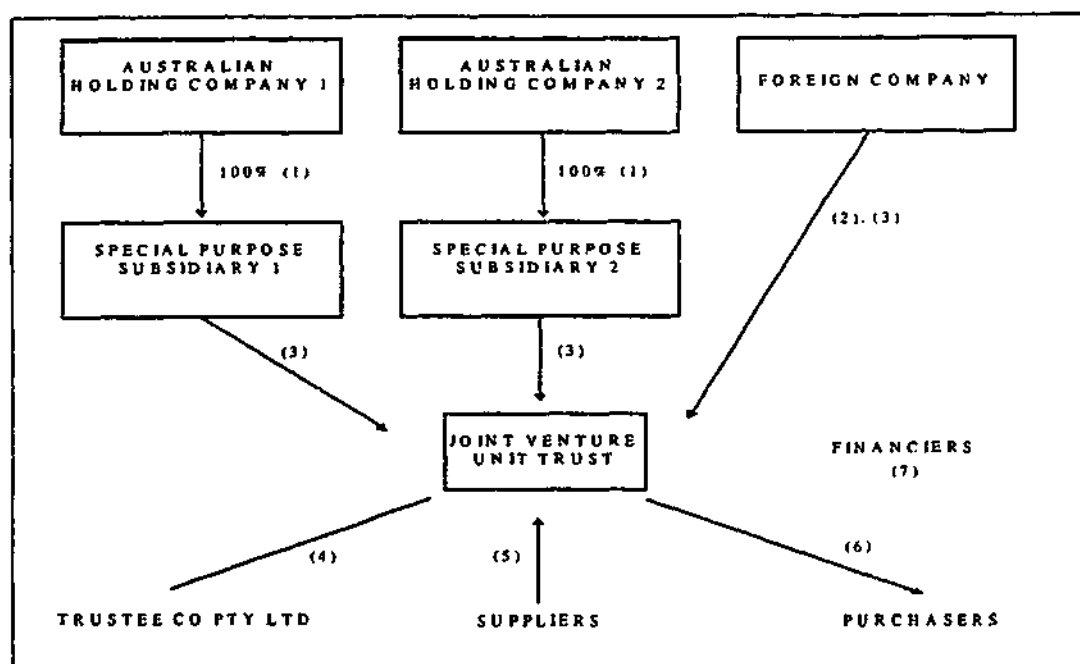
Unit trusts allow arm's length parties to join together in an undertaking, with defined rights to a proportion of the income and capital of the trust fund and specified entitlements as against the trustee, without the requirement that the participants become co-shareholders in a company. Another attraction of the unit trust lies in the legal position of the parties who contract with the trustee.²¹⁶ A simplified diagram of a unit trust joint venture structure is set out in Figure 2.3.

²¹⁴ Komesaroff (1999), 5.

²¹⁵ Rigney, *Australian Business Taxation*, (1990), 174.

²¹⁶ Ladbury (1984), 329. The term 'trustee' is defined broadly in s. 6(1) ITAA 36 in the following terms: 'trustee' in addition to every person appointed or constituted trustee by act of parties, by order, or declaration of a court, or by operation of law, includes: (a) an executor or administrator, guardian, committee, receiver, or liquidator; and (b) every person having or taking upon himself the administration or control of income affected by any express or implied trust, or acting in any fiduciary capacity, or having the possession, control or management of the income of a person under any legal or other disability.

Figure 2.3: Simplified Unit Trust Joint Venture Structure



Notes:

- (1) 100% ownership enables group relief to be utilised while protecting the assets of the Holding Companies from claims against the participants.
- (2) Subsidiary generally preferred to branch for taxation and commercial reasons.
- (3) Unit Trust Joint Venture Deed.
- (4) Agency Agreement.
- (5) Operator Co Pty Ltd (the trustee) deals with suppliers on behalf of the trust.
- (6) Sale of product to purchasers.
- (7) Finance documents.

A number of other agreements are in practice likely to be in place between the participants, which are not identified in the structure set out above.

The beneficiaries of a unit trust are not an association of persons.²¹⁷ Moreover, although the trustees of a trust estate are jointly and severally liable for their acts and omissions, they do not constitute a single legal entity. By contrast, the shareholders of the special purpose subsidiary 1 or special purpose subsidiary 2, or of their holding companies, are individual entities which are totally distinct from the legal entity of the company itself.²¹⁸

Liability to third parties

Despite the differences in ownership interests of unitholders in a trust to shareholders in a company, unitholders are in a position analogous to shareholders. Generally a unitholder is

²¹⁷ The leading judicial authority is *Smith v Anderson* (1880) 15 ChD 247. At 274, James LJ said that beneficiaries were not an 'association', because they were not linked by contractual relations inter se. See also Ong, *Trusts Law in Australia*, (1999), 54.

²¹⁸ *Ibid*, 55.

not personally liable for liabilities incurred by the trustee in the course of managing the trust and carrying on its business. The provisions of a trust deed may limit the liability of the unitholders to the par value of the units. In effect, this gives the unitholders the same limitation of liability as applies to a shareholder who subscribes for shares in a company.²¹⁹

Main tax advantages of fixed unit trust joint ventures

The net income of a fixed trust is currently subject to tax in the hands of the trustee unless the resident beneficiaries (not under a legal disability) are presently entitled to it. The trustee is assessed on income with an Australian source to which non-resident beneficiaries are presently entitled. Another attraction of the fixed unit trust is its flow-through capabilities, which advantage a company does not have.²²⁰ In 2000, the government released exposure draft legislation providing for the taxation of trusts like companies. In February 2001, the exposure draft legislation was withdrawn.²²¹

Trust beneficiaries not under a legal disability are taxed on their current entitlement to the net income of the trust, even where there has been no actual distribution.²²² The end result is that, in contrast to companies, the net income of the fixed trust is not currently subject to the prevailing company income tax rate.²²³ The net income of the trust is calculated as if the trust were a separate taxpayer.

²¹⁹ Ladbury (1984), 330. However, the *Corporations Law* prohibits the exclusion of the subrogation of a creditor to a trustee's right of indemnity against the unitholders.

²²⁰ Id; for a detailed consideration of unit trusts, see Ford (1960), 129-150, and Grbich, *Modern Trusts and Taxation*, (1978), 36-73.

²²¹ Under the withdrawn entity taxation regime, all resident non-fixed trusts would be taxed like companies unless they were specifically excluded. The proposed general rule was that unless the trust was a fixed trust, only non-fixed trusts created or settled as a legal requirement would be excluded. The proposed shift from taxing trust income on an entitlement basis to distribution basis, together with the profits first rule (a presumption that distributions are paid out of profits first), signified the importance of the distribution concept. *Exposure Draft: New Business Tax System (Entity Taxation) Bill 2000 (Cth)* was released in 2000. The Government intended entity taxation to commence from 1 July 2001. However, on 27 February 2001, the Treasurer announced the withdrawal of *Exposure Draft: New Business Tax System (Entity Taxation) Bill 2000 (Cth)*. The Treasurer stated that the government would 'begin a new round of consultations on principles which can protect legitimate small business and farming arrangements whilst addressing any tax abuse in the trust area': *Entity Taxation*, Press Release no. 008, 27 February 2001.

²²² 2 A *Platform for Consultation*, para. 18-1.

²²³ Id. It is noted that s. 254C of the *Corporations Law* provides that with effect from 1 July 1998, companies no longer require par values for their shares.

Accordingly, if a corporate trustee is subject to tax because no beneficiary is presently entitled to the net income of the trust estate, then the trustee will be taxed at the applicable corporate tax rate. Revenue losses are not allowed to be distributed to the unitholders; but they can be carried forward to subsequent income years. Unit trusts in receipt of imputation credits but which also make a tax loss, effectively lose those credits. Net capital losses cannot be distributed to beneficiaries but may be carried forward indefinitely to be offset against net capital gains derived by the unit trust in subsequent years. Restructuring of unit trusts in general gives rise to capital gains tax implications. Chapter 6 will evaluate the arguments for using unit trusts as an extension or development of the tolling company concept.

EQUITY JOINT VENTURES

This section of the chapter outlines some preliminary matters about equity joint ventures (their nature, the interests of equity participants and liability to third parties). It is then argued that financing equity joint ventures may be simpler than for unincorporated joint ventures. It is contended that the main tax disadvantages of an equity joint venture are the absence of any flow-through capability and the ineligibility to join the consolidation regime.

Nature of equity joint ventures

In an equity joint venture, the equity participants hold their interests in a special purpose vehicle (the *SPV*) incorporated specifically for the project as shareholders.²²⁴ Equity joint ventures possess a number of features that unincorporated joint ventures do not have. For the purposes of the ITAA 97, a 'company' is a body corporate or any other unincorporated association or body of persons, but does not include a partnership.²²⁵ We saw earlier that unincorporated joint ventures do not enjoy a legal personality. The *SPV* being a separate legal entity, owns assets in its own right and can sue and be sued in its own name. This mechanism is said to keep the liabilities created during the equity joint venture separated from the equity participants' other liabilities.²²⁶ Figure 2.4 sets out a simplified example of an equity joint venture structure.

²²⁴ Ahrens (1986), 463-464.

²²⁵ Section 995-1 of the ITAA 97.

²²⁶ Komesaroff (1999), 4.

An SPV can be set up by the equity participants who each subscribe for shares in a new company or who decide to transfer a business or assets (such as an individual property) to the SPV in exchange for shares in it.²²⁷ Alternatively, an equity participant can purchase shares in a company already controlled by another equity participant.²²⁸ If the equity participant purchases shares in a company whose assets qualify for accelerated depreciation because they were acquired or commenced to be constructed before 21 September 1999, then the purchase of shares will not alter that position.²²⁹ The *Corporations Law* is the primary code for the regulation of the equity joint venture and the equity participants inter se but the memorandum of association, constitution and shareholders' agreement regulate what the equity participants can and cannot do.

To a greater or lesser degree, a shareholders' agreement will contain provisions similar to those in a JVA or trust deed. For example, it governs the management of the assets, representation of directors and management, business plans, budget and financial reporting, dividend and borrowing policy, right to information and dispute resolution. Rights of pre-emption governing disposal of shares in the SPV are established and rights and obligations of the equity participants to wind-up the SPV are provided for.²³⁰

The SPV carries out the joint venture undertaking with individuals either employed directly by the SPV or seconded to the SPV by one or more equity participants pursuant to a service performance agreement or similar contract.²³¹ Alternatively, an equity participant may in practice be a sleeping participant, leaving day-to-day management to the other equity participants and only participating on key decisions. Frequently in this instance the SPV will enter into a management agreement with one of the equity participants by which that equity participant will undertake to carry out the project in return for a fee.

²²⁷ Malleons, *Australian Finance Law*, (1999), 254.

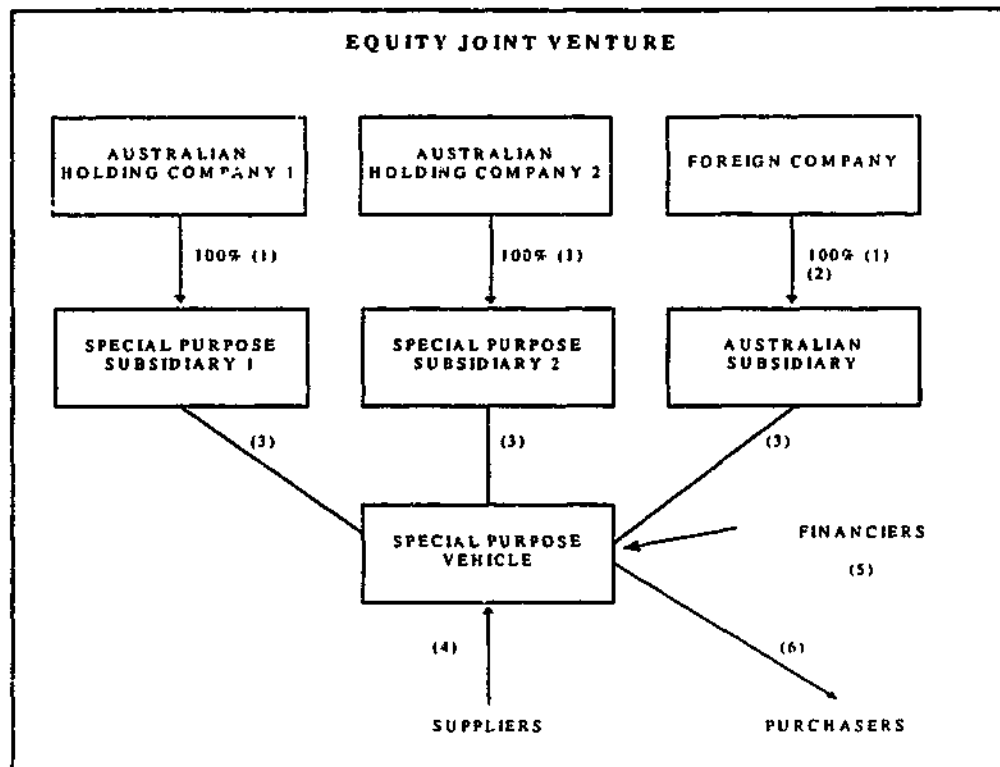
²²⁸ Although in this situation it would be usual to expect a shareholders' agreement to be entered into in order to, inter alia, regulate how the voting rights in the SPV are exercised.

²²⁹ Inquiry into Business Taxation Reform, 33. Taxpayers will be able to reassess the effective life of their assets, having regard to changing market or technology developments.

²³⁰ Stedman and Jones, *Shareholders' Agreements*, (1986), 168; Malleons, *Australian Finance Law*, (1999), 254.

²³¹ Thompson (1994), 172-173.

Figure 2.4: Simplified Equity Joint Venture Structure

**Notes:**

- (1) 100% ownership enables group relief to be utilised while protecting the assets of the Holding Companies from claims against the equity participants.
- (2) Subsidiary generally preferred to branch for taxation and commercial reasons.
- (3) Shareholders' agreement.
- (4) Special purpose vehicle purchases raw materials etc.
- (5) Finance documents.
- (6) Sale of product to purchasers.

A number of other agreements are in practice likely to be in place between the equity participants, which are not identified in the structure set out above.

Nature of interests of equity participants

An equity participant's interests in an equity joint venture consist of contractual rights and obligations under the shareholders' agreement²³² and a chose in action in respect of each of the shares in the SPV.²³³ The latter proposition follows from the classic description of a share by Farwell J in *Borland's Trustee v Steel Bros & Co Ltd*:²³⁴

[a] share is the interest of a shareholder in the company measured by a sum

²³² See generally Stedman and Jones, *Shareholders' Agreements*, (1986).

²³³ Komesaroff (1999), 4.

²³⁴ [1901] 1 Ch 279.

of money, for the purpose of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders *inter se* in accordance with s 16 of the *Companies Act* 1862. The contract contained in the articles of association is one of the original incidents of the share. A share is not a sum of money settled in the way suggested, but is an interest measured by a sum of money and made up of various rights contained in the contract, including the right to a sum of money of a more or less amount.²³⁵

Although Farwell J was concerned with a shareholder's interest in a company limited by shares, Ford argues that his Lordship's words can be applied to the interest of a shareholder of an unlimited company, with the necessary modification that a share will not measure the total liability of the shareholder.²³⁶

Moreover, an equity participant's chose in action is a complex one consisting of several rights. It is not possible to sever one right from the others. For example, Equity Participant A cannot sever a share and assign away the right to be paid dividends to Equity Participant B.²³⁷

The interests of an equity participant of an SPV are different from the complex hybrid of contractual rights and obligations and proprietary interests enjoyed by a participant of an unincorporated joint venture (some of which may be reducible or determinable in certain instances under the express provision of the JVA).²³⁸ It is argued that because the laws for taxing dealings in shares is simpler than for dealings in assets, the taxation of dealings by equity participants in their shareholdings in an SPV will be in general simpler and cheaper (in compliance cost terms) than the taxation of dealings by participants in their interests in an unincorporated joint venture. This theme is developed later in this thesis, particularly in chapters 4 and 5.

Liability to third parties

Liability of the equity participants in an equity joint venture is generally limited to the

²³⁵ Ibid, 288.

²³⁶ Ford, *Ford's Principles of Corporations Law*, (1999), [17-200].

²³⁷ Cf *Norman v FCT* (1963) 109 CLR 9; appld *Johnstone v Commissioner of Inland Revenue (NZ)* [1966] NZLR 833; *Williams v Commissioner of Inland Revenue (NZ)* [1964] NZLR 996.

²³⁸ Crommelin (1986), 70; Carson (1988), 1-2. McCann (1990).

shares²³⁹ that the equity participants own in the SPV.²⁴⁰ Limited liability means that an individual shareholder in the SPV may be ultimately required to take responsibility for the debts or liabilities of the SPV to the extent of the amount unpaid on its shares.²⁴¹ Therefore, if an equity participant holds fully paid-up shares, there can be no further call against him; if shares are partly paid-up to, say 25 percent, then the equity participant holder may be called upon to support the SPV to the extent of the unpaid 75 percent.

Main tax advantages of equity joint ventures

SPVs are taxpayers in their own right: they derive assessable income, claim allowable deductions and pay tax at the applicable corporate tax rate on any resultant taxable income (less and applicable rebates).²⁴² In this respect, they differ significantly from unincorporated joint ventures. The latter are not treated by Australia's tax laws as separate taxpayers.²⁴³ Characterisation risk is low to negligible for equity participants. Therefore, equity joint ventures need not incur tax lawyer's fees to determine the extent of characterisation risk, and ways to manage that risk. Accordingly, equity participants have a comparative compliance cost advantage compared to participants of unincorporated joint ventures. The cost advantage is equal to the compliance costs expended by a participant of an unincorporated joint venture because of characterisation risk.

The critical issues facing equity participants concerning the introduction of the cash flow/tax value approach are the same as for unincorporated joint ventures.

SPVs are classified for tax purposes as either public companies or proprietary companies.²⁴⁴ A public company is generally either listed on the Australian Stock Exchange and meets certain diversity of ownership criteria or is a majority owned subsidiary of another public

²³⁹ Pliner (1991), 6; Rigney, *Australian Business Taxation*, (1990), 189.

²⁴⁰ However, where the taxable entity is an unlimited liability, then the shareholder's liability is also unlimited.

²⁴¹ Rigney, *Australian Business Taxation*, (1990), 189.

²⁴² Tang (1999), 1.

²⁴³ Id.

²⁴⁴ Section 103A ITAA 36.

company.²⁴⁵ This distinction is relevant for determining the availability of dividend rebates (discussed below). It is more relevant to the equity participants of an equity joint venture than the taxation of the SPV itself.

Financing equity joint ventures is simpler than for unincorporated joint ventures to the extent that organising external finance is necessary.²⁴⁶ Assessment of lending risk is simplified by the absence of complex contractual rights for financiers to understand. A JVA will normally limit the right of a participant to give its interest as security by stating that the interest of the participant may not be used for security to raise money for purposes unconnected with the joint venture.²⁴⁷ If the SPV is the borrower, the SPV will grant the financier rights over its assets. This will enable the financier to take possession of its security more simply than where the borrower is a participant.²⁴⁸ Therefore, an SPV owns the plant and equipment of the venture and is entitled to depreciation charges arising therefrom.²⁴⁹ The abolition of accelerated depreciation will decrease, in after-tax terms, the net present value of an investment, or its rate of return below what it would be with accelerated depreciation. This will apply at the level of the SPV.²⁵⁰ Notwithstanding that an equity participant may sell its shares in the SPV whose assets qualify for accelerated depreciation because they were acquired or commenced to be constructed before 21 September 1999, the assets will keep their pre-21 September 1999 status.²⁵¹ The income tax and capital gain tax aspects of joint venture financing is examined in the next chapter.

A range of financing devices is available only to corporations. Of particular importance is the equitable floating charge, which an SPV may create over any assets passing through its hands

²⁴⁵ Sections 103A(2) and 103A(4) ITAA 36.

²⁴⁶ Fisher, *Natural Resources Law in Australia*, (1987), 482; Fowster (1977).

²⁴⁷ Komesaroff (1999), 12.

²⁴⁸ Pliner (1991), 7.

²⁴⁹ Section 42-15(a) ITAA 97.

²⁵⁰ Current Issues Brief 9, *Proposed Reforms to Business Taxation: A Critical Assessment of Some Budgetary and Sectoral Impacts*, (1999-2000), 21.

²⁵¹ Inquiry into Business Taxation Reform, 33. Taxpayers will be able to reassess the effective life of their assets, having regard to changing market or technology developments.

in the ordinary course of business.²⁵² Equity participants seeking to dispose of their shareholding in an SPV can, subject to rights of pre-emption in the shareholders' agreement, easily transfer their shares in the SPV to third parties. Equity participants face capital gains consequences arising from a disposal of their shares.²⁵³ The relevant issues are explored in chapter 5.

In the development context, the use of a limited liability SPV, the shares in which are owned by the equity participants, is common. However, if the undertaking concerns long-term investment with significant tax losses early on, then a SPV will probably not be the optimum joint venture structure because the benefit of those tax losses does not flow-through to the equity participants. This will reduce the equity participants' return on investment and increase the ratio of compliance costs to return on investment. As well, the SPV will derive the assessable income of the venture from the undertaking.²⁵⁴

The initial phases of mining and petroleum ventures are characterised by large outlays in respect of exploration and development with little or no income generated. A venture may never return the equity participants a profit. Unless the SPV elects otherwise, its taxable income is limited to the assessable income from all sources as remains after deducting all allowable deductions. Tax losses are deductible successively against assessable income derived by the SPV in subsequent years provided that the 'continuity of ownership' or 'same business' tests are satisfied.²⁵⁵ Where an election is made, the excess deductions are treated

²⁵² Rigney, *Australian Business Taxation*, (1990), 191. Romer LJ in *Re Yorkshire Woolcombers' Association Ltd* [1903] 2 Ch 284, 295 said: 'if a charge has the three characteristics that I am about to mention, it is a floating charge. (1) If it is a charge on a class of assets of a company present and future; (2) if that class is one which, in the ordinary course of the business of the company, would be changing from time to time; and (3) if you find that by the charge it is contemplated that, ..., the company may carry on its business in the ordinary way as far as concerns the particular class of assets I am dealing with'.

²⁵³ See Pliner (1991), 6. One of the disadvantages of unincorporated joint ventures is said by Pliner to be that (6-7): 'Since the joint venturers enter into most of the major agreements of the project individually, including financing, leasing, acquisition of plant and machinery, etc., the transfer of an interest requires a novation using deeds of assumption entered into by the assigning party in relation to all the project agreements to which the assignor is a party. This is not only legally cumbersome, but gives the other joint venturers scope to prevent a party assigning its interest.'

²⁵⁴ See s. 36-15 ITAA 97.

²⁵⁵ Sections 165-12 and 165-13 ITAA 97.

by the SPV as carry forward losses.²⁵⁶

A limited proprietary SPV is a widely used vehicle in property development joint ventures. The SPV has a separate legal identity and provides a relatively simple and well understood structure. The liability of the equity participants for the SPV's debts can only occur in very limited circumstances and the administration involved is not too burdensome. The income tax consequences may, however, be less favourable than other joint venture structures. As with mining and petroleum equity joint ventures, the absence of flow-through capabilities for tax losses could diminish the net present value of a project structured as an equity joint venture. This lack of fiscal transparency will play a role in making a determination to use such a vehicle for property investment transactions.

Accounting arrangements can be organised so that one of the equity participants can consolidate in its own financial statements the profits of the SPV or to keep the arrangement off-balance sheet.²⁵⁷ For example, the 'move by Carlton United Brewery Hotels Pty Ltd in 1984 to transfer numerous Melbourne hotel sites into 50/50 owned companies partly owned by and leased to the [hotel] managers, is a significant demonstration of the value of this device. It was not dissociated from "off balance sheet" treatment of the debt'.²⁵⁸

Disadvantages of using equity joint ventures

Ineligibility to join the consolidated group regime

Most SPVs will be ineligible to join the consolidated group regime because most of them lack full common ownership. Full common ownership is one of the conditions of entering the consolidation regime. The central concept is that of an 'Australian head entity'. Unless all of the equity participants of an SPV are themselves wholly owned subsidiaries of the same Australian head entity, this condition will not be satisfied and the SPV will be ineligible to join a consolidated group. Subject to that limitation, wholly-owned equity participants of the same equity joint venture could enter the consolidated group regime.

Consolidation is supposed to generate reduced compliance costs and lower revenue costs,

²⁵⁶ Section 36-15 of the ITAA 97.

²⁵⁷ Refer Davis, *Unincorporated Joint Ventures*, (1983).

²⁵⁸ Refer Ahrens (1986), 459, n.29. It is unknown whether the sites were leased to the taxpayer.

elimination of dividend rebate wastage and simplification of inter-company transactions. Earlier in this chapter, the author argued that the consolidation regime may produce no or less than all the stated benefits for participants of unincorporated joint ventures. The position is worse for equity participants of equity joint ventures, because in most cases, their SPV, will never be eligible to enter a consolidated group. Therefore, the benefits of the reform will probably be more theoretical than real.

New rules must be introduced to cover situations where consolidation is not possible. This is the real issue facing equity participants. It is contended that Australia's business taxation system should be designed with the key policy goals of simplicity and efficiency in mind. Reducing the number of structural barriers to consolidation is one aspect of this. Equity participants can surely benefit from legislative improvement. Legislative improvement requires a reduction in the impediments to bring losses (realised or unrealised) into the consolidated entity. Given the compliance cost penalties that will follow to affected taxpayers from not consolidating (eg not sharing in a reduction in compliance costs), measures should also be available to controlled groups (ie 80 percent) and should be elective within the controlled group.

No flow-through capabilities

Since SPVs are treated as separate taxpayers, the benefit of revenue and capital losses does not flow-through to the equity participants from one year of income to the next. Losses will remain in the SPV for offsetting against future income including revenue gains (in the case of revenue losses) or capital gains (in the case of capital losses) subject to the SPV satisfying the continuity of ownership or same business tests.²⁵⁹

However, an SPV's losses can be grouped with other companies within the same wholly owned group as the SPV, whether the other company is the shareholder of the loss company or not.²⁶⁰ The ability of an SPV to do this will be modified by the consolidation regime (discussed below). In general, the loss grouping provisions of the ITAA 97 do not provide the equity participants of a mining or petroleum equity joint venture with any tangible benefit

²⁵⁹ See Divs 165 and 175 ITAA 97 (these Divs are designed to prevent trafficking in loss companies); Jüttner, *International Finance & Global Investments*, (1995), 485.

²⁶⁰ Division 170 ITAA 97.

because none of them will typically own all the shares in the SPV. One exception would be where all the equity participants are themselves wholly owned subsidiaries of the same corporate group. If the equity participants in a *loss making* equity joint venture are the same equity participants in another *income producing* equity joint venture, then one question for determination will be the possibility of developing a corporate structure to allow grouping losses of the former SPV with the taxable income of the latter SPV. Real examples of this type of structure are difficult to identify.

Equity participants are not legally responsible to pay the tax on a SPV's taxable income. The SPV must pay tax in its own right and the shareholders—the equity participants—are taxed upon distributions of income (ie dividends). Therefore, the equity participants and the SPV will share tax compliance costs; whereas in the unincorporated joint venture structure the participants separately bear their own costs.

If the equity participants are corporations, then distributions to them are free of tax due to the incorporate dividend rebate provided the equity participant is a public company²⁶¹ or is a private company and the dividend is fully franked²⁶² or paid between wholly owned company groups²⁶³ (but for the reason stated above this latter test will generally not be satisfied in relation to a single equity joint venture). Any franking credits attaching to the dividend are credited to the franking account of the recipient equity participant and can, in turn, be used to frank its dividends.²⁶⁴

If the equity participant is a private company, the dividend is not fully franked and the equity participant is not part of the same wholly owned group as the SPV (which in most cases will be unlikely), no dividend rebate will apply to that part of the dividend which is unfranked. Therefore, the unfranked dividend is taxable to the equity participant and tax preferences (eg some R&D expenditure and tax-exempt income) are lost because the equity participant will pay tax on the dividend.²⁶⁵ That these issues may arise for equity joint ventures, but not

²⁶¹ Section 46(2) ITAA 36.

²⁶² Section 46F(2) ITAA 36.

²⁶³ Section 46F(3) ITAA 36.

²⁶⁴ Section 160APP ITAA 36.

²⁶⁵ Tang (1999), 3.

for unincorporated joint ventures, could add an additional layer of complexity to satisfactorily document the fiscal arrangements of them.

The issue of distribution of profits by the SPV is more complex where an equity participant is a non-resident carrying on business in Australia through a permanent establishment. For instance, s. 44(1)(b) of the ITAA 36 currently provides that the assessable income of a non-resident equity participant (where the SPV is a resident of Australia) will, subject to the section and s. 128D, include dividends paid to it by the SPV to the extent to which they are paid out of profits derived by it from sources in Australia. The effect of s. 128D of the ITAA 36 is that dividends paid by a resident SPV to a non-resident equity participant are subject to withholding tax. Pursuant to s. 128D, dividends in respect of which withholding tax is payable are not included in the assessable income of the non-resident equity participant. Therefore, dividends paid to non-resident equity participants by resident SPV's are not included in their assessable income but are, rather, subject at most to only withholding tax.

Reforming dividend full franking arrangements

The proposed reforms to dividend franking arrangements may lower compliance costs for equity participants and SPVs. Under the existing dividend imputation system, dividends are either franked or unfranked depending on whether they are paid out of taxable profits or not. This distinction adds complexity at both the shareholder level and the company level.²⁶⁶

The Committee has recommended that unfranked distributions (other than distributions within a consolidated group) between resident entities (including trusts and companies) be taxed in the recipient entity's hands.²⁶⁷ This measure:

would help address the unintended loopholes created by the way the existing section 46 rebate frees from tax most unfranked dividends between entities as well as the added complexity of the wide range of associated and other specific anti-avoidance provisions relating to the availability of the section 46 rebate.²⁶⁸

To prevent double taxation, it is proposed that the existing s. 46 inter-corporate rebate be

²⁶⁶ 2 A Platform for Consultation, paras. 15.6 - 15.7.

²⁶⁷ Ibid, recommendation 11.1.

²⁶⁸ A Tax System Redesigned, 411.

replaced with a gross-up and credit approach for preventing double taxation on distributions passing between resident entities (out of consolidated groups).²⁶⁹ 'This approach will determine tax payable on dividends received by individuals and superannuation funds' (who may be the shareholders of a participant).²⁷⁰

Participants of unincorporated joint ventures would probably not, however, directly benefit from this measure. This is because the unintended loopholes of the existing section 46 rebate only affect taxpayers. Unincorporated joint ventures are not taxpayers under the ITAA 97.

Capital gains tax provisions

The capital gains provisions of Pt 3-1 of the ITAA 97 can work both for and against equity participants. For example, equity joint ventures serve equity participants poorly where pre-capital gains tax assets are disposed of. Although an SPV will not be liable to pay capital gains tax on the profit, if the profits are distributed to the equity participants by way of dividend, then the dividends may not be franked dividends,²⁷¹ in which case the equity participants will derive no benefit from pre-30 September 1999 indexation of asset values. Even where the asset disposed of is a post-capital gains tax asset some but not all of the dividend would be franked.²⁷²

A joint venture structure which allows asset transfers between companies without giving rise to an immediate tax liability to one or both of the parties involved is *prima facie* to be preferred by a party to a structure which does not.²⁷³ This is not to imply that non-revenue law considerations will not be relevant, because in many cases they will be. The ITAA 36 and ITAA 97 contain a number of provisions allowing asset roll-overs within wholly-owned groups.²⁷⁴ Where assets are transferred between equity participants *inter se* or between equity participants and their corporate parents, roll-over will not be available and any gain on the

²⁶⁹ Ibid, 416.

²⁷⁰ Id.

²⁷¹ The events giving rise to a franking credit are set out in ss. 160APK – 160APV ITAA 36.

²⁷² Rigney, *Australian Business Taxation*, (1990), 192.

²⁷³ Burrell and Caradus (1997), 187.

²⁷⁴ See for example, s. 41-15 ITAA 97.

transfer may be liable to taxation. If the roll-over happens between equity participants which are members of the same consolidated group under the proposed business taxation reforms, then the transaction would be ignored for income tax purposes. It cannot be presumed from this fact alone that the equity participants would necessarily derive any compliance cost savings. Some record keeping would still be required.

HYBRID JOINT VENTURES

A hybrid joint venture is a structure which exhibits a characteristic from more than one structure. Taxpayers have different requirements when entering into a joint venture. The optimum fiscal outcome will depend on which structure is used. The last section of this chapter introduces hybrid joint ventures.

Farmouts

The legal characterisation of unincorporated joint ventures is quite distinct from a farmout. A farmout generally involves the granting of a right (but not the obligation) by a participant (the *farmor*) of an unincorporated joint venture to another participant of the same unincorporated joint venture or to a third party (the *farmee*) to earn a percentage of the farmor's participating interest in an exploration or prospecting entitlement or other asset upon the performance of work by the farmee.²⁷⁵ Per se, it is not a form of joint venture, but traditionally farmouts have been utilised in Australia by participants of unincorporated joint ventures.²⁷⁶

Several variations are possible as to the type of interest a farmee has the option to acquire when it has completed the agreed work. Commonly, a farmee may be assigned an undivided fractional interest in the exploration or prospecting area or the full interest in that area, subject to an obligation on its part to pay to the farmor an overriding royalty from the product of the undertaking. A participant of an unincorporated joint venture is not constrained in any practical sense from agreeing with the farmee to one of a variety of other possible arrangements. The income tax and capital gains aspects of farmouts are covered in chapter 4 of this thesis.

²⁷⁵ Discussed in *Amoco Minerals Australia Ltd v Commissioner of State Taxation (WA)* (1978) 8 ATR 719.

²⁷⁶ Industry Commission, *Study into the Australian Gas Industry*, (1995), xxviii.

Tolling companies

Equity participants derive their income from the sale of the joint venture product by way of dividend declared by the SPV. In a taxation system that is fiscally certain because it is neutral and fair, dividend payments would have the same utility to all taxpayers. The present tax system in Australia does not always necessarily provide all taxpayers with the same after-tax value in respect of a dividend. One factor affecting such utility to taxpayers is the residency status of an equity participant. For example, non-resident equity participants may be averse to franked dividends because of the comparative net cost to them of the tax on franked dividends compared to having dividend withholding tax levied on them. Non-resident equity participants or Australian resident equity participants with non-resident parents may have little use for franked dividends, if the parent cannot use them fully.

The alternative for equity joint ventures is to 'toll' the profits out of the management structure via a tolling company. Tolling is used in the mining sector in Australia,²⁷⁷ but in the author's opinion is significantly under-utilised in other business applications. Armstrong argued the case for tolling companies in 1982.²⁷⁸ A tolling company is a hybrid incorporated/unincorporated vehicle that owns the production facilities of the project and charges the participants a tolling fee. Tolling company structures are predicated on the basis that generating a sufficient return on an investment is a key objective for equity participants in any mining and petroleum joint venture and that start-up expenditures of a project may be so substantial as to leave a project in a tax loss position for many years. The inability of equity participants to utilise these tax losses in the early years of a project will decrease the project's rate of return. In a tolling company structure, the tolling company does not incur substantial tax losses in the early years because it charges or 'tolls' its tax deductible expenditures to the participants in each year of the project so that the participants derive the tax benefit of them. To illustrate, tolling company A, which operates an aluminium smelter, is owned 70 percent by participant B and 30 percent by participant C. In the 1999-00 year of income, tolling company A incurs \$300 million of tax deductible expenditure. Pursuant to a tolling agreement, tolling company A charges participants B and C a tolling fee in aggregate of \$300 million in consideration for tolling company A smelting alumina into aluminium.

²⁷⁷ Pliner (1991), 5.

²⁷⁸ Armstrong (1982).

In the tolling company situation, all production is taken in specie and controlled by the participants. Each participant is committed to provide the raw materials at a given rate, without interruption, and to take the output on a 'take or pay' basis. Without sales, the SPV obtains reward for its services by levying a tolling charge or fee sufficient to at least cover its tax deductible costs.²⁷⁹ In the context of smelting aluminium, the principle components included in the determination of the tolling charge would be hot metal process costs, operating and administration costs, costs of the delivery of aluminium to the participants, interest and financing charges, tax depreciation charges and costs applicable to the operation and maintenance of the costing facilities, although the types of costs can vary from project to project. Chapter 6 compares and contrasts tolling companies to unincorporated joint ventures, equity joint ventures, Canadian royalty trusts and United States oil and gas royalty trusts. That chapter also considers the case for tolling trusts as an extension or development of the tolling company concept.

²⁷⁹

Ahrens (1986), 461-462. See also Armstrong (1982).

TAXATION AND JOINT VENTURE FINANCING COSTS

Once established, an unincorporated joint venture or equity joint venture will require funds to operate.¹ There are many diverse methods available for financing joint ventures. This chapter is concerned with the impact of compliance costs of financing decisions as a determinant of the choice of joint venture structure. It begins by identifying different joint venture financing structures, the risks inherent in each and potential sources of finance for participants and equity participants. Then the taxation aspects of sources of finance are examined. The contention is that the compliance costs of the taxation of financing decisions are peculiar to the joint venture structure.²

COMPARING JOINT VENTURE FINANCING STRUCTURES

Unincorporated joint ventures

A participant of an unincorporated joint venture must choose between obtaining finance itself or through a special purpose finance company (a *SPFC*) in which some or all the participants are shareholders.³ This flexibility is said to play a role in the popularity of unincorporated

¹ A taxpayer's external financing needs depends on the magnitude of its internal cash flows relative to its investment opportunities. Consider, for example, Participant A of an unincorporated joint venture whose technology is capital-intensive and which therefore needs to finance large investment expenditures in order to grow. If Participant A has sufficient market power or faces high demand, it may be able to generate sufficient cash flow to finance investment internally; however, an equivalent participant in a more competitive market may require external financing to grow at the same rate.

² Burges (1986), 24. In addition, non-revenue law factors will play a role. For example: ownership of assets, ownership of output, limitation of liability, access to cash flow, financial objectives of the participants and the phase of the joint venture (ie exploration, development or wide-down of operations). See also the factors listed by Rendle (1988), 12-14.

³ A SPFC would ordinarily be a company limited by shares, which would raise funds to operate the unincorporated joint venture. Incorporation may be as a proprietary or a public company. The SPFC may be either debt financed or equity financed. If the SPFC issues shares (ordinary, preference and/or options), then potentially many parties could participate in a project. Shares may be issued as—either partially or fully paid up. Unless the participants agree otherwise, each participant would subscribe for shares in the SPFC in proportion to its participating interest in the JVA. If shares are partially paid shares, this will provide security for financiers as well as a further capital resource for the SPFC, which may call on further contributions from its shareholders. It also has the advantage of providing security for third party investors as a liquidator or manager can call upon the unpaid portion of the shares to repay creditors: Ford, *Ford's Principles of Corporations Law*, (1999), [17-120].

joint ventures in Australia.⁴

Comparing these two structures involves an assessment of the fiscal benefits and costs of each structure. It is argued that the former structure has fiscal advantages which the latter structure lacks, but both structures could arguably be subject to characterisation risk where funds are financed 'jointly'. To some degree, non-revenue law features will play a role.⁵

Participants who use the former structure can deduct their interest expenses from their share of the income they derive from the unincorporated joint venture and will not be rendered ineligible to join the consolidation regime. But participants who opt for the latter structure cannot deduct the interest expense because the SPFC is the taxable entity⁶ and in most cases will be ineligible to consolidate the interest expense into a corporate group.⁷ Figure 3.1 shows two simplified unincorporated joint venture financing structures.

It has been argued that the involvement by a financier⁸ in joint financing arrangements of the participants 'will lead to a presumption of partnership rather than the existence of a joint venture relationship.'⁹ It is not entirely clear what is meant by this proposition. If characterisation risk increases when the same financier(s) lends to each participant, but each participant assumes responsibility for the total debt and makes available its interest in the unincorporated joint venture assets as security for its payment, then Lehane has stated that the 'joint financing' of an unincorporated venture:

⁴ Mallesons, *Australian Finance Law*, (1999), 255.

⁵ Non-revenue law factors of financing unincorporated joint ventures can influence the choice between using a SPFC and not using one: financing is the responsibility of each participant and financing techniques have been designed to meet the needs and characteristics of large scale developments structured as unincorporated joint ventures. A JVA is likely to contain an express obligation on participants to bear or make good the losses as they arise and/or to provide working capital in as much as it is needed for the operations of the unincorporated joint venture. See generally Fisher, *Natural Resources Law in Australia*, (1987), 482; Fewster (1977); Ladbury (1987); Lehane (1986), 515; Milliner (1988); Rendle (1988), 18-20.

⁶ Rendle (1988), 16.

⁷ This is because in many cases shareholders having unrelated parents will own a SPFC. As a result, the requirement for 100 percent common ownership will not be satisfied. An exception to this would be where the SPFC is a wholly owned entity of one of the participants.

⁸ In this thesis, the term 'financier' includes: participants, equity participants (or shareholders of the participants or equity participants), shareholders of a SPFC or SPV, the public, government participants, banks (individually or syndicated), other types of financiers, other investors and governments.

in the sense that not only do the same financiers lend to each venturer, but each venturer assumes responsibility for the total debt and makes available its interest in the joint venture assets as security for its payment – is very uncommon and, where it occurs, gives rise to no particular difficulties from the fact that the borrowers are joint venturers.¹⁰

If a financier is not a party to the JVA but is involved in joint financing arrangements, it cannot escape liability as a general law partner by seeking to masquerade as a mere lender of money.¹¹ In each case, the status of the financier will depend on a careful analysis of the facility agreement and the rights and duties that attach to the financier pursuant to the loan documentation. All too often, the dividing line between loan and partnership will be a fine one. If it can be shown that the participants are partners, then it is submitted that the involvement of a financier in joint financing arrangements may lead to a conclusion that the financier is also a partner. There does not appear to be any judicial authority, however, supporting the contention that a financier's involvement in the joint financing arrangements of participants may or will necessarily lead to a conclusion that a partnership exists between the financier and the participants, on the one hand, or between the participants *inter se*, on the other hand. As Lord Lindley explained, the right of a financier:

is to be repaid his money with such interest or share of profits as he may have stipulated for; and his right to a share of the profits involves a right to an account and to see the books of the borrower, unless such right is expressly excluded by agreement. If however a lender stipulates for more than this (e.g. for a right to control the business) or if his advance is risked in the business or forms part of his capital in it, he ceases to be a mere lender and becomes in effect a dormant partner.¹²

To allay their concerns, some financiers may nevertheless *prefer* or in fact *direct* the participants to make the JVA go as far as it reasonably can to exclude the indicia of partnership, by providing for: separate ownership and disposal of the product of the joint venture, ownership of the joint venture assets by the participants as tenants in common and by

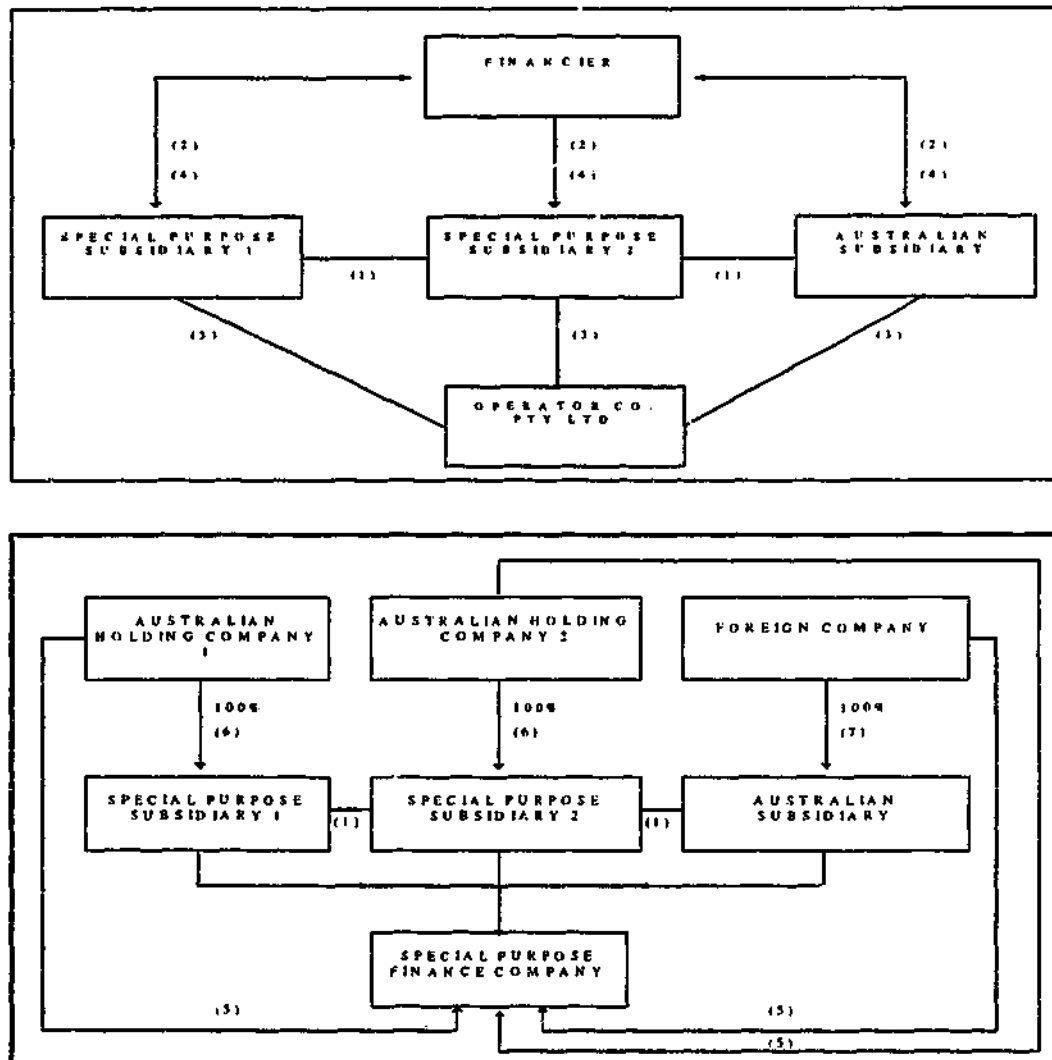
⁹ Milliner (1988), 12; cf Lehané (1986), 515.

¹⁰ Lehané (1986), 515.

¹¹ See *Pooley v Driver* (1876) 5 Ch D 458.

¹² Lindley and Banks, *Lindley and Banks on Partnership*, (1995), 87; cf *Mollwo March & Co v Court of Wards* (1872) LR 4 PC 419; *Re Young* [1896] 2 QB 484; *Pooley v Driver* (1876) 5 Ch D 458. See also *Re Beard & Co* [1915] Hansell Bank Rep 191, where one person guaranteed another's business account in return for a share of profits; Tang (1999), 7.

excluding mutual agency.¹³



Notes:

- (1) Joint Venture Agreement which specifically negates the existence of a partnership relationship.
 - (2) Finance documents.
 - (3) Agency Agreement.
 - (4) Security may or may not be given.
 - (5) Pre-completion guarantee (ie a guarantee provided to the financier prior to completion of construction of the project facilities).
 - (6) 100% ownership enables group relief to be utilised while protecting the assets of the Holding Companies from claims against the participants.
 - (7) Subsidiary generally preferred to branch for taxation and commercial reasons.
- A number of other agreements are in practice likely to be in place between the participants, which are not identified in the structure set out above.

Figure 3.1: Simplified Unincorporated Joint Venture Financing Structure

Equity joint ventures

It is simpler to finance equity joint ventures than unincorporated joint ventures.¹⁴ That an

¹³

Lehane (1986), 517.

SPV¹⁵ may attach differing rights to equity and debt capital issued to different classes of equity participants creates two benefits. First, tailoring of funding arrangements to meet the expected roles and economic objectives of the different classes of equity participants. For instance, where the equity participants contribute equity, it will usually be in the form of subscription for shares in the SPV. The issue of shares by an SPV will not create any tax consequences for the SPV. The equity participants would be treated as having acquired an asset with a cost base equal to investment.

Secondly, financing structures can be tailored to the equity participants' specifications. For example, a sophisticated share capital structure could be developed to balance the interests of a management group employed full-time to administer the affairs of an equity joint venture but with an investment in its capital of modest proportions, with those of one (or more) financiers whose concerns may relate more to the 'bankability' of its cash flows.¹⁶ One type of finance used to structure these transactions is the issue of preference shares. The articles of association of the SPV and the shareholders' agreement between the equity participants should address share issues and the special class rights attaching to the shares.¹⁷ Figure 3.2 sets out two simplified equity joint venture financing structures.

Financing non-resident corporate participants generally

Participation in Australian-based joint ventures by non-resident participants or non-resident equity participants, either directly or through Australian subsidiaries, adds an additional layer of complexity because it may give rise to a number of Australian taxation questions, particularly financing ones. Transfer pricing and withholding tax problems on cross-border

¹⁴ Fisher, *Natural Resources Law in Australia*, (1987), 482; Fewster (1977). We saw in chapter 2 that equity participants hold shares in a SPV, which owns the assets, develops the project and raises the finance required: Mallesons, *Australian Finance Law*, (1999), 254. Generally, the adoption of a company structure limits the liability of individual equity participants to a financier to the SPV unless the equity participants provide a guarantee or other third party protection: refer to Figure 3.2. The income tax consequences of making a payment under a contract of guarantee are outlined later in this chapter: Mallesons, *Australian Finance Law*, (1999), 254. Recourse could be provided via partly paid shares. This assists the project's balance sheet in showing an asset (and future recourse) rather than a liability, which would affect the equity joint venture's leverage.

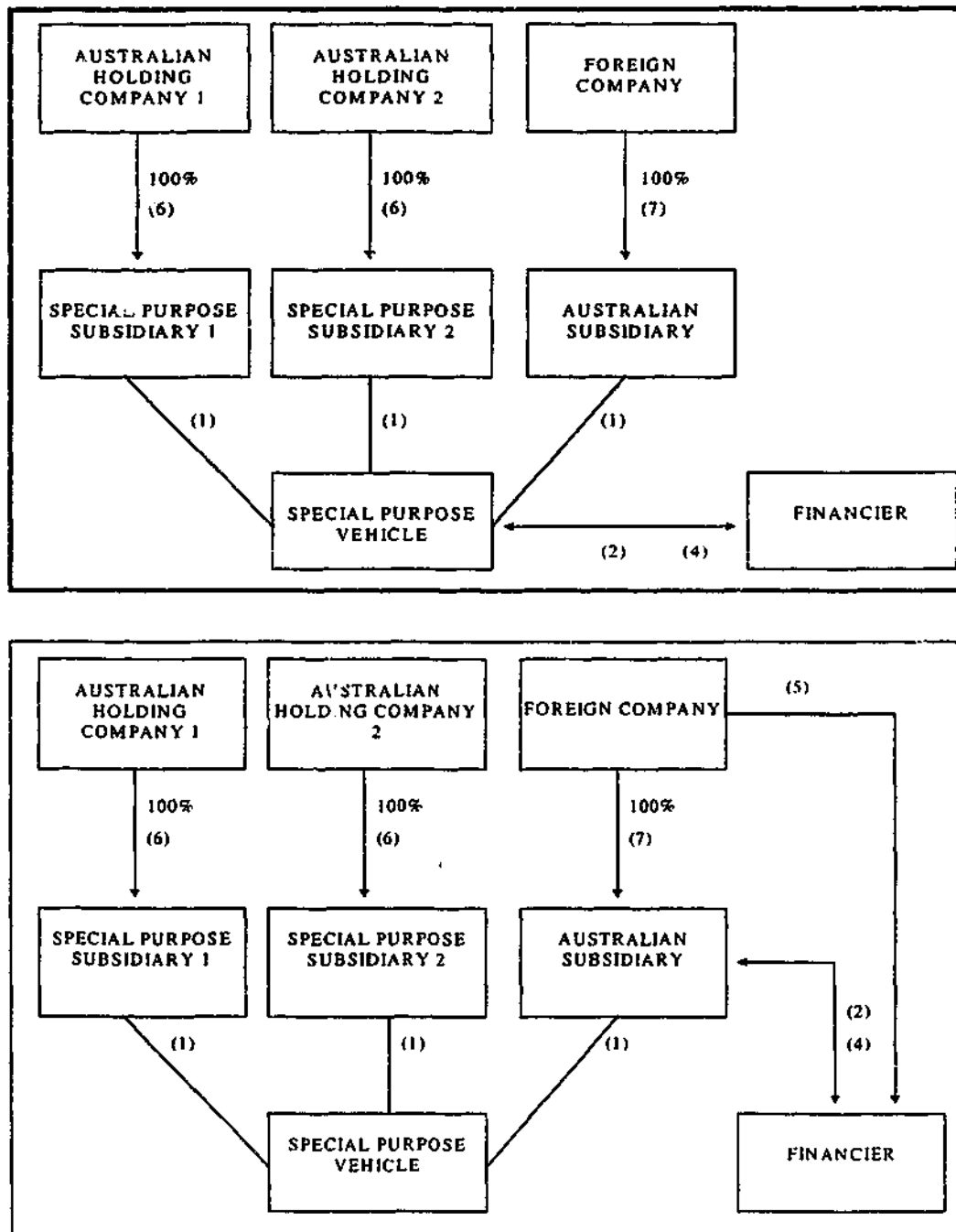
¹⁵ See, for example, the SPV in Figure 2.4.

¹⁶ Although the long-term interests of the SPV may affect its ability to generate cash flows sufficient to repay debt, which in turn bears on lending risk.

¹⁷ Pliner (1991), 10 - 11.

funding of subsidiaries (or branches) and interest deductibility problems in relation to Australian sourced income and thin capitalisation restrictions may arise.

Figure 3.2: Simplified Equity Joint Venture Financing Structure



Notes:

- (1) Shareholders' Agreement.
 - (2) Finance documents.
 - (3) Agency Agreement.
 - (4) Security may or may not be given.
 - (5) Pre-completion guarantee.
 - (6) 100% ownership enables group relief to be utilised while protecting the assets of the Holding Company from claims against the equity participants.
 - (7) Subsidiary generally preferred to branch for taxation and commercial reasons.
- A number of other agreements are in practice likely to be in place between the equity participants, which are not identified in the structure set out above.

SOURCES OF FINANCE

Sources of finance for a joint venture do not give rise to any issues peculiar to the joint venture behind its legal form.¹⁸ In the remainder of this chapter, a participant, SPFC or SPV borrower (as applicable) will be described as the *borrowing participant*.¹⁹

Participants and equity participants (or their parent companies) may contribute significant assets to a joint venture project. Contributions may take the form of capital, plant and equipment, buildings, licences (eg mining leases or production licences), real property, intellectual property, employees and management 'know-how'. These contributions may be in addition to or instead of cash contributions.

Contributions in kind may attract taxation consequences to the taxpayer disposing of (an interest in) the relevant asset and to the taxpayer or taxpayers acquiring (an interest in) the relevant asset when apportioned as an undivided interest in the unincorporated joint venture or when contributed in consideration for the issue of shares in a SPFC or SPV (as applicable). For example, if participant A contributes depreciable plant and equipment to the joint venture, then depreciation balancing charges could arise on its transfer to the joint venture. Had participant A contributed cash (to the same value of the depreciable plant and equipment), no tax consequences would have flowed to participant A.²⁰ If the taxation consequences of making contributions in kind add greater fiscal complexity to a financing transaction than would otherwise be the case say, because of a more onerous compliance burden or because of

¹⁸ Sources of finance fall into two broad categories: debt and equity: cf, Fisher, *Natural Resources Law in Australia*, (1987), 482. Equity capital can involve finance from participants or equity participants, shareholders of the participants or equity participants, shareholders of the SPFC or SPV, the public, other investors, financiers and government participants. Debt finance can consist of third party finance, participant finance or equity participant finance, banks (individually or syndicated), other types of financiers and government investment. In 1987, Australia adopted a system of dividend imputation. Imputation creates fiscal uncertainty for participants and equity participants because while it removes the double taxation of income at the corporate and individual levels. There is still bias against equity financing, which therefore discriminates against foreign investors: Jüttner, *International Finance & Global Investments*, (1995), 488; see also US Department of the Treasury, *Report on the Department of the Treasury on Integration of the Individual and Corporate Tax System*, (1992).

¹⁹ If the borrowing participant is a participant and characterisation risk is not significant, then interest deductions will accrue to that participant. If the borrowing participant is a SPFC or SPV, interest will accrue at the level of the SPFC or SPV (as applicable).

²⁰ See generally chapter 5.

realisation of assessable gains (or allowable deductions) (eg from balancing adjustments), then sources of finance involving fewer complexities or simpler issues will be more attractive. There is no reason in principle why tax laws effectively discriminate between different sources of finance.

COMPLIANCE COSTS OF TRADITIONAL DEBT FINANCING

A simple method to finance an unincorporated joint venture or equity joint venture is the loan of a sum of money.²¹ This simplicity does not necessarily translate to low compliance costs for borrowing participants. A borrowing participant will incur compliance costs to determine whether interest expenses are deductible or not. These costs arise because of the distinction tax laws make between interest expenses incurred on capital account and interest incurred on revenue account, and the distinction between interest incurred before and during the income producing activity.

Tax laws in this area should be made more certain, which could reduce compliance costs to borrowing participants and 'eliminate many sources of tax avoidance'.²² The framework of the ITAA 97 is to establish assessable income as the starting point and from it subtract allowable deductions to arrive at the taxable income of the borrowing participant.²³ Only one provision of the ITAA 97 deals specifically with interest deductions.²⁴ The recognition of interest deductions for a borrowing participant will depend upon the application of s. 8-1(1) of the ITAA 97. Interest expenses are deductible if they are a loss or outgoing incurred in gaining or producing assessable income or necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income.²⁵

A borrowing participant must incur tax advisor's fees to determine whether its interest bill draws its character from the use of the borrowed funds. If the expense draws its character from the use of the borrowed funds, then the expense will be of a kind falling within the

²¹ That is, a financier pays over to the borrowing participant the principal sum, which the borrowing participant repays on the agreed date(s).

²² Conwell (1999), 246.

²³ We saw in chapter 2 that the Ralph Committee has proposed the cash flow/tax value methodology.

²⁴ See s. 25-25 ITAA 97 ('Borrowing expenses').

²⁵ Section 8-1(1) ITAA 97.

predecessor provision to s. 8-1(1).²⁶ A borrowing participant must therefore incur costs to examine the advantages and purposes for which the application and use of the borrowed money are intended to gain.²⁷

A borrowing participant bears the cost of determining whether interest expenses are on capital or revenue account.²⁸ These costs are incurred because of the effective complexity of tax laws. In particular, a borrowing participant must apply the basic principle by which payments of interest may be assigned to capital or revenue account. This principle is found in the (dissenting) judgement of Dixon J in *Sun Newspapers v FCT*,²⁹ where his Honour formulated the general principle that distinguishes between the two types of expenditure. That distinction corresponds with the distinction between on the one hand the 'business entity, structure, or organisation set up or established for the earning of profit' and on the other 'the process by which such an organisation operates to obtain regular returns by means of regular outlay'.³⁰ In applying this test, borrowing participants must consider three matters identified by his Honour. First, the character of the advantage sought and in this its lasting qualities may play a part. Secondly, the manner in which the funds are to be used, relied upon and enjoyed, and in this context recurrence may play its part. Thirdly, the means adopted to obtain the advantage, that is by providing a periodical outlay to cover its use or enjoyment.³¹

²⁶ *Fletcher v FCT* (1991) 173 CLR 1 (High Court); appld *Steele v FCT* (1999) 197 CLR 459; *AAT Case 14/98* (1998) 98 ATC 201; 39 ATR 1105; *Madigan v FCT* (1996) 68 FCR 19. See also Wallschutzky and Richardson (1995), Richardson (1995) and Burford (1995). *FCT v Roberts and Smith* (1992) 92 ATC 4380, 4388-4389 per Hill J; 23 ATR 494, 504; 108 ALR 385, 396.

²⁷ *Fletcher v FCT* (1991) 173 CLR 1; appld *Steele v FCT* (1999) 197 CLR 459; *AAT Case 14/98* (1998) 98 ATC 201; 39 ATR 1105; *Madigan v FCT* (1996) 68 FCR 19. See also Wallschutzky and Richardson (1995), Richardson (1995) and Burford (1995).

²⁸ A borrowing participant will not be entitled to a deduction for its interest expense if the expense is properly regarded as being on capital account.

²⁹ (1938) 61 CLR 337. This basic principle was recently confirmed by the High Court in *FCT v Energy Resources of Australia Pty Ltd* (1996) 185 CLR 66.

³⁰ *Ibid.*, 359-360.

³¹ *Ibid.*, 363. Cathro (1999), 224 states that under the cash flow/tax value approach 'it is likely that when determining whether an asset exists, the considerations brought into play will be similar to those which arose under the first limb of the test enunciated by Dixon J in *Sun Newspapers Ltd v FCT* ... but the second and third considerations mentioned by Dixon J will be largely irrelevant'.

High Court authority further complicates the law. For example, in *GP International Pipecoaters Pty Ltd v FCT*,³² the High Court recognised that the character of expenditure is ordinarily determined by reference to the nature of the asset acquired or the liability discharged, but added that the chief factor in determining the character of the payment is the character of the advantage sought by making the expenditure.³³ As not every interest expense incurred by a borrowing participant will be automatically deductible, a borrowing participant must utilise expertise to interpret and apply the law.³⁴

Compliance costs for borrowing participants should reduce when the measures proposed by the Ralph Committee are enacted. The Committee considers that legislation should be introduced making it clear that interest expense is a cost of maintaining access to the capital funds underlying a business and on this basis, should be immediately deductible.³⁵ A statutory provision to this effect would promote certainty by reducing the extent and practical significance of effective complexity of relevant tax laws and authorities and 'eliminate many

³² (1990) 170 CLR 124.

³³ Ibid, 137.

³⁴ See *Steele v FCT* (1999) 197 CLR 459, where the High Court endorsed Lockhart J's dicta in *FCT v Total Holdings (Australia) Pty Ltd* (1979) 43 FLR 217, where, in qualifying the 'general' deductibility of interest incurred for the purpose of furthering a present or prospective income producing activity, his Honour said that some qualification may be necessary in appropriate cases, 'for instance, where interest is paid by a taxpayer as a prelude to his being in a position whereby he may commence to derive income. In such cases the requirement that the expenditure be incidental and relevant to the derivation of income may not be satisfied' (1979) 43 FLR 217, 224. See also *Ruling TR 2000/D3* ('Deduction for interest following the *Steele* and *Brown* decisions').

³⁵ *A Tax System Redesigned*, Overview, para. 159. It is noted that there are four exceptions to 'his general rule. But these are unlikely to apply to most mining and petroleum joint ventures in Australia. The exceptions are: (1) interest incurred as a private or domestic expense, (2) interest incurred to earn exempt income (other than exempt foreign source income), (3) prepaid interest and (4) borrowings relating to land which is held by an individual but not used for income-producing purposes (other than the realisation of a capital gain) (para, 190). Note that if this measure is enacted, then it will render redundant the principles in *Fletcher v FCT* (1991) 173 CLR 1. The determination of the characterisation of an outgoing will no longer be a relevant consideration for borrowing participants who incur interest expenses. In the meantime, such a determination is relevant for borrowing participants. See also Cooper, 282: Treasurer's response, *The New Business Tax System: Stage 2 Response*, Press Release no. 74, 11 November 1999, 5, where the Treasurer states: 'The Government sees considerable merit in the high level reforms proposed by the Review and has given in principle support to their introduction. However, it recognises the importance of developing a workable system that can be implemented with minimum disruption.'

sources of tax avoidance'.³⁶ The determination of the characterisation of an outgoing would no longer be a relevant consideration for borrowing participants who incur interest expenses.³⁷

If tax laws ceased to make a distinction between interest expenses incurred on capital account and interest incurred on revenue account, this would surely produce a compliance cost saving for borrowing participants. The cost saving would equal the resource saving to a borrowing participant from not seeking legal advice. But a borrowing participant who uses in-house tax advisors to provide such advice would probably not reap any savings, because it is likely that the salary cost of those in-house advisors would remain. It would, however, free up some time of those tax-advisors for other tax related activities.

If the borrowing participant were a participant of an unincorporated joint venture, then the compliance cost saving would be derived at the level of the participant. If the borrowing participant were a SPFC or SPV, then the SPFC or SPV (as applicable) would make the cost saving.

The introduction of the Ralph Committee's measure should also reduce the compliance cost burden on borrowing participants in respect of determinations about the recognition of interest deductions on debt used to purchase an asset before an income producing activity has commenced.

Under current law, it is well settled that substantial contemporaneity in the derivation of assessable income and the incurring of the outgoing is not legally essential,³⁸ but is one of a

³⁶ Conwell (1999), 246.

³⁷ Cathro (1999), 223-224: 'Under the proposals all expenditure is taken into account in calculating net income. Again the character of the expenditure as revenue or capital is strictly irrelevant'.

³⁸ *Steele v FCT* (1999) 197 CLR 459; appld *FCT v Brown* (1999) 99 ATC 4600; Csd *FCT v Email Ltd* (1999) 99 ATC 4868; *Pine Creek Goldfields Ltd v FCT* (1999) 99 ATC 4382; 41 ATR 471; *Bell & Moir Corp Pty Ltd v FCT* (1999) 99 ATC 4738; 42 ATR 421. See also *Ruling TR 2000/D3* ("Deduction for interest following the *Steele* and *Brown* decisions"). By contrast, it is settled law that a borrowing participant may recognise a deduction for interest on funds borrowed to purchase a business once the business has ceased to exist: *AGC (Advances) Ltd v FCT* (1975) 132 CLR 175, and its subsequent application by the Full Federal Court in *Placer Pacific Management Pty Ltd v FCT* (1995) 95 ATC 4459; 31 ATR 253. In the *AGC* case, the court held that where the occasion of the loss or outgoing is to be found in the occasion of carrying on of a business for the production of assessable income, the nexus requirement is satisfied (the High Court denied special leave to appeal from the decision in *Placer Pacific* and the ATO has indicated that it accepts the decision. It may be questioned whether the ATO necessarily accepts that the decision provides authority for the proposition that after a business ceases to operate a taxpayer will be entitled to a deduction for recurrent expenditure such as rental expenses or interest on funds borrowed for the purpose of carrying on business.). *FCT v Brown* (1999) FCA 563,

number of factors relevant to a judgement about whether the necessary connection between the incurring of an outgoing and the gaining or producing of assessable income by a borrowing participant might exist in a given case.³⁹ There may be cases where the necessary connection will be denied because the outgoing is entirely preliminary to the gaining or producing of assessable income⁴⁰ or is incurred too soon before the commencement of the business or income producing activity.⁴¹

A Tax System Redesigned states 'that interest expenditure be ... deductible in calculating taxable income in the year incurred except [when one of the enumerated exceptions apply]'.⁴² It can be inferred that interest incurred by a borrowing participant in purchasing an asset before commencement of an income producing activity is immediately deductible under the Ralph proposal. This view is supported by the absence of one of the four exceptions expressly or impliedly covering interest incurred before the commencement of an income producing activity.⁴³ As such, if borrowing participant A borrowed \$100 million to fund the development of a deep-sea petroleum venture and that borrowing participant incurred a \$2 million interest bill before the commencement of the development of a deep-sea petroleum venture, then that \$2 million expense would be recognised as a deduction.⁴⁴

Assuming that an Act and explanatory memorandum are introduced in the form of and to the effect of Option 2 as proposed by the Ralph Committee, the circumstances in which an

Full Federal Court, 3 June 1999 confirms the judicial trend to treat interest on a loan taken out to purchase a business which is later sold at a loss as continuing to be deductible after the business ceased (borrowings originally made to acquire an income-producing asset retained that character even after the sale of the business).

³⁹ Id.

⁴⁰ For example, *Softwood Pulp and Paper Ltd v FCT* (1976) 7 ATR 101, 113; 76 ATC 4439, 4450.

⁴¹ *FCT v Maddalena* (1971) 45 ALJR 426; 71 ATC 4161; 2 ATR 541; *Lodge v FCT* (1972) 128 CLR 171; cf *FCT v Riverside Road Lodge Pty Ltd (in Liq)* (1990) 23 FCR 305.

⁴² *A Tax System Redesigned*, 190.

⁴³ The four exceptions do not apply to interest expenses incurred by a borrowing participant before the commencement of an income producing activity. The exceptions are: (1) interest incurred as a private or domestic expense, (2) interest incurred to earn exempt income (other than exempt foreign source income), (3) prepaid interest and (4) borrowings relating to land which is held by an individual but not used for income-producing purposes (other than the realisation of a capital gain): *A Tax System Redesigned*, Overview, paras. 159 and 190.

⁴⁴ For ease of analysis, this example assumes that borrowing participant A is not involved in another business activities.

explanatory memorandum relating to a bill that is furnished to the members of either House of Parliament by a Minister when a provision is enacted may be considered in the interpretation of a provision of an Act are set out in s. 15AB(1) of the *Acts Interpretation Act 1901* (Cth). First, the extrinsic material must be 'capable of assisting in the ascertainment of the meaning of the provision'. Then, consideration may be given to the material,

- (a) to confirm that the meaning of the provision is the ordinary meaning conveyed by the text of the provision taking into account its statutory context in the Act and the purpose or object underlying the Act; or
- (b) to determine the meaning of the provision when:
 - (i) the provision is ambiguous or obscure; or
 - (ii) the ordinary meaning conveyed by the text of the provision taking into account its context in the Act and the purpose or object underlying the Act leads to a result that is manifestly absurd or is unreasonable.

Section 15AB(3) states that, in determining whether consideration should be given to any material in accordance with s. 15AB(1), or in considering the weight to be given to any such material, regard shall be had, in addition to any other relevant matters, to two factors. First, to the desirability of persons being able to rely on the ordinary meaning conveyed by the text of the provision taking into account its statutory context and the purpose or object underlying the Act. Secondly, to the need to avoid prolonging legal or other proceedings without compensating advantage.

The 'purpose or object' underlying an Act are given significance in its interpretation by s. 15AA too:

[i]n the interpretation of a provision of an Act, a construction that would promote the purpose or object underlying the Act (whether that purpose or object is expressly stated in the Act or not) shall be preferred to a construction that would not promote that purpose or object.

It has been pointed out that s. 15AA requires a court to prefer one construction to another and that such a requirement can only have meaning where two constructions are otherwise open.⁴⁵ To similar effect are the comments of the High Court (Mason, Wilson, Brennan, Deane and

⁴⁵ *Trevisan v FCT* (1991) 91 ATC 4416, 4420, per Burchett J.

Dawson, JJ) in *Ball v FCT*,⁴⁶ that comments made in a Minister's second reading speech that are reflected in an explanatory memorandum issued at the same time 'cannot ... be relied upon to give a different operation to one aspect of [a provision] which is plainly expressed'. More recently, speaking of provisions of the *Interpretation of Legislation Act 1984* (Vic) that allowed recourse to certain extrinsic materials but which, unlike s. 15AB of the Commonwealth Act did not restrict the purposes for which it was permissible to consider the extrinsic materials, Brennan and Gaudron JJ in *Catlow v Accident Compensation Tribunal*⁴⁷ said:

[w]hether or not extrinsic material is considered in interpreting a statutory provision, it is clear that the meaning attributed to the statute must be consistent with the statutory text. If the meaning which would otherwise be attributed to the statutory text is plain, extrinsic material cannot alter it. It is only when the meaning of the text is doubtful (to use a neutral term rather than those to be found in s. 15AB(1) of the Acts Interpretation Act), that consideration of extrinsic material might be of assistance.⁴⁸

It follows that it would be erroneous for a borrowing participant to look to the extrinsic material before exhausting the application of the ordinary rules of statutory construction. If, when that is done, the meaning of the statutory text is not doubtful there is no occasion to look at the extrinsic material. The remarks of Brennan and Gaudron JJ were made in a dissenting judgment but nothing in the majority judgments indicates disagreement with them and the decision in the case did not depend upon a construction derived from an examination of extrinsic material.⁴⁹

The language of Option 2 is not such as to require recourse to extrinsic material to ascertain its meaning. It requires all interest expenses to be deductible unless one of the four exceptions applies. The phrase 'that interest expenditure be ... deductible in calculating taxable income in the year incurred' is arguably neither ambiguous nor obscure. The words 'interest

⁴⁶ (1984) 15 ATR 1296, 1297.

⁴⁷ (1989) 167 CLR 543.

⁴⁸ Ibid, 549-550.

⁴⁹ See also *FCT v Bill Wissler (Agencies) Pty Ltd* (1985) 16 ATR 952, 955; *Gray v FCT* (1989) 20 ATR 649, 654-655, where it was concluded that particular language of the ITAA 36 was clear and unambiguous and the consequence of giving it its ordinary meaning did not lead to a result which was manifestly absurd or unreasonable though 'to some the result may seem extremely unfair' (to a taxpayer).

expenditure' indicate that the Ralph measure is concerned with a borrowing participant incurring the expenditure. The word 'incur' is unqualified. There is no ambiguity or obscurity in its failure to reveal whether or not the relevant expenditure must be incurred during the income producing activity. The fact that the expenditure may be incurred before the income producing activity has commenced suggests that such expenditure will be deductible.

This conclusion is consistent with the conceptual basis on which Option 2 is based. After all, matching of expenditure with an 'income producing activity' implied by temporal nexus requirements, for example, will not be needed under Option 2.⁵⁰

If, contrary to the author's opinion, it would be permissible to refer to the explanatory memorandum in aid of the interpretation of the Ralph measure (and assuming that the explanatory memorandum merely re-casts the text as set out in *A Tax System Redesigned*), the author does not consider that it resolves the critical question. The commentary in *A Tax System Redesigned* is unhelpful since there is no attempt to explain the concepts. It is true that the example of the possible application of the Ralph measure does not deny its application to it unless by necessary inference. It would have to be deduced from the example that the use made by the borrowing participant of the interest expense was not beyond the field of inquiry of the measure.

It may not be permissible to infer from the example that the interest deduction that is allowed is a way in which the exception can be attracted. If it is possible to deduce any general rule from the second example it is that the Ralph measure is attracted where a borrowing participant incurs interest expenses before the commencement of an income producing activity. That is to say it tends to support the view of the Ralph measure that the author prefers.

If interest incurred by a borrowing participant in purchasing an asset *before* commencement of an income producing activity is immediately deductible, then all taxpayers would stand to benefit from no longer having to incur costs (eg tax lawyer's fees) to determine whether

⁵⁰

See generally, Abbey (2000); Warburton Committee, *The Tax Value Method, Discussion Paper* (2000), and Grbich (2000).

sufficient contemporaneity exists between the incurring of the expenditure and the income producing activity.

In comparative terms, however, shareholders of a borrowing participant who is a SPV or SPFC would each have a lower cost saving than participants who separately arrange their finance. This is because the compliance costs relating to the deductibility of interest expenses for a SPV or SPFC are incurred at the level of the SPV or SPFC, whereas participants who separately arrange their finance bear all the compliance costs relating to the deductibility of their interest expenses.⁵¹

COMPLIANCE COSTS OF LEVERAGED LEASING

This section of the chapter explains what leveraged leases are and how they operate, then identifies the compliance cost issues facing lessee participants and explains how the Ralph Committee's recommendations will affect compliance costs in the future. Compliance costs arise because of the regulatory burden, the abolition of accelerated depreciation, the differing characterisations of rental payments, regulatory uncertainty and the potential operation of Pt IVA on leveraged lease arrangements.

Leveraged leasing is a form of tax effective financing used to finance the cost of significant capital items such as co-generation plants, power stations, mining infrastructure, pipelines and manufacturing plants. The use of a leveraged lease will be desirable if it can deliver to the lessee either a lower asset cost or a lower net financing cost compared to traditional debt finance.⁵² That is not the only benefit of leveraged leasing. A leveraged lease 'can also provide businesses with the ability to use major capital equipment over an extended period of time without affecting their balance sheets.'⁵³

Joint venture parties may decide against using a leveraged leasing arrangement to finance

⁵¹ This assumes that the original level of compliance costs in both cases is the same. It will not be permissible to make this assumption in all cases.

⁵² Schwarz (2000), 2. It follows that from a tax perspective, a leveraged lease will not be used where a lessee participant cannot procure either a lower asset cost or a lower net financing cost compared to traditional debt finance.

⁵³ Id.

project obligations if one of the parties has a low credit rating.⁵⁴ Suppose that a chemical company and a utility join together in an unincorporated joint venture to build, own and operate a co-generation facility for \$300 million. The chemical company requires steam; the utility requires electricity. The chemical company has an 'AAA' debt rating whereas the utility's debt rating is 'BBB'. As a result, the chemical company can secure cheaper debt finance than the utility. The chemical company is therefore reluctant to incorporate a SPFC with the utility to finance the lease of the facility. The terms and conditions of the JVA provide that each participant must provide one-half of the cost of the facility in return for which each participant has an undivided one-half participating interest in the facility. The chemical company contributes \$150 million from internally generated funds. Neither the utility nor any member of its corporate group can currently fully utilise the tax benefits of interest deductions on debt. If the utility did use debt finance, the net present value of the project to the utility would be too low for the board of directors of the utility to allow the project to proceed. Therefore, the utility relies on a third party leasing company to finance its \$150 million contribution to the project.⁵⁵

A leveraged lease transaction involves a tax shift in that the participant, SPFC or SPV leasing the plant or equipment (the *lessee participant*), loses a tax benefit accruing to it from owning the plant or equipment (fractionally or otherwise) by not acquiring that plant or equipment directly, which benefit is shifted to the owner(s) of the plant or equipment (ie the lessors).⁵⁶ Repayment of the borrowed money is secured against the subject matter of the lease (ie the plant or equipment) without recourse to the lessee participant personally.⁵⁷ Tax benefits in ownership of the plant (eg depreciation) accrue to the lessors giving them tax deferral advantages which, when combined with the rental, produce an attractive overall rate of return.

⁵⁴ Refer Buchanan (1989), 26 - 28 for a general outline of the commercial reasons why equipment leasing is an attractive alternative to purchasing.

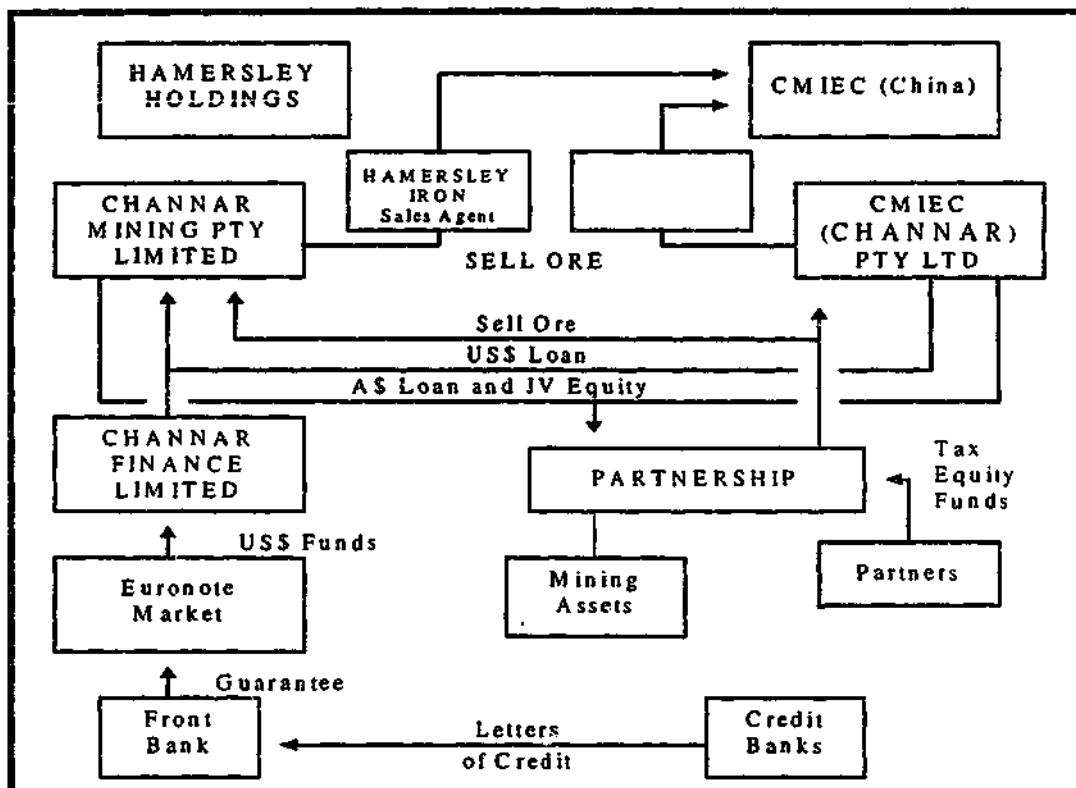
⁵⁵ Ibid, 29-30. If the size of debt is substantial, in practice a lessor would join with several other taxpayers (eg a partnership) to share risk. The partnership will purchase an undivided share of the leased asset using borrowed funds with only a small proportion of the total purchase price being contributed in equity: *Ruling IT 2051*, para. 3. The lease runs from the third party leasing company to the utility.

⁵⁶ This chapter is concerned with the tax implications of leveraged leases to lessee participants and not to the lessors. See *Ruling IT 2051* for a basic discussion on the tax implications for the lessor partners.

⁵⁷ Deutsch, *Australian Tax Handbook*, (1999), para. 20-370; Pennington, *Bank Finance for Companies*, (1987), 13 states that 'the value of a non-recourse loan facility to the borrowing company is that the

The operation of leveraged leases in the joint venture context is best illustrated by a relatively recent Australian example. The Channar Iron Ore Project in the Pilbara, Western Australia is an unincorporated joint venture formed in the 1980s in which Hamersley Holdings group and China Metallurgical Import and Export Corporation (CMIEC) hold beneficial interests of 60 percent and 40 percent, respectively.⁵⁸ The initial project financing structure of the joint venture is set out in Figure 3.3.⁵⁹

Figure 3.3: Channar Iron Ore Project - Financing Structure



As we can see from Figure 3.3, the funds were sourced from a partnership of investors formed to own and operate the mining plant and facilities during the financing period. The participants of the unincorporated joint venture entered into a sub-lease with the partnership and an ore purchase contract, under which all ore produced by the partnership was to be sold to the participants at a price that would cover the partnership's operating costs and give the partnership an agreed after tax return on its partners' investment.

company is no longer personally liable to repay the outstanding loan, which is now charged exclusively to the project which the loan was used to finance'.

⁵⁸

The beneficial interests of the participants and even the taxpayers themselves, may be different today.

The participants each subscribed for 50 percent of the issued shares in a SPFC (ie Channar Finance Ltd), which entered into a 12 year US\$170 million debt funding arrangement with an international banking syndicate, and on-lent the funds raised to the participants. The participants subsequently lent the funds (in Australian dollars) to the partnership. Further, the participants contributed 30 percent of the initial development cost to the partnership in the form of an unsecured promissory note facility postponed to all other finance.

Channar Finance Ltd was able to raise funds directly from banks pursuant to a credit agreement or to use letters of credit provided by those banks to support other financial arrangements. Moreover, the international banking syndicate underwrote a US\$60 million facility, which could have been activated at any time until December 1995 in order to fund expansion of the project from its initial production level to full capacity.⁶⁰

The regulatory burden

There is a significant 'paper burden' or administrative cost to lessee participants associated with complying with and/or reporting on the regulatory requirements for a leveraged lease. We know that it is not just the tax that matters to compliance costs but the requirements involved in complying. The Australian Chamber of Commerce and Industry considers that the painstaking detail and effort required by lessee participants in adhering to tax laws are a major impediment to the efficient operation of the economy.⁶¹ For example, leveraged lease transactions may be subject to additional provisions because they involve sale and lease back arrangements,⁶² or because non-resident lessee participants are involved,⁶³ or there are questions about the characterisation of certain (largely) immovable equipment as either chattels or fixtures.⁶⁴ It is easy to imagine the potential compliance burdens confronting

⁵⁹ Reproduced from: O'Leary (1989), 9.

⁶⁰ Modified from: O'Leary (1989), 9-10.

⁶¹ ACCI, *What Business Seeks from the Next Government of Australia: ACCI Review No. 18*, (1996), 4.

⁶² See for example *Ruling TR 95/30*.

⁶³ Refer s. 51AD and Div 16D of the ITAA 36, *Ruling TR 96/22* and draft *Ruling TR 94/D25*. It is noted that the Ralph Committee has recommended that s. 51AD be repealed: *A Tax System Redesigned*, 392.

⁶⁴ Speaking generally, ownership of an asset that is a chattel can be structured so that the asset is owned by either the lessor or lessee participant to produce the desired entitlement to depreciation. An asset that is a fixture may be owned (and thus only able to be depreciated, if at all) by the owner of the land to which it is affixed (refer draft *Ruling TR 94/D26* for the ATO's 'considered but not final' view of what is a

lessee participants.

Lessee participants must incur costs to comply with the ATO's tax rulings on the subject. Tax rulings are designed to give taxpayers and administrators guidance where the law is unclear.⁶⁵ Tax rulings are a response to legislative uncertainty. The Commissioner's views regarding leveraged leases, which are contained primarily in *Rulings* IT 28 and IT 2051, clarify but complicate the law. Traditionally, where a lessee participant complies with these rulings, the lessee participant would be entitled to a full deduction for rental payments (as opposed to the interest and depreciation charges).

The combined effect of *Rulings* IT 28 and IT 2051 is to set the minimum standards with which leveraged lease transactions must comply before the ATO would accept them. A lessee participant would therefore have to comply with the requirements of those rulings if its leveraged lease transaction is to be accepted by the ATO. In order to comply with the requirements of the rulings, a lessee participant must incur either in-house tax advisor costs, legal expenses, or both. For instance, a lessee participant must determine that its leveraged lease does not contain an option to purchase, that the lease agreement provides for the sale of the plant by public auction during or on termination of the lease,⁶⁶ it cannot retain the use of the plant at the expiration of the lease term (except from having purchased it), the lessors' normal business activities includes the lending of money or the leasing of property⁶⁷ and the lessors are fully at risk for at least 20 percent of the cost of the plant (ie borrowed money must not exceed 80 percent).⁶⁸ These should be relatively straightforward matters to clarify by a performing a due diligence. If, however, a leveraged lease transaction is particularly complex, either on the face of its terms, or because the transaction requires a lessee participant to understand the operation of a number of agreements (eg related finance and security documentation), then the compliance costs would be expected to be higher.

fixture). Exceptions have long existed to allow lessees of land under various Crown leases to be treated as the owner for depreciation purposes of plant and equipment they place on the land (refer s. 42-15 ITAA 97).

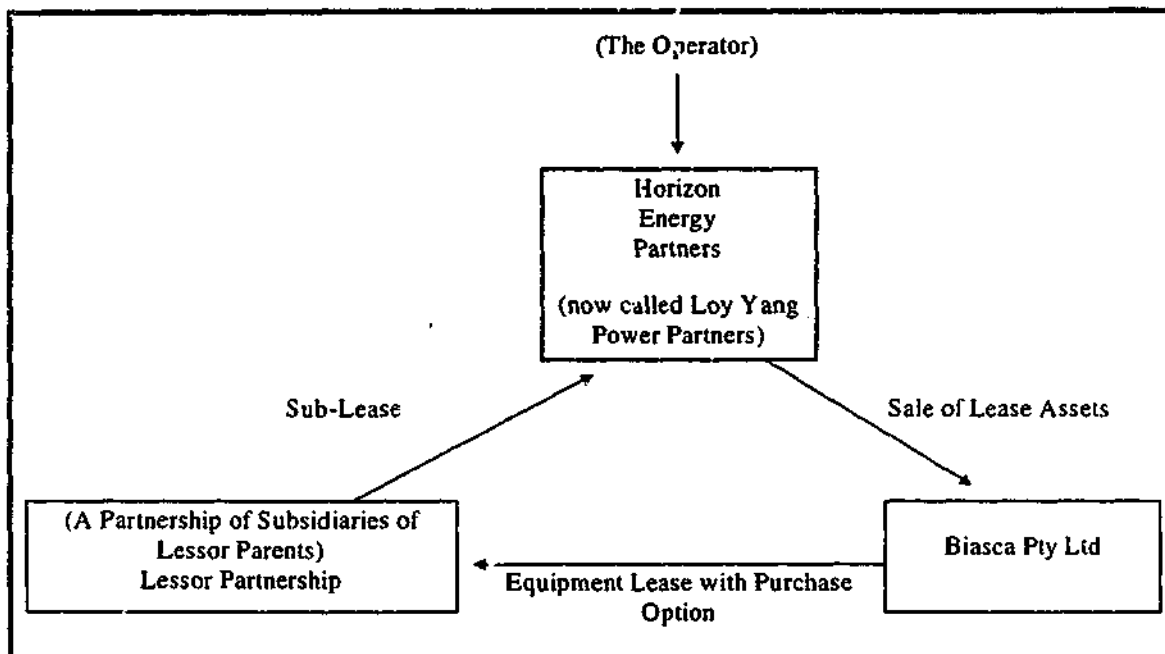
⁶⁵ In this context, a 'lawmaker' is defined to mean the Commonwealth Parliament, the Australian Taxation Office and the Australian courts and tribunals that make judgements on tax matters.

⁶⁶ *Ruling* IT 2051, para. 8.

⁶⁷ *Ibid*, para. 24.

In addition, there is considerable fiscal uncertainty about the degree of reliance lessee participants can place on the ATO's leasing rulings following the 1998 decision of the Full Federal Court in *Bellinz Pty Ltd v FCT*.⁶⁹ That case involved a leveraged lease of equipment in Australia that the lessor acquired pursuant to a lease with purchase option. The taxpayer was a member of the partnership involved in the purchase of a power station from the Victorian Government on 12 May 1997. The lease with purchase option was structured to comply with the ATO's various public rulings setting out the features considered sufficient to allow the lessor to be treated as the owner for taxation purposes. The relevant transactions in that case are shown diagrammatically in Figure 3.4.

Figure 3.4: *Bellinz Pty Ltd v FCT* - Leveraged Lease Structure



The ATO did not issue a private ruling to the lessor confirming its ownership of the equipment for taxation purposes so the matter was referred to the Federal Court. In the course of its judgement, the Court essentially confirmed three things. First, the lessor was not by virtue of the lease with purchase option, the owner of the equipment for Australian taxation purposes; secondly, the ATO was not required under its various public rulings to treat the lessor as if it were the owner and the failure of the ATO to issue a private ruling in this case

⁶⁸ Ibid, para. 10.

⁶⁹ (1998) 84 FCR 154. See also D'Ascenzo (1998).

was not an abuse of power by the ATO.

Merkel J (at first instance) stated that *Ruling IT 2419*⁷⁰ 'only applies to an "eligible trading ship" being hired under a hire purchase agreement'.⁷¹ The logical inference from his Honour's statement is that the mere fact that there was a different type of equipment in this case was sufficient to exclude reliance on the public ruling. The Full Federal Court agreed, and held that public rulings, if they can be relied upon at all, can only be relied on when the arrangement being tested is the same as the arrangement or class of arrangements described in the public ruling. Because the facts in *Bellinz case* were not precisely similar to the arrangements described in the ATO's various public rulings on leasing, the taxpayers could not rely on those rulings. Therefore, the taxpayers could not be treated as owning the equipment.

To the extent that the effect of the *Bellinz case* causes prospective lessee participants to obtain legal advice before entering into a leveraged lease transaction, then compliance costs for these taxpayers will increase. The cost increase will equal the cost of obtaining that legal advice plus any the cost of anything else which the lessee participant does pursuant to that advice (eg obtaining a private ruling from the ATO).

Moreover, some tax laws governing leveraged leases are obscure, complex or uncertain in their operation. This contributes to the level of compliance costs of lessee participants. For example, problems created by long carry forward periods for deductible expenditure on a joint venture project have been partially alleviated by Subdiv 170-B of the ITAA 97.⁷² Broadly, Subdiv 170-B enables the transfer of net capital losses from one company in a 100 percent wholly owned group to another company in the same group. However, Subdiv 170-B has helped neither participants which lack taxable income in the foreseeable future from any of their unincorporated joint venture operations nor equity participants whose SPV is not expected to generate any taxable income in the early years of a project where the provisions do not operate. If a lease is not a leveraged lease, it could be a hire purchase agreement, or a lease with an option to buy. Under *Rulings IT 28, IT 196 and TR 95/30*, the Commissioner

⁷⁰ This ruling confirms that a hirer of a trading ship under a hire purchase agreement is to be treated as the owner of the ship for depreciation purposes.

⁷¹ *Bellinz Pty Ltd v FCT* (1998) 38 ATC 4399, 4414; 38 ATR 350, 368.

⁷² Its predecessor was s. 80G ITAA 36.

considers that the lessee participant in these circumstances is the owner of the plant for Australian taxation purposes with effect that a lessee participant is entitled to depreciate the plant and claim allowable deductions for interest expenses on the hire payments.

Abolition of accelerated depreciation

Up until 21 September 1999, the annual rate at which a lessee participant has been entitled to depreciate an asset has been based on the 'effective life' of the plant adjusted by a 20 percent loading.⁷³ This loading has enabled depreciation to be calculated at a faster rate than would otherwise be expected. Accelerated depreciation was removed on 21 September 1999.⁷⁴

The removal of accelerated depreciation means that the tax deferral opportunities available under a leveraged lease are now gone. Although these tax deferral advantages did not create the tax savings generated under a leveraged lease, they did provide significance cash flow benefits to lessee participants in the early stage of a leveraged lease. By removing accelerated depreciation, any entitlement to depreciate will now be based on the effective life of the plant only. The removal of accelerated depreciation will affect the ability of lessee participants to obtain a lower cost of finance because they are no longer able to transfer the benefit of accelerated deductions to a financier. Whilst a lower corporate rate should compensate for this, it is unlikely to stimulate finance for currently marginal projects.⁷⁵

In addition to removing accelerated depreciation, the Government has accepted the Ralph Committee's recommendation to allow a taxpayer to reassess the effective life of an asset, where the plant has been affected by market, technological or other factors. Where these factors have an adverse affect on the effective life of the plant, a taxpayer will be entitled to shorten the effective life of the asset and, consequently, increase the rate of depreciation.⁷⁶

⁷³ See Subdiv 42-C ITAA 97.

⁷⁴ The Ralph Committee's recommendation to remove accelerated depreciation was accepted by the Government and accelerated depreciation was removed effective from 21 September 1999: Treasurer, *The New Business Tax System*, Press Release no. 58, 21 September 1999, Attachment B and sch 3 of *New Business Tax System (Capital Allowances) Act 1999* (Cth).

⁷⁵ Ernst & Young, *Minerals & Energy Tax Update*, November 1999, 2; F Buffini, 'Fears held for future of leasing markets', *The Australian Financial Review*, 1 October 1999, states that: 'The lower corporate tax rate and the removal of accelerated depreciation will slash returns in the billion-dollar leasing market, analysts have warned'.

⁷⁶ *A Tax System Redesigned*, 313.

At this stage, the extent to which a taxpayer will be entitled to increase the rate of depreciation as a result of reassessing the effective life of plant is not entirely clear. Therefore, a lessee participant who has entered into a leveraged lease transaction after 21 September 1999 and who believes that its plant has been affected by market, technological or other factors will not know how to proceed. It is likely that costs will be incurred in corresponding with the ATO to find a solution.⁷⁷ If a lessee participant agrees with the ATO to defer the reassessment of the effective life of the plant until the Commissioner publishes a ruling, then the lessee participant will bear costs of understanding the new rules, reassessing the effective life of the plant and modifying the lessee participant's information technology 'fixed assets' register' so that it depreciates the plant at the adjusted rate.

Characterising rental payments

Subject to a few specific provisions of the ITAA 36,⁷⁸ a lessee participant will be entitled to a deduction where the requirements of s. 8-1(1) of the ITAA 97 are met. This provision is generally well understood by tax advisors.

But the application of s. 8-1(1) does impose an administrative burden. In order for a lessee participant to be entitled to recognise rental payments as deductions pursuant to s. 8-1(1), a lessee participant must be satisfied that the rental payments are not incurred for the purpose of acquiring the plant at the end of the lease term, as would be the case under a hire purchase agreement. Where that purpose is found to exist, it will probably cause the rental payments to assume a capital character and therefore be non-deductible pursuant to s. 8-1(1) as currently enacted.⁷⁹

In addition, a lessee participant must consider whether s. 82KJ of the ITAA 36 will apply. The section was introduced partly in response to the decision in *South Australian Battery*

⁷⁷ However, this change, together with the reduction in the company tax rate, should soften the impact of the removal of accelerated depreciation on an Australian lessee.

⁷⁸ Part IVA and Subdiv D of Div 3 of Pt III ITAA 36 (comprising ss. 82KH – 82KL). This Subdiv contains various provisions denying deductions otherwise allowable in respect of specific tax avoidance schemes. For the purposes of Subdiv D, a tax avoidance agreement is defined extremely widely and arguably includes any arrangement entered into for purposes including the purpose of obtaining a taxation deduction (see s. 82KH(1) ITAA 36).

⁷⁹ In this connection, the definition of hire purchase agreement contained in s. 82AQ ITAA 36 may be relevant.

Makers Pty Ltd v FCT.⁸⁰ In that case, the taxpayer leased a turn key⁸¹ factory from a State instrumentality for an excessive rental, on terms that included the ability of an associate to purchase the factory for a bargain price. Largely because of the particular relationship of the associate to the taxpayer, the taxpayer successfully resisted the Commissioner's attempts to disallow the rental deduction.

If the section applies, it will deny any deduction *whatsoever* for a loss or outgoing.⁸² Two conditions must be satisfied before the section will apply to the detriment of a lessee participant.⁸³ It is arguable that since *FCT v Ilbery*⁸⁴ and *Ure v FCT*,⁸⁵ a court considering the *Battery Makers case* today would probably decide that s. 8-1(1) of the ITAA 97 would operate. If so, the rental outgoing will be deductible only to the extent it is a rental payment on commercial arm's length terms.

Under Option 2, the determination of taxable income involves recognition of the two components of a lessee participant's income—'the net annual cash flows from the use of relevant assets and liabilities and the change in tax value of those assets and liabilities.'⁸⁶ The recognition of expenditures will not involve the characterisation of an outgoing as either revenue or capital.⁸⁷ The critical determinant will be the tax value of the asset created. This

⁸⁰ (1978) 140 CLR 645.

⁸¹ A 'turn key' contract is a contract in which an independent contractor undertakes to furnish all materials and labour and do all the work required to complete a project in a workmanlike manner, place it in production and turn it on ready to 'turn the key' and start production running: Williams and Meyers, *Williams and Meyers Manual of Oil and gas Terms*, (1997), 1130.

⁸² If the section applies, then no deduction is allowable to the taxpayer in respect of the loss or outgoing as distinct from merely the excessive component, which is the case with the thin capitalisation rules.

⁸³ First, having regard to the benefit in respect of which a loss or outgoing is incurred (but without regard to any benefit relating to the acquisition of the property the subject of the outgoing), the amount of the loss or outgoing must be greater than the amount that might reasonably be expected to have been incurred, at that time, in respect of that benefit if the loss or outgoing had not been incurred by reason of, or as a result of or as part of a tax avoidance agreement. Secondly, property must be acquired under the arrangement by the lessee participant (or an associate) for less than the consideration that would reasonably be expected to be payable for the acquisition of the property had the loss or outgoing referred to above not been incurred.

⁸⁴ (1981) 81 ATC 4661.

⁸⁵ (1981) 81 ATC 4100.

⁸⁶ *A Tax System Redesigned*, 157.

⁸⁷ *Ibid*, Overview, 37.

reform should reduce compliance costs and improve the structural integrity of the present system, by reducing complexity and uncertainty, to provide a basis for ongoing simplification and to align more closely taxation law with accounting principles.⁸⁸

Regulatory uncertainty of the new regime

There is considerable uncertainty about the extent to which the proposed Divs 240 and 243 of the ITAA 97⁸⁹ and the Ralph Committee's proposed lease reforms will affect the level of activity in leveraged leases. Leveraged leasing will cease to be a tax effective financing structure if the use of a leveraged lease cannot deliver to a lessee participant either a lower asset cost or a lower net financing cost compared to traditional debt finance.⁹⁰ If activity in leveraged leasing transactions decreases because of the reforms, then lessee participants will have lost one method open to them to use major capital equipment over an extended period of time without affecting their balance sheets. A lessee participant will incur costs to understand the new rules and to assess whether the use of a leveraged lease delivers a higher asset cost or a higher net financing cost compared to traditional debt finance.

Divisions 240 and 243 of the ITAA 97 have been proposed. This Division, if passed into law in its current form, will apply from 27 February 1998 and will allow depreciation for goods held under 'hire purchase agreements' where certain conditions are met. Division 240 will deem such arrangements to be 'notional sales' of assets to the hirers, combined with 'notional loans'. Division 243 will ensure that deductions for capital allowances do not exceed the total amount expended by a taxpayer where expenditure relating to the capital allowances has been financed by limited recourse debt or hire purchase.⁹¹ The selling price is either the agreed cost or value, or the arm's length value of the property in question.⁹² For the notional buyer, the cost of the property is the same as the selling price. The consequences of the transaction are that the notional buyer is treated as the owner of the property and is entitled to relevant

⁸⁸ Id.

⁸⁹ The proposed new rules are contained in *Taxation Laws Amendment Bill (No 5) 1999* (Cth).

⁹⁰ Schwarz (2000), 2.

⁹¹ Division 243 ITAA 97.

⁹² The gain to revenue from this measure is anticipated to be approximately \$40 million in 1998-99 and \$50 million per year in 1999-2000, 2000-01, 2002-03 and 2003-04: Explanatory Memorandum, *Taxation Laws Amendment Bill (No 5) 1999*, 4.

taxation benefits such as depreciation or, if the property is trading stock, deductions for the cost.

The effect of the proposed Div 240 is that a lessee participant can depreciate plant that is the subject of a leveraged lease by simply choosing to structure the transaction in such a way that it is characterised as a sale for Australian tax purposes.

In the future, it appears that lessee participants will always be entitled to depreciate regardless of whether a leveraged lease is structured as a sale or as a genuine lease for tax purposes. This is because the Government has accepted in principle the Ralph Committee's recommendations relating to the taxation of leases which includes the 'sale and loan approach' for all leases involving big ticket capital items, referred to by the Ralph Committee as 'non-routine' leases.

The sale and loan approach, recasts a non-routine lease⁹³ for tax purposes as a sale by the lessor to the lessee participant financed by a loan from the lessor to the lessee participant.⁹⁴ Consequently, the lessee participant is treated as the 'owner' of the plant for depreciation purposes, while payments made by the lessee participant are treated as repayments of the loan plus interest, with only the interest component being deductible. However, the Committee has said that 'tax preference transfer should be permitted in relation to leasing between taxpayers'.⁹⁵ But, the removal of accelerated depreciation has essentially removed this as an issue for the Revenue.⁹⁶

According to the Ralph Committee, the introduction of the sale and loan approach will ensure that the tax benefits associated with leasing transactions are removed⁹⁷ and leases are taxed

⁹³ See *ibid*, 387-388. A non-routine lease is one with a term of less than 12 months, or if longer than 12 months with rent payable at least annually and based on a realistic residual, or, in the case of longer term leases over high value items, a scale is established based on value and length of lease.

⁹⁴ *Ibid*, 388.

⁹⁵ *Ibid*, 386, 387.

⁹⁶ *Ibid*, 386.

⁹⁷ *Ibid*, 219: Tax benefits such as 'tax preference transferring' and structured lease payments. According to the Committee, tax benefits can be obtained from structuring lease payments, where, for example, an Australian lessee participant is a tax exempt entity or is in a tax loss situation and the payments are 'rear weighted' so that the derivation of the rental income in the hands of a foreign lessor is deferred. In these circumstances, the lessor will gain more by deferring the derivation of income than the lessee participant loses through deductions being deferred.

under a general framework that more closely reflects the economic substance of the arrangements.⁹⁸ The Committee claims that neutrality will be achieved in the choice between leasing and borrowing to purchase an asset.⁹⁹ The Ralph measure to introduce a sale and loan approach for all non-routine leases, is an extension of proposed Div 240.

The introduction of this Ralph reform is likely to have four consequences so far as leveraged leases are concerned. First, under the sale and loan approach, the lessee participant will be treated as the 'owner' of the plant for depreciation purposes, while payments made by the lessee participant will be treated as repayments of the loan plus interest, with only the interest component being deductible. Secondly, as accelerated depreciation has been removed and it is not entirely clear to what extent tax preference transfer will be permitted in relation to leasing between taxpayers,¹⁰⁰ it is fair to say that the reform could change the cost of plant or change the net financing cost compared to traditional debt finance. Thirdly, for leveraged leases that are structured as hire-purchase arrangements, the consequences arising from the introduction of the sale and loan approach should be no different from the way these arrangements are currently treated under the ATO's administrative practice and proposed Div 240. Fourthly, lessee participants will need to expend funds training their in-house tax advisors on the new rules.

If a lessee participant can claim depreciation notwithstanding that it is not the legal owner of the plant, then distortions caused by the current tax system will be removed from decisions to use leveraged leases over other forms of asset financing. That is, because a lessee participant will automatically be entitled to depreciate, leveraged leases will require provisions designed to transfer the lessee participant's entitlement to depreciation in a manner acceptable to the ATO. This will ensure that no adverse consequences arise to the lessee participant and lessor participant. However, at the moment it is not clear what forms of agreement will be acceptable and what will not. As a result, the level of leveraged leasing activity in Australia may decrease as a fewer number of lessee participants in the mining and petroleum industries will be able to participate in these transactions.

⁹⁸ Ibid, 317.

⁹⁹ Ibid, 388.

¹⁰⁰ Ibid, 386, 387.

The introduction of the sale and loan approach is likely to increase lessee participant's legal costs because of the uncertain effect the sale and loan approach will have on a lessee participant's ability to satisfy the new thin capitalisation rules as recommended by the Ralph Committee.

Basically, the thin capitalisation rules place restrictions on the deductibility of interest paid by an Australian resident on debts it owes to foreign related parties. It does this by allowing the Australian resident to claim a deduction for interest to the extent that the debt provided by the foreign related party does not exceed a permitted foreign debt to foreign equity ratio of 2:1. The thin capitalisation rules proposed by the Committee have been accepted by the Government and are intended to come into effect on 1 July 2001.¹⁰¹ The rules will be extended to include all debt incurred by an Australian resident.¹⁰² It is arguable that the loan created by a leveraged lease pursuant to the sale and loan approach will be included in a lessee participant's total debt for the purposes of the new thin capitalisation rules (as it should be). If so, this may, in certain circumstances, restrict a lessee participant's ability to claim interest deductions in respect of its actual borrowings.

Potential operation of Part IVA on leveraged lease arrangements

Compliance costs may be incurred by lessee participants in considering the potential application of Pt IVA of the ITAA 36. Costs would likely take the form of legal costs or a private ruling. Provided that the quantum of rental payable by a lessee participant is commercially justified, it is unlikely that Pt IVA will apply to deny any deduction otherwise allowable to the lessee participant under s. 8-1(1) as the dominant purpose inferred from the payment of the rental will be to secure the use of the rental property by the lessee participant, or its agent (ie the operator). If the rental payments are excessive, this inference cannot be drawn. Presently, Pt IVA will apply only if there is a tax benefit within s. 177C(1). By s. 177C(1)(a), a tax benefit is constituted by an amount not being included in the assessable income of the lessee participant in a year of income where that amount would have been included, or might reasonably be expected to have been included, in the assessable income of

¹⁰¹ See s. 2, *Exposure Draft: New Business Tax System (Thin Capitalisation and Other Measures) Bill 2001* (Cth).

¹⁰² Refer definition of 'total debt amount' in s. 820-100(2) *Exposure Draft: New Business Tax System (Thin Capitalisation and Other Measures) Bill 2001* (Cth). See also Treasurer, *The New Business Tax System: Stage 2 Response*, Press Release no. 74, 11 November 1999, Attachment G.

the lessee participant of that year of income if the relevant scheme had not been entered into or carried out. By s.177C(1)(b), a tax benefit is constituted by a deduction being allowable to the lessee participant in relation to a year of income where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the lessee participant in relation to that year if the scheme had not been entered into or carried out. If, for example, a lease incentive is constituted by the setting of a lower rental rate for the lessee participant than might otherwise have been expected, s.177C(1)(b) will be capable of applying. If a lease incentive is constituted by a cash payment a question of fact will arise whether, had the arrangement not been entered into in that form, the course taken by the lessee participant would probably not have involved deductions, or deductions of as great an amount, for rental payments. If an adverse answer were given to this question of fact, a tax benefit would arise.

However, even if a tax benefit arises under s.177C, Pt IVA would not apply unless the s.177D test applied adversely to the lessee participant; that is, unless it appeared on the objective test set out in that section that the purpose of the arrangement was to give rise to that tax benefit. It should be pointed out that the application of this objective test cannot be determined until all the relevant details of an arrangement and all relevant circumstances have been considered.

Subject to the application of s. 177D, it is unlikely that s. 177D will apply to a lessee participant in receipt of a tax benefit. Where the actual main purpose of a lessee participant is to obtain an asset to meet the lessee participant's obligations under the JVA or shareholders' agreement, any incentives that it obtains to enter into an agreement to lease may be properly said to constitute an important bonus or benefit, but not its principal objective. The risk that a contrary view might be accepted by an appellate court would be greatest, if all or the greater part of a lease incentive were received in the form of a cash receipt.¹⁰³ That notwithstanding, it is by no means certain that Pt IVA would apply. In *FCT v Montgomery*,¹⁰⁴ the High Court did not consider the question of whether a cash lease incentive was assessable under Pt IVA.

COMPLIANCE COSTS OF SALES AND LEASEBACKS

If a participant, SPFC or SPV (the *vendor participant*) enters into a sale and leaseback

¹⁰³ *FCT v Cooling* (1990) 22 FCR 42.

¹⁰⁴ (1999) 198 CLR 639.

arrangement, the decision is probably predicated on a desire to either remove certain assets off its balance sheet¹⁰⁵ or to invest more profitably cash flows generated by the sale of an asset. The compliance cost issues of a leaseback of assets are the same as for lessee participants in leveraged leasing transactions, save for the extra costs that will be incurred because of Pt IVA implications. But these costs are counterbalanced by cost savings from the removal of the balancing charge offset and the removal of plant from the capital gains provisions of the law (this is explained below).

A vendor participant must incur costs (eg legal fees) to determine whether a tax benefit will arise from selling an asset and then leasing it back particularly if allowable deductions attributable to the asset are greater in respect of the rentals paid to the lessor than were previously allowable as depreciation (and interest expense). The question is whether the *dominant purpose* of the vendor participant in entering into the transaction, determined on the basis of the objective criteria set out in s. 177D, is to obtain that tax benefit. It would be fair to say that in many sale and leaseback transactions, the dominant purpose of the vendor participant is to release capital tied up in the asset, to retire existing, more expensive debt, while still retaining the use of the asset, or to fund expansion of a project in accordance with the intention of the vendor participant as manifested by the terms of the JVA or shareholders' agreement.

Compliance costs of Pt IVA implications are counterbalanced by the removal of the balancing charge offset and the removal of plant from the capital gains provisions of the law. If a vendor participant sells depreciable plant and the termination value¹⁰⁶ of the plant exceeds its written down value,¹⁰⁷ an amount must be included in the vendor participant's assessable income as a balancing charge.¹⁰⁸ Similarly, a vendor participant can claim an allowable deduction if the termination value of plant is less than its undeducted cost¹⁰⁹ (for the difference between these

¹⁰⁵ See Buchanan (1989), 28.

¹⁰⁶ Termination value is defined in s. 42-205 ITAA 97.

¹⁰⁷ Written down value is defined in s. 42-200 ITAA 97.

¹⁰⁸ Section 42-30 ITAA 97.

¹⁰⁹ Section 42-175 ITAA 97.

two amounts).¹¹⁰

Up until 30 September 1999, if a vendor participant sold plant for more than its written down value, the vendor participant could elect to have the balancing charge used to reduce the depreciated values of other depreciable property owned by the vendor participant (*balancing charge offset*).¹¹¹ The effect of a balancing charge offset was to remove the balancing charge from the assessable income of a vendor participant. If a vendor elected to apply a balancing charge offset, costs would be incurred in calculating the offset and offsetting the balancing charge against other assets. Because the system was elective, a vendor participant could avoid the compliance costs, although if such costs were incurred they would likely be insignificant.

The Ralph Committee recommended the removal of the balancing charge offset system and the Government accepted this recommendation with effect from 30 September 1999. The balancing charge offset was removed because 'no conceptual basis support[ed] the availability of the balancing charge offset'.¹¹² Therefore, since that date, a vendor participant can no longer elect to offset a balancing charge from the sale of plant against the depreciated values of other depreciable property owned by the vendor participant.¹¹³

The introduction of this Ralph reform is likely to have two consequences so far as sales and leasebacks are concerned. First, vendor participants can no longer be subjected to the compliance burden imposed by the elective system. If the compliance burden were insignificant, then the benefit to vendor participants would similarly be minor. If, despite the author's opinion, the likely cost savings are significant, then vendor participants will derive a net benefit. Whether or not vendor participants will derive a net benefit depends on whether the cost savings to them in the long run exceed the costs of acquiring the knowledge to apply the new rules. Secondly, if a vendor participant is a participant of an unincorporated joint venture, then the effect of a disposal by that participant of its undivided fractional interest in plant will be the lost flexibility to duplicate tax benefits: 'from tax deferral on their assets attracting accelerated depreciation allowances; and the further tax deferral provided by the

¹¹⁰ Section 42-195 ITAA 97.

¹¹¹ Treasurer, *The New Business Tax System*, Press Release no. 58, 21 September 1999, Appendix B.

¹¹² *A Tax System Redesigned*, 319.

¹¹³ Treasurer, *The New Business Tax System*, Press Release no. 58, 21 September 1999, Appendix B.

offset if the assets are sold on the second-hand market'.¹¹⁴

In addition, prior to 30 September 1999, plant was subject to the capital gains provisions of the ITAA 97. Therefore, not only did vendor participants have to incur costs in applying the income provisions relating specifically to plant, but costs in determining the impact of Pt 3-1 as well. Not all vendor participants were affected by these costs. This was the case only for vendor participants who sold plant that was acquired on or after 20 September 1985,¹¹⁵ or deemed to have been acquired on or after that date under the anti avoidance provisions,¹¹⁶ where sale proceeds exceeded the (indexed) cost base.¹¹⁷

The Ralph Committee recommended the removal of plant from the capital gains provisions of the ITAA 97. This recommendation was made because the pre-30 September 1999 system:

can be complex to comply with because some disposals can be subject to both the capital allowance and CGT provisions of the law. This means that even though the assets are depreciable, records of original cost must be maintained on the chance that it may be disposed of for a consideration in excess of its original cost base.¹¹⁸

The Government accepted the Committee's recommendation and plant disposed of after 30 September 1999 was removed from the capital gains provisions of the law.¹¹⁹ As well, the capital gains indexed cost bases of assets were frozen at their 30 September 1999 value and the excess of disposal proceeds over the frozen indexed cost base will be taxed as balancing adjustments.¹²⁰

The removal of plant from the capital gains provisions of the law will simplify the compliance obligations of vendor participants because all disposals after the effective date will be subject only to the capital allowance provisions of the law. This should deliver a cost saving to

¹¹⁴ *A Tax System Redesigned*, 319.

¹¹⁵ Section 100-25(1) ITAA 97.

¹¹⁶ Sections 149-30 and 104-230 ITAA 97.

¹¹⁷ Section 104-10(5)(a) ITAA 97.

¹¹⁸ *A Tax System Redesigned*, 319.

¹¹⁹ Treasurer, *The New Business Tax System*, Press Release no. 58, 21 September 1999, Appendix B.

¹²⁰ *Id.*

vendor participants. The cost saving to a vendor participant would equal the cost incurred by a vendor participant each time plant was disposed of and the capital gains provisions of the law were attracted, multiplied by the number of disposals of plant in the life of a vendor participant.

COMPLIANCE COSTS OF USING PREFERENCE SHARES

Preference shares will be recognised immediately as a form of joint venture finance providing an advantage to both the financier¹²¹ and to borrowers. But the advantage is not necessarily without a cost to the issuer. There has been an enormous surge in issues of redeemable preference shares since the intercorporate dividend rebate was introduced.¹²²

Preference shares are a cross between equity and fixed-rate financing.¹²³ They may be issued either by participants, equity participants or their specially incorporated financing companies—the SPFC or SPV—the *issuing participant* to a financier. A preference share carries a fixed-rate dividend obligation, at a rate lower than that which applies to non-convertible securities of the issuing participant.¹²⁴ The holder (ie the financier) may convert the share into ordinary shares, at a price or prices – in the case of a staged conversion privilege – above current market prices.¹²⁵ Financiers who subscribe for preference shares typically require a *significantly less* rate of return than interest on traditional debt finance¹²⁶ because interest is assessable income subject to tax whereas a dividend from a preference share is tax-free by virtue of the intercorporate dividend rebate.¹²⁷

The introduction of the intercorporate dividend rebate means that a financier may be paid an

¹²¹ Provided the dividends are fully franked.

¹²² Burges (1986), 29. See s. 46 ITAA 36.

¹²³ Blinn, *International Petroleum Exploration & Exploitation Agreements – Legal, Economic, and Policy Aspects*, (1986), 260.

¹²⁴ Id.

¹²⁵ *A Tax System Redesigned*, Glossary, 793 defines a 'preference share' as having preferential rights over ordinary shares, usually in relation to dividends or the repayment of capital in the case of the liquidation of the issuing company. The time period over which the conversion privilege may be exercised varies from issue to issue, depending on market conditions at the time of marketing.

¹²⁶ Burges (1986), 29.

¹²⁷ Section 46 ITAA 36.

unfranked dividend. Assuming that a financier's rate of return is fixed,¹²⁸ a financier paid an unfranked dividend will have a lower after-tax rate of return than a financier who is paid a franked dividend. If an issuing participant is likely to be in a tax loss position for a number of years, so that it can only pay a financier an unfranked dividend, the difference to an issuing participant between the cost of raising capital using preference shares and by using traditional debt finance will diminish (ie the financier will want a higher rate of return if it has to pay tax on the unfranked dividend). In appropriate cases, the difference may disappear altogether. If that happens, then the choice between using preference shares and traditional debt finance will involve a comparison of the compliance costs of the two.¹²⁹ Two costs are relevant.

The first cost that a prospective issuing participant will incur is to determine whether it will benefit from the issue of preference shares. Two types of issuing participants could benefit. The first is an issuing participant not deriving income subject to tax and in receipt of franked dividends from arm's length investments. If an issuing participant is an SPFC or SPV incorporated specifically to undertake the activities of the unincorporated joint venture or equity joint venture, so that the SPFC or SPV does not derive any income subject to tax, then the issue of preference shares will not provide any tangible fiscal benefits because the issuing participant will not have any franked dividends.

The second type is an issuing participant with tax losses, which losses are unable to be utilised, partly or in whole, in the short term, and which also has a credit to its franking account, perhaps from previous years of income. How many tax-loss issuing participants have franking credits? Surely very few, and in any event, companies with tax losses pay less tax than companies without tax losses. If an SPV is likely to incur substantial tax losses in the early years of the project, then preference shares would be a relatively attractive form of finance. The same could not be said of participants of unincorporated joint ventures who use a SPFC, because any tax losses accruing from the project would accrue directly to the participants as owners as tenants in common, rather than the SPFC.

Beyond those costs, provided an issuing participant pays a fully franked dividend on its preference shares, there will not normally be any great concern about whether the dividend

¹²⁸ Subject to the forces of demand and supply.

¹²⁹ This assumes that the transactions costs of both types of finance are the same. This assumption may be impermissible in some cases.

will be rebateable in the hands of the financier, provided the financier is a corporation.¹³⁰ This will ordinarily be the case. Normally, questions about the rebateability of dividends will only arise if the transaction involves an element of dividend stripping.¹³¹

FISCAL UNCERTAINTY OF USING DRILLING FUNDS

Drilling funds have been a very successful fund raising vehicle in the United States and Canada for petroleum exploration.¹³² A drilling fund describes a type of organisation established to attract venture capital to oil and gas exploration and development. Typically, the fund is established by offering an investor a farmout and interest in unincorporated joint venture so that an investor who wishes to participate in a fund must execute a farmout agreement and a JVA.¹³³ The fund is designed to give the drilling fund investors the benefit of expensing intangibles.¹³⁴

Drilling funds have not been nearly as successful in Australia,¹³⁵ principally because ITAA 97 provisions do not assist the average drilling fund investor. An average drilling fund investor's primary objective will be to obtain an allowable deduction for his contribution.¹³⁶ Currently, a drilling fund investor's principal difficulty lies in satisfying the conditions of s. 330-15(1) and (2) of the ITAA 97.

Section 330-15(1) provides that expenditure (whether of a capital nature or not) incurred in the 1997-98 year of income or later on petroleum exploration or prospecting,¹³⁷ obtainable by eligible mining or quarrying operations¹³⁸ is deductible for that year. According to s. 330-

¹³⁰ *FCT v Radilo Enterprises Pty Ltd* (1997) 72 FCR 300.

¹³¹ Refer s. 46B ITAA 36.

¹³² Gascoine and Mizen (1982), 373.

¹³³ Ibid, 375.

¹³⁴ Williams and Meyers, *Manual of Oil and Gas Terms*, (1994), 312.

¹³⁵ Ladbury (1987), 241.

¹³⁶ Walsh (1983), 171.

¹³⁷ Exploration or prospecting is defined in s. 330-20 ITAA 97.

¹³⁸ Eligible mining or quarrying operations are operations for extracting minerals or quarry minerals from their natural site or for obtaining petroleum, for the purpose of producing assessable income: s. 330-30 ITAA 97.

15(2), a taxpayer can deduct the expenditure during that year of income where the taxpayer carried on eligible mining operations in the course of petroleum mining, or that it would be reasonable to conclude the taxpayer proposed to carry on such operations or that the taxpayer carried on a business of (or a business that included), petroleum exploration or prospecting obtainable by such operations, or the expenditure was necessarily incurred in carrying on that business. Therefore, if a drilling fund investor does not incur expenditure on exploration or prospecting within the meaning of s. 330-15(1) or (2), a deduction will be disallowed.

Up until 21 September 1999, unless a taxpayer elected otherwise, the deduction was limited to so much of the assessable income from all sources as remains after deducting all other allowable deductions. This allowed deductions for expenditure of an otherwise capital nature. Excess exploration expenditure incurred in a year of income was deductible successively against assessable income derived in later years.¹³⁹

From 21 September 1999, the excess deduction rules were repealed.¹⁴⁰ The rules were introduced when there was a seven year limit on the carry forward of non-primary production losses,¹⁴¹ and recognised the fact that the mining sector might not be able to use early year losses within seven years. However, the seven year limit was removed in 1990,¹⁴² and as a consequence of that and other recommendations of the Ralph Committee, the Federal Government considers that separate rules are no longer necessary.¹⁴³

The expression 'incurred' in s. 330-15(1) may be usefully compared with the corresponding use of that expression in s. 8-1(1) of the ITAA 97. In *Coles Myer Finance Pty Ltd v FCT*,¹⁴⁴ the joint majority judgment of Mason CJ, Brennan, Dawson, Toohey and Gaudron JJ accepted both *FCT v James Flood Pty Ltd*¹⁴⁵ and *Nilsen Development Laboratories Pty Ltd & Ors v*

¹³⁹ Subdivision 330-F ITAA 97.

¹⁴⁰ Treasurer, *The New Business Tax System*, Press Release No.58, 21 September 1999, Attachment Q.

¹⁴¹ See former ss. 80-80F ITAA 36.

¹⁴² See s. 22 *Taxation Laws Amendment Act (No.2) 1990* (Cth), which inserted s. 79E and extended the general mining provisions of Div 10 and the mineral transport provisions of Div 10AAA into the ITAA 36.

¹⁴³ *Id.*

¹⁴⁴ (1993) 93 ATC 4214; 112 ALR 322; 25 ATR 95; 67 ALJR 463.

¹⁴⁵ (1953) 88 CLR 492.

*FCT*¹⁴⁶ as authority for the proposition that 'a liability must presently be existing in order to be incurred within the meaning of s. 51(1)'.¹⁴⁷

That a drilling fund investor would have 'incurred' exploration or prospecting expenditure merely by remitting cash to the operator of a drilling fund or by approving the exploration budget probably would be untenable because there would be no presently existing liability to the account of the drilling fund investor in respect of the exploration or prospecting expenditure.

The same result is likely to exist under Option 2, for the reason that the tax law will retain the concept that expenditure must be *incurred* in order to be deductible.¹⁴⁸ On the other hand, a presently existing liability is more likely to arise once the operator has paid the sub-contractor's accounts (or employee's wages), or performed its budgeted exploration activities, or received an invoice from a sub-contractor.¹⁴⁹

Whether or not a drilling fund investor's activities amount to the carrying on of a business is critically important in deciding whether the particular receipts of the investor will be of an income nature and, in turn, whether outgoings incurred in the course of the activities of a drilling fund investor will be allowable deductions.¹⁵⁰ 'The distinction is often between whether the activities amount to a business or are a mere hobby'.¹⁵¹ It is well established that whether or not the activities of a drilling fund investor constitute a business will depend on a number of factors, including the commerciality,¹⁵² scale,¹⁵³ frequency,¹⁵⁴ profit purpose¹⁵⁵ and

¹⁴⁶ (1981) 144 CLR 616.

¹⁴⁷ (1993) 25 ATR 95, 105.

¹⁴⁸ *A Tax System Redesigned*, 159, where it is stated that 'Consistent with the well understood meaning of "incurred" in the existing law, there must be a present obligation to provide future benefits for there to be a liability'.

¹⁴⁹ Wilson, 641.

¹⁵⁰ Deutsch, *Australian Tax Handbook*, (1999), [7 010].

¹⁵¹ Id.

¹⁵² *Ferguson v FCT* (1979) 37 FLR 310.

¹⁵³ *Fairway Estates Pty Ltd v FCT* (1970) 123 CLR 153 per Barwick CJ.

¹⁵⁴ *FCT v Radnor Pty Ltd* (1991) 91 ATC 4689, 4700; 22 ATR 344, 357; 102 ALR 187, 202, per Hill J.

commercial character of the activities. The primary question of whether an investor is carrying on a business is one of fact, not of law, depending upon a variety of circumstances.¹⁵⁶ Whether or not a business is carried on is a matter to be determined having regard to the facts of the particular case.¹⁵⁷ Section 995-1 of the ITAA 97 defines a 'business' inclusively as 'any profession, trade, employment, vocation or calling, but does not include occupation as an employee'. Unless an investor is actively involved in the conduct of exploration or prospecting activities (eg by contracting directly with sub-contractors), it would seem unrealistic to think of an investor as being in any business other than that of investing or trading in the shares or units or other instruments representing the investment in the drilling fund.¹⁵⁸

An investor need not be a registered holder of a petroleum or prospecting right to qualify for a deduction under s. 330-15.¹⁵⁹ Section 330-595 deems a holder of a mining, quarrying or prospecting right who has had a sub-contractor do work which, had it been done by the holder of the right, would have amounted to petroleum exploration, to have done the work and the consideration given by the holder for the work is taken to be expenditure incurred in carrying on petroleum exploration for the purposes of Div. 330. Section 330-595 corresponds to s. 124AJ of the ITAA 36. In *Re Negative Instruments Pty Ltd v FCT*,¹⁶⁰ the Federal Court confirmed that the wording of the predecessor provision to s. 330-15(1) was broad enough to allow a deduction to any taxpayer having incurred petroleum exploration or prospecting expenditure, notwithstanding that taxpayer was the registered holder of the authority to prospect in spite of s. 124AJ of the ITAA 36.

Absence of a requirement that the drilling fund investor be the holder of a petroleum or prospecting right or interest therein simplifies the organisation of public investment in drilling

¹⁵⁵ *Thomas v FCT* (1972) 72 ATC 4094, 4099; [1972-73] ALR 368, 373-374; 46 ALJR 397, 400-401; 3 ATR 165, 171, *per* Walsh J.

¹⁵⁶ *Werle & Co v Colquhoun* (1888) 20 QBD 753, 761 *per* Fry LJ; quoted with approval by Starke J in *Blockey v FCT* (1923) 31 CLR 503, 511.

¹⁵⁷ *Newton v Pyke* (1908) 25 TLR 127.

¹⁵⁸ Ladbury (1987), 243.

¹⁵⁹ Several commentators have expressed a dissimilar view: see Sharwood (1983), 147; Walsh (1983), 169; Kovess (1983), 182; Ladbury (1987), 243.

¹⁶⁰ (1994) 94 ATC 4809; 29 ATR 423; 30 AustLawyer (No.1) 43k [note].

funds because the difficulties associated with individual investors having an interest in a petroleum tenement are eliminated.

Structuring a drilling fund

One possible structure of a drilling fund would be for drilling fund investors to hold units in a unit trust, the trustee of which holds on trust all the shares in a company registered as an owner of the petroleum permit along with any other participants. Each investor holds the units in the same proportion as the contractual interests held by the investor correspond to all contractual interests of investors.

Alternatively, a drilling fund investor could hold shares in a company, the company could then itself be a party to any JVA or farmin agreement. Use of a company can become problematic where one or more drilling fund investors are non-residents who carry on business in Australia through a permanent establishment. As we saw with equity joint ventures, unless a withholding tax exemption applies, dividends derived by a non-resident equity participant who carries on business in Australia through a permanent establishment are subject to withholding tax instead of being taxed by assessment.¹⁶¹

The mineral and petroleum industries in Australia have developed a number of financing techniques for sharing the risk associated with large mining and petroleum projects.¹⁶² One risk sharing technique—the farmout, plays a particularly important role in the practice of the mining and petroleum industry.¹⁶³

A fourth possible structure is a take or pay contract. A take or pay contract is a contract between a buyer and a seller of an asset-based service under which the buyer undertakes to pay regularly to the seller a fixed minimum sum, regardless of the actual level of consumption of

¹⁶¹ Section 44(1)(b) of the ITAA 36 provides that the assessable income of a non-resident equity participant (where the SPV is a resident of Australia) shall, subject to the section and s. 128D, include dividends paid to it by the SPV to the extent to which they are paid out of profits derived by it from sources in Australia. The effect of s. 128D of the ITAA 36 is that dividends paid by a resident SPV to a non-resident equity participant are subject to withholding tax. Pursuant to s. 128D, dividends in respect of which withholding tax is payable are not included in the assessable income of the non-resident equity participant. Accordingly, dividends paid to non-resident equity participants in SPV's resident in Australia are not included in assessable income but are, rather, subject at most to only withholding tax.

¹⁶² Blinn, *International Petroleum Exploration & Exploitation Agreements – Legal, Economic, and Policy Aspects*, (1986), 260.

¹⁶³ Australian revenue law issues arising from farmout agreements are covered in the next chapter.

the service by the buyer. For instance, suppose that three equity participants have formed a SPV and the equity participants have entered into a shareholders' agreement to form an equity joint venture to build, own and operate a co-generation facility. The investors of the drilling fund own the shares in one equity participant. Each equity participant separately enters into a take or pay contract with the SPV, pursuant to which each participant undertakes to pay regularly to the SPV a fixed minimum sum, whether power is supplied by the SPV or not. The SPV arranges a loan or lease with a financier or lessor acting for them. Proceeds of the loan or lease are used to finance the construction of the co-generation facility. Each equity participant makes take or pay contract payments to the SPV. Using the cash receipts from the take or pay payments, the SPV pays the debt owing to the financier or lessor; excess cash flow is kept by the SPV. The contract has the effect of transferring market risk associated with the assets from the seller (also the owner of the assets) to the buyer.

Payments are in an amount sufficient to service the debt needed to finance the project, which provides the services or the product, and to pay operating expenses of the project. The obligation to make minimum payments is unconditional and payment must be made whether or not the service is actually performed or the product actually delivered.¹⁶⁴

A fifth possible structure is a throughput contract. Throughput contracts are often used to finance the construction of pipelines. The operator of the pipeline charges a 'throughput' or 'tolling' fee to the participants for the carriage of goods (eg gas) through the pipeline. Again, the investors could own shares in one of the participants in the drilling fund. For example, a SPFC with limited credit might finance a pipeline by arranging a borrowing based on the assignment to the financier by way of security of a throughput contract from participants of an unincorporated joint venture seeking transportation of a product.¹⁶⁵

Under a throughput contract, the participants enter into a long term contract to transport minimum amounts of gas, oil or refined product through a pipeline at periodic intervals at fixed prices determined by formula, but in total sufficient to service debt and operating expenses of the pipeline. Each participant is unconditionally obligated to transport a certain

¹⁶⁴ Nevitt, *Project Financing*, (1980), 212.

¹⁶⁵ Cf U.S. utility, Duke Energy, which ostensibly did not use a tolling contract, but awarded the construction contract for the Eastern Gas Pipeline to take Bass Strait gas from Victoria, into New South Wales to a joint venture between builders Transfield, pipeline contractor Willbross and civil engineers Macmahon: M Skully, 'Duke pipeline turns up heat', *The Australian Financial Review*, 28 June 1999, 7.

minimum amount during each time period. If any participant fails to transport gas during a time period, the participant must nevertheless pay for a minimum shipment. A participant who does not ship during a particular time period may or may not receive a credit against future shipments in excess of its future obligated shipments. This type of contract is sometimes called a *tolling agreement*. The taxation factors associated with tolling and consortium companies are discussed in chapter 6.

INTEREST WITHHOLDING TAX ADDS ADDITIONAL LAYER OF COMPLEXITY

Due to the scope and complexity of the subject, this section of the chapter only briefly outlines the main provisions of the ITAA 36 relevant to interest withholding tax, resident and non-resident participants and equity participants, SPFC's and SPV's (the *joint venture taxpayer*). As shall be seen, considerable fiscal complexities and uncertainties could potentially arise when interest withholding tax (IWT) questions must be resolved. In general, complexity and uncertainty add to the compliance burden on taxpayers involved in joint ventures. If IWT questions arise for a participant of an unincorporated joint venture, then it will arise at the level of the participant, unless the participants have incorporated a SPFC. But where SPVs are concerned, the issue must be resolved at the SPV level. It will therefore prima facie impact on all the equity participants and will increase the comparative cost of using this joint venture structure compared to an unincorporated joint venture.

Liability to IWT

Where interest is derived by non-residents, IWT will arise when the interest is paid either by a resident and it is not wholly incurred by the resident in carrying on business in a country outside Australia¹⁶⁶ or by a non-resident and it is wholly or partly incurred in carrying on business in Australia at or through a permanent establishment in Australia.¹⁶⁷ Various types of non-residents could be affected by IWT: for example, non-resident parent companies and associates of resident participants or equity participants, non-resident financiers or investors.

Meaning of 'interest' is uncertain

The crucial question in determining liability of a joint venture taxpayer to IWT is whether the

¹⁶⁶ Section 128B(2)(b)(i) ITAA 36.

¹⁶⁷ Section 128B(2)(b)(ii) ITAA 36.

payment in question is interest. Interest is not specifically defined in the ITAA 97. Following amendment of the definition of interest in s. 128A(1) in recent years, 128A(1) of the ITAA 36 now defines interest broadly as including amounts in the nature of interest, amounts which could be reasonably regarded as having been converted into a form that is in substitution for interest or that could be reasonably regarded as having been received in exchange for interest in connection with a washing agreement.¹⁶⁸

Accordingly, we must look to the common law meaning of interest and then the specific statutory provisions (which expand the common law meaning of interest) to determine what constitutes 'interest' or constitutes 'amounts in the nature of interest', which can be subject to IWT under s. 128B. If an amount cannot be described as 'interest or in the nature of interest', then no Australian IWT will arise to the extent the source of the income is outside Australia.

Despite the extended definition of interest in Div. 11A, it is noted that Parliament considers several types of arrangements to be generally outside the IWT provisions. Examples of transactions which would not generally be considered as falling within the withholding tax provisions are 'forward exchange transactions, forward rate agreements, swaps, and reciprocal purchase agreements. Broadly speaking, these transactions do not involve the provision of finance.'¹⁶⁹ Parliament's intention notwithstanding, the general rule for joint venture taxpayers is to err on the side of caution.¹⁷⁰ One writer cautions that several traditionally successful methods of avoiding liability under the IWT provisions appear to be ineffective under the expanded definition of interest in Div. 11A.¹⁷¹ Any attempt at measuring changes in the extent of IWT avoidance before and after the introduction of the extended definition of interest in Div. 11A with any accuracy would be fraught with difficulty. Its existence, however, is assumed in the literature.¹⁷²

¹⁶⁸ Section 128(1AB) ITAA 36. 'Washing agreement' is also defined in s. 128A(1AB) ITAA 36.

¹⁶⁹ Supplementary Explanatory Memorandum to *Taxation Laws Amendment Bill (No.2) 1997* (Cth), para. 1.8.

¹⁷⁰ Methods affected ostensibly include assignment of the right to income, sale of promissory notes evidencing an interest obligation, reciprocal purchase agreements, securities lending arrangements, bong washing techniques: Hiou (1998).

¹⁷¹ Refer Hiou (1998).

¹⁷² Huizinga (1994) 291.

Possibly the best judicial definition of interest was given by Rowlatt J in *Bennett v Ogston*.¹⁷³ 'Interest', he said, is a 'payment by time for the use of money'.¹⁷⁴ Notice from this definition that in order for interest to exist at common law, there must be a sum of money by reference to which the payment is to be ascertained (ie the principal) and that sum must be a sum which is due to the person entitled to the interest, unless the right to interest has been assigned to a third party.¹⁷⁵ For example, at common law, interest swap payments from a participant to a non-resident party would not have the character of interest because the payments are separate from the underlying loan arrangement.¹⁷⁶

One situation in which the issue has been considered at some length both in judicial decisions and in academic writings concerns bill discounts. Assume that a resident joint venture taxpayer purchases equipment for use in a co-generation facility situated in Australia from a supplier resident in the United States. Because the joint venture taxpayer has insufficient funds to pay for the goods immediately, the joint venture taxpayer arranges through its Australian bank to deliver a bill of exchange to the supplier drawn by the joint venture taxpayer and accepted by an Australian bank. The supplier could either wait until the bill matures to collect payment for the equipment or negotiate the bill with a third party before maturity and realise cash (for an amount less than face value of the bill). Where the supplier takes the latter option, the U.S. third party would, upon maturity of the bill, present the bill for payment to the Australian bank. Any gain made by the U.S. third party would be the difference between the purchase price and maturity value. To the extent that any payment by the Australian bank to the third party would be equivalent to the discount for which the bill was purchased, it would not constitute interest on ordinary principles.

The approach of the courts has been to say that a discount is no more interest than a bill of

¹⁷³ (1930) 15 Tax Cas 374; appld *Stainer's Executors v Purchase* [1952] AC 280; cited in *FCT v Orica Ltd* (1998) 194 CLR 500.

¹⁷⁴ *Ibid*, 379.

¹⁷⁵ King (1980-1981).

¹⁷⁶ Refer *Ruling IT 2050*.

exchange is a loan.¹⁷⁷ It now appears that bill discounts are caught by s. 128AD.

Division 11A of the ITAA 36 contains three provisions which widen the definition of interest to include within that concept various types of payments which at common law would fall outside the definition of interest. First, s. 128AA effectively deems the difference between the sale price of a discounted security (a qualifying security)¹⁷⁸ and its issue price¹⁷⁹ to be income that consists of interest, thereby subjecting that amount to IWT under s. 128B. The operation of the section is affected by s. 265B under which the holder of a qualifying security may require the issuer to provide a notice giving specified details of the security.¹⁸⁰ If the details provided in the notice are incorrect IWT may be less than the correct amount. The Commissioner has a power to remit all or part of the additional tax otherwise applicable under s. 128C(3).¹⁸¹

The application of s. 128AA is not without its difficulties. For example, when a qualifying security is sold by one non-resident (eg a parent company of an Australian subsidiary, which is a participant or equity participant) to another non-resident at a transfer price¹⁸² in excess¹⁸³ of the issue price and there is a subsequent sale by the second non-resident to a resident joint venture taxpayer (or an associate) at a higher price, no IWT will arise in respect of the first sale because the payment is not one made by a resident to a non-resident as required by s. 128B. However, in relation to the transfer by the second non-resident to the resident joint venture taxpayer, s. 128AA deems the amount by which the transfer price in that second transaction exceeds the original issue price to be interest on which IWT is payable under s. 128B. This can be illustrated by a simplified example. Assume that a resident SPV purchases

¹⁷⁷ *Chow Yoong Hong v Choong Fah Rubber Manufacturing* [1962] AC 209. See also *Inland Revenue Commissioners v Rowntree & Co Ltd* [1948] 1 All ER 482; *K D Morris & Sons Pty Ltd (in Liq) v Bank of Queensland Ltd* (1980) 146 CLR 165 and *Re Securitibank Ltd (No.2)* (1978) 2 NZLR 136.

¹⁷⁸ Qualifying security is defined in s. 128(1A) and (1B) by reference to the definition of that term in s. 159GP of Div 16E ITAA 36.

¹⁷⁹ Issue price is defined in s. 159GP ITAA 36.

¹⁸⁰ Security is defined in s. 159GP(1) ITAA 36.

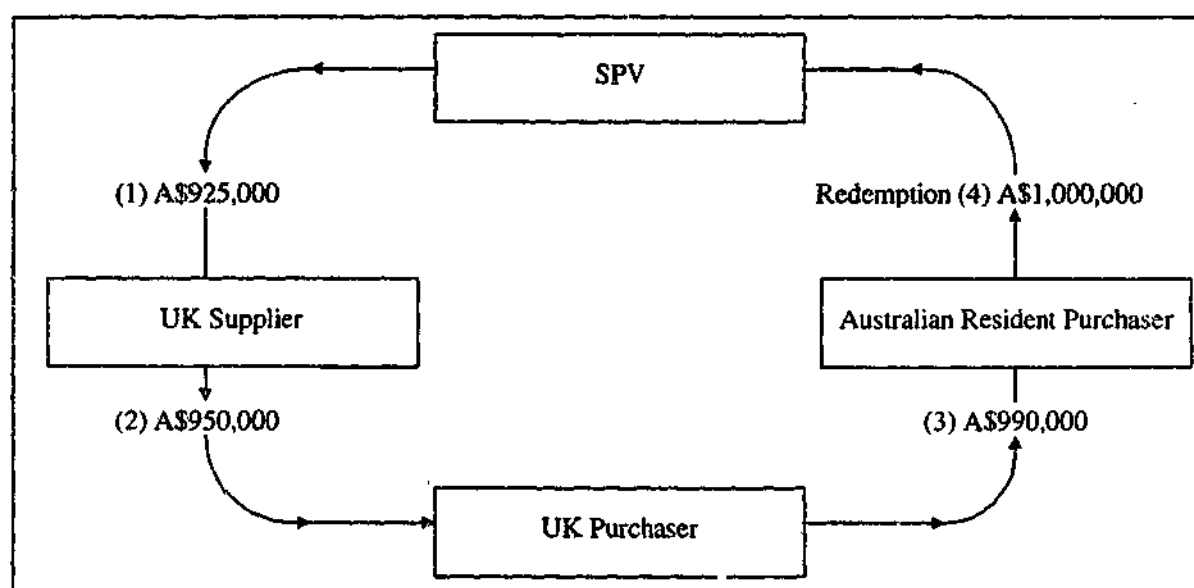
¹⁸¹ See s. 128C(4AA) ITAA 36.

¹⁸² Transfer price is defined in s. 159GP(1) ITAA 36. By virtue of s. 128A(1A)(b) the definition of transfer contained in s. 159GP has been adopted for the purposes of s. 128AA ITAA 36.

¹⁸³ See s. 128AA(1) ITAA 36.

heavy lifting equipment on behalf of the equity participants costing A\$1 million for use by the joint venture and issues a qualifying security at a discount (through its bank) of A\$925,000 to the United Kingdom supplier to pay for the heavy lifting equipment. If the United Kingdom supplier sells the qualifying security to another UK resident at \$950,000 and there is a subsequent sale by the second UK resident to an Australian resident investor just before maturity at A\$990,000, then at that point, the deemed interest element will be \$65,000 (transfer price (\$990,000) less issue price (\$925,000)), and the IWT liability will be \$6,500. For convenience, this example is represented by Figure 3.5.

Figure 3.5: Interest Withholding Tax Example



It is evident that the second UK resident effectively bears the tax on the gain that accrued to the first non-resident. This may or may not have been reflected in the transfer price between the first and second UK resident.

Section 128AB entitles a non-resident transferee to apply for a certificate which has the effect of substituting the purchase price of the discounted security for its issued price. Application must be made under s. 128AB if the transferor is a resident joint venture taxpayer or if the transferor is a non-resident and the transfer price is derived from a source in Australia so that IWT can apply to the transferor's gain. A certificate issued by the Commissioner will specify the consideration for the transfer of the qualifying security and that amount is taken to be the issue price of the security for the purposes of applying s. 128AA in relation to a later transfer of the security or, if the holder of the certificate retains the security until its redemption, in

determining the extent if any to which the redemption payment comprises an amount in the nature of interest under s. 128A. The benefit of such a certificate is entirely lost if the non-resident, who purchased a qualifying security from a resident joint venture taxpayer, thereafter sells the security to a non-resident instead of merely holding the security until maturity or selling it to a resident. Where there has been a subsequent transfer to another non-resident a certificate under s. 128AB cannot issue and the problem indicated above will arise.

The provisions of s. 128NA should be noted since they will effectively deem IWT to be payable on the basis of arm's length prices that have been paid for a qualifying security rather than the prices which have in fact been charged by the parties in the situation where the parties are not dealing at arm's length.

Secondly, s. 128AC operates in respect of charges paid by a resident joint venture taxpayer under hire purchase arrangements and deems portions of certain payments under such arrangements to be income that consists of interest so as to be liable to IWT in the circumstances set out in s. 128B.

Thirdly, s. 128AD is designed to ensure that IWT is payable in respect of amounts remitted offshore by a resident joint venture taxpayer which has drawn a bill of exchange to indemnify or reimburse an offshore acceptor of the bill for its face value at maturity. If a non-resident bank accepts a bill drawn by an Australian resident joint venture taxpayer drawer and then discounts the bill to a third party who is also a non-resident, the bank will be obliged to pay the face value of the bill to the discounter when the bill is presented for payment on maturity. Since the bank and the discounter are both non-residents there would otherwise be no obligation to pay withholding tax in Australia. However, if the drawer then reimburses the bank the amount of the face value which the bank was committed to pay to the discounter, so much of the reimbursement as represents interest shall, for the purpose of Div. 11A, be deemed to be income that consists of interest.

Permanent establishment test

Before IWT is payable by either a non-resident corporation or an individual, it is necessary to show that the non-resident is carrying on business in Australia at or through a permanent establishment of the non-resident in Australia. In this connection the definition of 'permanent establishment' in s. 6(1) of the ITAA 36 expressly excludes a place where the person is

engaged in business dealings through a bona fide commission agent or broker. This means that in the case of properties managed by a real estate agent acting as a commission agent it could not generally be said that the non-resident participant or equity participant has a permanent establishment in Australia unless other factors are present.¹⁸⁴

If the facts of a particular case lead to the conclusion that a non-resident participant or equity participant is carrying on a particular business in Australia through a permanent establishment in Australia, it will follow that interest paid by the non-resident to a non-resident financier on moneys borrowed to purchase property in Australia is liable to IWT under s. 128B(2)(b)(ii).¹⁸⁵ If the IWT is paid,¹⁸⁶ an income tax deduction would be allowed to the borrower under s. 8-1(1) of the ITAA 97 for the interest paid.

THIN CAPITALISATION RULES ARE FISCALLY UNCERTAIN

The fundamental differences in the taxation treatment of debt and equity can heavily influence the financing of investment by non-residents in Australian-based joint ventures.¹⁸⁷ Foreign multinational groups often have the flexibility to allocate a disproportionate share of debt to their Australian joint venture operations with detrimental revenue consequences.¹⁸⁸ Considerable fiscal uncertainty exists in relation to the current thin capitalisation rules. An investigation into the meaning of the expression 'accumulated profits' will be undertaken to demonstrate this. For joint venture taxpayers, uncertainty adds complexity to the law, which in turn increases compliance costs. The complexity will arise at the level of the participant in unincorporated joint ventures, unless they have incorporated an SPFC, in which case the issue will be centralised. Equity joint ventures must resolve thin capitalisation issues at the level of the SPV.

¹⁸⁴ Ruling IT 2423, para. 6.

¹⁸⁵ Ibid, para. 7.

¹⁸⁶ Section 221 YRA(1) ITAA 36.

¹⁸⁷ See *A Tax System Redesigned*, recommendation 22.1.

¹⁸⁸ *2 A Platform for Consultation*, para. 33.33.

Rationale for the rules

Where a foreign controlled resident participant funds its commitments under the JVA by means of debt, the interest, assuming it meets the deductibility requirements under the ITAA 97, will be deductible against its share of assessable income derived from the unincorporated joint venture. The untaxed interest paid to its non-resident financier is normally subject to an IWT rate of 10 percent. The position is similar for SPFCs and SPVs, except that the SPFC and SPV will claim an allowable deduction in respect of the interest expense against all the assessable income derived from the operations of the joint venture. By comparison, equity funding involves the payment of dividends to the non-resident shareholders. Such dividends are generally paid out of taxed profits at the prevailing company tax rate and unfranked dividends are subject to withholding tax of 30 percent or, if a treaty applies, 15 percent. Franked dividends are currently untaxed and not subject to further withholding tax.

The thin capitalisation rules were developed to discourage the difference in the preferential tax treatment of debt funding relative to equity, by placing a limit on the proportion of interest expense payable on certain foreign debt that can be deducted for Australian tax purposes.¹⁸⁹

Statutory framework

The rules are found in Div. 16F of Pt III of the ITAA 36 and may deny a resident participant, SPFC or SPV (the *resident participant*) an allowable deduction in respect of interest¹⁹⁰ payable on foreign debt provided by a foreign controller where the prescribed foreign debt to foreign equity ratio of the resident participant—and its associates—is exceeded. These rules must be taken into account if a resident participant pays interest on a debt provided to it by a foreign controller of that taxpayer.

The ratio is 2:1 (or 6:1 for financial institutions).¹⁹¹ If the ratio is exceeded, an allowable deduction will be denied to the resident participant in relation to interest paid on the debt, on a pro rata basis, having regard to the extent of the excess. Thus, under the 2:1 ratio, if the

¹⁸⁹ Hamilton and Deutsch (1996), para. 5.460.

¹⁹⁰ 'Interest' is defined very broadly by s. 159GZA ITAA 36. See *Rulings* IT 2479 and 2050 for the Commissioner of Taxation's interpretation of 'where interest is or may become payable' (para. 10) and for his approach to interest swap transactions, respectively.

¹⁹¹ Section 159GZA, definition of 'foreign equity product' ITAA 36.

foreign investor lends to the Australian resident participants more than \$2 for every \$1 of equity, the reduction rule will operate to deny a deduction to that portion of the interest calculated by applying the ratio of excess foreign debt to total foreign debt.

For example, if a resident participant's foreign debt is \$100 million, foreign debt interest is \$1 million and foreign equity is \$3 million, the interest disallowed will be \$940,000 (ie $\$1M * [100M - (2 * 3M) / 100M]$).

Meaning of 'foreign controller'

Speaking generally, a foreign controller¹⁹² is a person who has a substantial control of voting power¹⁹³ (or the capacity to gain that degree of control) of the resident participant or who has a direct or indirect beneficial entitlement (or the capacity to gain that degree of control) to receive at least 15 percent of the relevant distributions of income and capital of the resident participant or who has de facto control because of informal adherence by the resident participant or its directors, instructions or wishes of the foreign controller. The current control test will impose a compliance cost on participants affected by them. The cost will be to determine the level of control in the corporate group. The CFC control test requires 50 per cent control (or 40 per cent where there is no other person with the ability to control). Introducing a higher threshold for control that is consistent with the CFC control test will reduce compliance costs for participants.¹⁹⁴

Meaning of 'foreign debt'

Foreign debt¹⁹⁵ refers to debts owing to foreign controllers or their associates¹⁹⁶ but does not include arm's length overseas borrowings (even when supported by parent company guarantees¹⁹⁷), funds raised in Australia from Australian sources, or interest free debt. Under

¹⁹² Foreign controller is defined in s. 159GZE ITAA 36.

¹⁹³ Substantial control of voting power is defined in s. 159GZJ ITAA 36.

¹⁹⁴ *A Tax System Redesigned*, recommendation 22.7.

¹⁹⁵ Foreign debt is defined in s. 159GZF ITAA 36.

¹⁹⁶ Associate is defined in s. 159GZC ITAA 36.

¹⁹⁷ The income tax consequences of making a payment under a contract of guarantee are outlined earlier in this chapter.

Ruling IT 2479, where no interest is payable on debt provided it is repaid within a certain date, but that interest becomes payable from the date the debt was originally incurred if the principal is not repaid, then the Commissioner's view is that interest will be considered to be payable by the resident participant from the date upon which the debt was originally incurred.

Meaning of 'foreign equity'

A number of items are included in determining foreign equity.¹⁹⁸ Section 159GZG requires certain amounts to be deducted in determining the foreign equity held by a foreign controller. These amounts include the balance of any loans by the resident participant to its foreign controllers (and associates), the amount of any accumulated profits or asset revaluation reserves applied to issue bonus shares to foreign controllers and accumulated losses which represent a deficiency of capital.

Scope of meaning of 'accumulated profits'

The accumulated profits at the beginning of the year of income are taken into account in determining the foreign equity product of a resident participant for that year. The precise meaning of the expression 'accumulated profits' is unclear. There are two views that may be adopted about the meaning of the expression 'accumulated profits' in s. 159GZG(1). The narrow view is that the section refers only to those profits which have been identified by properly drawn accounts as being available for distribution by way of dividend and have not been allocated by the directors of the resident participant towards the establishment of reserves or the replacement of losses of paid up capital.¹⁹⁹

The wider view is that the term profits as used in s. 159GZG(1) has the same meaning as that term is used in s. 44(1) of the ITAA 36 concerning the taxation of dividends paid out of the profits of a company. In s. 44(1), profits has been held to mean the excess of value of the assets of a company at a particular date over the value of the assets of a company at an earlier date.²⁰⁰ The adoption of this latter approach would allow the increase in value of the shares

¹⁹⁸ See s. 159GZG ITAA 36.

¹⁹⁹ See *Marra Developments Limited v BW Rofe Pty Ltd* (1977) 2 NSWLR 616; *FCT v Miller Anderson Ltd* (1946) 73 CLR 341.

²⁰⁰ *FCT v Slater Holdings Limited (No. 2)* (1984) 156 CLR 447. *MacFarlane v FCT* (1986) 13 FCR 356; appld *Richardson & Wrench (Holdings) Pty Ltd v Ligon No 174 Pty Ltd* (1994) 123 ALR 681; ATPR(Digest) 46-133.

in the resident participant to be taken into account in determining the accumulated profits of the resident participant.

The wider concept of profits has its genesis in the judgment of Fletcher Moulton LJ in *Re Spanish Prospecting Company Limited*.²⁰¹ In that case, it was stated that a profit is the increase in the value of the total assets of a company between two dates, allowance being made for further capital introduced by shareholders.²⁰² For this purpose, it is arguably unnecessary for an actual valuation of the assets of the resident participant at the later date to have been made.²⁰³ If this reasoning is adopted then the increase in value of the shares in a resident participant would be a profit regardless of whether or not either the *Corporations Law* or generally accepted accounting principles would prevent the profit from being disclosed on that date.

The High Court has considered the judgment of Fletcher Moulton LJ in *Re Spanish Prospecting Limited* as only a guide and not authoritative statement of the legal meaning of profits.²⁰⁴ However, in determining whether a dividend, as defined in s. 6(1) of the ITAA 36, has been paid by a resident participant out of profits for the purposes of s. 44(1) it is the broad concept of profit that is applicable.²⁰⁵ Accordingly, one could argue that the ITAA 36 should be consistent in the meaning attributed to profits whenever that term is used. Consequently, the wider concept applicable to s. 44(1) should equally be applicable to s. 159GZG(1)(c)(i). The result of such an argument being successful is that the undisclosed increase in value of the shares in a resident participant would be a profit which would need to be taken into account in determining the foreign equity of the resident participant in the relevant year of income.

The contrary view would be founded on the separate reference in s. 159GZG(1) to accumulated profits and asset revaluation reserves from which dividends are able to be distributed. That is, the section is referring only to dividends that are distributable from

²⁰¹ (1911) 1 Ch 92.

²⁰² Ibid, 99.

²⁰³ Ibid, 103, 105 per Fletcher Moulton LJ.

²⁰⁴ *FCT v Slater Holdings Limited (No. 2)* (1984) 156 CLR 447, 460 per Gibbs CJ; see also *Read v Commonwealth of Aust.* (1988) 167 CLR 57, 65-66 per Mason CJ; Deane & Gaudron JJ.

²⁰⁵ *MacFarlane v FCT* (1986) 13 FCR 356, 377-378 per Burchett J.

accumulated profits and asset revaluation reserves disclosed by properly drawn company accounts.

However, even if the narrow view of profits were adopted, an argument may be raised that the increase in value of the shares in a resident participant is nevertheless able to be taken into account. The Court of Appeal in New South Wales has held that a final dividend is not able to be paid from the surplus which arises upon an increase in the value of a company's assets unless a revaluation of those assets is undertaken by the directors and an appropriation of such a surplus is made to the profit and loss account.²⁰⁶ However, no such restriction is placed upon the declaration of an interim dividend by the company. In particular, Hutley JA stated:

[t]he directors, in declaring an interim dividend, are not subject to the formal restrictions which lie in the way of the declaration of a final dividend, in that there may not be in existence the accounts which actually sustain the declaration. It is, therefore, theoretically proper for there to be a declaration of an interim dividend which may in fact require revaluation of fixed assets to provide the fund to justify it in the annual accounts, even though the revaluation has not been carried out.²⁰⁷

Section 159GZG(1)(c)(i) makes no reference to whether the dividend able to be distributed from accumulated profits is an interim or a final dividend. In the result, it may be argued that if an interim dividend was declared by the resident participant at the beginning of the relevant year of income, and if such dividend was justified on the basis of a subsequent revaluation of assets revealing the necessary profits, there existed accumulated profits of the resident participant at the beginning of the year to be taken into account in determining the foreign equity held by a foreign controller in that resident participant.

If the ATO accepts either of the above arguments, then the foreign debt to foreign equity equation must be adjusted to take account of accumulated profits. However, whilst the matter is not free from doubt, there is significant risk that an appellate court find the arguments too self-evident to be accepted.

²⁰⁶ *Blackburn v Industrial Equity Limited* (1978) 78 CLC 40-324.

²⁰⁷ *Ibid*, 29,386. See also *Marra Developments Ltd v BW Rofe Pty Ltd* [1977] 2 NSWLR 616, 622 *per* Hutley JA.

Arrangements outside thin capitalisation rules

The thin capitalisation rules do not present difficulties where joint venture project finance is raised overseas from unrelated financial institutions (paying close attention to the wide association rules²⁰⁸) or by means of redeemable preference shares.²⁰⁹ Because foreign equity includes the paid up value of all shares beneficially owned by the foreign controllers as at the end of an income year, capital can be injected prior to year end to raise foreign equity for the purposes of the debt to equity ratio. To qualify as equity the newly injected equity must be left in place for two years from the end of the year of income in which the equity is originally injected.²¹⁰

TAXATION OF FINANCIAL ASSETS AND LIABILITIES - A NEW REGIME

In September 1999, the Ralph Committee recommended a new policy framework for the taxation of financial assets and liabilities. The latest proposals were preceded by three other papers.²¹¹ If implemented as presently proposed, the new rules will impact on the taxation of basically all financial assets and liabilities.²¹² The Ralph Committee considers that the current system is characterised by uncertainty and incoherence.²¹³ It is easy to see the compliance burden this places on participants of unincorporated joint ventures as well as on equity participants of equity joint ventures. Administration of tax policy is seen as complicated and to have threatened to undermine the revenue base of the Australian government.²¹⁴ The objectives of the development of a new framework are to provide greater consistency and neutrality and to overcome the inconsistencies and deficiencies of the current system. It is too early to tell whether mining and petroleum companies and other types of companies which have traditionally utilised the joint venture structure will be subjected to tax rules more

²⁰⁸ See s. 159GZC ITAA 36.

²⁰⁹ See chapter 3 for a discussion of the tax consequences of raising capital via preference shares.

²¹⁰ See ss. 159GZG(6) and 159GZG(8) ITAA 36.

²¹¹ A Consultative Document, *Taxation of Financial Arrangements*, (1993); An Issues Paper, *Taxation of Financial Arrangements*, (1996) and *A Platform for Consultation*.

²¹² 1 *A Platform for Consultation*, para. 3.1 defines financial assets and liabilities very broadly.

²¹³ *Ibid*, para. 3.5.

²¹⁴ *Id*.

appropriate to other kinds of taxpayers, and whether they will have to establish new systems and processes to deal with the complexities of the new rules.

The proposals

The Ralph Committee has basically proposed five areas of reform. First, to provide an elective mark-to-market basis of accounting for certain transactions or assets and liabilities. Secondly, if the mark-to-market election is not made, then to provide an accruals basis of accounting (the timing adjustment method) for instruments with cash flows which are known or fixed or can be estimated with 'reasonable accuracy'.²¹⁵ Thirdly, to provide a realisation basis of accounting as a default mechanism for the taxation of gains and losses in all other situations. Fourthly, to include robust disposal rules in an attempt to clearly identify when there has been a realisation and lastly, to include a test which enables particular financial instruments to be easily classified as debt or equity.

There are two aspects to the scope of election involved. The first is that the election will apply to all of a taxpayer's financial assets and liabilities that are marked to market by the taxpayer for accounting purposes (with other financial assets and liabilities accounted for on an accruals or realisation basis).²¹⁶ Secondly, the election will apply to all financial assets and liabilities within a recognised asset class that are marked to market by the taxpayer for accounting purposes (the *asset class election*).²¹⁷ The safeguards listed in the proposal are arguably too cumbersome and will create an unnecessary compliance burden. Mining and petroleum companies carrying on treasury functions and dealing in debt or derivative instruments for purposes other than hedging, would potentially be caught by the new mark-to-market rules. Any short-term money market instruments or commodity forward contracts may be caught.

It is important that Parliament includes a definition of 'realisation' in the ITAA 97, and the definition should be based on economic substance rather than legal form.

²¹⁵ An example of a gain (or loss) which is 'certain' occurs where the amounts of all future payments are stipulated in the relevant joint venture financing contract (for example, a fixed interest debt instrument or a 2000 zero coupon bond).

²¹⁶ *A Tax System Redesigned*, 337.

²¹⁷ *Id.*

Hedging rules

It is necessary for appropriate hedging rules to be introduced. *A Platform for Consultation* did not consider many of the complex issues about hedging and the specific circumstances in which hedging rules may be required. Hedging rules are needed to allow for hedging strategies by participants and equity participants, SPFCs and SPVs, whereby a rolling series of hedge transactions are used to hedge a longer dated underlying exposure. Such strategies may be required because of an absence or illiquidity of long term hedge products. The Ralph Committee has proposed that hedging treatment will be required where the necessary documentary and objective criteria are satisfied.²¹⁸ In particular, the recommendation is that internal hedges between 'domestic business units' be recognised in the calculation of a taxpayer's taxable income, with the internal hedge recognised as an asset or liability, and any associated cash flows as a receipt or payment of the respective business units.²¹⁹ Exclusions from internal hedging will be internal transactions where the income of one or both of the business units is subject to taxation in another jurisdiction and transactions involving the transfer of an existing asset or liability (rather than transactions creating assets or liabilities) between a business unit which accounts on a non-market value basis and a business unit which accounts on a market value basis.²²⁰

Mining and petroleum extraction are businesses characterised by long-term cross-border investments, frequently involving large capital investment. It is not uncommon for mining and petroleum companies to develop natural hedges of commodity and currency values, to manage these elements of risk. For instance, a mining or petroleum company might borrow (long-term) in \$US, rather than \$A, to reduce its perceived exposure to changes in value of equity investments in overseas affiliates, whose revenue streams are earned in \$US. Because of the strict definition of hedge,²²¹ this arrangement may not qualify for hedge treatment (which would defer taxation of currency gains on the debt until realised), and the fluctuation in currency values at year end may be brought to account as a taxable gain or loss, based on annual retranslating of the debt.

²¹⁸ 1 *A Platform for Consultation*, para. 6.62.

²¹⁹ *A Tax System Redesigned*, 346.

²²⁰ *Ibid*, 346-347.

Anti-avoidance rules

The Ralph Committee appears to place a strong reliance on specific anti-avoidance rules to counter particular practices that the Ralph Committee considers may occur as a consequence of a realisation basis for taxing certain gains and losses. It is queried whether the range of new anti-avoidance measures proposed are necessary. Part IVA should be sufficient to deal with tax avoidance issues in this area. At any rate, there is arguably a conflict with chapter 24 of *A Platform for Consultation* which highlights that the current system over-relies on specific anti-avoidance rules.

Broadly, the new recommendation relates to the economic disposal rules²²² and anti-synthetic rules.²²³ Previous proposals for loss quarantining,²²⁴ foreign exchange accrual rules,²²⁵ and debt/equity recharacterisation prevention²²⁶ appear not to have been endorsed.

It is unclear at this stage how the economic disposal rules are intended to operate. The recommendation is that as a general rule, a disposal (involving a balancing adjustment for tax purposes) occurs when a taxpayer ceases to hold a financial asset or to be subject to a financial liability—whether, in part or whole, by sale, exchange, maturity or other alienation, extinguishment or synthetic disposal. Is the 'or other alienation' intended to operate as a catch-all? Will a contingent disposal, such as of the type that occurs in farmouts, be caught within the rules if a financial asset is involved?

Debt/equity distinction

It is important that the debt/equity distinction is clear and consistent and maintains symmetry for holders and issuing participants. Australia provides a different tax treatment for debt and equity. Generally, interest is deductible to the borrowing participant and fully taxable to the financier, whilst dividends are not deductible to the issuing participant, but are tax-free to the

²²¹ Ibid, Glossary, 787.

²²² Ibid, recommendation 9.7.

²²³ 1 *A Platform for Consultation*, para. 7.41.

²²⁴ Ibid, para. 6.120.

²²⁵ Ibid, para. 6.48.

²²⁶ Ibid, para. 7.26.

recipient.

One writer considers that 'modern tax policy analysis agrees that there is no rational basis for debt and equity to be differently treated for tax purposes' and that 'optimal tax reform would remove the tax differentiation between debt and equity'.²²⁷

The Ralph Committee did not opt for that approach. Rather, two frameworks were identified: the 'facts and circumstances' test²²⁸ and the 'single determinative factor' test. It is important that any test that is developed is based on objective rather than subjective criteria consistent with an understanding that equity and debt are *functionally* equivalent. This would mean that an instrument possessing certain attributes would be equity, and all other instruments would be debt. Accordingly, the definitions of debt and equity should be mutually exclusive.

²²⁷ Rumble (1999), 52, 55.

²²⁸ See also An Issues Paper, *Taxation of Financial Arrangements*, (1996), ch 6.

FARMOUTS

A farmout normally involves the farmee committing itself to carrying out certain tasks including expenditure in relation to the property held by a participant of an unincorporated joint venture in order to earn an interest in that property.¹ A farmee is either an aspirant holder of an exploration or prospecting entitlement or a holder seeking to increase its interest.² Farmouts are a fundamental and essential vehicle for the exploration and development of mining and petroleum areas and over the years they have evolved from short and simple letter agreements to voluminous and complex documents.³ Farmouts in Australia can involve tens of millions of dollars, yet the application of Australian taxation laws to them is uncertain and complex, primarily because they have not been designed with farmouts in mind. Therefore, when a farmor is a participant of an unincorporated joint venture, characterisation risk⁴ may be compounded.

This chapter is concerned with the role of the taxation of farmouts as a determinant of the choice of joint venture structure used by resident taxpayers. The starting point is the nature of the farmout concept. The farmout arrangements under consideration are ones in the nature of option agreements.⁵ Then the income tax and capital gains tax aspects of these arrangements for farmors and farmees are examined. Relevant taxation factors depending on whether a farmor is a participant or an equity participant, are identified. This examination will reveal that a farmout structured as a disposal of assets bears more compliance costs than farmouts

¹ Fletcher (1988), 291.

² Dawe (1985), 311; Manning (1986), 135.

³ Schaefer (1986).

⁴ That is, the risk of an adverse finding that the relationship between participants of an unincorporated joint venture is one of partnership.

⁵ Martin (1992), 688; Alexander (1994), 236; Pratt (1988), 325; Roberts (1983), 23, states that it is always possible for the parties to define a particular structure or formation and to provide that the farmee becomes entitled to whatever is produced from that structure alone. This is more common in the United States than in the North Sea and examples of this practice in the United Kingdom are not common. See, eg *Moncrief v Martin Oil Service, Inc*, 658 F.2d 768, 770 (10th Cir. 1981).

structured as options over shares. The typical farmout agreement raises important taxation questions in Australia.⁶

NATURE OF A FARMOUT

The expression 'farmout' has its genesis in America. It has come to be used to describe a variety of arrangements but a definition is hard to find. Although the first judicial recognition given to the definition of farmout seems to appear in *Petroleum Financial Corp v Cockburn*,⁷ the concept is said to have originated with the late Earl Brown, former general counsel of Magnolia Petroleum Company.⁸

As far as unincorporated joint ventures are concerned, farmout arrangements may involve a participant (the *farmor*) agreeing to assign rights to all or part of its percentage interest under an exploration or prospecting entitlement (a *prospecting entitlement*) to another participant of the same unincorporated joint venture or to some other party, in exchange for value. Provided the unincorporated joint venture is not characterised as a 'partnership' for income tax purposes,⁹ a participant would ordinarily hold an undivided percentage interest in the rights and obligations derived from the prospecting entitlement.¹⁰ A participant 'farms out' to the farmee; the farmee is said to 'farm in'.¹¹

If equity participants farm out their interest in a prospecting entitlement, the terms and conditions of the farmout agreement will be different than for unincorporated joint ventures: equity participants only hold a shareholding in a SPV incorporated specifically for the venture whereas participants hold a direct interest in the assets of an unincorporated joint venture as a

⁶ Arguably, in the United States, notwithstanding that prima facie farmout agreements are covered by Revenue Ruling 77-176 (see Wegher (1978)), the tax considerations are prima facie simpler than in Australia because of the popular technique of electing tax partnership treatment employed to avoid that Ruling's impact: Schaefer (1986), 18-29.

⁷ 241 F.2d 312, 313 (5th Cir. 1957).

⁸ Cage (1970).

⁹ Section 6(1) ITAA 97; see also the detailed discussion contrasting unincorporated joint ventures from partnerships in chapter 2.

¹⁰ See the definition of 'Participating Interest' in Article 1, *AIPN Model Form International Operating Agreement* (1995).

¹¹ Norton and Rowe, *Accounting and Auditing Guide for United Kingdom Oil and Gas Exploration and Production*, (1978), 78.

tenant in common.¹² For example, in 1999 the unlisted Australian Power & Energy Corp (APEC) entered into a farmout agreement of a percentage of its interest in the Esperance power and liquids project—a one billion tonne resource of lignite at Salmon Gums, 100km north of Esperance—to Hillcrest Resources on the following terms:

Hillcrest can earn 50 percent of APEC by providing \$2.5 million toward feasibility costs. Hillcrest can move to 100 percent of APEC by issuing 50 percent of its issued capital or sell back its interest at cost.¹³

In general, farmouts occur in the exploratory, pre-discovery stage, when the commercial risks of the project failing to recover its costs are considerably greater than at the development stage. The underlying rationale of farmouts has, therefore, been said to be the *reduction or sharing of risk* to the farmor.¹⁴ Debt financing is therefore either not available to the farmor or subject to a lending margin that incorporates the inherent riskiness of a project, thereby rendering debt finance uneconomic. Consequently, the potential future benefits assigned to the farmee are potentially greater than under normal financing arrangements; so that in the oil and gas industry at least, it is usual for the farmee to assume *all* of the farmor's obligations to complete the exploratory drilling programme (sometimes this involves reimbursement of the farmor's costs incurred to date) in consideration for the right to a percentage interest in all future production relating to the farmor's interest in the prospecting entitlement.¹⁵

Commercial drivers of farmouts

There are a number of commercial reasons why participants and equity participants farm out their interests in prospecting entitlements, the most likely being that a farmor is threatened with prospecting entitlement expiration and must drill or lose a prospecting entitlement.¹⁶ In addition, a prospecting entitlement may not meet a farmor's investment criteria, based on its perception of the geological prospectivity of the prospecting entitlement project area and its

¹² See chapter 2.

¹³ M Weir, 'Texaco closes on \$900m WA deal', *The West Australian*, Business Section, 30 November 1999, 1.

¹⁴ Herd (1988), 293; Industry Commission, *Study into the Australian Gas Industry*, (1995), xxiv.

¹⁵ Norton and Rowe, *Accounting and Auditing Guide for United Kingdom Oil and Gas Exploration and Production*, (1978), 78 - 79.

¹⁶ Schaefer (1986), 18-5.

assessment of the probability of a positive financial outcome of future work on the project area, either because of its own work¹⁷ or work conducted by the operator.¹⁸ The farmor may be therefore unwilling to commit further funds to the project at that time. A farmor may, due to pre-existing capital commitments or ranking of opportunities, have cash flow constraints and, while still being optimistic as to the prospectivity of the area, be unable to fund, either in part or in full, its share of the work programme in the prospecting entitlement, but be unwilling to surrender or relinquish all of its interest in the prospecting entitlement or in the unincorporated joint venture or equity joint venture (as applicable).¹⁹ A reluctance to relinquish or surrender can be caused by a desire to maintain good relations with the relevant prospecting entitlement issuing authority²⁰ concerning work commitment undertakings.

Additionally, as part of the normal management of prospecting entitlements, a farmor may receive an offer from other participants, equity participants or third parties to farm out all or part of its total acreage portfolio. Finally, there could be a desire to maintain the maximum number of prospective entitlements under its control or management if the farmor's perception of economic attractiveness is proved incorrect by subsequent exploration activities. Bratby has listed succinctly a considerable number of additional reasons why participants and equity participants may seek to alienate or vary their interests.²¹

It is useful to consider the commercial reasons why other participants or equity participants of

¹⁷ See, for example, the sole risk provisions in Article 7 *AIPN Model Form International Operating Agreement* (1995).

¹⁸ Gibson (1993).

¹⁹ Ibid; McArthur (1997), 666.

²⁰ For example, Department of Natural Resources & Energy.

²¹ Bratby (1984), 966: an outright sale by one participant to third parties, a sale by one participant to another of the whole or part of his interest in the particular venture; an agreed variation between participants as to their respective percentage interests for activities both present and future; a change in interest pursuant to provisions of an independent operations clause or because of provisions relating to expansion or other changes in scope where not all participants participate in the expansion; the desire of a group of companies to substitute another of its companies as a participant for that of another participant; progressive changes in percentage interests as between the participants resulting from different rates of contributions by them to the exploration or development activities; the purchase from a government or governmental instrumentality of its interest in an existing joint venture; the introduction of new Australian equity participants to a joint venture as required by the Foreign Investment Review Board; the variation in interests which can result from the completion of the obligations of a farmee under farmout arrangements; variations in interests caused by default or the merger of two or more companies or arising from the expiration of a period due to which one member has had a free carried interest.

the same joint venture and other parties would want to farm in to a prospecting entitlement. Many exploration and production companies monitor the progress of 'like' companies and, where applicable, integrate competitors' work results into their own studies. By this process, an aspirant farmee may develop different technical rationales for conducting exploratory investigations in areas of land and seabed outside those governed by its own prospecting entitlements. An aspirant farmee wishing to participate in those other areas simply may not otherwise have an opportunity to acquire an interest in the unincorporated joint venture or equity joint venture. This would be so if the participants or equity participants do not wish to sell or are incapable of selling their interests.²² Consequently, at a practical level, the only available form of entry may be for the farmee to farm in to the joint venture.

Legal structures of farmouts

Farmouts may be structured in two ways: as a *deferred transfer farmout*, or an *immediate transfer farmout*.²³ Both these structures can be used by unincorporated and equity joint ventures. A person has an 'interest' in a thing 'when he has rights, titles, advantages, duties, liabilities, connected with it, whether present or future, ascertained or potential, provided they are not too remote'.²⁴ With deferred transfer farmouts, the farmee agrees to undertake certain financial obligations or work commitments, following which it will be entitled to take an interest in the exploration entitlement. It is not unusual for deferred transfer farmout agreements to be drafted as an option (exercisable either immediately or after certain expenditure is incurred or work is performed).²⁵ A judicial definition of a deferred transfer farmout is that it is:

a contract to *assign* oil and gas lease rights in certain acreage upon the completion of drilling obligations and the performance of any other covenants and conditions therein contained. It is an executory contract. It is largely used in cases where the owner of a lease is unable or unwilling to drill on a lease which is nearing expiration, but is willing to assign an interest therein to another who will assume the drilling obligations and

²² Due to pre-emptive rights or inflexible assignment and/or novation provisions in the JVA or shareholders' agreement.

²³ Gately (1987), 58; Dawe (1987) 56; Herd (1988), 293.

²⁴ Bird, *Osborn's Concise Legal Dictionary*, (1983), 183.

²⁵ Gately (1987), 58; Herd (1988), 293.

save the lease from expiring. Often the owner of the lease retains an overriding royalty of a carried interest as his consideration ...²⁶ [emphasis added]

It is clear from that definition that farmouts effect an assignment of an interest, and are executory contracts; that is, farmouts are conditional contracts which, conventional legal reasoning would suggest, create contingent or executory equitable interests in the property.²⁷

By way of illustration, a typical deferred farmout agreement might say:

I, the farmor, have a 30 percent interest in a JVA for the exploration of the Exploration Entitlement. If you, the farmee, will pay for half my 30 percent share of the cost of 1,000kms of seismic and the next four wells to be drilled, then I will assign to you one quarter of that 30 percent interest.²⁸

An immediate transfer farmout involves an immediate transfer of an interest in the relevant prospecting entitlement, subject to an obligation to re-convey in the event of default in the performance of the farm in obligations.²⁹ It has been pointed out that the 'assignment of a complete legal and beneficial interest up-front is not unusual for mineral joint ventures. It is less usual for petroleum joint ventures but far from being infrequent, and is a matter for negotiation.'³⁰

It should not be presumed that all definitions of a 'farmout' have recognised the distinction between deferred and immediate transfers, because they have not. For example, one commentator has defined a farmout as 'an assignment of all or part of an interest in all or part of a mining concession with the reservation to the assignor of an interest in the concession or in its production or the value thereof.'³¹ This definition lacks an appreciation of *when* the actual assignment of an interest takes place. Notice also the context is the mining industry and

²⁶ *Petroleum Financial Corp v Cockburn* 241 F.2d 312, 313 n.2 (5th Cir. 1957). For a simplified definition see *Moncrief v Martin Oil Service, Inc.* 658 F.2d 768 (10th Cir. 1981); *Mengden v Peninsula Prod. Co.* 544 S.W.2d 643, 645 n.1 (Tex.) (1978); Roberts (1983). Overriding royalties and carried interest farmouts are considered later in this chapter.

²⁷ Farrands, *The Law of Options*, (1992), 16.

²⁸ Dawe (1985), 311.

²⁹ *Ibid*, 314.

³⁰ Dawe (1987), 58.

³¹ Williams (1978).

not the petroleum industry.³² Absent from this definition is the requirement that the contract be an executory one.

The description attributed to farmouts in the Australian mining industry by the Commissioner is broader still—he has ruled that farmouts are used to describe a wide variety of arrangements including any arrangement under which the holder of a prospecting or mining right assigns or disposes of a portion of that right to another person in return for any form of consideration.³³ It is noted that variations to this basic model include, for instance, stepped or incremental earning programmes, in which the farmor incrementally assigns a percentage of its interest to the farmee on the incremental completion of obligations under the farmout agreement.³⁴

In the analysis so far, it should be evident that there are three recognised forms of 'interests' relating to farmouts. First, the chose in action under the farmout agreement, which is the contractual right to acquire the prospecting entitlement.³⁵ Secondly, the contingent or executory equitable interest in the property the subject of the farmout;³⁶ this is not the underlying asset but rather the farmee's entitlement to call on equity to compel a conveyance of the property from the farmor to the farmee.³⁷ An equitable interest may be created by having the farmor acknowledge that the farmor holds the prospecting entitlement on trust for the farmee either during the entire period that the contract is executory, or, more usually, from the time that the farmee completes the earning obligations.³⁸ Where a farmout involves an immediate transfer, then the question of equitable interest will not arise.³⁹ And thirdly, the property the subject of the farmout, being the chose in action in the rights and obligations the farmee will acquire once it becomes a participant of the JVA and a proprietary interest in the prospecting entitlement as a tenant in common or the chose in action in the rights and

³² Cf. the *Cockburn* formulation and the Commissioner of Taxation's definition, both outlined earlier in this chapter.

³³ *Ruling IT 2378*, para. 1.

³⁴ Herd (1988), 293.

³⁵ Farrands, *The Law of Options*, (1992), 115.

³⁶ *Ibid*, 105.

³⁷ *Ibid*, 115.

³⁸ Dawe (1985), 314.

³⁹ Wilcocks (1980).

obligations of the farmee under the shareholders' agreement.⁴⁰ Therefore, the 'interests' acquired by a farmee on execution of a farmout agreement will depend on whether the transfer is upfront or deferred.

By contrast, a participant of an unincorporated joint venture will normally have a proprietary interest in *all* the assets of the joint venture as a tenant in common.⁴¹ Therefore, a farmee's interest may or may not be *identical* to the contractual and proprietary interests acquired by a participant in the assets of the joint venture as a tenant in common⁴² on entry to a JVA.

That notwithstanding, a farmout will involve an assignment of property.⁴³ A farmout will be assignable by the farmee unless, by the terms of the farmout agreement, it is stipulated that the farmee's obligations are personal, so that they must be exercised by the farmee in person.⁴⁴ For example, in *Shearer v Wilding*,⁴⁵ Harvey J, referring to an option to purchase set out in a lease, stated:

[p]rima facie it is a right of property given to him under the lease... The authorities show that the use of the word 'assigns' is not necessary to render the option capable of assignment. It could have been assigned apart from the lease.⁴⁶

TYPES OF FARMOUTS

Farmouts vary in type. The following grouping is not used as the basis of this chapter as generally speaking, the Australian taxation principles governing farmouts apply equally to all the groups. Where necessary, however, some distinction between the groups has been made.

⁴⁰ Dawe (1985), 314.

⁴¹ Crommelin (1986), 70.

⁴² Id.

⁴³ Dawe (1987), 58.

⁴⁴ Cf *Carter v Hyde* (1923) 33 CLR 115, 120-121, per Knox CJ; *Griffin v Pelton* [1958] Ch 205; Farmston (1993).

⁴⁵ (1915) 15 SR(NSW) 283.

⁴⁶ Ibid, 286.

Carried interest agreements

A farmor could have its costs carried by the farmee.⁴⁷ The farmee is obligated to perform specific work, not limited or calculated by reference to dollars (eg drilling a well to a certain depth or acquiring a prescribed number of kilometres of seismic data). The prospecting entitlement is farmed out using a deferred transfer farmout agreement.⁴⁸ A carried interest arrangement is generally, but not always, between two participants of the same unincorporated joint venture.⁴⁹ The farmor's percentage interest of the costs are borne by the farmee for a defined period or until some defined event occurs. During the carrying period, the farmor may buy back its percentage interest of future benefits and commit itself to bear its share of future costs by reimbursing the farmee for its share of costs incurred to date, plus interest and perhaps with an additional sum to cover the risks borne by the farmee. The reimbursement may either take the form of an immediate cash payment or a percentage of the farmor's share of future production. If the farmor chooses not to exercise its option, it suffers no penalty and the farmee has the right to acquire an interest under the prospecting entitlement.⁵⁰

Unitised agreements

A farmor and farmee could agree to unitise a proven field which straddles two or more blocks. All the parties concerned agree to operate the field as a unit and agree on their respective interests in the field as a whole. Costs will be then reallocated to each prospecting entitlement holder in accordance with their revised percentage interests, and balancing payments are made by those who have underpaid to those who have overpaid. During the production period, as further data become available as to the size and location of the reserves, the respective

⁴⁷ Bratby (1984), 966.

⁴⁸ There are at least three standard forms of carried interest: the 'Manahan' interest, under which the farmor assigns all of its property but gets back half (or some other percentage) under a right of reversion after drilling costs are recouped; the 'Herndon' type, in which the farmor assigns a portion of its mineral interest, plus a production payment (discussed below) covering the cost attributable to its retained interest, with the latter assigned back after the farmee recoups its costs; and the 'Abercrombie' type, in which a farmor assigns part of its interest and gives a mortgage against development costs on the rest of its interest. See generally *United States v Cocke*, 399 F 2d 433, 436-37 (5th Cir. 1968), cert. denied, 394 US 922 (1969); *Estate of Weinert v Comm'r*, 294 F 2d 750, 750 n.1 (5th Cir. 1961).

⁴⁹ Norton and Rowe, *Accounting and Auditing Guide for United Kingdom Oil and Gas Exploration and Production*, (1978), 80.

⁵⁰ Pratt (1988), 331.

interests of each party are recalculated and further balancing payments made.

Earning obligation agreements

A farmee could earn a right to acquire an earning obligation in the prospecting entitlement. The earning obligation might involve the farmor agreeing to spend a certain percentage of future exploration costs up to a defined dollar limit at which time an undivided percentage interest in the prospecting entitlement and information will be farmed out to the farmee. Alternatively, the farmee could reimburse the farmor for all or part of its prior exploration costs. The parties would then bear future exploration costs in proportion to their percentage interests in the prospecting entitlement then owned by each. This would be an example of where the exploration expenditures are borne jointly.

Production payment agreements and overriding royalties

Production payments describe a share of the oil produced from a described tract of land, free of the costs of production at the surface, terminating when a specified sum from the sale of such oil has been realised.⁵¹ Oil payments may be reserved by a lessor, by an assignor of a lease, or carved out by the owner of a working interest or royalty interest.⁵²

An overriding royalty is similar to a production payment in that a farmor grants to a farmee a right to acquire a percentage interest in future production for a fixed monetary amount. However, unlike a production payment, the future production assigned is not fixed in quantity or value terms, but is expressed as a fixed percentage of the gross production appropriate to the farmor's interest.⁵³ The specific wording of the provision in the farmout agreement, which establishes conversion of the overriding royalty into a working interest for record title purposes, will also be important.⁵⁴

But there is a risk that the grant by a farmor of an overriding royalty could expose the farmor

⁵¹ Williams and Meyers, *Williams and Meyers Manual of Oil and Gas Terms*, (1997), 847. Production payments are also known as oil payments.

⁵² *Ibid*, 712. Refer *Tennant v Dunn*, 130 Tex. 285, 110 S.W.2d 53 (1937); *State v Quintana Petroleum Corp*, 134 Tex. 179, 133 S.W.2d 112 (1939).

⁵³ Pratt (1988), 331.

⁵⁴ Schaefer (1986), 18-25 and 18-26. See, for example, Div. 5 ('Registration of Instruments') of the *Petroleum (Submerged Lands) Act 1967* Cth.

to characterisation risk.⁵⁵ Such a risk will exist if a farmee's rights under an overriding royalty agreement go beyond those appropriate in a financier and borrower relationship, then a court may treat the advance of funds by the farmee as a capital contribution and the farmee as a partner in the business.⁵⁶ In most cases, a farmee's rights under an overriding royalty agreement will not go beyond those appropriate in a financier and borrower relationship.

In *John Bridge & Co Ltd v Magrath*,⁵⁷ the plaintiff company, which ran a woolbrokers, stock and station agents business, entered into an agreement to finance the defendant's produce and skin dealer's business. The agreement provided that the plaintiff was entitled to be paid one-third of the profits of the defendant's business in reduction of the loan and a second one-third was to be paid to the plaintiff to be held as a 'reserve fund' for the purposes of the defendant's business. The plaintiff reserved the right to end the agreement at any time after six months or to extend its operation and the defendant undertook to make his accounting statements and books available for inspection by the plaintiff at all times during the subsistence of the loan. The court held that the rights vested in the plaintiff by this agreement were no more than was reasonable to preserve the security of the loan and did not constitute evidence of a partnership agreement to be submitted to a jury.

The decision in *John Bridge* is binding on all the courts of New South Wales except the Full Court. It is likely, in the author's view, that the Full Court would follow *John Bridge* and the author considers that it is not improbable that an inferior court would seek to follow *John Bridge*.

If a farmee's rights under an overriding royalty agreement go beyond what is reasonable to preserve the security of the loan and constitute evidence of a partnership agreement, then characterisation risk may be more significant. For example, if a farmor could be forced to account for its share of the product of the joint venture activity as partner with the farmee, then it would be easier to draw the inference that there is a 'joint profit'. Partnership requires

⁵⁵ Assuming the farmor is a participant of an unincorporated joint venture.

⁵⁶ See *Re Butchart; Ex parte Jones* (1865) 2 WW & AB (IE & M) 8, per Molesworth J, where His Honour stated: '[t]here is nothing to prevent a person lending money to be used in trade, making any such stipulation as to not giving credit, and keeping accounts, and not carrying on any other business. All these stipulations are consistent with the mere relationship of borrower and lender.'

⁵⁷ (1904) 4 SR(NSW) 441, per Owen J, Cohen & Pring JJ.

there to be an activity with a view of profit.

But farmees taking their minerals or other asset in kind as a fixed percentage of the gross production appropriate to the farmor's interest obtain no profit at that stage. However, as we have seen in chapter 2, it is not beyond argument that product sharing is mutually exclusive with general law partnerships. Whilst the better view is that Australian courts would probably not regard a fixed percentage of the gross production itself as constituting 'profit' for the purposes of the *Partnership Acts*,⁵⁸ there remain some doubt about whether a 'view to joint profit' is a necessary prerequisite for a finding of partnership.⁵⁹ If the resolution of the latter question depends on the method of interpretation of the statutory definition of partnership under the *Partnership Acts* and the definition of a partnership is viewed as three separate elements, the definition may be construed as requiring only that a farmor and farmee each have a (separate) view to profit.⁶⁰ But if the definition is treated as a composite expression, it leads to the conclusion that the profit motive must attach to the farmor and farmee as a group in the conduct of their common business.⁶¹ On this approach, which is supported by Dawson J in *Brian's case*,⁶² the statutory definition of partnership under the *Partnership Acts* must be read as requiring profit to be gained jointly, which is not the case in a typical farmout structured as an overriding royalty.⁶³

No Australian court has decided whether a farmout structured as an overriding royalty is a general law partnership and it is not possible to conclude with absolute certainty that it is not. Therefore, characterisation risk will be a feature of these farmouts. To a greater or lesser degree, prospective farmees and farmors would be likely to incur compliance costs to make an assessment of the level of characterisation risk in a given case. Assuming that a farmor will always seek the same after-tax return no matter which type of farmout agreement the farmor

⁵⁸ Ryan (1982), 140-41; cf Chetwin (1991), 263; Crommelin (1986), 68.

⁵⁹ Chetwin (1991), 263; Ryan (1982), 139-41.

⁶⁰ Chetwin (1991), 263: 'It is not clear whether or not sharing of profits is essential for a partnership... The implication of this approach is that the "in common" refers to the mode of conducting business and not with the disposal of the profit.'

⁶¹ See Crommelin (1986), 68.

⁶² *United Dominions Corporation Ltd v Brian Pty Ltd* (1985) 157 CLR 1, 15-16 per Dawson J.

⁶³ Crommelin (1986), 68.

enters into with a farmee, the compliance cost disadvantage of overriding royalty agreements compared to other types of farmouts will make overriding royalty agreements less attractive than other types of farmout agreements.⁶⁴

Equalisation agreements

In addition, a farmee and farmor could structure the transaction so that the farmee is required to spend a specific sum of money until it has equalised that incurred by the farmor. If a farmor has incurred expenditure prior to the new arrangement, then the farmee will only acquire the right to a given percentage of the farmor's interest after it has incurred a given level of the exploration costs.

COMPLIANCE COSTS OF FARMOUTS OF ASSETS

With farmouts of assets, a farmee acquires an interest in both a prospecting entitlement and the JVA from the farmor. The farmor will never be the unincorporated joint venture, because it does not enjoy a separate legal personality. The farmor will always be a participant. Therefore, the taxation factors of farmouts that are relevant to the farmor will always operate at the participant level. The only caveat on this is if the consolidation regime becomes law and a farmor participant is a member of a consolidated group.⁶⁵ For the convenience of discussion, it is assumed that the consolidated group proposals of the Ralph Committee, will not be relevant.

It is argued that the compliance costs of farmouts of assets are higher than for farmouts of shares and the principal causes of this are the complexity and sheer volume of laws applicable

⁶⁴ There are two reasons to support this. First, if a farmor entering into an overriding royalty agreement does not increase its overall rate of return by an amount equal to its compliance costs, then in aggregate terms, the farmor will be economically worse-off to the extent of those compliance costs. Secondly, if a farmor decides to pass-on its increased compliance costs to the farmee, then the farmee will be disinclined to enter into an overriding royalty agreement because this type of farmout is comparatively more expensive than other types of farmouts.

⁶⁵ In this instance, the taxation factors of farmouts which are relevant to the farmor will operate at the participant level, but will be consolidated into the group. The consolidation regime will not apply directly to unincorporated joint ventures, because this joint venture structure is not recognised by the ITAA 97 as a taxpayer in its own right. Unincorporated joint ventures will not be eligible to join the consolidated regime: see *A Tax System Redesigned*, chapter 15. Therefore, for unincorporated joint ventures, the consolidation regime will only ever operate at the participant level. Unless equity participants who are members of the same corporate group wholly own a SPV, the SPV will not be able to consolidate its tax position into that corporate group.

to asset farmouts compared to share farmouts.⁶⁶ Other compliance burdens are imposed by characterising the profit from the farmout, the trading stock provisions of the tax law, depreciation and mining and petroleum balancing adjustments, resource rent tax payments and capital gains provisions. To some extent, these compliance costs are counter-balanced by the cash-flow benefits a farmor derives from being eligible for the genuine prospectors exemption.

Characterising the profit from a farmout

A farmor will incur compliance costs to comply with obligations in the tax law to characterise the proceeds it receives from a farmout. These costs arise because of the distinction tax laws make about profit that is ordinary income,⁶⁷ profit made under a profit making undertaking or plan,⁶⁸ profit from the sale of trading stock⁶⁹ or a capital gain.⁷⁰

When will a farmor derive a profit from farming out an interest in the prospecting entitlement? A 'profit' will arise where a farmee pays the farmor a premium for the right to earn a percentage interest in that entitlement. The farmor's 'profit' is the amount the farmee must pay in excess of the cost of the entitlement to the account of the farmor. But a farmor will not always derive a profit from entering into a farmout agreement; the farmee may merely recompense the farmor by satisfying the farmor's obligations under the prospecting entitlement or by performing certain work.

A farmor will incur compliance costs to assess whether its proceeds are characterised as revenue or capital in nature. If the proceeds are capital profits arising from the disposal of an asset acquired after 19 September 1985, they will be subject to tax as a capital gain. If the gain is characterised as one made in the course of the farmor's business activities or as a separate business activity altogether, then the profit will be income according to ordinary

⁶⁶ This complexity also exists when there is a change in the ownership of participants of an unincorporated joint venture if it is an asset sale, as chapter 5 will demonstrate.

⁶⁷ Section 6-5(1) ITAA 97.

⁶⁸ Section 15-15 ITAA 97.

⁶⁹ Section 70-20 ITAA 97.

⁷⁰ See Pt 3-1 ITAA 97 'Capital gains and losses: general topics'. This assumes that a prospecting entitlement has been acquired severally by participants of an unincorporated joint venture on or after 20 September 1985.

concepts.⁷¹

If the proceeds are part of a farmor's business, then they will be on revenue account. It is well established that whether or not activities constitute a business will depend on factors including commerciality,⁷² scale,⁷³ frequency,⁷⁴ profit purpose⁷⁵ and commercial character of the activities.

In many cases, characterisation of the proceeds should be a relatively straightforward matter given the nature of a farmor's business activities. But from time to time there may be instances where a farmor must expend resources to properly characterise its proceeds. In theory, one such instance might be where a superannuation fund acquires, as part of its normal business activities, undivided fractional interests in unincorporated joint ventures specifically to farm out those interests for a profit.⁷⁶

A farmor might expend resources to make a determination in the following example. Assume that company A—an insurance company, acquires all the shares in company B. Company B is mainly an insurance company, but it has a small ownership in an unincorporated joint venture. Shortly after company A acquired company B, the management of company B concluded a deal with company D to farm out a 40 percent share in a prospecting entitlement to company D. Company A is unsure how to treat the proceeds of the farmout.

If the circumstances are such that a farmor must characterise its proceeds as either revenue or capital, then a farmor will expend resources determining whether a business is carried on, and

⁷¹ *Case D67* (1972) 72 ATC 400; see also *Thorpe Nominees Pty Ltd v FCT* (1988) 88 ATC 4886; 19 ATR 1834, where the taxpayer was held assessable on the sale of the 'nominee rights' held by it as grantee of certain options.

⁷² *Ferguson v FCT* (1979) 37 FLR 310.

⁷³ *Fairway Estates Pty Ltd v FCT* (1970) 123 CLR 153 per Barwick CJ.

⁷⁴ *FCT v Radnor Pty Ltd* (1991) 102 ALR 187; 22 ATR 344, 357 per Hill J.

⁷⁵ In *Thomas v FCT* (1972) ATC 4094, 4099; 46 ALJR 397, 401; 3 ATR 165, 171; ALR 368, 374, per Walsh J. The High Court was prepared to infer a profit motive where the taxpayer aimed to produce quantities of the relevant item which were significantly greater than domestic needs.

⁷⁶ The author was unable to identify any authorities on this point.

if so, the nature of the business.⁷⁷

Whether or not a business is carried on is a matter to be determined having regard to the facts of the particular case.⁷⁸ The determination will involve some consideration of the definition of a 'business' in the ITAA 97.⁷⁹ Case law may also assist in appropriate circumstances,⁸⁰ but it has been said that 'it is not possible exhaustively to enumerate the facts or circumstances which will support the inference that a course of activity is a business'.⁸¹

An investigation into whether a taxpayer is carrying on business will involve considering whether any and how many of the indicia of business are present.⁸² No single indicator will in itself be determinative.

A farmer may incur compliance costs to assess whether its proceeds are characterised as gains made from a profit-making undertaking or plan. If so, then s. 15-15(1) of the ITAA 97 provides that a farmer's profit includes profit arising from the carrying on (or carrying out) of a profit-making undertaking or plan. The provision does not, however, apply to a profit that is assessable as ordinary income under s. 6-5⁸³ or which arises in respect of the sale of property acquired on or after 20 September 1985.⁸⁴ In the *Myer Emporium case*,⁸⁵ the Full High Court found unanimously in a joint judgment that Myer was assessable as income under s. 25(1) and also as profit from the carrying on or carrying out of a 'profit-making undertaking or scheme' under s. 26(a) of the ITAA 36. The High Court held that a gain:

⁷⁷ Whether or not a farmer is carrying on a business is a question of fact, not of law, depending upon a variety of circumstances: *Werle & Co v Colquhoun* (1888) 20 QBD 753, 761 per Fry L J; quoted with approval by Starke J in *Blockey v FCT* (1923) 31 CLR 503, 511.

⁷⁸ *Newton v Pyke* (1908) 25 TLR 127.

⁷⁹ Section 995-1 ITAA 97 defines a 'business' as including 'any profession, trade, employment, vocation or calling, but does not include occupation as an employee'.

⁸⁰ What may be extracted from the cases on this issue is that there is a 'multitude of things' which together make up the carrying on of a business: *Erichsen v Last* (1881) 8 QBD 414.

⁸¹ *London Australia Investment Ltd v FCT* (1977) 138 CLR 106.

⁸² See *Erichsen v Last* (1881) 8 QBD 414.

⁸³ Section 15-15(2)(a) ITAA 97.

⁸⁴ Section 15-15(2)(b) ITAA 97.

⁸⁵ (1987) 163 CLR 199, 209.

made otherwise than in the ordinary course of carrying on the business that nevertheless arises from a transaction entered into by the taxpayer with the intention or purpose of making a profit or gain may well constitute income. Whether it does depends very much on the circumstances of the case. Generally speaking, however, it may be said that if the circumstances are such as to give rise to the inference that the taxpayer's intention or purpose in entering into the transaction was to make profit or gain, the gain will be income, notwithstanding that the transaction was extraordinary judged by reference to the ordinary course of the taxpayer's business.⁸⁶

The *Myer Emporium* case highlights the traditional distinction between items on revenue account and items on capital account by emphasising a taxpayer's profit-making intention. Accordingly, if the circumstances of a farmout give rise to the inference that the farmor's intention or purpose in entering into the farmout was to make a profit or gain, then that profit or gain will be income, notwithstanding the transaction was an extraordinary one judged by reference to the ordinary course of the farmor's business.⁸⁷

Even if a farmout is not an ordinary incident of a farmor's business activities, a farmor may nevertheless incur compliance costs to assess whether the proceeds of a one-off or isolated transaction constitute ordinary income. It is well settled that the proceeds of isolated ventures or one-off transactions can be characterised as assessable income.⁸⁸ *FCT v Wharfords Beach Pty Ltd*⁸⁹ was decided on the basis that an isolated transaction could constitute a business. In this case, the taxpayer company bought 1,584 acres of land. Over a decade later, the shares in the taxpayer company were sold to an insurance company and two land developers which companies proceeded to develop, subdivide and sell the land owned by the taxpayer company in order to realise a profit. The lots were subsequently sold at a substantial profit.⁹⁰

⁸⁶ Id.

⁸⁷ Id.

⁸⁸ *FCT v Myer Emporium Ltd* (1987) 163 CLR 199.

⁸⁹ (1982) 150 CLR 355.

⁹⁰ Ibid, 384 per Mason J. In finding that there was a business which commenced on 20 December 1967, Mason J said: 'in deciding whether what the respondent did was the mere realisation of an asset or the carrying out of a profit-making undertaking or scheme, it is relevant to take into account that the company came under the ownership and control of new shareholders whose purpose was to use the company for the execution of what, judged from their point of view, was a profit-making undertaking or scheme. In deciding whether the company was carrying on the business of land development it is material that the new shareholders would have been carrying on such a business had they purchased the land from the company and carried out the development and sale on their own account.'

We have seen in this section of the chapter that tax laws governing the characterisation of proceeds from a farmout are based on legal concepts of income, which have built up over time. The law involves concepts of ordinary income, statutory income including capital gains and expenses, and losses of either a revenue or capital nature. Consequently, the proceeds from a farmout of assets under a farmout agreement may be taxed in a variety of ways depending on the purpose for which the assets are held before they are disposed of.

The Ralph Committee has proposed the cash flow/tax value approach to calculate taxable income. The approach involves a comparison of beginning and end of year balance sheets and will involve adjustments between the profit and loss account and taxable income.⁹¹ If this reform is enacted, then it will affect all future farmouts.⁹²

Under the cash flow/tax value approach, taxable income will be derived from receipts less payments plus or minus changes in the tax value of assets and liabilities.⁹³ All receipts and expenditures would be brought into the net income calculation. It would no longer be relevant to characterise proceeds in the same manner as is currently the case.⁹⁴

Trading stock

A farmor may so frequently farm out its interests in prospecting entitlements that the trading stock provisions may apply. The difficulty is that there is no clear statement in the law that a prospecting entitlement can be an item of trading stock. The definition of trading stock in the ITAA 97 is inclusive only,⁹⁵ and many of the words used are broad in scope and require interpretation; that is, legal complexity exists. Consequently, a farmor seeking to bring to account under the trading stock provisions its proceeds from a farmout will need to first incur a cost to determine whether its prospecting entitlement which is the subject of the farmout is

⁹¹ *A Tax System Redesigned*, recommendation 4.1.

⁹² In the Treasurer's response, *The New Business Tax System: Stage 2 Response*, Press Release no. 74, 11 November 1999, 5, the Treasurer states: 'The Government sees considerable merit in the high level reforms proposed by the Review and has given in principle support to their introduction. However, it recognises the importance of developing a workable system that can be implemented with minimum disruption.'

⁹³ *Id.*

⁹⁴ Cathro (1999), 224.

⁹⁵ 'Trading stock' includes 'anything produced, manufactured or acquired that is held for purposes of manufacture, sale or exchange in the ordinary course of a business and livestock': s. 70-10 ITAA 97.

capable of constituting an item of trading stock.

The High Court decision of *St Hubert's Island Pty Ltd v FCT*⁹⁶ is authority for the proposition that land will constitute trading stock if it is acquired for the purpose of sale. However, the question of whether a prospecting entitlement will constitute trading stock if it is acquired for the purpose of sale remains unreviewed by an Australian court. Accordingly, the author believes that *St Hubert's Island* is persuasive authority. In this connection, an Australian court would consider it significant that *St Hubert's Island* has been followed or cited favourably in at least two cases; namely, *FCT v Suttons Motors (Chullora) Wholesale Pty Ltd*⁹⁷ and *Parfew Nominees Pty Ltd v FCT*.⁹⁸

In *FCT v Suttons Motors (Chullora) Wholesale Pty Ltd*,⁹⁹ the Full High Court said 'the ordinary meaning of the term "trading stock" upon which section [70-20 of the ITAA 97]¹⁰⁰ builds is that which is attributed to it by legal and commercial people for accounting and other purposes ... It is not necessary for present purposes however to explore the outer limits of the area covered by that ordinary meaning of the term. Its traditional and narrower denotation still lies at the centre of that meaning and is adequate for the present purposes. That denotation is of goods held by a trader in such goods for sale or exchange in the ordinary course of his trade.'¹⁰¹

If prospecting entitlements are acquired 'for exchange', then they are capable of constituting 'trading stock'. As trading stock, a farmor would be entitled to a deduction for the cost of the prospecting entitlement when it is assigned to the farmee.¹⁰² The nature of the transfer provision (ie upfront or deferred) contained in the farmout agreement will be determinative of the timing of the disposal.

⁹⁶ (1978) 138 CLR 210.

⁹⁷ (1985) 59 ALJR 615.

⁹⁸ (1986) 86 ATC 4673.

⁹⁹ (1985) 157 CLR 277; *apld FCT v Brambles Holdings Ltd* (1991) 28 FCR 451.

¹⁰⁰ Section 31C ITAA 36, 'trading stock' is defined in s. 995-1 ITAA 97.

¹⁰¹ (1985) 157 CLR 277, 282.

¹⁰² See chapter 5.

When a prospecting entitlement is disposed of, a farmor must determine the value of each article of trading stock in accordance with any one of three methods¹⁰³—the cost¹⁰⁴ price of the trading stock, the market selling value of the trading stock,¹⁰⁵ or the replacement price of the trading stock.¹⁰⁶ If a farmor elects to substitute market selling value for cost, then the profit or loss arising on realisation of the item of trading stock must be brought to account. An election of market selling value where the market selling value of the item is less than cost will anticipate a loss. An election of cost at the end of the following year will reverse the anticipation of a loss. There will obviously be a compliance cost in complying with this provision.

Unless there are questions about the precise meaning of 'cost price', it is hard to envisage a situation where a farmor's compliance burden in this area will be more onerous than for any other trader. 'Cost price' generally means the cost of the trading stock to the taxpayer in getting the trading stock into its existing condition. For the corresponding provision of the ITAA 36, *Phillip Morris Limited v FCT*¹⁰⁷ held that a number of remote expenses should enter the determination of cost. It is clear that if more remote expenses enter a farmor's determination of cost, then an increase in the deferral of outgoings will take place. This will result in a higher taxable income than otherwise if only direct costs entered the determination of cost.

The Ralph Committee has recommended reforms to the trading stock provisions of the tax law as part of the change to the cash flow/tax value approach of calculating taxable income. In particular, the Committee recommends limiting the definition of trading stock to tangible assets produced, manufactured or acquired and held for the purposes of manufacture, sale or exchange in the ordinary course of a business. Livestock will also be included. Intangibles like shares and other financial assets will no longer qualify as trading stock.¹⁰⁸ Trading

¹⁰³ Section 70-45(1) ITAA 97.

¹⁰⁴ 'Cost' as defined in the ITAA 36 has been held to mean the actual cost of the taxpayer's stock up to the relevant time: *Phillip Morris Limited v FCT* (1979) 38 FLR 383; *Rulings* IT 2350 and IT 2402.

¹⁰⁵ See also *Australasian Jam Co Pty Ltd v FCT* (1953) 88 CLR 23.

¹⁰⁶ See (regarding ITAA 36) *Parfew Nominees Pty Ltd v FCT* (1986) 85 FLR 370.

¹⁰⁷ (1979) 38 FLR 370.

¹⁰⁸ *A Tax System Redesigned*, 180.

stock will be valued at the lower of cost or net realisable value, as in accounting. Upward valuation to net realisable value will also be possible subject to constraints.¹⁰⁹

The Government has not yet announced its position in relation to this measure. If a law is passed giving effect to the Ralph Committee's recommendations, then the uncertainty inherent in the trading stock provisions of the tax laws will disappear. If the fiscal uncertainty disappears, farmers will no longer need to incur a compliance cost in relation to questions about trading stock.

Balancing adjustments add additional layer of fiscal complexity

Depreciation balancing adjustments

The compliance cost burdens imposed by the depreciation balancing adjustment and roll-over provisions are considered at length in following chapter in the context of changes in the ownership of participants of unincorporated joint ventures.¹¹⁰ Those comments apply equally to farmouts of assets.

Depreciation balancing adjustment complications may unexpectedly arise if the farmer and farmees' intentions are not sufficiently documented during the drafting phase of the farmout agreement. For instance, if a farmee incurs 100 percent of the expenditure on items of plant but pursuant to the farmout agreement is only entitled to an ownership interest of say, 35 percent of that plant, then it will be denied a depreciation deduction in excess of its ownership interest in the plant. This is because tax laws give taxpayers deductions for depreciation for plant and equipment when a taxpayer is the legal owner of the asset (the *legal ownership test*).¹¹¹ Given that the participants own plant and equipment as tenants in common, deductions for depreciation are based on the ownership percentage interests in the plant and

¹⁰⁹ In addition, trading stock will continue to be excluded from capital gains treatment on the bases that such treatment would run counter to the objectives of encouraging investment in longer term capital assets and would be inconsistent with the existing concept of taxing income from trading activities. The inclusion of trading stock assets in loss quarantining would undermine the integrity of capital loss quarantining. Absorption cost will continue to apply and be extended to the valuation of assets for tax purposes generally. Similarly, trading stock conventions for the identification of cost with particular assets (actual cost, FIFO or weighted average cost) will extend to all assets other than capital assets. Current livestock valuation options will be retained: *id.*

¹¹⁰ See chapter 5, p 200.

¹¹¹ *A Tax System Redesigned*, 309.

equipment and not just the amount of expenditure incurred.¹¹²

The legal ownership test does not cater well for farmouts of the type described in the preceding paragraph. The Ralph Committee has recommended that a taxpayer's entitlement to a write-off in respect of depreciable assets for taxation purposes should be given to the taxpayer who incurs the loss in value of the asset, which is not necessarily the legal owner of the asset.¹¹³ According to this measure, one of the persons who will be entitled to tax depreciation are persons who hold assets jointly such as co-owners or joint venture participants. Such taxpayers would be able to write off the cost of their share of depreciable assets regardless of how they paid for those shares.¹¹⁴

Although the Government has not yet announced its position in relation to this recommendation, a commitment by the Government to the core principle of this measure would be likely to produce a compliance cost saving for farmers and farmees.

Mining and petroleum balancing adjustments

If the parties enter into an agreement to transfer allowable capital expenditure, then a taxation clause could be included in the farmout agreement.¹¹⁵ Depending on the nomination of value of the property on the interests subject to the farmout, a tax clause may take the following form (or similar):

For the purpose of this Agreement, if section 330-235 of the *Income Tax Assessment Act 1997* (Cth), as amended (the *Act*) is applied with respect to any change of ownership or interest brought about by or in relation to this Agreement:

- (a) the value of the property subject to such change shall not exceed by more than \$100.00 the total capital expenditure incurred by all parties in respect of the said property less the sum of all deductions allowed and allowable in respect of that expenditure under Division 330 of the *Act*; and

¹¹² Section 42-15 ITAA 97.

¹¹³ *A Tax System Redesigned*, recommendation 8.3.

¹¹⁴ *Ibid*, 309.

¹¹⁵ The mining and petroleum balancing adjustment and roll-over provisions and capital gains tax matters are considered in detail in chapter 5. Subject to the additional points made in this chapter 4, those comments apply equally to farmouts.

- (b) the value to any one party of the said property shall not exceed by more than \$100.00 the total capital expenditure incurred by that party in respect of the said property less the sum of all deductions allowed and allowable in respect of expenditure under Division 330 of the Act.

Where any two provisions of the Act referred to in clause 1.1 do not apply and analogous provisions do apply, clause 1.1 shall be read *mutatis mutandis*.

It could be argued that exploration or prospecting expenditure is never incurred in respect of a prospecting entitlement and therefore s. 330-480 will never apply to such expenditure when a prospecting entitlement is disposed of. However, in *Ruling IT 2378* the Commissioner has expressed the opposite view. Whichever is correct, it is clear that where a farmor disposes of its undivided fractional interest in exploration plant, expenditure on such plant would be dealt with pursuant to s. 330-480.

Mining information

The provisions of the ITAA 97 for taxing mining information are complex and add an unnecessary compliance burden on farmees and farmors. The law should be simplified to reduce the compliance burden.

From the perspective of a farmee, the issue is the lack of specificity in the tax law about the basis on which to apportion the farmin purchase price between the prospecting entitlement and the information. The framework created by Div 330 in the provisions of Subdiv 330-E entitles a farmee of a mining, quarrying or prospecting right or information (as defined by s. 300-240(c)) to an allowable deduction for the farmin purchase price over a number of years.¹¹⁶ The mechanism whereby a farmee becomes entitled to an allowable deduction does not specify the basis upon which the purchase price paid collectively for the prospecting entitlement and information is to be apportioned between the prospecting entitlement and the information. Such expenditure ought to be treated consistently with other expenditure and without a limit applying. For example, expenditure on information should be treated according to the benefit obtained from that information. If the information relates to exploration and prospecting activities, it should be immediately deductible to the farmee (consistent with retaining the current immediate write-off of the treatment of exploration and

¹¹⁶

See s. 330-245 of the ITAA 97.

prospecting expenditure).¹¹⁷ If it relates to an existing mine, it should be deductible over the effective life of that mine. Otherwise, it should be immediately deductible.¹¹⁸

From the perspective of a farmor, the issue is whether the balancing adjustment in s. 330-480 will apply if there is an allocation of consideration. Arguably, because s. 330-480 applies in respect of disposals of 'property' and since it is debatable that information is not property at general law,¹¹⁹ then if consideration supporting the farmout of a prospecting entitlement and information are wholly allocated to the information, it would be necessary to consider whether the conditions for the operation of s. 330-480 would be satisfied.¹²⁰ On this analysis, a construction of Div 330 leads to the conclusion that mining or prospecting information comprises 'property' for the purposes of the division, in which case the disposal of information would be covered by the provision.¹²¹

Similarly, *Ruling* TR 98/3 states that because prospecting information is not property, any consideration received for the disclosure of the information itself does not trigger the operation of the balancing adjustment provisions in Subdiv 330-J and that in any transaction involving the disclosure of prospecting information it is necessary to examine the facts to see if any of the consideration relates to items of property.¹²²

Although prospecting information is stored on a medium such as paper, computer memory (or similar) and this medium is property per se, it is accepted by the Commissioner that unless the facts indicate otherwise, the medium containing the information has a negligible value so that, as a practical matter, 'no amount is to be accounted for under Subdiv 330-J in respect of the

¹¹⁷ *A Tax System Redesigned*, recommendation 4.3(v).

¹¹⁸ *Ibid*, recommendation 8.15.

¹¹⁹ *Pancontinental Mining Ltd v Commissioner of Stamp Duties (Qld)* [1989] 1 QdR 310. See also *JV (Crows Nest) v Commissioner of Stamp Duties (NSW)* (1985) 85 ATC 4198; 16 ATR 372 (see on appeal, (1986) 7 NSWLR 529. See also Stuckey (1981); Palmer (1990), ch. 5; Gurry, *Breach of Confidence*, (1984), 46-56; Rickelson (1977), 289; Mitchell (1997); McKeough and Steward, *Intellectual Property in Australia*, (1997), 69-74. See also McKeough and Steward, *Intellectual Property in Australia*, (1997), 70-72; Palmer (1990), ch. 5; Pattison (1996), 142-143.

¹²⁰ Green (1997), 173.

¹²¹ *Ibid*, 174.

¹²² *Ruling* TR 98/3, para. 33.

medium'.¹²³

It is noted that the Commissioner's position in TR 98/3 departs from his earlier view expressed in IT 2378 that exploration and prospecting expenditure is capital in nature incurred 'in respect of' the prospecting entitlement. Information obtained by the farmor from exploration or prospecting is something separate from the prospecting entitlement. In the context of s. 330-480, the Commissioner now considers that 'in respect of' means expenditure incurred to *acquire* or *improve* the property and because information may be about a certain prospecting entitlement does not mean that it is in respect of a prospecting entitlement.¹²⁴

The Ralph Committee has recommended that all receipts from the sale of mining information be subject to taxation.¹²⁵ It is not intended that such receipts will be assessed under the balancing adjustment provisions. The balancing adjustment provisions must therefore be amended to make this expressly clear. This measure will be, in principle, consistent with the notion that all business receipts should be taxable with deductions being allowed for the costs of earning those receipts.¹²⁶

Balancing adjustment roll-over relief

The effect of TR 98/3 is relevant for the application of the balancing adjustment roll-over relief available under Subdiv 41 of the ITAA 97. Subdivision 41 allows balancing adjustment roll-over relief for changes in ownership of property the subject of a farmout agreement between related companies or to a wholly owned company (for the purpose of Subdivs 122-A and 126-B of the ITAA 97)¹²⁷ where the farmor and farmee jointly make an election for roll-over relief under s. 330-520(4). The consequences of election are threefold: no balancing adjustment is required for the farmout; the farmee stands in the farmor's shoes with regard to the amount and timing of future allowable deductions, and the amount of potential balancing adjustment on a later disposal. If the farmor has undeducted exploration or prospecting

¹²³ Ibid, para. 36.

¹²⁴ Ibid, para. 37.

¹²⁵ *A Tax System Redesigned*, recommendation 8.16.

¹²⁶ Id.

¹²⁷ Section 41-20(1)(b) ITAA 97.

expenditure in respect of information, then s. 41-20 will not apply to allow roll-over relief in respect of such expenditure.¹²⁸

Allowable deductions to the farmee for exploration and prospecting expenditure

A farmee would be entitled to an allowable deduction in respect of its exploration or prospecting expenditure incurred during an income year. Section 330-15 of the ITAA 97 allows a deduction for expenditure (whether of a capital or revenue nature) incurred on exploration or prospecting.¹²⁹

Petroleum resource rent tax payments

The *Petroleum Resource Rent Tax Assessment Act 1987* (Cth) imposes a compliance burden in the form of a petroleum resource rent tax in respect of all offshore petroleum projects in Australia except the North West Shelf of Australia. Petroleum resource rent tax in relation to a particular prospect is determined on an accruals basis at 40 percent of 'taxable profits'¹³⁰ based on the excess of 'assessable property receipts'¹³¹ over 'deductible expenditure'¹³² and transferred exploration expenditure.¹³³ In general, payments of petroleum resource rent tax pursuant to the PRRTA Act and instalments of petroleum resource rent tax payable under the PRRTA Act are allowable deductions,¹³⁴ whether the farmor is personally liable in the capacity of agent or trustee (each application is separate from the other).¹³⁵ Any refund of such rent tax is correspondingly assessable income.

Petroleum resource rent tax is a project based tax. The 'project' is defined by reference to the production licence area. Section 48A of the PRRTA Act provides that where a person (the

¹²⁸ Ruling TR 98/3, para. 41.

¹²⁹ The expression 'exploration or prospecting' is defined in s. 330-20(1) ITAA 97 in broad, inclusive terms.

¹³⁰ Section 22 PRRTA Act.

¹³¹ Section 27 PRRTA Act.

¹³² Section 32 PRRTA Act.

¹³³ Division 3A PRRTA Act.

¹³⁴ Section 330-350(1) ITAA 97.

¹³⁵ Section 330-350(4) ITAA 97.

farmor) enters into a transaction that transfers part of its entitlement to the assessable receipts from a project (eg entitlement to production), the *farmee* will automatically inherit a proportion of the *farmor*'s entitlement / obligations for receipts, expenditures and tax liabilities.

Section 48A can apply to a petroleum exploration permit prior to the grant of a production licence such as in the case of a farmout of an exploration interest.¹³⁶ The amount of the deductions that would be transferred to the *farmee* is determined by multiplying the total project deductions by the ratio of the *farmor*'s transferred interest to the *farmor*'s total project interest prior to the transfer.

The effect of this provision is twofold. First, a *farmor* that transfers a percentage of its entitlement to any production from an area (either a production licence area of exploration permit) as would occur in the case of a farmout, will lose that percentage of the total petroleum resource rent tax deductions incurred over the whole of the production licence area or exploration permit. Secondly, the *farmee* will inherit the percentage of the total petroleum resource rent tax deductions that were previously incurred by the vendor in the whole of the production licence area or exploration permit.

Capital gains provisions are ill-equipped to deal with asset farmouts

Farmouts are taxed under complex provisions of Pt 3-1 of the ITAA 97.¹³⁷ It is unclear whether a *farmee* has an executory equitable interest in the property when the *farmee* is under no or only a limited obligation to earn an interest. A *farmor* will incur compliance costs to determine whether a CGT event happens on the sale of prospecting information, and which CGT event to apply when an asset is disposed of, and the timing of the CGT event, its cost base or reduced cost base, disposal consideration and associated difficulties.

The legal structure of farmouts plays a determinative role in their classification as 'assets'¹³⁸ for capital gains purposes. In the end, their tax treatment is not always the same as for

¹³⁶ Section 48A(3) PRRTA Act. The section does not require any consideration for the transfer.

¹³⁷ These provisions apply to disposals of assets acquired (sec s. 100-25(1) ITAA 97) or deemed to be acquired (see ss. 149-30 and 104-230 ITAA 97) on or after 20 September 1985 by a *farmor*.

¹³⁸ See chapter 5 for the definition of 'asset' for Pt 3-1 ITAA 97 purposes.

changes in the ownership of assets of participants or of shares of equity participants. CGT event D1 concerns the creation of contractual or other rights. The event happens if a taxpayer creates a contractual right or other legal or equitable right in another entity.¹³⁹ Under the tax reform proposals, it will no longer be relevant to consider whether a gain arising on an asset is on revenue or capital account.¹⁴⁰

As far as asset farmouts are concerned, it is appropriate to consider what assets are disposed of. The most obvious asset is the property the subject of a farmout, being the chose in action in the rights and obligations a farmee will acquire once it becomes a party to the JVA and acquires a proprietary interest in a prospecting entitlement as a tenant in common.¹⁴¹ Other assets would comprise the chose in action under the farmout agreement¹⁴² and the contingent or executory equitable interest in the property the subject of the farmout.¹⁴³

Does a farmee have an equitable interest in farmout property if the farmee is under no or only a limited obligation to earn an interest?

Assume that a farmee has a chose in action under the JVA and farmout agreement and a proprietary interest in a prospecting entitlement as a tenant in common, but not a contingent or executory equitable interest in a deferred transfer farmout. Participant A agrees to assign 50 percent of its undivided share of a prospecting entitlement to B if B pays all of Participant A's work obligations under the prospecting entitlement for the next three years and there is no obligation or only a limited obligation imposed on B to make those payments and hence earn an interest. In *Amoco Minerals Australia Co v Commissioner of Stamp Duties (WA)*,¹⁴⁴ Jones J in the Western Australian Supreme Court held that such an arrangement, where Amoco had a right but not an obligation to earn an interest in statutory mining interests by making payments to the owners and incurring agreed exploration costs, was not dutiable as a conveyance on sale or as an agreement for the sale of property, since, quoting Channell J in *West London*

¹³⁹ Section 104-35(1) ITAA 97.

¹⁴⁰ Cathro (1999), 224.

¹⁴¹ Dawe (1985), 314.

¹⁴² Farrands, *The Law of Options*, (1992), 115.

¹⁴³ Ibid, 105

¹⁴⁴ (1978) 8 ATR 719.

Syndicate v IRC,¹⁴⁵ '[s]ale is correlative with purchase: there is no contract for sale unless the purchaser agrees to buy whilst the vendor agrees to sell: if the vendor merely agrees to sell and the purchaser does not agree to buy, it is merely an offer and not a contract of sale'. However, Jones J was prepared to hold that the right gained by Amoco upon execution of the agreement (ie the right to procure the rights of exploration and development and the right to perform and conduct related activities), was an 'interest in any property' within the meaning of s. 74(1) of the *Stamp Act* (WA), so that the sum which Amoco had to pay to the owners on executing the agreement was chargeable with ad valorem duty.

The decision in *Allgas Energy Ltd v Commissioner for Stamp Duties (Qld)*,¹⁴⁶ however, suggests that the contingent or executory equitable interest in the property the subject of the farmout will be present in the above example if it involves an *immediate transfer* farmout and all the other facts remain unchanged. In this case, the court held that the agreement was of 'an altogether different nature' from that in *Amoco*, stating that the former agreement 'provides for an immediate assignment and creates an obligation on the part of the assignee to deposit certain sums subject to the forfeiture of its rights under the Agreement if it should fail to do so', and that 'the real nature of the transaction effected by the instrument is one of the sale of the property concerned. This position is not altered by the fact that, if the payments provided for by the instrument are not made, the assignee forfeits its interest or that in certain events the payments made are refundable'.¹⁴⁷

At the time the agreement was made in *Allgas*, the vendor had been granted, by a previously executed deed with holders of certain leases and authorities to prospect granted under the *Petroleum Act* (Qld), a right to earn a 50 percent working interest in parts of those titles and the right to assign part of the working interest it may earn. The working interest was to be earned by the vendor on the completion of an exploration well in the relevant area. While it could complete any well alone or in conjunction with the owners it was under no obligation to do so and could terminate the deed at any time. In the relevant agreement, the vendor purported to assign to the purchaser, subject to the vendor earning the 50 percent interest in two specified blocks of a petroleum permit in accordance with the prior deed, a 47.5 percent

¹⁴⁵ [1898] QB 228, 238.

¹⁴⁶ (1979) 10 ATR 593.

¹⁴⁷ *Ibid*, 597.

working interest in those blocks being transferred to the vendor pursuant to the prior deed, the purchaser and vendor would execute such further documents as might be necessary to transfer the 47.5 percent working interest in those blocks to the purchaser. The agreement provided that the purchaser had to deposit specified sums in accounts upon the Minister's approval of, and failure so to deposit would result in the purchaser forfeiting its rights under the agreement. If the wells reached the prescribed depth, those amounts would be paid to one of the holders of the titles in part satisfaction of payments that the vendor was obliged to make under the prior deed. If those wells did not reach the prescribed depth within a certain time after drilling had commenced, then the monies would be refunded to the purchaser.

The Commissioner assessed the agreement to ad valorem conveyance duty by reference to the amounts deposited and the court upheld this assessment. The court held that the agreement effected an assignment of an equitable interest in property (ie the 47.5 percent working interest in the two blocks when that interest came into existence), with nothing further being required to be done by the parties in order to convey that interest to the assignee and there was consideration for the assignment. As well, the agreement assigned to the purchaser a percentage of the vendor's existing rights under the prior deed. The existing rights under the deed were held to be property under the *Stamp Act*.

It is difficult to accept the court's reasoning. The court stated that the relevant clause of the agreement assigned a percentage of the working interest if and when it was earned by the vendor, but referred to the agreement as effecting an immediate assignment of that percentage of the working interest. It is not easy to see how the vendor could assign any interest greater than the interest it had at the date of execution of the agreement; that interest was only a *right* to obtain a working interest together with any other rights granted by the prior deed. The consideration upon which duty was calculated was calculated by reference to the monies deposited by the purchaser. These monies ostensibly represented the price payable by the purchaser to the vendor in the event the vendor earned its 50 percent interest and thereby enabled the assignment of 47.5 percent of that interest to the purchaser, and those sums were repayable if that event did not happen. It therefore seems inaccurate to describe those monies as representing the *sale* of the interest assigned by the agreement, since what was assigned was something else; namely, the vendor's *rights* to earn the interest.

The court in *Allgas* distinguished the facts of *Amoco* without questioning the conclusion

reached in that case. It is noted that the crucial factor in *Allgas* was the purchaser's obligation to pay over the relevant sums, notwithstanding they were refundable. It seems that while the vendor had the opportunity under the prior deed to decide whether or not to earn its interest, the purchaser was bound by the agreement to obtain its interest should the vendor decide to exercise its rights.

Determining whether a CGT event happens in relation to the sale of prospecting information

The other important issue to be considered here is prospecting information developed by the farmee on the prospecting entitlement area. If a CGT event happens in relation to the sale of prospecting information, then the sale of that information by a farmor to a farmee under a farmout agreement would attract Pt 3-1 consequences. If a CGT event does not happen in relation to the sale of prospecting information, then the sale of that information pursuant to a farmout agreement would not attract Pt 3-1 consequences. If a farmor must determine whether prospecting information is an asset each time it enters into a farmout agreement, then the compliance costs for farmors will also increase.

CGT events are at the centre of the operation of the provisions in Pt 3-1. It is only when a CGT event happens that a capital gain or capital loss can arise.¹⁴⁸ CGT assets are central to most CGT events, and most, but not all, CGT events arise as a result of something happening to a CGT asset.¹⁴⁹ If an asset is not a CGT asset, it will 'not be affected by the event and no capital gain or capital loss will arise in respect of it.'¹⁵⁰

Whilst the basic definition of a CGT asset includes any kind of property, at general law, prospecting information is not property.¹⁵¹ Prospecting information is not itself a CGT asset

¹⁴⁸ Deutsch, *Australian Tax Handbook* (1999), [11 120].

¹⁴⁹ Ibid, [11 130].

¹⁵⁰ Id.

¹⁵¹ See s. 108-5(1) ITAA 97; see *Pancontinental Mining Ltd v Commissioner of Stamp Duties (Qld)* [1989] 1 QdR 310, 311-312, where de Jersey J said (on behalf of the Full Supreme Court of Queensland) 'There is no definition of "property" in the Act, but the ordinary meaning of the word does not encompass information. There is plenty of support for that view in the authorities.' Gibbs J, in *Brent v FCT* (1971) 125 CLR 418, 425, said '[i]t is not possible speaking strictly to say that in communicating the information to the agents of the company the appellant was parting with property. Neither knowledge nor information is property in a strictly legal sense, although they can be said to be property in a loose metaphorical sense and have been referred to as property in a number of cases.' See also

for the purposes of Pt 3-1.¹⁵² Strictly speaking, the medium in which information is contained (eg. paper, floppy disk etc.) is a CGT asset. However, the Commissioner considers that the value of the medium is usually negligible.¹⁵³

The Commissioner's general administrative practice is to accept that no amount must be allocated to the medium in which information is contained by farmees and farmors under apportionment rule modification 2 pursuant to s. 116-40(1) in farmout transactions¹⁵⁴ and that the amount of consideration received by the farmor does not give rise to a capital gain pursuant to the application of CGT events D1 and H2.¹⁵⁵

The Ralph Committee has proposed that all receipts from the sale of mining information will be subject to taxation on the basis that in principle, all business receipts should be taxable with deductions being allowed for the costs of earning those receipts.¹⁵⁶

The Government has not announced its position in relation to this Ralph measure. It would be an improvement to the law if legislation made it abundantly clear that all receipts from the sale of mining information will be subject to income tax and that the expenses would not fall to be determined under the capital gains provisions of the law.

CGT events

The legal structure of the farmout will determine which CGT event applies. This determination will not usually impose a particularly onerous compliance burden on a farmor, but the grant by a farmor of a right to income from a prospecting entitlement may impose a higher compliance obligation.

A number of different CGT events may apply to the one contract. The chose in action under a

Nischu Pty Ltd v Commissioner of State Taxation (WA) (1990) 90 ATC 4391; 21 ATR 391, Csd
Emerson v Custom Credit Corporation Ltd [1994] 1 QdR 516; appld *Commissioner of State Taxation (WA) v Nischu Pty Ltd* (1991) 4 WAR 437; Green (1997), 161-162 for a discussion of the *Nischu* case.

¹⁵² *Ruling* TR 98/3, para. 8.

¹⁵³ *Id.*

¹⁵⁴ *Ibid*, para. 66.

¹⁵⁵ See ss. 104-35(1) and 104-155(1) ITAA 97.

¹⁵⁶ *A Tax System Redesigned*, recommendation 8.16.

farmout agreement will attract CGT event D1 if the farmor creates a contractual right or other legal or equitable right in a farmee.¹⁵⁷ The contingent or executory equitable interest in the property the subject of a farmout will attract CGT event E1 if the farmor creates a trust over a CGT asset by declaration or settlement.¹⁵⁸ Property the subject of a farmout would attract CGT event A1 if the farmor disposes of a CGT asset.¹⁵⁹ Receipt of proceeds from a farmee might attract CGT event H2.¹⁶⁰ As an example, the Pt 3-1 consequences for the parties in farming out a percentage interest in a prospecting entitlement could be different than when a right to income is granted to the farmee but there is no underlying transfer of the prospecting entitlement.

If a farmor owns an interest in a 'prospecting or mining entitlement'¹⁶¹ and grants a farmee a right to receive any part of the future income from the operations permitted to be carried on by that prospecting entitlement,¹⁶² then the farmor makes a capital gain if the proceeds from the grant of the right exceed the expenditure incurred by the farmor in granting it.¹⁶³ The disposal of a right to future income will not be treated as a disposal of the interest in the prospecting entitlement but rather a disposal of the right to receive future income.¹⁶⁴ The right to receive future income is created by a farmor immediately before entering into the farmout agreement. CGT event D3 happens if a farmor owns a prospecting entitlement or a mining entitlement, or an interest in one, and grants a farmee a right to receive ordinary or statutory income from operations permitted to be carried on by the entitlement.¹⁶⁵ The farmor makes a capital gain if

¹⁵⁷ Section 104-35 ITAA 97.

¹⁵⁸ Section 104-55 ITAA 97.

¹⁵⁹ Section 104-10 ITAA 97.

¹⁶⁰ Pursuant to s. 104-155(1) ITAA 97, CGT event H2 happens if an act, transaction or event occurs in relation to a CGT asset that is owned, and the act, transaction or event does not result in an adjustment being made to the asset's cost base or reduced cost base.

¹⁶¹ 'Prospecting or mining entitlement' is defined by ss. 124-710(c) and (2) ITAA 97.

¹⁶² For example, an overriding royalty or production payment. These types of farmouts are discussed earlier in this chapter.

¹⁶³ Section 104-45(3) ('CGT event D3') ITAA 97. A farmor makes a capital loss if those capital proceeds are less than the expenditure incurred by the farmor in granting it.

¹⁶⁴ Section 104-45 ITAA 97. There seems to be little doubt that s. 104-45 is capable of applying to farmout arrangements providing for production, overriding royalty or equalisation payments.

¹⁶⁵ Section 104-45(1) ITAA 97.

the capital proceeds from the grant of the right are more than the expenditure the farmor incurred in granting it.¹⁶⁶ The expenditure can include giving property, but does not include amounts received as a recoupment of it (and that is not included in the farmor's assessable income), or amounts to the extent that the farmor has deducted or can deduct from it.¹⁶⁷

Timing of CGT event

The time of a disposal of an asset for capital gains purposes is generally the time that an agreement is made.¹⁶⁸ With deferred transfer farmout agreements, the relevant point in time is when the offer is accepted (ie upon exercise). But immediate transfer farmout agreements are made when the farmor grants the right to the farmee. Accordingly, the time of acquisition and disposal of the prospecting entitlement under a farmout agreement depends on the legal structure of the farmout agreement.

Capital Gains Tax Cell Determination No.16 provides that the date of acquisition or disposal is the date of the transaction entered into as a result of the exercise by the farmee of the right. Cell determinations provide taxpayers with answers to common but significant capital gains questions and do not have the force of law, but can be relied on as being the considered view of the ATO.

Further, IT 2378 consistently states that 'the time of disposal, ascertained in accordance with the provisions of [Divs. 104 and 109 of the ITAA 97],¹⁶⁹ would generally depend on the terms of the agreement between the parties.'¹⁷⁰

Cost base and reduced cost base

There are two elements to be taken into consideration in determining whether a capital gain or

¹⁶⁶ Section 104-45(3) ITAA 97.

¹⁶⁷ Section 104-45(4) ITAA 97.

¹⁶⁸ Refer to the note at the foot of s. 104-45(1) ITAA 97. If CGT event D1 happens, the time of the event is when the farmor enters into the farmout agreement, or creates the other legal or equitable right in the farmee (s. 104-35(2) ITAA 97). If CGT event E1 happens, the time of the event is when the trust over the asset is created (s. 104-55(2) ITAA 97). If CGT event H2 happens, the time of the event is when the act, transaction or event occurs (s. 104-155(2) ITAA 97).

¹⁶⁹ Section 160U ITAA 36.

¹⁷⁰ Ruling IT 2378, para. 8.

a capital loss has occurred on the disposal of a prospecting entitlement - the cost base and the consideration received. In general, the cost base of an asset consists of five elements (acquisition costs, incidental costs, assessable balancing adjustments, capital expenditure to increase value and capital expenditure to establish or defend title to or a right over an asset).¹⁷¹ Cost base indexation was frozen on 30 September 1999. The ending of indexation means the Government is switching from taxing after-inflation gain to taxing the before inflation gain.

Exploration or prospecting expenditure 'does not form part of the cost base of a mining, quarrying or prospecting right.'¹⁷² Whether or not it follows that expenditure on prospecting information forms part of the cost base of a mining, quarrying or prospecting right will depend on how expenditure on prospecting information is characterised by a farmor.

If expenditure on prospecting information were characterised as a form of exploration or prospecting expenditure, then it would be unlikely to form part of the cost base of a mining, quarrying or prospecting right. As a general business expense, the expenditure would be an allowable deduction to a farmor.¹⁷³ This characterisation may be easier to make when there is a temporal nexus between the incurring of the expenditure on prospecting information and the incurring of the exploration or prospecting expenditure.

Calculating consideration on disposal

The calculation of the market value of a farmout of a prospecting entitlement is fraught with difficulty. Tax laws require farmors to determine the 'market value' of the asset disposed of at the time of disposal but do not prescribe a definition of 'market value' or criteria to be used to assist in making a determination.¹⁷⁴ The law is legally and effectively complex. This increases the compliance burden on farmors. Before examining the causes of this compliance burden, it is appropriate to outline the components comprising a farmor's disposal consideration.

¹⁷¹ See s. 110-25(6) ITAA 97.

¹⁷² *Ruling* TR 98/3.

¹⁷³ Subject to satisfying the rules in s. 8-1(1) ITAA 97.

¹⁷⁴ The effect of market value substitution rule No. 1 in s. 116-30 ITAA 97 is to deem the non-cash consideration to be the market value of the asset disposed of at the time of disposal. The ITAA 97 does not define 'market value'.

A farmor's consideration will have one, possibly two components. The first component is comprised of the ongoing expenditure / work obligations of the farmee under the farmout agreement. The level of the farmee's expenditure / work obligations may be proportionate to the interest it will acquire in the prospecting entitlement or disproportionate (ie the farmor has a carried interest).¹⁷⁵ An example of the former would be where a farmor incurs 35 percent of the expenditure / work obligations to acquire a 35 percent interest in a prospecting entitlement, whilst an example of the latter would be where a farmor incurs 65 percent of the expenditure / work obligations to acquire a 35 percent interest in a prospecting entitlement. The second component is an upfront cash payment component.

The Commissioner encourages farmors and farmees to reach agreement on and specify either in the farmout agreement or in a separate written statement signed by them, the agreed fair and reasonable value (if any) of the prospecting entitlement disposed of at the time of the disposal.¹⁷⁶ It is clear that such an approach is not without risk to the revenue.¹⁷⁷ That is why the parties may be required to reconcile the valuation with the agreed work program commitments if the two appear inconsistent.¹⁷⁸ This reconciliation, if required, may need a supporting statement setting out the basis of valuation and assumptions used.¹⁷⁹ This approach seems overly-prescriptive given the uncertainty and cost of making a valuation. It could even be argued that this is an instance where the lawmaker's response to uncertainty by producing a new authority (ie a tax ruling) has complicated the law.¹⁸⁰ The difficulty in valuing exploration expenditure was recently put in these terms:

[a]pplying the recommended treatment of expenditure and assets without recognising the *valuation difficulties* associated with the results of exploration and prospecting expenditure would mean that the tax treatment of this expenditure would depend on the results of the exploration or

¹⁷⁵ Gately (1987), 58; Herd (1988), 293.

¹⁷⁶ *Ruling IT 2378*, para. 15. But the law changed in 1997, with the introduction of CGT events D1 and H2 - valuation exercises are not always needed.

¹⁷⁷ *Id.* For instance, the Commissioner has ruled that a nil or very low valuation may not be consistent with very large work program commitments.

¹⁷⁸ *Id.*

¹⁷⁹ *Id.*

¹⁸⁰ In this context, a 'lawmaker' is defined to mean the Commonwealth Parliament, the Australian Taxation Office which makes tax rulings on tax matters.

prospecting activity.¹⁸¹ [emphasis added]

The value of an asset must be determined in light of the circumstances that exist at the time of disposal. According to *Ruling IT 2378*, the value of a percentage interest in a prospecting entitlement disposed of at the 'grass roots' or 'wild cat' exploration stage would be low if not nil, but the value would be expected to be higher if the interest were disposed of after exploration indicated deposits or reserves that warranted development and production. A 'grass roots' or 'wild cat' well is 'an exploratory well being drilled in unproven territory, that is, in a horizon from which there is no production in the general area.'¹⁸² Further, the discovery of minerals in neighbouring prospecting entitlement areas may have the effect of increasing the market value of the prospecting entitlement disposed of, notwithstanding the prospecting entitlement may or may not subsequently prove to be worth developing (the *recent commercial transactions valuation method*).¹⁸³

The author considers that the recent commercial transactions valuation method is unsustainable to the extent it is inconsistent with the principle laid down in *Spencer v The Commonwealth*.¹⁸⁴ In *Spencer's* case, the High Court held that, in assessing the value of land for the purposes of a resumption statute, the basis of valuation should be the price that a willing purchaser would at the date in question have to pay to a willing but not anxious vendor. Isaacs J said that to arrive:

at the value of the land at that date, we have, as I conceive, to suppose it sold then, not by means of a forced sale, but by voluntary bargaining between the plaintiff and a purchaser, willing to trade, but neither of them so anxious to do so that he would overlook any ordinary business consideration. We must further suppose both to be perfectly acquainted with the land, and cognizant of all circumstances which might affect its value, either advantageously or prejudicially, including its situation, character, quality, proximity to conveniences or inconveniences, its surrounding features, the then present demand for land, and the likelihood, as then appearing to persons best capable of forming an opinion, of a rise or fall for what reason soever, in the amount which one would otherwise

¹⁸¹ *A Tax System Redesigned*, 167.

¹⁸² Williams and Meyers, *Williams and Meyers Manual of Oil and Gas Terms*, (1997), 1185.

¹⁸³ *Ruling IT 2378*, para. 11.

¹⁸⁴ (1907) 5 CLR 418.

be willing to fix as the value of the property.¹⁸⁵

It is apparent from *Ruling IT 2378* that the Commissioner broadly adopts the principle expressed in *Spencer's case*. This is implicit from the authorities the Commissioner cited approvingly in the ruling. For example, in *Ruling IT 2378*, the Commissioner referred to *Building and Civil Engineering Holidays Scheme Management Ltd v Post Office*,¹⁸⁶ where Lord Denning MR stated that 'market' in the expression 'market value' in the statutory provision under consideration in that case 'does not connote a market where buyers and sellers congregate. The "market value" here means the price at which the goods could be expected to be bought and sold as between willing seller and willing buyer, even though there may be only one seller or one buyer, and even though one or both may be hypothetical rather than real.'¹⁸⁷

On the valuation question, some guidance is to be found in Waddell J's decision in *Brisbane Water County Council v Commissioner of Stamp Duties (NSW)*,¹⁸⁸ which concerned the scope of meaning of the expression market value in s. 84G of the *Stamp Duties Act 1920* (NSW). His Honour said that where the value of property is to be determined the value is to be calculated by reference to three factors. First, if there is no general market (eg shares in a proprietary company), then a general market is to be assumed. Secondly, all possible purchasers are to be taken into account; and thirdly, even a purchaser who is prepared for his own reasons to pay a fancy price and the value to be ascertained is the value to the vendor.

The basis of the Commissioner's approach in the ruling to the meaning of market value was stated originally by Dixon J in *Commissioner of Succession Duties (SA) v Executor Trustee and Agency Co of South Australia Ltd*¹⁸⁹ in the following terms:

there is some difference of purpose in valuing property for revenue cases and in compensation cases. In the second the purpose is to ensure that the person to be compensated is given a full money equivalent to his loss, while in the first it is to ascertain what money value is plainly contained in the asset so as to afford a proper measure of liability to tax. While this

¹⁸⁵ Ibid, 441.

¹⁸⁶ [1966] 1 QB 247.

¹⁸⁷ Ibid, 269.

¹⁸⁸ [1979] 1 NSWLR 320.

¹⁸⁹ (1947) 74 CLR 358.

difference cannot change the test of value, it is not without effect upon a court's attitude in the application of the test. In a case of compensation doubts are resolved in favour of a more liberal estimate, in a revenue case, of a more conservative estimate.¹⁹⁰

Dixon J's approach in that case is not appropriate to farmouts of percentage interests in prospecting entitlements, since the adoption of a more conservative estimate in matters arising under Pt 3-1 would in many cases favour a farmor participant, and disadvantage a farmee. To illustrate, for a farmor, an immediate transfer farmout agreement has attraction because any added value as a result of the earn-in work may not be taken into account when determining the 'market value' of the prospecting entitlement. Similarly, a deferred transfer farmout agreement is attractive to a farmee in that there is the possibility of no immediate capital gains tax (subject to the quantum of premium paid), with the opportunity for tax planning to be implemented prior to the actual transfer some time later.

The value of an asset disposed of by a farmor once the participants of an unincorporated joint venture have determined the existence of an economic quantity of mineral would be likely to be significant. In this situation, the characterisation of the interest that is to be farmed out has shifted from what the Commissioner regards as the high risk to the low risk category.¹⁹¹ The 'Orthurus 1 wild cat well in Australian permit WA-267-P, which in 1999 had encountered a 53 metre net gas zone revealing a large gas field'¹⁹² is an example of an interest that is in the low risk category.

Miscellaneous difficulties in applying Pt 3-1 to farmouts

A number of other observations can be made in relation to the operation of Pt 3-1 to farmouts. First, non-cash farmouts are not excluded from Pt 3-1. *Ruling IT 2378* states that in the Commissioner's view it adequately addresses the technical issues of applying the capital gains provisions to non-cash farmouts.¹⁹³ The ruling was issued on 24 December 1986—over a

¹⁹⁰ (1947) 74 CLR 358, 373-374, *per* Dixon J

¹⁹¹ *Ruling IT 2378*, para. 21.

¹⁹² The WA-267-P joint venture participants include Mobil, Chevron Asiatic Ltd and Texaco Australia Pty Ltd, each with 25 percent, and Shell Development Australia Pty Ltd and BP Amoco Exploration (Alpha), each with 12.5 percent: I Howarth, 'Shelf yields new huge gas field', *The Australian Financial Review*, 22 October 1999, 49.

¹⁹³ *Ruling IT 2378*, para. 2. The market value substitution rule of s. 112-20(1) ITAA 97 will not necessarily help a farmor, either, because this provision is also predicated on the basis that a 'market

decade ago.¹⁹⁴ It was issued to address a number of concerns as to how the capital gains legislation applied to farmout arrangements and particularly how the consideration for a non-cash transaction would be determined for the purposes of capital gains and losses provisions.

Secondly, *Ruling IT 2378* does not attempt to canvass all the issues which may arise under the wide variety of farmout arrangements entered into by taxpayers but aims to illustrate, by way of basic examples, the common basis upon which the consideration for the disposal of an interest in a prospecting or mining right under a farmout arrangement has been determined for income tax purposes and will be determined for capital gains purposes.¹⁹⁵ No further rulings have been issued to clarify other aspects of the application of the capital gains legislation to farmouts.¹⁹⁶

Thirdly, the rules for valuing prospecting entitlements must deal with the problems of uncertainty and risk inherent in the very nature of the exploration sector of the mining or petroleum industry. The application of any particular methodology is dependent upon the particular circumstances. Despite its limitations, the Commissioner accepts the use of the recent commercial transactions valuation method, at the expense of other valuation methods, for example, the net present value method.

A net present value calculation is a determination of the current value of a future revenue stream.¹⁹⁷ For instance, the recent commercial transactions valuation method compares recent commercial transactions, ideally involving the property which is the subject of the valuation, or alternatively adjacent or nearby permits or prospects with similar prospectivity. Key assumptions are an arm's length transaction involving both a willing buyer and seller. Whilst such an approach is subject to prevailing market sentiment, it frequently provides the most realistic valuation available. Where recent transactions are not available or applicable the

value' is ascertainable. This rule replaces the acquisition costs element of the (reduced) cost base of a CGT asset acquired from another entity with the asset's market value at the time of acquisition if either no expenditure was incurred to acquire it, some or all of the expenditure incurred cannot be valued, or the taxpayer did not deal at arm's length with the entity in connection with the acquisition.

¹⁹⁴ Id.

¹⁹⁵ Id.

¹⁹⁶ Cf *Ruling IT 2378*, para. 2.

¹⁹⁷ Price (1999).

taxpayer may have recourse to a 'hypothetical farmout agreement', which draws on the taxpayer's knowledge of the prevailing market to arrive at a 'most likely' estimate of contract terms. If a farmout agreement has been executed at a time when the economy is depressed, then in this circumstance it is unlikely there will be any 'active' market in prospecting entitlements. This renders the recent transactions method inappropriate.

Net present value is a valuation based on a financial model. The inputs are technical and economic assumptions that yield a series of cash flows: these are then discounted in order to recognise opportunity cost and the time value of money. The series of discounted cash flows are then summed in order to derive a net present value. This method is generally applicable when key variables have been determined in the lead up to a fully fledged feasibility study. These variables include resource size, contract terms, including price, quantities, work commitments, transport costs, capital expenditure and operating expenses. Prior to this, it is necessary to discount the derived value in order to allow for the degree of risk in the estimates or assumptions.

The genuine prospectors exemption provides cash-flow benefits

A farmor will derive cash-flow advantages if it is eligible for the genuine prospectors exemption. These cash-flow benefits will reduce a farmor's compliance costs of entering into asset farmouts. Cash-flow benefits will ensue from the farmor having access to and use of funds that are ultimately exempt from income tax.

It is unlikely that these cash-flow benefits will exceed a farmor's compliance costs. Although it is too difficult to estimate the precise extent of the cash-flow benefits, the findings of the 1997 study by Evans into tax compliance costs of taxpayers in Australia in the 1994-95 year of income do give some indication of their likely extent in comparison to a taxpayer's social compliance costs. That study concluded that the social compliance cost of tax compliance for business taxpayers in Australia were estimated to be \$8,874 million¹⁹⁸ and large taxpayers (ie annual turnover in excess of \$10 million) were estimated to bear 11 percent of these costs (ie around \$976 million). By comparison, the value of tax deductibility of compliance costs to business taxpayers was estimated for the 1994-95 year of income to be \$2,446 million and cash flow benefits accruing to them were about \$1,781 million; that is, cash-flow benefits

¹⁹⁸ Evans, *A Report into Taxpayer Costs of Compliance*, (1997), vii.

amounted to 20 percent of social costs of tax compliance.

Taking into account these cash-flow benefits, it is reasonable to assume that the cash-flow benefits of the genuine prospectors exemption will reduce a farmor's compliance costs of entering into an asset farmout by around 20 percent.¹⁹⁹

COMPLIANCE COSTS OF FARMOUTS OF SHARES

Until now, this chapter has looked at the taxation factors of farmouts of assets by participants of unincorporated joint ventures. Now we look at the taxation factors when the farmor is an equity participant of an equity joint venture. This will involve a consideration of farnees who are shareholders of the farmor when the farmout agreement is entered into and those that are not.

The capital gains provisions of the tax law are relevant to share farmouts. The contention is that the compliance costs of farmouts of shares are lower than for asset farmouts and the principal causes of this are the absence of complex provisions to interpret and relatively fewer laws applicable to share farmouts compared to asset farmouts.²⁰⁰

It is noted that share farmouts are available to both participants and equity participants. This contrasts with asset farmouts, which are not available to equity participants as they do not hold a direct interest in the assets of the joint venture. If a participant chose to structure a farmout agreement as a share farmout, then it would likely take the form of an option over shares in the corporation that owns an interest in the assets of the unincorporated joint venture.²⁰¹ In fact, this will be fiscally simpler.

However, it is not axiomatic that a participant choosing to use a share farmout in lieu of an asset farmout will ultimately incur less compliance costs than if an asset farmout were used. The impact of the operation of the consolidation regime, for example, could negate all of a

¹⁹⁹ The author accepts that more rigorous financial modelling will be required to derive a more accurate estimation of the extent to which the cash-flow benefits of the genuine prospectors exemption reduce a farmor's compliance costs.

²⁰⁰ This simplicity also exists when there is a change in the ownership of equity participants if it is a share sale, as chapter 5 will demonstrate.

²⁰¹ The word 'likely' is used because in theory a share farmout could be structured so that an option is offered over shares in a *parent company* of the corporation which owns an interest in the assets of the unincorporated joint venture.

participant's compliance cost savings. For instance, the entry by a participant into a share farmout will mean that the company whose shares change ownership will not be 100 percent common owned. 100 percent common ownership is a condition that a company must satisfy to gain entry into a consolidated group. If a participant cannot consolidate its tax position into a consolidated group, then the participant will continue to incur high compliance costs and high tax revenue costs (and concomitant complex anti-avoidance provisions) associated with the current tax laws.²⁰²

Share farmouts could be structured in one of three ways.²⁰³ An equity participant (the *farmor*) could grant to the farmee an option to acquire a percentage of the shares the equity participant holds in the SPV. Alternatively, a farmor could grant an option to acquire shares in the special purpose subsidiary or the Australian company holding all the shares in the equity participant.

Farmee is an existing shareholder of the farmor

If a farmee is an existing shareholder of the farmor when the farmout agreement is entered into, then the legal implications are straightforward. If a farmee is an existing shareholder of the farmor and the farmout agreement has been entered into for no consideration, then the option is acquired by the farmee at the time the farmee acquired the original shares²⁰⁴ and for no consideration.²⁰⁵ The exercise of the option by the farmee is not treated as a disposal of the option, so no capital gains tax liability should arise on its exercise.²⁰⁶ The farmee is deemed to acquire the new shares at the time when the option is exercised.²⁰⁷

If the option is exercised by the farmee, the acquisition cost of the new share may be either the exercise price or the market value of the option at the time of the exercise plus

²⁰² A Tax System Redesigned, 517.

²⁰³ It is useful to read this paragraph whilst also reviewing Figure 2.4 on p 63.

²⁰⁴ Section 130-45(1) ITAA 97.

²⁰⁵ Section 112-20(3) ITAA 97.

²⁰⁶ Section 130-40(7) ITAA 97.

²⁰⁷ Section 130-45(2) ITAA 97.

any amount paid on their exercise.²⁰⁸ The former applies if the option is acquired after 19 September 1985²⁰⁹ and the latter applies if the option is deemed to be acquired before 20 September 1985.²¹⁰

If the option is exercised by a person other than the farmee (ie a person who acquired the option from the farmee), then the acquisition cost of the new share is either the price of acquiring the option plus the price payable on its exercise²¹¹ or the market value of the option at the date of exercise plus any amount paid on its exercise.²¹²

An option will not be taken to have been disposed of by the farmee by the exercise of an option. The acquisition of an option and the exercise of the farmee's rights under the farmout agreement will be treated as a single transaction and therefore the consideration paid for the option forms part of the consideration paid by the farmee in respect of the acquisition of the shares.²¹³

Since an option is an asset,²¹⁴ if the farmee disposes of the option then a capital gain may accrue or capital loss be incurred. Further, if the right is not exercised, then there is a disposal of the option by the farmee and in such a case a capital loss may be incurred by the farmee. The consideration paid will be the cost base of the option.

Farmee is not an existing shareholder of the farmor

If a farmee is not an existing shareholder of the farmor when the farmout agreement is entered into, the legal implications are also straightforward. If a farmee is not an existing shareholder of the farmor, the option to acquire shares in the farmor is granted on or after 20 September 1985 and consideration is given for that right, neither the grant nor the

²⁰⁸ Section 130-40(6) ITAA 97.

²⁰⁹ Section 130-40(6) ITAA 97.

²¹⁰ See s. 160ZYT ITAA 36.

²¹¹ Section 130-40(6) ITAA 97.

²¹² Section 130-40(6) ITAA 97.

²¹³ Section 134-1 ITAA 97.

²¹⁴ Section 108-5 ITAA 97.

exercise of the right is a disposal by the company.²¹⁵ No capital gains liability therefore arises at this time. If and when such a right expires without being exercised, or is cancelled, released or abandoned, then the grant of the right at that later time constitutes a disposal of the right by the equity participant.²¹⁶ The right is treated as having been owned by the SPV immediately before the disposal so that tax will be payable on the consideration received for the issue of the farmout (if any).²¹⁷

If a farmee exercises its right to be issued shares, the grant of the right and the issue of shares by the farmor in fulfilment of its obligations under the farmout will be treated as a single transaction. The consideration for the farmout forms part of the consideration received by the farmor in respect of the issue of the shares.²¹⁸ That receipt does not attract capital gains tax.

Additional compliance costs may arise

The question of majority underlying ownership and sales of interests in interposed entities provisions will need to be considered in appropriate circumstances and, if relevant, will add an additional layer of complexity, and cost, to a share farmout. The compliance cost implications of these provisions of the tax law are considered at length in next chapter in the context of changes in the ownership of participants of unincorporated joint ventures.²¹⁹ Where relevant, those comments will apply equally to share farmouts.

²¹⁵ Section 104-40(6) ITAA 97.

²¹⁶ Section 104-40(1) ITAA 97.

²¹⁷ See section 104-30 ITAA 97.

²¹⁸ Section 104-40(5) and s. 116-65 ITAA 97.

²¹⁹ See chapter 5, p 206.

DEALINGS WITH THE OWNERSHIP OF JOINT VENTURES

This chapter looks at the role of taxation for dealings in the ownership of participants and the disposal of shares by equity participants as determinants of joint venture structures. This analysis will reveal that transactions structured as asset sales of interests of participants of unincorporated joint ventures have greater compliance costs than transactions structured as share sales because the laws relating to the former are legally and effectively more complex and more uncertain. However, differences in the compliance costs of both structures will vary from transaction to transaction. The chapter ends with an analysis of the specific problems encountered in the taxation of independent operations.¹

COMMERCIAL DRIVERS OF DEALINGS IN OWNERSHIP

There are four reasons for a change in the ownership of a joint venture. First, one (or more) of the parties may decide to sell its interest for a profit (or at a loss) in the ordinary course. An instance of this was the acquisition with a profit motive by BP-Amoco in September 1999 of a 12.5 percent stake in the WA-267-P exploration permit² joint venture from Shell Development Australia.³ A proposed sale in the ordinary course could trigger pre-emption rights contained in the JVA or shareholders' agreement in favour of the other participants or equity participants (as applicable) to acquire the relevant interest at a prescribed price (which may or may not be exercised).⁴ It could lead to the entry of an incoming participant, or a reduction in the overall number of participants. Secondly, participants or equity participants (as applicable) may wish

¹ That is, non-consent and sole risk operations. See Ryan (1983) for a discussion of these types of operations.

² Commonly known as the Gorgon gas field.

³ I Howarth, 'Dramatic change for LNG as Shell sells to BP-Amoco', *The Australian Financial Review*, 23 September 1999, 24. As well, US energy company Amoco and The Australian Gas Light Company—participants of an unincorporated joint venture to develop the coal bed methane resources north of Sydney—'poured millions of dollars into the venture, but walked away from it due to other priorities and the failure to demonstrate that enough gas enough be extracted to justify the investment: B Hextall, 'Gas deregulation sparks', *The Australian Financial Review*, 15 May 2000, 51.

⁴ Sullivan, *Financing Transnational Projects*, (1988), 8-15.

either to further reduce their financial risk associated with the project or raise funds by introducing a new party (a *farmout*). Thirdly, a participant or equity participant's interest in a joint venture may be bought out, diluted or forfeited.⁵ One cause of this is a failure to meet expenditure commitments.⁶ Other parties' interests will proportionately increase by the interest of the outgoing party. Fourthly, at the completion or failure of the undertaking carried on by the joint venture, participants or equity participants may simply wish to terminate the joint venture and dispose of their assets.⁷

Tax indemnities could be sought from a party who is disposing of its ownership of assets or shares in an unincorporated joint venture or equity joint venture (as applicable) by the incoming participant in respect of any latent taxation liabilities of the assets or shares being purchased.⁸ A tax indemnity confers on the transferee participant a contractual right to recover any loss which arises by particular forbearances done by a party who is disposing of its ownership of assets or shares, and therefore avoids the difficulty which can arise where the damage suffered is considered too remote under ordinary principles established in *Hadley v Baxendale*⁹ in relation to breach of contract. The transferee participant may require a joint venture due diligence and audit to be conducted prior to making the acquisition, to determine whether the transferor participant has been overcharged for operating costs prior to the sale and to ascertain other legal risks.

COMPLIANCE COSTS OF ASSET SALES

If a change of ownership in one joint venture structure involves a less onerous compliance burden than other joint venture structures because it is fiscally simpler and more certain, then *ceteris paribus*, taxpayers will prefer the former structure. The contention in this chapter is

⁵ See Duncan and Clarke (1994), 270-277.

⁶ Invariably, the precise circumstances in which a participant or equity participant's interest may be bought out, diluted or forfeited will depend on the terms and conditions of the JVA (for unincorporated joint ventures) or the shareholders' agreement (for equity joint ventures). See generally Figures 2.1 and 2.3.

⁷ For example, Conoco, Transfield and Tristar Petroleum formed a joint venture to develop a planned \$500 million to \$1 billion gas development scheme in central Queensland, which has stalled due to a dispute over the quantum of drilling costs and native title claims: J McCarthy, 'Qld's huge gas joint venture in dispute', *Courier Mail*, 2 May 2000, 25.

⁸ Pane, para. 80-010.

⁹ (1854) 9 Exch 341.

that the compliance costs of share sales are lower than for asset sales and the principal causes of this are the absence of complex provisions to interpret and relatively fewer laws applicable to share sales compared to asset sales.¹⁰

With asset sales, a purchaser (the *transferee participant*) acquires an interest in assets and the JVA from the vendor. The vendor will always be a participant.¹¹ The taxation factors of dealings in joint venture assets that are relevant to a transferor participant¹² will always operate at the participant level. The only caveat on this is if the consolidation regime becomes law and a transferor participant is a member of a consolidated group.¹³ For the convenience of discussion, it is assumed that the consolidated group proposals of the Ralph Committee, will not be relevant.

It is argued that not only are the compliance costs of asset sales are higher than for share sales, but that other compliance burdens are imposed because a transferor participant must characterise the revenue from the sale in a certain way and perform depreciation and mining and petroleum balancing adjustments.

Compliance cost impact of nature of transferor participant's interests in joint venture assets

If a transferor participant disposes of a percentage of its 'interest' in the assets of an

¹⁰ For example, if a transferor participant sells its interests in the assets of an unincorporated joint venture, it must account for the taxation issues arising on the disposal of an interest in *each asset* which is being disposed of. A transferor participant will therefore incur compliance costs to compile a detailed listing of each asset in respect of which it owns an undivided share in the unincorporated joint venture, identifying the nature of the asset, its acquisition date or deemed acquisition date, its (indexed) cost base and disposal consideration, written down value, and so on.

¹¹ Equity participants cannot structure their transaction as an asset sale, because unlike participants, equity participants do not have a direct ownership interest in the assets of the venture; the SPV owns the assets, and claims depreciation deductions for them and so on.

¹² The term 'transferor participant' describes a participant of an unincorporated joint venture that sells to the purchaser its interests in the assets, or sells shares in the special purpose subsidiary that owns an interest in those assets, or sells shares in the Australian holding company, or sells its interests in some assets and sells shares in either the special purpose subsidiary or the Australian holding company.

¹³ The consolidation regime will not apply directly to unincorporated joint ventures, because an unincorporated joint venture is not a taxpayer in its own right. Unincorporated joint ventures will not be eligible to join the consolidated regime: see *A Tax System Redesigned*, chapter 15. Therefore, for unincorporated joint ventures, the consolidation regime will only ever operate at the participant level. Unless equity participants who are members of the same corporate group wholly own a SPV, the SPV will not be able to consolidate its tax position into that corporate group.

unincorporated joint venture, then it must incur costs to meet the requirements of the tax law. These will occur in certain major areas of cost applicable to taxation compliance activities undertaken by transferor participants, such as labour/time consumed in completion of tax activities, external advice to assist with completion of tax activities and incidental expenses incurred in completion of tax activities.¹⁴

An instance of a transferor participant assigning its right to some of its joint venture rights but not others is to be found in *Mt Isa Mines Ltd v Seltrust Mining Corporation Pty Ltd and Paragon Pty Ltd*.¹⁵ This case raised the question whether a particular transaction involved the assignment of *part* of a participant's interest. A pre-emptive right was effectively circumvented by having 'back-to-back' sale contracts under which the purchaser agreed to buy all the transferor participant's share of production from the joint venture in return for paying the transferor participant's share of joint venture expenditures. The transferor participant at no time parted with its joint venture interest and the court held that that arrangement was not caught by the provisions of the assignment clause. The JVA specifically excluded a participant's share of production from the definition of the participant's interest. The court came to its conclusion notwithstanding the parties to the arrangement, in the documentation, made it clear that their intention was to be placed in the same financial position as if the purchaser of the share of production had taken as assignment of the transferor participant's interest in the unincorporated joint venture. For convenience of discussion, it is assumed in this section of the chapter that transferor participants dispose of their full 'interest' in the assets of a joint venture.¹⁶

Characterising the revenue from the sale

A transferor participant will incur compliance costs to comply with obligations in the tax law to characterise the revenue it derives from a sale. These costs arise because of the distinction tax laws make about revenue from the sale of trading stock,¹⁷ revenue that is ordinary

¹⁴ See Evans, *A Report into Taxpayer Costs of Compliance*, (1997), 3.

¹⁵ (Unreported, Full Supreme Court of Western Australia, 27 September 1985).

¹⁶ In the last section of this chapter, the changes in the interests of participants by operation of sole risk and non-consent provisions will be examined.

¹⁷ Section 70-20 ITAA 97.

income,¹⁸ revenue made under a profit-making undertaking or plan,¹⁹ or a capital gain.²⁰

Trading stock

An unincorporated joint venture does not itself hold trading stock. It is likely that transferor participants will hold their share of the joint venture product as trading stock. That legal title in those assets may be held by one participant, or by the operator, on behalf of all participants does not affect this conclusion.²¹ Even though the product held by one transferor participant may constitute trading stock,²² the product held by another transferor participant may be held otherwise than as trading stock.²³

The disposal by a transferor participant of its trading stock could also be treated as a notional disposal of the trading stock by all the old owners to all the new owners. All affected participants will no doubt incur compliance costs in the form of labour time and expenses in order to comply with this law. If a transferor participant disposes of its trading stock and one of the participants who owned the property before the change has an interest in the property after the change, then s. 70-100(3) applies as if the participants who owned the property before the change had disposed of the property to the persons who own it after the change (where the participants unanimously agree). For the section to apply, one of the participants who owned the trading stock before and after the change must have an interest in the property of not less than 25 percent of the value of the property.²⁴ A number of restrictions on the availability of the election are provided for in s. 70-100(4). Section 70-

¹⁸ Section 6-5(1) ITAA 97.

¹⁹ Section 15-15 ITAA 97.

²⁰ See Pt 3-1 ITAA 97 ('Capital gains and losses: general topics'). This assumes that a prospecting entitlement has been acquired severally by participants of an unincorporated joint venture on or after 20 September 1985.

²¹ Pritchard (1986), 508.

²² This would be the case if the product held by a transferor participant is something 'produced, manufactured or acquired that is held for purposes of manufacture, sale or exchange in the ordinary course of business and livestock': s. 70-10 ITAA 97.

²³ This would be the case if the product held by a transferor participant does not satisfy the definition of trading stock found in s. 70-10 ITAA 97.

²⁴ Section 70-100 ITAA 97.

100 prescribes the timing of making an election.²⁵ There is obviously a compliance burden on participants imposed by s. 70-100.

The following example illustrates the operation of the compliance cost impact of s. 70-100. On 30 June 2000, Participant A and Participant B, participants in a gold mining unincorporated joint venture, agree to Participant C's entry as a participant, each selling one-third of their undivided interests in the total unincorporated joint venture assets to Participant C. As at 30 June, the closing value at cost of all the participants' stock on hand was \$3 million, its market value \$5 million. As there is a two-thirds continuity of interest of Participant A and Participant B in the unincorporated joint venture of Participant A, Participant B and Participant C, it is open for all three to make an agreement under s. 70-110(4).

If no agreement is made, then for tax purposes Participants A and B are deemed to have sold, and Participant A, Participant B and Participant C to have purchased, the trading stock for its market value of \$5 million. Participant A and Participant B are then assessed on the profit of \$2 million (ie \$5 - \$3 million).

If an agreement is made, then for tax purposes Participant A and Participant B are deemed to have sold, and Participant A, Participant B and Participant C to have purchased, the trading stock for its market value of \$5 million and there is no assessable profit on the transaction. The assessment of profit is deferred until the stock is sold in the ordinary course of the new business.

In addition, the law about the ownership of trading stock of unincorporated joint ventures is legally complex. There are two views on the question of the first recognition of the joint venture product as trading stock of each participant. The narrow view is that participants have no trading stock until the product is divided or appropriated in specie severally by them because the product is not produced for subsequent processing or sale by the unincorporated joint venture itself.²⁶ In effect, this approach contemplates a disposal and acquisition of

²⁵ See s. 70-100(7) ITAA 97.

²⁶ Cf *John v FCT* (1989) 166 CLR 417, 417-8; cf *Guinea Airways Ltd v FCT* (1950) 83 CLR 584 (stockpile beyond holding for sale in the ordinary course of business may not be trading stock); *FCT v Suttons Motors (Chullora) Wholesale Pty Ltd* (1985) 157 CLR 277 (where stock merely in the possession of the taxpayer was already held by the group for sale in the ordinary course of its overall business).

undivided fractional interests in the product as a result of mutual releases, so that valuable consideration is given and received in the division or appropriation of the product in specie.²⁷ The argument would be that even if this division involves the disposal of a revenue asset so that an amount must be included in the assessable income of the participant,²⁸ it also involves a corresponding acquisition of another revenue asset, so that there would be a corresponding deduction allowed under s. 8-1(1) of the ITAA 97, and the net income effect to the participants would be neutral.²⁹

Under the wide view, the product of the joint venture project becomes the trading stock of each participant from the time each participant is liable to dispose of the product in specie notwithstanding the participants each have an undivided fractional interest in the trading stock until its subsequent division or appropriation in specie. The wide view is supported by the authorities.³⁰ This view is subject to the definition of trading stock in the ITAA 97 being satisfied.

If the assets disposed of by a transferor participant are also revenue assets, then an amount will be included in the assessable income of the transferor participant as a result of the disposal (albeit with an offsetting allowable deduction), so that s. 118-20 of the ITAA 97 will operate to avoid any overlap with the revenue provisions. The net effect is that no capital gains consequences arise from the division in specie of the trading stock among the participants.³¹

The fiscal uncertainty and compliance costs associated with the provisions of the tax law should disappear under the cash flow/tax value methodology. The reason is that the proposed definition of an 'asset' set out in *A New Tax System (Income Tax Assessment) Bill 1999* (Cth)

²⁷ See Alexander (1994), 213; cf *Comptroller of Stamps (Vic) v Christian* (1990) 21 ATR 1036; cf *Rose v FCT* (1951) 84 CLR 118. These cases concern partnerships, not unincorporated joint ventures.

²⁸ *Memorex Pty Ltd v FCT* (1987) 87 ATC 5034; 77 ALR 299; 19 ATR 553; 13 ALD 685; appld *G K N Kwikform Services Pty Ltd v FCT* (1990) 21 ATR 769; 90 ATC 4823; *FCT v Cainero* (1988) 15 ALD 368; 19 ATR 1301; 88 ATC 4427.

²⁹ But see Alexander (1994), 213. The author says that 'there is net income effect as a result of the division itself'.

³⁰ *FCT v Suttons Motors (Chullora) Wholesale Pty Ltd* (1985) 157 CLR 277, 282 (where goods merely in the possession of but not owned the taxpayer were held to be trading stock); see also *Ruling IT 2670*.

³¹ Id.

is broad and looks comprehensive.³² The current rules should become irrelevant.

Income according to ordinary concepts

The distinction tax laws make between receipts on revenue and capital account increase the volume of tax laws, which adds to a transferor participants' compliance burden. This is the result of the historic significance of the taxation of revenue proceeds. Before the capital gains legislation was introduced in 1985, the distinction between income receipts and capital proceeds was critical, because capital proceeds generally escaped tax.³³ A finding that an item is on capital account rather than on revenue account is significant today because the capital proceeds will probably fall to be taxed as a capital gain. The distinction will be irrelevant under the cash flow/tax value methodology of calculating taxable income as the focus will be on a comparison of beginning and end of year balance sheets and will involve adjustments between the profit and loss account and taxable income.³⁴

Not only that, a transferor participant must identify its normal proceeds of business. It is argued that this can be a complex process. The more resources (eg in-house tax advisors and external lawyers) a transferor participant requires in order to identify its normal proceeds of business and/or the more expensive those resources are, then the more onerous a transferor participant's compliance burden. When a transferor participant receives an amount that substantially affects its business structure, the revenue will not be an ordinary incident of its business; but a structural receipt, taxed under Pt 3-1 of the ITAA 97.³⁵ A transferor participant must incur costs to make a determination about the nature of its revenues.

But under the cash flow/tax value approach, the key issue will be whether or not a receipt gives rise to an asset (as that term will be defined) or whether it is merely to be accounted for

³² A New Tax System (*Income Tax Assessment*) Bill 1999 (Cth) provides in s. 6-15 that an asset is 'any thing (tangible or intangible) that embodies future economic benefits'.

³³ Flynn (1999), 155.

³⁴ *Id*; A Tax System Redesigned, recommendation 4.1; Cathro (1999), 224. Refer chapter 2 for a detailed discussion about the cash flow/tax value methodology.

³⁵ In *CMI Services Pty Ltd v FCT* (1990) 90 ATC 4428, 4437, Lockhart J indicated that in identifying the ordinary proceeds of business it is necessary to have regard to the 'nature of the company, the character of the assets realised, the nature of the business carried on by the company and the particular realisation which produced the profit'. *Appld AGC (Investments) Ltd v FCT* (1991) 21 ATR 1379; 91 ATC 4180; cited *Montgomery v FCT* (1998) 98 ATC 4120; 152 ALR 241; 38 ATR 186; *AAT Case 13,147* (1998) 98 ATC 209; 40 ATR 1001.

as a receipt.³⁶ If the amount received does not give rise to any future economic benefits, then the amount will be more likely to be accounted for as a receipt.

A transferor participant's revenue will be structural if the JVA governs and provides the 'framework' for other contracts.³⁷ A JVA that defines the rights and obligations of participants will have the capacity to govern and provide the framework for other contracts.³⁸

But an amount received by a transferor participant for cancellation of its rights under the JVA might be income on ordinary concepts. The High Court has enunciated the circumstances in which a profit or gain may be income according to ordinary concepts in *FCT v Myer Emporium Ltd*.³⁹ If a transferor participant's business is to promote or deal in interests in unincorporated joint ventures, then a profit on the change of the ownership of such interests would be assessable income.⁴⁰ For example, in *General Construction Co Ltd v Minister of National Revenue*,⁴¹ the taxpayer's business involved entering into joint ventures with other parties and partially funding them with a view to profit. When the joint venture in question was substantially completed, the taxpayer sold its interest in the joint venture to one of the

³⁶ See *A Tax System Redesign*, 159.

³⁷ *Californian Oil Products Ltd v FCT* (1934) 52 CLR 28.

³⁸ For instance, a JVA might define the *scope* of the operator's authority to enter into contractual arrangements with third parties, which can bind the transferor participant. Or, the JVA might prescribe the maximum dollar limit in respect of which the operator can contract with third parties before the prior approval of the operating committee is required. Potential financial arrangements which participants may be otherwise free to enter into might be rendered unavailable to participants by implication of the provisions of the JVA: Milliner (1988), 13-16 (where lenders' concerns over taking security over participant's interests in the unincorporated joint venture context is discussed). The JVA might also prescribe the rights of participants to enter into arrangements in competition with each other, to enter into contractual arrangements in the event of a discovery of natural gas and sales and marketing contracts. There is no rule of law that such matters must be contained in a JVA—although the basic contractual principle that contractual arrangements must be certain—may play a role: Leslie (1970), 18.

³⁹ (1987) 163 CLR 199, 209. This case stands for the proposition that since taxpayers carry on business with a view to profit, a taxpayer who makes a gain in the ordinary course of carrying on a business has a profit-making purpose and the profit which is produced is revenue in nature: (1987) 163 CLR 199, 209. Cf. chapter 2, where it is argued that the element of joint profit is missing from unincorporated joint ventures. For further analysis of the *Myer Emporium* decision, see *FCT v Spedley Securities Ltd* (1988) 88 ATC 4126; 19 ATR 938; *Moana Sand Pty Ltd v FCT* (1988) 88 ATC 4897; 19 ATR 1853; *Cooling v FCT* (1990) 22 FCR 42; *Gutwenger v FCT* (1995) 55 FCR 95.

⁴⁰ See *Fanmac Ltd v FCT* (1991) 91 ATC 4703; 22 ATR 413; *Australian Machinery & Investment Co Ltd v FCT* (1946) 180 CLR 9.

⁴¹ (1959) 19 DLR (2d) 373 (SC), *referred to in* *Burnett's Motors Ltd v Inland Revenue Commissioner (NZ)* (1977) 8 ATR 620.

other participants for a profit of \$90,000. The court found that the agreement to sell the taxpayer's interest made provision for a return of invested capital plus the share of profits in the enterprise. The \$90,000 was held to be income within the test laid down in *Californian Copper Syndicate Ltd v Harris*.⁴²

If a transferor participant derives revenue from dealing with its rights under a JVA, the JVA is not an ordinary commercial contract made in the transferor participant's course of business and the JVA relates to the whole structure of the transferor participants' profit-making apparatus, then the revenue will be capital and taxed accordingly.⁴³ To illustrate this, in *Van den Berghs Ltd v Clark*,⁴⁴ the taxpayer had entered into a market-sharing agreement with a competing Dutch company in 1912. The parties disputed amounts payable by one party to the other. After a protracted process, an agreement was entered into in 1927 under which all claims and counterclaims were withdrawn and the Dutch company agreed to pay £450,000 in 'damages' to the taxpayer in consideration of the cancellation of the contract. The £450,000 was paid to the taxpayer in the same year. Finlay J held it was capital. His decision was unanimously reversed by the Court of Appeal, but was unanimously reinstated by the House of Lords.

Profit-making undertaking or plan

A transferor participant may incur compliance costs to determine whether the revenue is characterised as a gain made from a profit-making undertaking or plan. If so, then s. 15-15(1) of the ITAA 97 provides that its profit includes profit arising from the carrying on (or carrying out) of a profit-making undertaking or plan. The provision excludes profit that is assessable as ordinary income under s. 6-5⁴⁵ or which arises from the sale of property acquired on or after 20 September 1985.⁴⁶ If the facts give rise to the inference that the transferor participant's intention or purpose in entering into the transaction was to make a profit or gain, then that

⁴² (1904) 5 TC 159. This case was referred to approvingly by the High Court in *FCT v Myer Emporium Ltd* (1987) 163 CLR 199, 209.

⁴³ *Van den Berghs Ltd v Clark* (1935) 19 TC 390.

⁴⁴ (1935) 19 TC 390; appld *Moneyman Pty Ltd v FCT* (1990) 21 ATR 1142; 97 ALR 265; 91 ATC 4019. See generally Krever (1997) and Waincymer (1994).

⁴⁵ Section 15-15(2)(a) ITAA 97.

⁴⁶ Section 15-15(2)(b) ITAA 97.

profit or gain will be income, notwithstanding the transaction was an extraordinary one judged by reference to the ordinary course of the taxpayer's business.⁴⁷

In *Forwood Down & Co Ltd v Commissioner of Taxation (WA)*,⁴⁸ the taxpayer company (a participant of an unincorporated joint venture) conducted a general and structural steel engineers business and also manufactured and dealt in machinery. The taxpayer purchased mining machinery that had been in use at mines. On occasions, where the mine had been closed down, it purchased the mining lease so that it could leave the machinery at the site pending resale. Usually the lease was surrendered or allowed to lapse as soon as the machinery was disposed of. In 1923, together with another taxpayer, it purchased a mining lease that was disposed of in a different manner. Portions of the machinery were sold and removed from time to time. The mine was then let and, subsequently, the leases and the remaining machinery were sold for a consideration consisting of shares in the purchasing company. The High Court held that although the transaction was not ordinarily within the scope of the company's trading operations, the realisation of the mining lease and machinery was not a mere change of investment but acts done in carrying on the business operations of the taxpayer. Consequently the profit was assessable.

Under the cash flow/tax value methodology, the transferor participant may be required to: include the proceeds from the sale of an interest in joint venture assets in the calculation of net income; and to adjust the tax values of assets disposed of. Whether the receipt by the transferor participant is revenue or capital in nature is irrelevant to the calculation of net income under the cash flow/tax value methodology.⁴⁹ If the receipt is money received in a year of income, whether constructive or not, then it is a 'receipt' as defined and must be included in the transferor participant's net income.⁵⁰ It is likely that the transferor

⁴⁷ *FCT v Myer Emporium Ltd* (1987) 163 CLR 199, 209.

⁴⁸ (1935) 53 CLR 403; *Dist Geo W Cheverton Pty Ltd v FCT* (1962) 8 AITR 497; 12 ATD 461; *referred to in Producers & Citizens Co-op Assurance Co Ltd v FCT* (1956) 95 CLR 26; *Case 27* (1956) 6 CTBR(NS); *Case No 28* (1954) 5 CTBR(NS) 181; *Case No 32* (1954) 5 CTBR(NS); *Case 73* (1954) 4 CTBR(NS); *Case No 17* (1950) 1 CTBR(NS); *Western Gold Mines NL v Commissioner of Taxation (WA)* (1938) 59 CLR 729; *Ridgway v DFCT* (1937) 40 WALR 43; 1 AITR 236; 4 ATD 439.

⁴⁹ Explanatory Notes to the draft *A New Tax System (Income Tax Assessment) Bill 1999* (Cth), 52.

⁵⁰ See s. 5-65 draft *A New Tax System (Income Tax Assessment) Bill 1999* (Cth).

participant's rights cancelled under the JVA will be treated as an asset,⁵¹ so that the decrease in the tax value of that asset will be brought to account in calculating the net change in the tax value of assets over the income year.⁵²

The point is that, the cash flow/tax value method may involve simpler, shorter and more easily managed tax legislation and lower compliance costs, particularly for those presently unfamiliar with the tax law.⁵³ If the new law is more transparent, then it should increase certainty for transferor participants.

However, it has to be accepted that at least in the short term, participants will incur temporary costs to acquire the knowledge about the new law. Then there are one-off costs that may be incurred to modify information technology systems to accommodate the new law as well as the recurrent costs of complying with the new approach. The public sector will no doubt incur commencement costs and recurrent costs in administering the new law.

It is not possible at this stage to estimate the net benefit (or net cost) of complying with the new law because the Explanatory Notes to the draft *A New Tax System (Income Tax Assessment) Bill 1999* (Cth) do not disclose estimates of the likely reduction in the compliance cost burden to taxpayers and to the community. In any event, given that external tax advisor costs have been estimated in the 1994-95 year of income to be \$45,181 for large companies,⁵⁴ even a small reduction in such costs for each large company has the potential to create savings for each transferor participant.

One-off or isolated transactions

If the disposal of an undivided share of the assets of an unincorporated joint venture is not a natural incident of a transferor participant's business activities, the proceeds may nevertheless constitute ordinary income of the transferor participant because an isolated venture or a one-

⁵¹ S. 6-15 draft *A New Tax System (Income Tax Assessment) Bill 1999* (Cth) defines an asset to be 'any thing (tangible or intangible) that embodies future economic benefits. The two main kinds of future economic benefits come from using the asset, and from disposing of it. See also items 5 and 6 of the table set out in s. 6-15 of that draft bill.

⁵² See ss. 6-40 and 6-75 draft *A New Tax System (Income Tax Assessment) Bill 1999* (Cth).

⁵³ Explanatory Notes to the draft *A New Tax System (Income Tax Assessment) Bill 1999* (Cth), 44-45.

⁵⁴ Evans, *A Report into Taxpayer Costs of Compliance*, (1997), 33, table 4.2.

off transaction does not preclude the proceeds from being properly characterised as assessable income.⁵⁵

In *Edwards v Bairstowe*,⁵⁶ participants in an unincorporated joint venture who engaged in an isolated transaction of buying and selling a complete spinning plant, with a view to making a profit, but having no intention of using the plant or deriving income from it, were held liable to income tax on the profit made on resale. In this case, the judge was dealing with the same question as arises under Australian legislation. Lord Radcliffe concluded that it was a profit from an adventure in the nature of a trade because the participants had no intention of using the machinery and therefore did not buy it to hold as an income-producing asset or to consume it or for the pleasure of enjoyment; and, instead of having any intention of holding the plant, they planned to sell it before they bought it. This they did, making a net profit, as they hoped and expected to do. In his Lordship's opinion this was 'inescapably, a commercial deal in second-hand plant.'⁵⁷

In principle, the author considers that the same conclusion could have been achieved had the participants divided the property *inter se* before sale for a profit. But in the *Myer Emporium* decision,⁵⁸ the High Court confirmed that the proceeds of a mere realisation or change of investment or enhancement of capital was not income.⁵⁹

Similarly, in *Burnett's Motors Ltd v Inland Revenue Commissioner (NZ)*,⁶⁰ where under arrangements for the dissolution of a JVA to carry out the construction work on a project, one participant assigned its interest in the contract to another taxpayer for \$38,728, the whole of which was assessed to tax by the Commissioner. The Supreme Court of New Zealand held that the taxpayer did not sell its interest in the JVA as part of a profit-making scheme, but an

⁵⁵ *FCT v Myer Emporium Ltd* (1987) 163 CLR 199, 209.

⁵⁶ [1956] AC 14; appld *FCT v Brixius* (1987) 16 FCR 359; Csd, *FCT v Myer Emporium Ltd* (1987) 163 CLR 199, 209.

⁵⁷ [1956] AC 14, 38.

⁵⁸ (1987) 163 CLR 199.

⁵⁹ In *Mooney v Commissioner of Taxation (Vic)* (1905) 3 CLR 221, where one of three co-owners, who had taken up land and developed a mine, which was subsequently sold for a price payable in instalments, was assessed to income tax on his share of the sale proceeds, the court held that proceeds were not income notwithstanding mining was a speculative enterprise.

⁶⁰ (1977) 8 ATR 620.

interest in a business project that was a major asset; consequently the moneys received were of a capital nature. The joint venture was a trade or business in itself and was outside the ordinary business of the taxpayer, so the consideration was not received as income but was received as part of the selling price of the taxpayer's interest of the joint venture and was consequently of a capital nature.

Balancing adjustments increase the compliance burden

A transferor participant must interpret complicated balancing adjustment provisions of the tax law. Assuming that a transferor participant will incur tax advisor's fees to comply with these provisions, there could be an additional compliance burden on them. The compliance burden would involve costs incurred by the transferor participant in disposing of items of plant and equipment, such as labour costs and perhaps costs of hiring external advisors. The transferee participant might also incur compliance costs in acquiring such items of plant and equipment.

A transferor participant's obligation to make balancing adjustments—and the compliance costs that go with them—would disappear if a sale was structured as a share sale instead. The reason for this is that share sales do not involve the disposal of the underlying assets.

The first set of balancing adjustment provisions that will be examined in this chapter are the ones concerning depreciation on plant. The ITAA 97 provides a framework for depreciation on plant and balancing adjustments.⁶¹ The operation of the depreciation balancing adjustment rules to unincorporated joint ventures is legally complex and should be simplified. This can be demonstrated by outlining the provisions of the tax law.

If a transferor participant sells its interest in plant to a transferee participant, s. 42-330(1) of the ITAA 97 will render s. 42-185 applicable by deeming the owners of the plant after the change to have acquired it from its owners before the change,⁶² and a balancing adjustment

⁶¹ See, s. 42-18(1) ITAA 97 (depreciation on plant and articles which varies according to the type of asset held); s. 73B ITAA 36 (expenditure on plant and equipment wholly attributable to research and development, which is deductible at the rate of 50 percent in the first year and in each of the following two years); and s. 330-80 (allowable capital expenditure incurred in the 1997-98 income year or a later year).

⁶² Section 42-335(1) ITAA 97.

event to have occurred⁶³ unless the participants who owned the plant before the disposal (the *original participants*) and the participants who owned the plant after the disposal (the *new participants*) jointly elect for roll-over relief to apply.⁶⁴ An election must be in writing, and must contain enough information about the original participants' holding of the property for the new participants to work out how common rule 1 applies to the new participants' holding of the property.⁶⁵

In addition, an election must be made within six months after the end of the income year in which the roll-over event occurred, or within any longer period allowed by the Commissioner.⁶⁶ All affected participants will presumably need systems in place to ensure their compliance with this legal obligation.

Common rule 1 applies when a joint election is made.⁶⁷ It is understood that the Commissioner's practice is not to apply s. 42-330 to changes in interests in an unincorporated joint venture.⁶⁸ If the Commissioner's practice is not in accordance with the law, then it will be difficult for a taxpayer to hold the Commissioner to that practice.⁶⁹ It is clearly inadequate that unincorporated joint ventures, which already must manage characterisation risk, should also have to manage their way through legislative provisions that have not been drafted specifically with them in mind.⁷⁰

The second set of balancing adjustment provisions that will be examined in this chapter are the ones applicable when mining, quarrying or petroleum property⁷¹ is lost, destroyed or sold,

⁶³ See the note at the foot of s. 42-330 ITAA 97 stating that 'if subsection (1) or (2) applies, a balancing adjustment event occurs for the plant, see subsection 42-30(3).'

⁶⁴ Section 42-335(3) ITAA 97.

⁶⁵ Section 41-55(2) ITAA 97.

⁶⁶ Section 41-55(2) ITAA 97.

⁶⁷ See ss. 42-335(3), 42-35(a) and Subdiv 41-A ITAA 97.

⁶⁸ Tang (1999), 8.

⁶⁹ *Bellinz v FCT* (1998) 84 FCR 154; *applied AAT Case 13,192*; *Pierce & DFCT* (1998) 98 ATC 2240; 39 ATR 1222.

⁷⁰ The Ralph Committee has specifically recognised this problem: see *A Tax System Redesigned*, 554.

⁷¹ See s. 330-5(2) ITAA 97.

its use for qualifying purposes⁷² ceases, or it is no longer being used primarily and principally for mining or quarrying transport, a balancing adjustment will apply.⁷³

The compliance costs of making a mining or petroleum balancing adjustment are similar in nature to those arising because of depreciation balancing adjustments. The reason is that the process of the law is practically the same in both cases. Therefore, a transferor participant would need the same or similar resources to administer its obligations in both areas. For instance, if the termination value of the property exceeds the property's written down value (ie the total capital expenditure on the property less deductions previously allowed), the transferor participant must include the amount of the excess (up to the amount of the deductions) in its assessable income.⁷⁴ Conversely, if the termination value is less than the written down value, then the difference is an allowable deduction.⁷⁵ The termination value of the property is defined in s. 330-490 as the price for which the property was sold, or its market value (if the property was disposed of other than by sale or ceased being used for qualifying purposes), or the insurance proceeds of the amount otherwise received for the loss or destruction of the property, or a reasonable amount (if the property was not owned by the taxpayer and ceased being used primarily and principally for mining or quarrying transport).

It is unlikely that a transferor participant must include revenue received for mining, quarrying or prospecting information in calculating its mining or petroleum balancing adjustment. The Commissioner considers that the balancing adjustment provisions do not apply to consideration received for dealing with or disclosing mining, quarrying or prospecting information as such information is not property,⁷⁶ although such consideration may be assessable under s. 6-5(1).

The Commissioner also accepts that the balancing adjustment provisions do not apply to the medium on which the information is stored (eg document, disc, computer memory).⁷⁷ Again,

⁷² Qualifying purpose is defined in s. 330-480(2) ITAA 97.

⁷³ Subdivision 330-J ITAA 97.

⁷⁴ Section 330-485(2) ITAA 97.

⁷⁵ Section 330-485(3) ITAA 97.

⁷⁶ See chapter 4.

⁷⁷ See chapter 4. For the capital gains tax implications, see chapter 4.

if transferor participants structured a sale of their interest in a JVA as a share sale rather than an asset sale, these compliance cost issues would not arise.

Burden of the capital gains provisions is not particularly onerous

The operation of the capital gains provisions of the tax law does not impose any particularly onerous compliance cost obligations on transferor participants. A transferor participant can expect to incur administration costs in complying with these provisions whenever they apply.

The definition of a CGT asset is broad and means any kind of property or a legal or equitable right that is not property,⁷⁸ and to avoid doubt, includes part of, or an interest in any kind of property or a legal or equitable right that is not property,⁷⁹ goodwill or an interest in it,⁸⁰ an interest in an asset of a partnership⁸¹ and an interest in any other partnership assets.⁸²

It is beyond doubt that the definition of asset is wide enough to cover the proprietary and contractual⁸³ interests of a transferor participant in an unincorporated joint venture. The proprietary interest is that of a tenant in common in the assets of the joint venture. The contractual interest is constituted by choses in action relating to the management of the common undertaking.⁸⁴

The provisions will only apply if there is the beneficial ownership of the asset changes from the transferor participant to another entity.⁸⁵ Therefore, a transferor participant must have an understanding of when a change in beneficial ownership will occur to comply with this. Given the sophisticated nature and size of many mining and petroleum joint venture taxpayers, the cost of acquiring this knowledge would be likely to be negligible.

⁷⁸ Section 108-5(1) ITAA 97.

⁷⁹ Section 108-5(2)(a) ITAA 97.

⁸⁰ Section 108-5(2)(b) ITAA 97.

⁸¹ Section 108-5(2)(c) ITAA 97.

⁸² Section 108-5(2)(d) ITAA 97.

⁸³ See *United Dominions Corporation v Brian Pty Ltd* (1985) 157 CLR 1, 10. Cf *Canny Gabriel Castle Jackson Advertising Pty Ltd v Volume Sales (Finance) Pty Ltd* (1974) 131 CLR 321, 327-328.

⁸⁴ Crommelin (1986), 70.

⁸⁵ Section 104-10(2) ITAA 97.

COMPLIANCE COSTS OF SHARE SALES

Thus far, this chapter has examined the taxation factors of dealings by transferor participants of their interests in the assets of unincorporated joint ventures. In this section of the chapter, the focus is on the taxation factors when the vendor is an equity participant (a *transferor equity participant*). The company whose shares are being sold will be described as the *target company*. The target company will either be the SPV, the SPS or the Australian holding company (see Figure 2.4).

The income and capital gains provisions of the tax law are relevant to share sales. It is clear that the compliance costs of share sales for transferor equity participants are lower than for transferor participants who conduct asset sales because of the absence of complex provisions to interpret and relatively fewer laws applicable to share sales compared to asset sales.⁸⁶ However, those low compliance costs are counter-balanced by higher compliance costs for the purchaser (the *transferee equity participant*) and target company.

The transferor equity participant's compliance cost burden

It is unlikely that a transferor equity participant would incur compliance costs in administering the income provisions of the tax law by reason of its entry into a share sale agreement. The reason is that a sale of shares in a target company is unlikely to give rise to an assessable profit or deductible loss to a transferor equity participant under the ordinary income tax provisions of the ITAA 97 unless the transferor equity participant can be characterised as conducting a business of share trading or has specifically entered into the sale or purchase of the shares for a profit-making purpose or as part of a business of investing in shares in companies (eg venture capital companies or conglomerates).⁸⁷

Compliance costs would be incurred in administering the capital gains provisions that apply. For instance, the transfer of any shares in the target company by the transferor equity participant can impose a compliance cost burden in the nature of retrospective adverse tax consequences, by denying the effectiveness of any capital gains tax free rollovers entered into

⁸⁶ This simplicity also exists when there is a change in the ownership of equity participants if it is a share sale, as chapter 5 will demonstrate.

⁸⁷ Compare the decision in *London Australia Investment Co Ltd v FCT* (1977) 138 CLR 106; *Charles v FCT* (1954) 90 CLR 598.

by the target company earlier in the year of income in which the disposal of the shares to the transferee equity participant takes place. This may result in a transferor equity participant being subject to an unexpected liability for capital gains tax in relation to that rollover. Alternatively, another member of the transferor equity participant's group might instead be subject to that unexpected CGT liability in relation to that rollover.

Assuming that the sale of shares by a transferor equity participant attracts immediately the operation of the capital gains provisions, the transferor equity participant will incur compliance costs as a result. These costs will be incurred because of the effort and management time required to comply with the capital gains provisions. These provisions will be attracted if the shares being sold were acquired by the transferor equity participant after 19 September 1985 as well as those acquired before that date but which have subsequently lost their exempt status by virtue of the transitional provisions set out in div 149 and s 104-230 of the ITAA 97.

The transferee equity participant's compliance cost burden

A transferee equity participant will not incur any immediate compliance costs under the capital gains provisions on the acquisition of the shares in the target company. The transferee equity participant will be subject to the costs of applying the capital gains provisions on future disposal of the shares, on the excess of the deemed or actual sale proceeds over and above the transferee equity participant's cost base.

On the income side, if a transferee equity participant purchases 100 percent of the shares in the target company, it will form part of the transferee equity participant's group from the commencement of the next full year of income, such that income losses and capital losses incurred by the target company after the commencement of that year can be transferred to other fully owned resident companies in the transferee equity participant's group.

Similarly, losses incurred by those other group companies in the subsequent full income years will be able to be transferred to the target company. Further, excess foreign tax credits arising in the target company in the subsequent full tax years will be transferable to other fully owned resident companies in the transferee equity participant's group. Excess foreign tax credits may also be transferred to the target company from other group companies in the subsequent full tax years.

One area where compliance costs are likely to arise is in transferring prior year tax losses between companies in the same wholly-owned group. In particular, this is due to the legal complexity of determining whether a taxpayer has a right, power or option or is able to affect the rights of the transferee equity participant in relation to the target company.

The ITAA 97 provides a framework for dealing with the grouping of losses. That Act provides that if the target company is a wholly owned subsidiary of a single ultimate holding company,⁸⁸ the sale of any of the shares in the target company by the transferor equity participant will remove the target company from the transferor equity participant's corporate group for the grouping of income tax and capital losses, the transfer of excess foreign tax credits and the calculation of thin capitalisation ratios, each of which require 100 percent grouping for the whole of an income year to be available.

A transferee equity participant must first determine whether it and the target company are members of the same wholly owned group. This should be relatively straightforward and inexpensive. This test will be satisfied when one of the companies is a 100 percent subsidiary of the other company⁸⁹ or each of the companies is a 100 percent subsidiary of the same third company.⁹⁰ A target company is a 100 percent subsidiary of a transferee equity participant if all the shares in the target company are beneficially owned by the transferee equity participant or one or more 100 percent subsidiaries of the transferee equity participant or the transferee equity participant and one or more 100 percent subsidiaries of the transferee equity participant.⁹¹

In addition, the common ownership test must be satisfied⁹² along with several other conditions.⁹³ Even if the common ownership test is satisfied the target company will not be

⁸⁸ This is obviously more likely to be the case where the target company is either the SPS or the Australian holding company.

⁸⁹ Section 975-500(a) ITAA 97.

⁹⁰ Section 975-500(b) ITAA 97.

⁹¹ Section 975-505(1) ITAA 97.

⁹² Section 170-30(2) ITAA 97.

⁹³ Subdivision 170-A of the ITAA 97 contains a number of other conditions before a loss can be transferred from the target company to the transferee equity participant. For example: the target company must be an Australian resident company and not a prescribed dual resident (s. 995-1 ITAA 97 and s. 6(1) ITAA 36) in either the loss year or the deduction year (s. 170-35(1) ITAA 97), the transferee

allowed to transfer the tax loss to the transferee equity participant if there is a right, power or option under which a person can or would be able to affect the rights of the transferee equity participant in relation to the target company.⁹⁴ The loss transfer is not permitted where the transferee equity participant of the target company or the transferor equity participant has granted a third party an option to acquire its shares in the target company.⁹⁵

If a person is in a position to affect rights, in relation to the target company of either the transferee equity participant or a 100 percent subsidiary of the transferee equity participant, then the target company will not be a 100 percent subsidiary of the transferee equity participant.⁹⁶ Therefore, the tax-deferral benefit of tax losses could be lost.

A right of pre-emption in a shareholders' agreement could cause loss-transfer difficulties for the transferee equity participant: assume that equity participant A decides to sell 100 percent of the shares in the SPS (the *loss participant*) to another group company. The SPS owns 50 percent of the issued share capital of the SPV of an equity joint venture. A pre-emption clause in the shareholders' agreement allows equity participant B to pre-empt the sale. Equity participant B exercises its right of pre-emption. Pre-emptive rights most commonly require an equity participant who wishes to transfer its shares in the company and who has received an offer from a third party, to give the other equity participants an opportunity to acquire those shares on terms no less favourable than to the third-party offer.⁹⁷

Sections 975-150 and 975-505(2) of the ITAA 97 provide that if a person is in a position to effect rights of a loss participant in relation to another company because the person has a right, power or option to acquire those rights from one or other of those companies or to do something that would prevent one or other of those companies from exercising its rights for its

equity participant must be an Australian resident (s. 170-40(1) ITAA 97), the transferee equity participant requires a taxable income for the year of income in which the loss is to be transferred (s. 170-20 ITAA 97), the common ownership test must be satisfied (s. 170-30(2) ITAA 97) and formal requirements must be met (s. 170-50 ITAA 97).

⁹⁴ See ss. 975-150 and 975-505(2) ITAA 97.

⁹⁵ Sections 975-150(1) ITAA 97.

⁹⁶ Section 975-505(2) ITAA 97.

⁹⁷ Manning (1986), 122; Stedman and Jones, *Shareholders' Agreements*, (1986), 44; McCann (1990) states: 'A... joint venture agreement relating to the exploration and production of resources in Australia and in other jurisdictions will normally contain an agreement by each participant to give a right of first refusal or pre-emption over its interest in the joint venture in favour of the other participants.'

own benefit, or from receiving any benefit arising from having those rights, then those companies will not be 'group companies' and a right to transfer the loss will not exist. It is noteworthy that the statutory definition does not require that the right be proprietary in nature. Could a contractual right therefore trigger the operation of the provision?

If contractual rights suffice, then the contractual rights vested in equity participant B pursuant to the shareholders' agreement could be many in number. Any single contractual right in favour of participant B could thwart equity participant A's plans to sell its shareholding in SPS. Equity participant B could have rights to appoint nominated directors, to regulate certain special relationships arising between shareholders which are unconnected to the administration of the SPV, to protect minority rights conferred by the constitution and to place the SPV under an obligation to recognise certain rights and obligations of shareholders which it would not otherwise be obliged to.⁹⁸

A normal pre-emption provision in an equity joint venture for an Australian mining and petroleum project would not be in the nature of an option to purchase.⁹⁹ Only when a certain event happens would the holder of the right of pre-emption be entitled to buy and therefore be entitled to an equitable interest. Australian authority establishes that pre-emption clauses of themselves do not create an equitable interest in property held by the equity participants. The orthodox view established in *Mackay v Wilson*¹⁰⁰ was recently affirmed in *Pata Nominees v Durnsford*:¹⁰¹

...a right of pre-emption, so called, upon its construction may be a conditional option so that when the condition is satisfied there is a standing and by that time an unconditional offer to sell so that 'the holder of the right of pre-emption would be entitled to buy and therefore entitled to an equitable interest'. But for that to happen it would, I think, be necessary, as was the case in *Prichard v Briggs*... that the price and the other terms necessary to establish a completed contract to buy and sell be agreed upon and expressed within the provisions conferring the pre-emptive right. If that be the case, then it may be, the condition being

⁹⁸ Stedman and Jones, *Shareholders' Agreements*, (1986), 44.

⁹⁹ *Laybutt v Amoco Australia Pty Limited* (1974) 132 CLR 57, 70-76, per Gibbs J, which reviews the law relating to options to purchase.

¹⁰⁰ (1947) 47 SR(NSW) 315.

¹⁰¹ [1988] WAR 365; appld *Fightvision Pty Ltd v Tszu* (27/03/1998) SCNSW 50120/95.

satisfied, that the holder of the pre-emptive right could accept what has become the standing offer and so conclude an agreement that could be specifically enforced. But that is not this case. In this case, the right conferred was a right of refusal to purchase 'the said land at the price and upon the terms and conditions which the lessor shall stipulate as applicable to the sale'. So even if the lessor is desirous of selling so that the condition controlling the right is satisfied, there exists no offer which could, by acceptance, create a contract to buy and sell. It would be necessary first for the grantor to stipulate the price and the terms and the conditions. In other words, it would be necessary for the grantor first, in fact, to make an offer. Without that it would not be the case that the grantee would be 'entitled to buy'.¹⁰²

As there is no case law dealing specifically with the operation of s. 975-150, the provision may be usefully compared with its predecessor. Section 80G(2) of the ITAA 36 provided that for the purposes of the section,

a company... shall be taken to be the subsidiary of another company... during a period..., if:

...

- (b) there was no agreement, arrangement or understanding in force during any part of the relevant period by virtue of which any person was in a position, or would become in a position after the relevant period, to affect rights of the holding company or of a subsidiary of the holding company in relation to the subsidiary company.

Section 80G(4) went on to provide that:

[f]or the purposes subsection (2), a person shall be taken to be in a position during a year of income, or a part of a year of income, to affect any rights of a company in relation to another company if, during the year of income, or that part of the year of income, that person has a right, power or option (whether by virtue of any provision in the constituent document of either of those companies or by virtue of any agreement or instrument or otherwise) to acquire those rights or do an act or thing that would prevent the first-mentioned company from exercising those rights for its own benefit or receiving any benefits accruing by reason of those rights.

Neither ss. 80G(2)(b) nor 80G(4) prescribed the nature of the rights capable of being caught by s. 80G. In *Ruling IT 2465*, the Commissioner ruled that these sections of the ITAA 36 operated 'as a safeguard against the possibility of any collateral arrangement being used to

¹⁰²

Ibid, 372.

circumvent the shareholding test to establish common ownership'.¹⁰³

In that ruling, the Commissioner stated that a security arrangement made by a holding company, solely for the purposes of a genuine financing transaction, which does not affect the holding company's full beneficial interest in the shares in, and dividends paid by, the subsidiary company, would not be treated as requiring the application of s. 80G(2)(b) to deny a subsidiary relationship.¹⁰⁴ The Commissioner went on to state that he would need to be satisfied that the execution of the security arrangement is not intended to create a situation in which a financier could affect the right of a holding company to go on exercising its existing rights in the subsidiary company, unless an event of genuine default occurs. The implication is that if an event of default happens, a financier would have a power, right or option of a kind within s. 80G(2)(b):

[a] case in point is the granting by a holding company of a legal mortgage over the shares of a subsidiary company, such that the mortgagee is made the shareholder of the shares at company law. If the subsidiary company is to be treated as a subsidiary for s. 80G purposes, it will be necessary to show that it is not intended by the execution of the share mortgage:

- (i) to create a situation in which the security trustee, unless in the exercise of security powers where an event of default occurs, could prevent or vary in any way the right of the holding company to go on exercising its existing rights under the relevant shares in the subsidiary company; or
- (ii) to alter the incidence of taxation for either party from that which would have prevailed had the financial accommodation been secured by other than the legal mortgage.¹⁰⁵

The wide view is that the contractual rights of equity participant B constituted by the exercise of the right of pre-emption are not expressly excluded from the operation of s. 975-150, and therefore may be each a right, power or option to which the section refers. Pre-emptive rights in the nature of 'conditional options' would also seem to be caught by the section, because s. 975-150 does not discriminate between different types of options.

The narrow view is that the contractual rights and equitable interest will only ever be *rights*,

¹⁰³ Ruling IT 2465, para. 22.

¹⁰⁴ Ibid, para. 23.

¹⁰⁵ Ibid, para. 25.

powers or options of a kind recognised by s. 975-150 when they cause to disappear the safeguard against the possibility of any collateral arrangement being used to circumvent the shareholding test to establish common ownership.¹⁰⁶ This could conceivably be the case as a result of three factors: the dual character of the rights arising out of equity participant A's shareholding, the operation of the law of property applicable to assignments of proprietary rights and the law of contract applicable to the assignment of contractual rights arising out of in joint ventures.

The mechanism by which equity participant A could avoid difficulties of transferring its loss to another group company is a clause in the shareholder's agreement which permits a transfer of equity participant A's participating interest to a related company on condition that the participating interest is re-transferred to equity participant A or another related company if the original assignee ceases to be related to equity participant A.¹⁰⁷

The target company's compliance cost burden

Fiscal uncertainties and therefore compliance costs, could easily arise for a target company where the deductibility of prior year tax losses is at stake, where there is a change in the persons that held the majority underlying interests in the target company on 19 September 1985 or where the value of the CGT exempt assets of the target company, or any of its subsidiaries, has fallen below the 25 percent net value of the relevant threshold. Each of these circumstances will be considered, in turn.

Losing prior year tax losses

A transfer of shares in a target company can have immediate taxation consequences that may diminish its attractiveness to a transferee equity participant. Prima facie, if there is a change in the beneficial ownership of shares in the target company, and the shares confer on the owner either the right to exercise more than one-half of the voting power in that company, the right to receive more than one-half of any dividends that may be paid by the target company or the right to receive more than one-half of any distribution of capital of the target company, it will preclude the target company from being able to continue to carry forward both income tax

¹⁰⁶ *Ruling IT 2465*, para. 22.

¹⁰⁷ McCann (1990), 464.

and capital gains tax losses (the continuity of ownership test).¹⁰⁸

If, however, the target company continues to conduct the same business before and after the change in shareholding and does not enter into transactions of a kind it had not entered into before the change, the availability of income tax and capital gains tax losses for carry forward will not be lost (the same business test).¹⁰⁹ The requirements for meeting the continuity of business test are very strict.¹¹⁰ Accordingly, great care must be exercised by a transferee equity participant seeking to purchase a majority interest in a loss laden target company to ensure that the benefit of those tax losses are not lost.

The continuity of ownership test requires a determination that shares in the target company (the *loss participant*) carrying more than 50 percent of all voting, dividend and capital rights are beneficially owned at all times during the loss year and year of income by the same shareholders.¹¹¹ Each condition is cumulative, so that if the loss participant fails to satisfy one of them, the loss will be disallowed. This determination would involve a review of the loss participant's member's register. Unless there have been a great number of dealings in the relevant shares, it would be surprising if significant costs would be expended in order to make this determination.

If the loss participant is a proprietary company, it must satisfy the Commissioner that these requirements are met (compare public companies for which the Commissioner need only be satisfied that it is reasonable to assume compliance).¹¹² Notwithstanding that the continuity of ownership test could be satisfied, the ITAA 97 has a number of safeguards designed to prevent the carrying forward of losses in undesirable circumstances.¹¹³ For example, the Commissioner has discretion to treat a person (ie the transferee equity participant) as not being

¹⁰⁸ See s. 165-12 Subdiv 165-D ITAA 97.

¹⁰⁹ See s. 165-13 and Subdiv 165-E ITAA 97.

¹¹⁰ The same business test has been considered on many occasions by the courts: the result on the facts of the case and the test is strictly applied. For example, *Avondale Motors (Parts) Pty Ltd v FCT* (1971) 124 CLR 97 stands for the proposition that carrying on the same kind of business is not the same business and does not satisfy the test.

¹¹¹ Section 165-12 ITAA 97.

¹¹² Section 165-165(2) ITAA 97.

¹¹³ See, for example, ss. 165-12 and 165-15; Subdivs 175-A and 175-B ITAA 97.

a beneficial owner during the ownership test period if an arrangement was entered into that effected the beneficial interest in the shares for the purpose of reducing a tax liability.¹¹⁴

If a loss participant determines that it fails to meet the continuity of ownership test, it must then determine whether it satisfies the same business test.¹¹⁵ This will require an investigation of whether the continuity of ownership conditions are satisfied during the continuity period. The continuity period commences at the start of the loss year and finishes during or after the loss year due to a failure to satisfy the continuity conditions.¹¹⁶ The same business test will operate in respect of the business that a loss participant carried on immediately before the time when the continuity period ends. As well, the loss participant must satisfy the same business test for the whole of the income year.¹¹⁷

A determination of whether a loss participant is carrying on the same business post-acquisition as it was before is not always an easy matter. Such a determination involves an understanding of the concept of *identity* and not merely *similarity*.¹¹⁸ This does not mean identical in all respects. What is required is the continuation of the actual business carried on immediately before the change-over. Nevertheless, it will be insufficient if the business carried on by the target company after the change-over meets some industry-wide definition of the same kind. Nor would it be sufficient for there to be mere continuance of business operations before the change-over into the period of recoupment, if the business of the target company had so changed that it could no longer be described as the same business.

The same business test puts a limit on the type of expansion a loss participant may undertake if it is to retain the benefit of accumulated losses.¹¹⁹ Generally, the taxpayer may not engage in an undertaking or enterprise of a kind in which it did not engage before the change-over. A

¹¹⁴ Section 165-180(2) – (3) ITAA 97.

¹¹⁵ Sections 165-13 and 165-210 ITAA 97.

¹¹⁶ Section 165-13(2) and (3) ITAA 97.

¹¹⁷ Section 165-13(3) ITAA 97.

¹¹⁸ See *Avondale Motors (Parts) Pty Ltd v FCT* (1971) 124 CLR 97; *Ruling* TR 95/31 explains in detail the operation of the same business test for the previous provision s. 80E ITAA 36.

¹¹⁹ In *Fielder Downs (WA) Pty Ltd v FCT* (1979) 45 FLR 242, for example, the taxpayer argued unsuccessfully that the natural development of its business justified a decision that it carried on the same business as was carried on prior to the change in shareholding.

loss participant may incur costs in actively managing this.

Whilst it could be argued that such costs do not constitute costs that a loss participant is obliged to incur in complying with tax obligations and therefore they are not part of a loss participant's compliance costs,¹²⁰ that view is not shared by the author. Given the size and complexity of the activities of many of the taxpayers who use joint ventures as a business structure, it would be hard to accept that a transferee equity participant would not factor in the value of the loss participant's prior year losses in calculating its bid price for the shares. Moreover, the sophistication of the taxpayers involved blurs the line between avoidable and unavoidable compliance costs, so it would be extremely difficult to consistently distinguish activities and costs related to retain the benefit of accumulated losses from those related to satisfying the compliance demands of the tax system. In accordance with research conducted by Evans on compliance costs, therefore, avoidable compliance costs of loss participants to retain the benefit of accumulated losses are compliance costs.¹²¹

Freshening-up pre-CGT assets

If a target company has assets with capital gains tax exempt status (ie shares in subsidiary companies and assets held by those subsidiaries), there is a risk that such status may be lost when the persons holding the majority underlying interests in the target company change. If those assets stop being pre-CGT assets, then a target company should take steps to become aware of this.¹²² In this context, 'majority underlying interests' mean more than one half of the beneficial interests held by natural persons either directly or indirectly in both the target company and the income from the target company.

Unlike the carry forward of loss provisions, where it is necessary to look at the ownership of the company immediately before and after the acquisition of the shares by the transferee equity participant, Div 149 requires a transferee equity participant to undertake a study of all ownership changes in the target company since 19 September 1985 to determine whether the majority underlying interest provisions will be triggered by the acquisition of shares by the

¹²⁰ Evans, *A Report into Taxpayer Costs of Compliance*, (1997), 3.

¹²¹ Id.

¹²² The reason is that if a target company's shares stop being pre-CGT assets, then a subsequent disposal by the target company of those assets may attract a capital gain, which might be liable to taxation.

transferee equity participant.

The loss of capital gains tax exempt status will not give rise to an immediate compliance cost for the target company. The previously exempt assets are deemed to have been acquired by the target company on the day that their exempt status is lost with an initial cost base of their then fair market value. It is only a subsequent disposal of those previously exempt assets that may give rise to an assessable capital gain or a deductible capital loss. If it is prudent for a transferee equity participant to obtain a fair market valuation of all assets to establish the cost base for a later sale, these costs would form part of a transferee equity participant's compliance cost bill.

For example, assume in Figure 2.4 that SPV acquired an appreciating asset (an oil rig), before 20 September 1985. At that time and up to and including 19 September 1985, SPS 1, SPS 2 and the Australian Subsidiary owned all the issued shares in SPV in equal proportions. Accordingly, the shares in SPV and the oil rig are pre-CGT assets. In 1999, SPS 1 and SPS 2 sell all their shares in SPV to Z Pty Ltd.¹²³ The shares acquired by Z are subject to capital gains tax, but the oil rig is a pre-CGT asset. In 2000, Z decides to realise the capital gain on the rig. If Z sells its shares in SPV, then a capital gains tax liability will arise. Conversely, if Z and Australian Subsidiary arrange for SPV to sell the oil rig, then in the absence of Div 149, the sale by SPV of the oil rig would be a disposal of a pre-CGT asset and no capital gains tax liability would arise, notwithstanding more than 50 percent of the beneficial ownership of the shares in SPV has changed after 19 September 1985.

It is noted that the predecessor provision to s. 149-30,¹²⁴ as interpreted by *Ruling IT 2530*, provides that where a change of 50 percent or more occurs in the underlying ownership of assets in the target company, s. 149-30 would operate to deem the assets of the target company which were acquired before 20 September 1985 to have been acquired after that date.¹²⁵ It follows that where natural persons who, immediately before 20 September 1985, held more than one half of the underlying interests in an asset, continue to hold more than one half of the underlying interests at all times on and after that date, there will be no change in the majority

¹²³ See Figure 2.4.

¹²⁴ Section 160ZZS ITAA 36.

¹²⁵ *Ruling IT 2530*, para. 6.

underlying interests in the asset for the purposes of s. 149-30.¹²⁶

The effect of s. 149-30(1) is that a change in the majority underlying ownership will be to change the deemed date of acquisition of the asset to the target company to the date of the change in shareholding. The consideration for the acquisition is the market value of the asset at the time of the disqualifying event.¹²⁷ The determination of market value is a complex issue.¹²⁸

In *Ruling* TR 99/4, the Commissioner has stated his views about when he will exercise his discretionary powers under s. 149-70(3) of the ITAA 97. Obviously, some target companies will be more inclined to request the Commissioner to exercise his discretion than others. If a target company makes such a request, then it will incur costs in doing this. Section 149-70(3) gives discretionary powers to the Commissioner to help to overcome the difficulties some taxpayers may face in tracing the holders of underlying interests. If a transferor equity participant that is a 'public entity' (as defined in the ITAA 36 but no similar term is contained in the ITAA 97) determines under ss. 149-55(1) and 149-60 that the same natural persons did not hold the majority underlying interests in a pre-CGT asset at the starting day and at a test day, the effect of s. 149-70(3) is that that determination is disregarded if the Commissioner is satisfied, or considers it reasonable to assume, the same natural persons did hold the majority underlying interests at both times. Section 149-55 describes the meaning of a 'test days' and s. 149-60 explains the meaning of 'starting day'.

The Commissioner states in the ruling that this could occur, for example, if a target company cannot fully trace through its shares to natural persons but can otherwise demonstrate that it would be reasonable for the Commissioner to assume the same natural persons had continued to hold the majority underlying interests in the target company's pre-CGT assets.

When asking the Commissioner to exercise the discretion under s. 149-70(3), a target company should state in detail the grounds for the application, and include all information that might indicate the same natural persons have or have not continued to hold certain underlying interests and all information that could assist in making assumptions about the extent to which

¹²⁶ Ibid, para. 10.

¹²⁷ Section 149-35 ITAA 97.

¹²⁸ See *AAT Case 7529* (1991) 22 ATR 3532; *Barnsdall v FCT* (1988) 19 ATR 1352.

underlying interests have or have not continued to be held by the same natural persons.¹²⁹

The matters the Commissioner takes into account in deciding whether to exercise the discretion in s. 149-70(3) in favour of a target company that is a public entity (as defined in the ITAA 36 because there is no similar term in the ITAA 97) are prescribed in the ruling, and include the time that has elapsed between the starting day and the test day, the extent of trading in, or creation and cancellation of, shares or other membership interests of the target company, known changes in underlying interests and the extent of the underlying interests that have been shown not to have changed, known changes in registered interests in the entity and the extent of the registered interests known not to have changed.¹³⁰ The Commissioner did not rule in *Ruling* TR 99/4 that he would exercise the discretion in s. 149-70(3) in favour of all taxpayers to which the provision applies.

In making a case for consideration under s. 149-70(3), a target company that is a public company may ask the Commissioner to rely on the special tracing rules and, where relevant, on the concession set out in the ruling.¹³¹ If the Commissioner is satisfied, or considers it reasonable to assume, from the information supplied, the same natural persons held the majority underlying interests in a pre-CGT asset of the target company at the starting day and at the test day, no further analysis is necessary of changes in individual interests.

Section 149-30 is mandatory and it is mandatory in a rather unusual way. It provides that an asset, which is acquired by the taxpayer before 20 September 1985, shall stop being a pre-CGT asset when certain conditions have been met. In other words, all taxpayers are deemed to have acquired all their assets after the relevant date unless the qualification applies. This aspect is frequently overlooked and it is often incorrectly assumed that the section will only apply if the Commissioner is satisfied that there has been a change in the majority underlying interest.¹³²

Secondly, there is the administrative burden (and its associated compliance cost) that an entity

¹²⁹ *Ruling* TR 99/4, para. 15.

¹³⁰ *Ibid.*, para. 16.

¹³¹ *Ibid.*, paras. 19 - 20.

¹³² Compare ss. 149-30(1) and (2) ITAA 97.

to which Subdiv 149-C of Pt 3-1 applies, is required to periodically test on prescribed dates whether there has been a change in majority underlying interests to determine whether its assets still have the same majority underlying ownership.¹³³

Potential application of section 104-230

The potential application of section 104-230 is also important to the target company. Section 104-230 of the ITAA 97 is designed to tackle the problem that in many respects is the reverse to that which is covered by s. 149-30. Section 104-230 is intended to stop taxpayers from using a target company acquired before 20 September 1985 'to confer an artificial exempt status on assets actually acquired on or after 20 September 1985'.¹³⁴

For example, assume in Figure 2.4 that up to and including 19 September 1985, SPS 1, SPS 2 and the Australian Subsidiary owned all the issued shares in SPV in equal proportions. SPV acquired an appreciating asset (an oil rig), in 1998. Accordingly, the shares in SPV are pre-CGT assets and the oil rig is a post-CGT asset. In 2000, SPS 1, SPS 2 and Australian Subsidiary decide to sell the oil rig because they have found a buyer who is willing to pay a high price (Z Pty Ltd). Rather than sell the oil rig to Z (thereby potentially giving rise to a capital gain to SPV), the transferor equity participants sell their shares in SPV to Z. In the absence of a provision such as s. 104-230, the transferor equity participants could dispose of their shares in SPV (and therefore the underlying assets of SPV) without incurring a capital gains tax liability.

If there is a change in ownership of more than one-half of the shares in the target company, the target company must determine whether this constitutes a disqualifying event. If it constitutes a disqualifying event under Subdiv 165-B, the result is that the benefit of any revenue losses and capital losses otherwise arising to the target company or its subsidiaries in that year will be lost, unless the tests described above are satisfied. This may well be an unintended result of the complex drafting of the ITAA 97 and probably will be of little consequence in practice. The same provisions will technically deny any income loss incurred by any subsidiary of the target company being available for transfer to the target company or other wholly-owned subsidiaries of the target company in the year the disqualifying event occurs.

¹³³ Section 149-55 ITAA 97.

Section 104-230 addresses this problem by providing that a capital gain in relation to CGT event K6 arises in relation to the disposal of the shares, the capital gain being the difference between the capital proceeds from the shares that is reasonably attributable to the market value of property disposed of and the cost bases of that property.¹³⁵ This will ensure that the capital gain - which would have arisen had the underlying asset been disposed of at the time of the disposal - will be assessed to the shareholders of the target company at the time that the shares are disposed of.¹³⁶

Two observations can be made in relation to this provision. First, the application of this provision is contingent on the application of the 75 percent rule.¹³⁷ The effect of that provision is that the section will not operate unless the market value of interests the target company owned through interposed companies in property that was acquired on or after 20 September 1985 is at least 75 percent of the net value¹³⁸ of the transferor equity participant. Therefore, if it is proposed that a company, the shares of which are owned by a target company who acquired those shares prior to 20 September 1985, wishes to purchase an asset on or after that date it might be advisable to introduce further capital into the company so that the company could be assured of being in a net value position in which the underlying post-20 September 1985 assets do not constitute more than 75 percent of that net value. The time at which this calculation is to be done is 'just before the other event happens'¹³⁹ (ie just before the share transfer). Therefore, although the acquired asset may not exceed 75 percent of the net value of the target company at the time of acquisition, if the asset is one which is likely to appreciate in value to any significant degree a recalculation may need to be done at the relevant time to ensure that s. 104-230 is not triggered.

Secondly, the interaction of ss. 149-30 and 104-230 could have a rather unusual result in that a change in majority underlying interests could trigger a new acquisition date in relation to

¹³⁴ Woellner, *Australian Taxation Law*, (1998), para.11-630.

¹³⁵ Section 104-230(6) ITAA 97.

¹³⁶ Section 104-230(5) ITAA 97.

¹³⁷ See s. 104-230(2)(b) ITAA 97.

¹³⁸ Net value is defined by s. 995-1 ITAA 97 to mean the amount by which the sum of the market values of the assets of the entity exceeds the sum of its liabilities.

¹³⁹ Section 104-230(2) ITAA 97.

underlying property and if that then flowed through to s. 104-230, a shareholder who still held pre-September 1985 shares in the target company could on sale of its shares trigger a s. 104-230 result with a capital gain being taken to have accrued to that shareholder. This would be an inequitable result since that shareholder may not have triggered the change in the majority underlying interest that gave rise to the application of s. 149-30. The Commissioner has recognised this point in *Ruling IT 2363* that the application of the predecessor provision to s. 149-30 to a target company or other taxpayer in relation to its assets is limited for the purpose of defining the capital gains tax provision to that taxpayer. However, *Ruling IT 2363* was issued over ten years before the enactment of the ITAA 97¹⁴⁰ and dealt with ss. 160ZZS and 160ZZT, which operate differently from their corresponding provisions of the ITAA 97 so it has to be questioned whether the ruling will now apply. If it does reflect the Commissioner's current views about the provisions of the ITAA 97, then where by an application of s. 149-30 an asset is taken to have been acquired by a target company after 19 September 1985, that fact does not require the asset also to be treated as one acquired after that date for the purposes of the application of s. 104-230 in relation to another taxpayer (a shareholder) on disposal of the shares by the shareholder.

COMPLIANCE COSTS OF INDEPENDENT OPERATIONS

There will be instances during the term of some unincorporated joint ventures when it will be in the interests of individual participants for some but not all of the participants to proceed with operations independent from those conducted by the joint venture.¹⁴¹ For instance, some but not all participants may be convinced that a proposed operation will produce a positive financial outcome, either because of their own work¹⁴² or work conducted by the operator.¹⁴³ A participant may, due to pre-existing capital commitments or ranking of opportunities, have cash flow constraints and, while still being optimistic as to the potential financial upside of the proposed operation, be unable to fund, either in part or in full, its share of the work

¹⁴⁰ *Ruling IT 2363* was issued on 18 September 1986.

¹⁴¹ Waite (1986), 186.

¹⁴² See, for example, the sole risk provisions in Article 7, *AIPN Model Form International Operating Agreement* (1995).

¹⁴³ Gibson (1993).

programme.¹⁴⁴

Sole risk and non-consent clauses are often found in petroleum exploration JVAs.¹⁴⁵ Before examining the compliance costs of taxing gains and recognising expenditures for independent operations, it is necessary to distinguish between two different forms of independent operations, namely, non-consent and sole-risk programmes.

Non-consent programmes

A non-consent provision in a JVA describes the contractual right of a participant not to participate in all (or part) of a programme or operations, which has been proposed by the operator as a common activity for the venture, which has been voted upon by the participants and which has received the affirmative vote of less than all the participants but a vote of sufficient majority to ensure that the programme or operations will nevertheless proceed as a joint venture activity (the *consenting participants*).¹⁴⁶

If a participant elects not to participate in an independent programme (the *minority participant*), then the JVA may stipulate a number of consequences to flow from this.¹⁴⁷ The tax consequences of an 'acreage penalty' will be outlined in this section of the chapter.

Sole risk programmes

Sole risk is different from non-consent. A sole risk provision has been described as enabling:

one party to proceed with exploration, or certain other work, at its own risk, when the other parties elect not to participant. The sole risk party carries out the exploration, or other work, at its own cost. If the exploration, or other work, is successful, the non-participating parties can join back in, and share with the benefits. But if they do this, the non-participating parties pay, in cash or in kind, a premium, so as to reward the sole risk party for taking the initial risks. If the exploration, or other work, is unsuccessful, the sole risk party is unable to seek payment from the non-

¹⁴⁴ Id; McArthur (1997), 666.

¹⁴⁵ Manning (1994), 306.

¹⁴⁶ Waite (1986), 186; Manning (1994), 306.

¹⁴⁷ See the types of penalties outlined by Waite (1986), 189; Manning (1994), 306-307.

participating parties.¹⁴⁸

Manning suggests that in Australia sole risk provisions are more common than non-consent provisions because participants regard the latter as a 'soft option' to 'sit back and see' if a programme or operation is successful.¹⁴⁹ The view has previously been expressed that:

... the question of whether there should be sole risk, or non-consent provisions as such is basically a matter of the commercial deal which is struck between the parties. There is, I believe, no particular aspect of either type of activity which inexorably pushes one into adopting non-consent instead of sole risk provisions for independent mineral exploration and development operations.¹⁵⁰

In minerals joint ventures, there is usually no provision for sole risk.¹⁵¹ Accordingly, this section of the chapter is concerned with sole risk operations in petroleum joint ventures.

The performance of a sole risk operation per se does not alter the participating interest of the non-sole risk participants in the unincorporated joint venture: their participating interests remain unaltered, but become subject to additional rights and obligations in respect of the sole risk operation.¹⁵² One consequence to a non-sole risk participant is that, if it fails to elect to join in the subsequent programme arising out of the sole risk programme, it loses its interest in the sole risk area (ie its interest is diluted).¹⁵³ This raises a number of compliance cost implications, which are considered below.

Compliance costs of acreage penalties

A minority participant may lose its proprietary interest in a geographical part of the joint venture tenement area either in the form of surface area or sub-surface depth because of the relevant independent operation in which it elected not to participate.¹⁵⁴ This scenario is a

¹⁴⁸ Ryan (1983).

¹⁴⁹ Manning (1994), 306.

¹⁵⁰ Nicholls (1980), 42.

¹⁵¹ Saville (1986), 229.

¹⁵² Ryan (1983), 277.

¹⁵³ Manning (1994), 306; Ryan (1983), 277.

¹⁵⁴ Waite (1986), 190.

'carve out' because the participating interest of the minority participant is diminished and will be available to the benefit of the participants which have consented to the operations.¹⁵⁵

Where the consenting participants have assumed the working interest obligations of the minority participant relative to the property or an interest in the property disposed of by the minority participant, but have made no payment for the acquisition of that property or interest, s. 330-480 of the ITAA 97 will apply.

If s. 330-480 applies, then the participant whose ownership has changed is taken, for the purposes of the section, to have disposed of that part of property and the written down value of the property is calculated on the basis of the percentage interest disposed of. This disposal must therefore be accounted for in the minority participant's income tax return in the relevant year of income.

However, s. 330-480 will not apply if s. 330-520 applies to the change. A minority participant must determine whether or not s. 330-520 applies. Section 330-520 will not apply to unincorporated joint ventures which are not 'partnerships', as defined in the ITAA 97.¹⁵⁶ Therefore, if characterisation risk is not a significant issue for a minority participant, it will be a simple matter for a minority participant to determine the application of the provision. But if characterisation risk is a significant issue for a minority participant, the obligation to determine whether or not the provision applies is much more difficult. It is possible that the cost of making a determination in such circumstances would include in-house tax advisor costs and given the seriousness of the issues involved, external legal advisor costs, even barrister's fees.

If s. 330-480(6) is to be applied, then s. 330-480(1) would operate. Where the termination value of the property exceeds the property's written down value (that is, the total capital expenditure on the property less deductions previously allowed), the amount of the excess (up to the amount of the deductions) must be included in the taxpayer's assessable income.¹⁵⁷

¹⁵⁵ Id.

¹⁵⁶ Section 330-520 ITAA 97 is confined to a situation involving a change in the ownership of, or in interests of persons in property because a partnership is formed or dissolved or because the constitution of a partnership or the interests of partners are varied: s. 330-520(1)(b)(ii) ITAA 97.

¹⁵⁷ Section 330-485(2) ITAA 97.

Conversely, if the termination value¹⁵⁸ is less than the written down value, then the different is an allowable deduction.¹⁵⁹

If a minority participant elects under s. 330-40(1) to have the normal depreciation provisions of Div. 42 ('Depreciation of plant'), rather than having the cost deducted as exploration expenditure under s. 330-15, then similar balancing charge considerations will arise under common rule 1 ('Roll-over relief for related entities')¹⁶⁰ as modified by s. 41-23.

Clearly, the lending risk for a financier advancing funds to a participant in these circumstances is obvious. Financiers will almost certainly require security over their borrower's interest in the tenement as a legal holder. It can be expected that the financiers would require a covenant against assignment of, or the creation of a trust with respect to, a sub-area of the tenement, at least without their prior consent.¹⁶¹ Financiers' involvement in financing a joint venture could give rise to characterisation risk.¹⁶²

Compliance costs of dilutions of interests

We saw earlier that a non-sole risk participant might have its interest diluted for electing not to participate in a sole risk venture. Although dilution clauses are almost always never the same,¹⁶³ such clauses take effect by reducing the interest of a non-sole risk participant.¹⁶⁴

In general terms, though, the compliance cost issues of dilution would be as in the acreage penalty example. If the sole risk operation is 'successful'¹⁶⁵ then the JVA might provide the

¹⁵⁸ The termination value of the property is defined in s. 330-490 ITAA 97 as the price for which the property was sold, or its market value (if the property was disposed of other than by sale or ceased being used for qualifying purposes), or the insurance proceeds of the amount otherwise received for the loss or destruction of the property, or a reasonable amount (if the property was not owned by the taxpayer and ceased being used primarily and principally for mining or quarrying transport).

¹⁵⁹ Section 330-485(3) ITAA 97.

¹⁶⁰ Section 41-15 ITAA 97.

¹⁶¹ Waite (1986), 195.

¹⁶² See chapter 3.

¹⁶³ Macdonald (1983), 217.

¹⁶⁴ Id.

¹⁶⁵ Refer Saville (1986), 234 for the discussion about the meaning of 'success'.

non-sole risk participants with an opportunity to participate in the sole risk operations (ie buy back), but after rewarding the sole risk participants for taking the risk.¹⁶⁶ The sole risk participants engaged in drilling operations would probably have incurred capital and revenue expenditure, and thereby would have deducted or be entitled to deduct losses or outgoings in the nature of exploration and prospecting expenditure¹⁶⁷ or allowable capital expenditure,¹⁶⁸ depreciation¹⁶⁹ and other general business deductions.¹⁷⁰

Assuming the buy back payment is to be met by the non-sole risk participants (the *incoming participants*) through foregone production on their part, the sole risk participant will incur compliance costs to determine the characterisation of the proceeds of sale from the portion of foregone production as ordinary income, or profit from a profit-making undertaking or plan pursuant or a disposal of trading stock, or as a capital receipt.

If the cash flow/tax value methodology is introduced, such a characterisation will no longer be required. Accordingly, a sole risk participant's compliance costs could be expected to decrease by an amount equal to the cost of making such a characterisation.

The questions for the incoming non-participants relate to the extent to which expenditure incurred by the sole risk participants is deductible to them under Subdiv 330-E of the ITAA 97.

Whether the buy back premium constitutes assessable income or an allowable deduction (as the case may be) ultimately will depend on the circumstances of each particular case and the particular wording used in the sole risk clause.

¹⁶⁶ Manning (1994), 307.

¹⁶⁷ Section 330-15 ITAA 97.

¹⁶⁸ Section 330-80 ITAA 97.

¹⁶⁹ Section 42-15 ITAA 97.

¹⁷⁰ Section 8-1(1) ITAA 97.

TOLLING COMPANIES AND THEIR TAXATION FEATURES

Participants seeking to combine selected characteristics of unincorporated joint ventures and equity joint ventures can do so through the use of a tolling company. Participants establish tolling companies to build, own and operate production facilities at which the raw materials owned by the participants in the joint venture will be processed into finished product for use or disposal by the participants individually. Tolling companies which carry on business for ITAA 97 purposes transfer or 'toll' their allowable deductions to the participants via a 'tolling charge'. Tolling charges are unique to tolling companies. Each year, tolling companies charge the participants a processing or tolling charge equal to their allowable deductions for that year: tolling companies are flow-through entities.

This chapter critically examines the taxation characteristics (including compliance costs features) of tolling companies and compares them to those of unincorporated joint ventures and equity joint ventures.¹ It is argued that whilst tolling companies facilitate fiscal benefits for participants by transferring the incidence of tax in respect of a business activity to them, the compliance costs of reaping these fiscal benefits may not be insignificant.

NATURE OF TOLLING COMPANIES - A COMPARATIVE ANALYSIS

The expression 'tolling company' is neither known to the Australian common law nor defined in the ITAA 97 or the ITAA 36. Figure 6.1 usefully illustrates the interrelation of the participants to the tolling company and to the financiers. The operation of a tolling company structure can be illustrated by a simplified example based on Figure 6.1.

Assume that a tolling company, which operates a gold refining plant, is owned 50 percent by Participant A, 25 percent by Participant B and 25 percent by Participant C. Participant A provides the tolling company with raw materials, Participant B provides technology and Participant C provides financial and general management services. In the 1999-00 year of

¹ Unless otherwise stated, it is assumed in this chapter that participants are Australian resident corporations.

income, tolling company A incurs \$150 million of tax deductible expenditure (gold-refining costs, depreciation on plant, running costs etc). Pursuant to a tolling agreement, tolling company A charges Participants A, B and C a tolling fee in aggregate of \$150 million in consideration for tolling company A refining gold during the year.

A tolling company arrangement allows its participants to fund expensive capital works necessary for the refinement, transportation or conversion of raw materials extracted by the joint venture into a finished product for sale. An example of a tolling arrangement is the Portland Aluminium Smelter in Victoria, Australia, where bauxite is converted into aluminium ingots on behalf of the participants.² A tolling company is a hybrid creature - governed both by statute law (the *Corporations Law*) and by contract. Tolling arrangements are said to have originated from techniques devised to deal with pipeline throughput contracts in the United States.³ Pipeline throughput contracts deal with the terms and conditions on which the gas supplier will supply gas to the other party. The first known adoption of the tolling company concept in Australia was by a consortium of aluminium companies which built an alumina refinery at Gladstone, Queensland in the 1960s.⁴ An aluminium smelter has also been established using a tolling company structure⁵ at Boyne Island, Queensland. More recently, tolling companies have been utilised in the gold refining,⁶ petroleum,⁷ electrodes and other solid graphite products industries.⁸

² Fahey (1990), 48.

³ Armstrong (1982), 400.

⁴ Queensland Alumina Limited (QAL) is a tolling company which operates the world's largest alumina refinery on behalf of its participants (*Queensland Alumina Limited* - Comalco Limited, Kaiser Alumina Australia Corporation, Aluminium Pechiney Australia Pty Ltd and Alcan Queensland Pty Ltd): refer Armstrong (1984), 400.

⁵ *Boyne Smelters Limited* - Comalco Aluminium Limited, Kaiser Alumina Australia Corporation, SLM Australia Pty. Limited, Kobe Aluminium (Australia) Pty. Limited and Sumitomo Aluminium Smelting (Australia) Pty. Limited: see Armstrong (1982), 40.

⁶ Company Prospectus on CD-Rom V.2.01, Lihir Gold Limited, 1995, Section 5 ('Selected Financial Data').

⁷ Ibid, Novas Petroleum, 1995, Section 1 ('The Company' and 'The Business'); Tap Oil NL, 1996 ('Summary of The Offer').

⁸ Ibid, Asian Energy Limited, 1995 (Withdrawn), Section 5 ('Investment Overview'). Tolling companies could conceivably be used in timber processing operations: 'Timber joint venture may provide resolution to RFA row', *ABC News*, 6 July 1999, abc.net.au/news/regionals/sunshine/regsun-6jul1999-5.html.

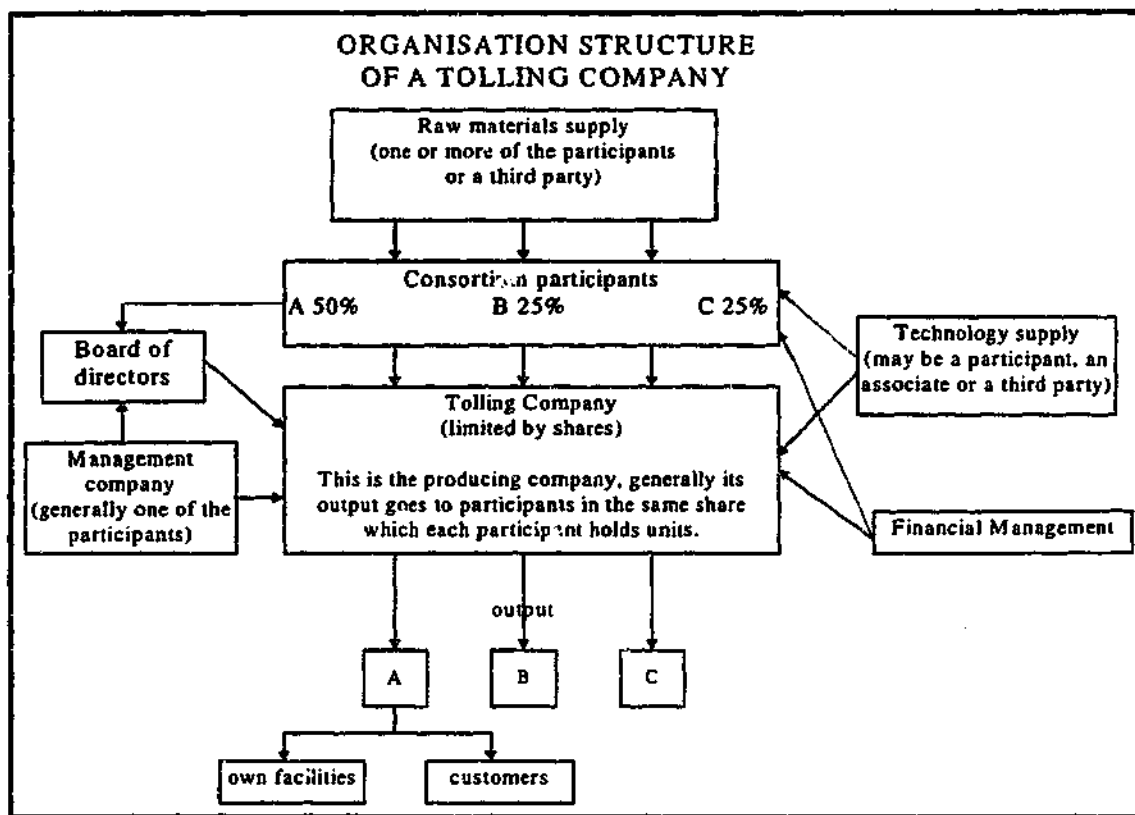


Figure 6.1: Simplified Organisation Structure of a Tolling Company⁹

The constituent documents

Participants of tolling companies incur costs in negotiating and preparing a tolling company's constituent documents. These documents are necessary to create a tolling company structure. If it is assumed that a taxpayer will incur a flat fee to negotiate and prepare a contract, then the costs for a taxpayer establishing a tolling company structure might well be higher than for establishing an unincorporated joint venture or equity joint venture, because more contracts must be executed for tolling companies than for the other two joint venture structures. The components of such a flat fee may include management effort, in-house tax advisor labour costs, external lawyers' fees and technical advisor costs.

Constituent documents are governed principally by a memorandum and constitution, participants agreement, tolling agreement and principal raw material supply agreements.

⁹

Reproduced from Armstrong (1982), Appendix 1.

There may also be other agreements.¹⁰ The voluminous documentation requirements of tolling companies suggest that documenting unincorporated joint ventures is simpler, and probably cheaper.¹¹

It has been said that the constitution of a tolling company could contain provisions for preference shares.¹² If so, then a tolling company would either correspond to a participant or equity participant or their specially incorporated financing company (a SPFC or SPV, respectively) which issues preference shares to the financier.¹³ To that extent, a tolling company will be subject to the same income tax consequences. A constitution is required for equity joint ventures¹⁴ but not for unincorporated joint ventures (because the latter has no separate legal personality).¹⁵

Participants agreement

The participants agreement is the core agreement. It defines the rights and obligations between the participants and the tolling company and between the participants *inter se*. This contract covers matters relevant to the establishment and limited role of the tolling company, its operation during the term of the agreement, the consequences and effects of the withdrawal or removal of any of the participants from the venture, the shareholding structure of the tolling company and, generally, restricting its use for the benefit of the participants only.¹⁶ By analogy, JVAs perform a similar role for unincorporated joint ventures and shareholders' agreements perform a similar role for equity joint ventures, subject to appropriate modifications¹⁷ to take into account the peculiar aspects of each type of joint venture structure.

¹⁰ For example, an expansion agreement, a management agreement, technology agreement and financing or loan agreements required in organising and providing the construction and working capital finance for the project.

¹¹ Blanshard (1982), 420.

¹² Armstrong (1982), 402.

¹³ Factors in the taxation of preference shares in the joint venture context are considered in chapter 3.

¹⁴ Refer chapter 2.

¹⁵ Although participants which are *corporations* would have a memoranda and articles of association, too.

¹⁶ Armstrong (1982), 403; Blanshard (1982), 421.

¹⁷ For unincorporated joint ventures, see Merralls (1988), 912; for equity joint ventures, see Stedman and Jones, *Shareholders' Agreements*, (1986), 168.

Tolling agreement

Tolling agreements exhibit similarities to shareholders' agreements. Both are entered into between each of the participants and their special purpose vehicle (ie a tolling company or SPV). Their operation is similar to agreements utilised by both unincorporated joint ventures and equity joint ventures. Tolling agreements prescribe the rights and obligations of participants relating to tolling (or processing) of the basic raw material into the finished product.¹⁸ As with the SPV of an equity joint venture, the tolling company owns the plant and equipment required in order to process raw materials into finished products and, as owner, is entitled to claim allowable deductions in respect of plant and articles.¹⁹

It will be seen later in this chapter however, that because of the imposition of tolling fees, the *benefit* of the depreciation deductions for plant and articles in the tolling structure ultimately lies with the participants. This unique feature of tolling companies distinguishes them from the equity joint ventures. Unincorporated joint ventures produce the same result as in tolling company structures, but for a different reason. In the latter case, the individual owners are entitled to deductions for depreciation in respect of their separate percentage interests in the plant and articles as of right²⁰ because of the proprietary rights of each individual participant in the assets of the unincorporated joint venture as a tenant in common.²¹ Therefore, unincorporated joint ventures involve no separation of ownership and control of the assets, whereas such separation is a feature of tolling companies.

In consideration for the services which the tolling company provides to the participants, the tolling company charges the participants a service or process fee.²² This is known as a *tolling charge* and this is discussed at length later in this chapter. The tolling charge is functionally different to the payment of cash calls (ie invoices issued by the tolling company to meet its cash needs) by participants of unincorporated joint ventures to the operator. In the latter case, the payment by each participant is designed to reimburse the operator for expenditure incurred

¹⁸ Armstrong (1982), 404; cf Blanshard (1982), 421.

¹⁹ Section 42-15(a) ITAA 97; Blanshard (1982), 421.

²⁰ See chapter 2.

²¹ Davies (1983), 44.

²² Armstrong (1982), 404.

by the operator on behalf of the participants. A tolling charge transfers the benefit of allowable deductions from the tolling company to the participant.

Principal raw material supply agreement

Pursuant to a principal raw material supply agreement, each of the participants severally contracts with the tolling company to provide the basic raw material to the tolling company, for processing at the production facilities. The sale of raw materials by a participant to the tolling company involves an acquisition of trading stock²³ by the tolling company and the tax features of this will be considered shortly. Where one of the participants is a producer of the basic raw material it would generally be the supplier under separate contracts with each of the other participants.²⁴ If more than one participant is in this position, they could each supply the raw material (as appropriate).

Nature of interests of the participants

The nature of the interests of participants in tolling company arrangements is very similar to the nature of the interests of equity participants in an equity joint venture. There are similarities to unincorporated joint ventures as well. As with equity joint ventures, a participant's interests in a tolling company consist of a complex hybrid of contractual rights and share ownership of the issued capital of the tolling company. Participants of unincorporated joint ventures have contractual rights in the JVA, but also possess proprietary rights over the assets of the venture, which participants of tolling company arrangements do not possess.²⁵

Ownership of inputs of the production process

Ownership of the inputs of the production process is similar to equity joint ventures, but not identical. In equity joint ventures, unless the equity participants sell the raw material to the SPV, the SPV will own the inputs of the production process at all stages of production before the finished product is eventually sold to equity participants or to third parties. The treatment

²³ 'Trading Stock' is defined inclusively in s. 70-10 ITAA 97; Blanshard (1982), 419.

²⁴ Armstrong (1982), 406.

²⁵ See chapter 2.

of trading stock for participants of unincorporated joint ventures is different again.²⁶ The tolling company acquires the raw material provided to it by one or more participants. All production is taken by the participants in specie (as with unincorporated joint ventures) and controlled by the participants who are committed to provide the raw materials at a given rate, without interruption, and to take the product on a 'take-or-pay' basis, under raw material purchase contracts.

A 'take-or-pay' provision assumes that ownership of the work in progress and finished product lies with the tolling company until tolled to the participants. A take-or-pay clause in a purchase contract has been described as requiring the purchaser to take, or (failing to take) to pay for a minimum volume of finished product which the producer-seller has available for delivery.²⁷ For instance, suppose that three participants have incorporated a tolling company 'T' to smelt alumina into aluminium and have each entered into a tolling agreement with T to construct smelting facilities. Each participant enters into a take-or-pay contract with T to purchase minimum quantities of aluminium, or, failing to take, to pay prescribed fees. T establishes a long-term financing facility. Proceeds of the loan are used to construct the smelting operation. The participants each meet their take-or-pay payment obligations so that T, in turn, can service its debt obligations to the financier.

Explanations of the economic rationales of long-term take-or-pay contracts contend that these agreements are a 'rational response to specific industry characteristics'.²⁸ It is not entirely clear what that phrase is intended to convey, but presumably it refers to specific industry problems. One commentator suggests that this is primarily because the production, transportation and distribution of finished product involves the use of capital, which is useful only as long as the transaction that motivates its investment continue to take place.²⁹ Such capital is known as transaction-specific or relationship-specific capital.³⁰ Without sales, the

²⁶ See chapter 2 for a detailed discussion of trading stock issues facing unincorporated joint ventures.

²⁷ Williams and Meyers, *Williams and Meyers Manual of Oil and Gas Terms*, (1997), 1070; Sullivan, *Financing Transnational Projects*, (1988) 7-13[1]. This definition was discussed in *Williamson v Elf Aquitaine*, 925 F. Supp. 1163 (N.D. Miss. 1996) and *Thomas Well Service, Inc. v Williams Natural Gas*, 873 F. Supp. 474, 477; Ricker (1982), 429.

²⁸ See generally Mulherin (1986); Hubbard (1987); Canes (1985).

²⁹ Industry Commission, *Study into the Australian Gas Industry*, (1995), 239.

³⁰ *Id.*

tolling company obtains reward for its services by levying a tolling charge or fee sufficient to cover its tax deductible costs.³¹

As tolling companies carry on business for ITAA 97 purposes, costs incurred by the tolling company in purchasing raw materials are allowed as a deduction pursuant to s. 8-1(1) of the ITAA 97.³² The participants are not entitled to allowable deductions incurred by the tolling company. The participants must first incur the tolling charge (discussed below). The acquisition is not on capital account.³³ Similarly, the SPV of an equity joint venture would ordinarily be entitled to deductions for the acquisition of the inputs into the production process.³⁴ By contrast, the participants of unincorporated joint ventures are entitled to claim their share of allowable deductions as separate taxpayers.

If a tolling company incurs an outgoing that is directly attributable to the buying or obtaining delivery of an item of trading stock, but the tolling company and participant do not deal with each other at arm's length and the amount of the outgoing is greater than the market value of what the outgoing is for, the amount of the outgoing is instead taken to be that market value.³⁵ The words 'market value' and 'arm's length' are not defined in the relevant provision of the ITAA 97. However, the intent of the provision - as interpreted through its predecessor provision; namely, s. 31C of the ITAA 36 - is to overcome arrangements which 'artificially' increase the price paid for trading stock of the kind considered by the High Court in *Cecil Bros Pty Ltd v FCT*.³⁶

The Ralph Committee has specifically recommended that tangible assets produced, manufactured or acquired and held for the purposes of manufacture, sale or exchange in the ordinary course of a business be included within trading stock.³⁷ This should not adversely

³¹ Ahrens (1986), 461-462. See also Armstrong (1982).

³² Cf. Blanshard (1982), 421.

³³ Section 70-25 ITAA 97 provides that an outgoing incurred in connection with acquiring an item of trading stock is not an outgoing of capital or of a capital nature.

³⁴ Section 8-1(1) ITAA 97.

³⁵ Section 70-20 ITAA 97.

³⁶ (1964) 111 CLR 430.

³⁷ *A Tax System Redesigned*, 180.

affect tolling companies or participants. If the tolling charge includes an amount in respect of 'intangibles', then whilst these could be treated as trading stock under the current rules, they will be outside the definition of the proposed measure.³⁸

Role of the tolling company

The tolling company makes capital expenditure to provide a service for the joint venture through funds borrowed from a financier. The shareholders in the tolling company are the participants who, through the use of that company, ensure that financing is, where possible, non-recourse.³⁹ Security is provided by the assets of the tolling company including the contracts with the participants. Fahey considers that because the assets of the tolling company are generally highly specific and specialised (and thereby have limited value to other parties), debt securitised over the assets is not disclosed in the participants' balance sheets.⁴⁰

TAXATION FEATURES OF TOLLING COMPANIES - A COMPARATIVE ANALYSIS

It is argued that the principal fiscal benefit of using a tolling company structure is the transfer of the incidence of tax to the participants. Subsidiary benefits are: absence of characterisation risk and generally lower compliance costs than for asset sales when participant's interests are disposed of. But the compliance costs of reaping these fiscal benefits may not be insignificant, because costs will arise in determining the quantum of the tolling charge and in determining whether a tolling company is 'carrying on a business'.⁴¹

Fiscal benefits of using tolling companies

The incidence of tax falls on the participants where tolling companies are concerned. In this respect, they are similar to participants of unincorporated joint ventures. 'Incidence' describes

³⁸ Id.

³⁹ As to the meaning of non-recourse, see the discussion on s. 51AD ITAA 36 later in this chapter.

⁴⁰ Fahey (1990), 48.

⁴¹ It shall be seen that this uncertainty is probably more theoretical than real given the size of business operations involved. Tolling companies are not flow-through entities. They are fiscally transparent, and because of that, they share many of the taxation advantages associated with unincorporated joint ventures. These advantages must be weighed against the complexity inherent in the number of agreements required to establish a tolling company structure.

a taxpayer on whom the *burden* to pay tax in respect of taxable income falls.⁴² In each case, the incidence of tax falls on the participants for a different reason.

With unincorporated joint ventures, the unincorporated joint venture has no separate legal personality, so therefore the incidence of tax must fall to the participants as individual taxpayers according to their undivided interests in the JVA and assets.⁴³ Even if, on the proper construction, an unincorporated joint venture is to be characterised as a partnership for taxation purposes, then the incidence of tax similarly falls on the partners.⁴⁴ However, in this instance, the partnership would have to submit an income tax return each year of income, because it is a tax reporting entity.⁴⁵

With tolling companies, a tolling company levies a tolling charge on the participants each year. The tolling charges approximately equal the sum of the tolling company's tax deductible expenditure for that year. Each participant pays these charges. In turn, a tolling company's taxable income each year is approximately zero, because the income and the expenditures net-off. The participants each recognise a deduction for the tolling charges they have incurred.

Significantly, then, both legal structures lead to the same result as for incidence of tax, notwithstanding that the nature of the 'interests' held by the participants of each structure is different.

With equity participants, the incidence of tax lies with the SPV. Equity participants are merely shareholders of a SPV.⁴⁶ An SPV derives all the assessable income of the joint venture by selling all the output from it.⁴⁷ An SPV incurs losses and outgoings from the undertaking and is entitled to the deductions allowable therefrom under s.8-1 of the ITAA 97.

⁴² Section 4-10 ITAA 97; Jüttner, *International Finance & Global Investments*, (1995), 484. There are two theories dealing with the incidence of tax. See Harberger (1962); Hufbauer, *US Taxation of International Income*, (1992).

⁴³ See chapter 2.

⁴⁴ Rigney, *Australian Business Taxation*, (1990), 162-166; ss. 90-94 ITAA 36 is based primarily on the premise that a partnership is merely an aggregation of partners: Deutsch, *Australian Tax Handbook*, (1999), [29 010].

⁴⁵ Section 90 ITAA 36.

⁴⁶ Ahrens (1986), 463-464.

⁴⁷ See chapter 2.

Accordingly, the incidence of tax in equity joint ventures falls on the SPV. Payment of a SPV's retained earnings to the equity participants is by way of dividend. But in the tolling company context, it is as though each participant has its own production facilities to process that participant's raw material for use or disposal within that participant's production system.

Tolling companies are not subject to characterisation risk. Accordingly, tolling companies are not subject to the compliance costs a prospective participant would be likely to incur to make an assessment of the level of characterisation risk in a given case.

As the ownership interest of a participant in a tolling company is the same as for equity participants of equity joint ventures, in general a dealing by a participant in its shareholding in the tolling company will probably lead to similar compliance costs being incurred as for dealings by equity participants in their shareholding in an SPV.

In juxtaposition, it is probably also reasonable to assume that the compliance costs of a dealing by a participant in its shareholding in a tolling company will be lower than the compliance costs participants incur when they dispose of the assets of a joint venture. Factors supporting this assumption are several: absence of complex laws to apply compared to asset sales, no obligation to characterise the profit from the farmout or rely on the trading stock provisions of the tax law and the depreciation and mining and petroleum balancing adjustment provisions will be irrelevant.

Tolling companies also process raw material into finished product, control the use or disposal of the finished product, have the flexibility to reflect accounting, tax and other consequences in a manner appropriate to the business operations of each of the participants, allow each participant to manage its own tax affairs separately and, to the satisfaction of the ATO, allow flexible financing of the capital required for building and operating the production facilities to allow either global financing or individually arranged financing by each of the participants and flexibility to deal with expansions of the production facilities.⁴⁸

Compliance costs of using tolling companies

Costs of calculating the tolling charge

⁴⁸ Armstrong (1982), 399-400; Blanshard (1982), 420.

A tolling company will incur costs to determine the tolling charge. A tax accounting model for determining tolling charges is set out below. It is argued that these costs are in addition to the costs a tolling company will incur to determine its taxable income (or loss) annually. The more significant the costs are, the more the fiscal benefit of using this joint venture structure are reduced. In theory, there will be a point where the compliance costs equal the benefits derived. If 'break-even' point is reached, then from a revenue law perspective, there is no justification for using a tolling company structure in preference to other structures.

Tolling charges are unique to tolling companies. They could be determined either as a fixed amount to be reviewed from time to time or by taking into account specified component costs covering fixed and variable costs including interest and depreciation. Tolling companies are not expected to generate any taxable income.⁴⁹ Accordingly, a tolling company's annual tolling charges approximate the total deductions of the tolling company allowable under tax laws in that year of income.

A tolling company will invoice the participants with tolling charges for payment by them. Invoices are limited to the amounts required by the tolling company to meet its cash outgoings. If a participant defers the payment of a tolling charge, it will be treated as a credit allowance in the tolling company's accounts. In turn, the credit allowance may be called up at any time to meet its future cash requirements. Tolling charges are debited to a 'credit allowance account'—a debtor account between the tolling company and the participants (discussed below). The other side to the credit allowance account is the cash calls.⁵⁰

If the tolling charges exceed the amount of cash a tolling company receives, then the participants will owe money to the tolling company. Conversely, if the amount of cash received exceeds the value of the tolling charges, then the tolling company owes money to the participants. To ensure that the tolling company is never in a position of cash deficiency, the tolling agreement will contain provisions requiring the participants to make prepayments of tolling charges as necessary to meet the cash requirements of the tolling company.⁵¹

⁴⁹ Armstrong (1982), 404.

⁵⁰ Id.

⁵¹ Id. With effect from 21 September 1999, the 13 month prepayment rule was removed. This is unlikely to cause any substantial impact on participants: see Treasurer, *The New Business Tax System*, Press Release No. 58, 21 September 1999.

A tolling company will use a tax accounting model to determine the quantum of the tolling charge. Annual tax accounting is 'one of the central pillars of the [Australian] taxation system'.⁵² Even though it is well settled that in determining 'taxable income' of a taxpayer, accountancy practice is relevant, the tests given statutory force in the ITAA 97 and ITAA 36 in relation to either income or allowable deductions, will override accountancy practice.⁵³

Nonetheless, there is support for a broad reliance on accountancy principles. Such reliance by Australian courts dates back to 1953. In the High Court decision of *FCT v James Flood Pty Ltd*,⁵⁴ for example, Dixon CJ, Webb, Fullagar, Kitto and Taylor JJ said:

[c]ommercial and accounting practice may assist in ascertaining the true nature and incidence of the item as a step towards determining whether it answers the tests laid down by [s.8-1(1)]⁵⁵ but it cannot be substituted for that test.⁵⁶

In 1988, the Full Federal Court in *Hooker Rex Pty Limited v FCT*⁵⁷ recognised the role of accounting principles and practices as a guide to the courts when determining the timing of deductions:

[i]t may readily be conceded that commercial and accountancy practice cannot be substituted for the test laid down by [s. 8-1]⁵⁸...Nevertheless, the tendency of judicial decision has been to place increasing reliance upon the concepts of business and the principles and practices of commercial accountancy, not only in the ascertainment of expenditure...⁵⁹

In 1999, the Ralph Committee proposed the cash flow/tax value framework for calculating

⁵² Deutsch, *Australian Tax Handbook*, (1999), [22 010].

⁵³ Ibid, [2 310].

⁵⁴ (1953) 88 CLR 492.

⁵⁵ Formerly s. 51(1) ITAA 36.

⁵⁶ (1953) 88 CLR, 492, 506-507. See also to the same effect *Broken Hill Theatres Pty Ltd v FCT* (1952) 85 CLR 423, 435; *Nilsen Development Laboratories Pty Ltd and Ors v FCT* (1981) 33 CLR 161, 165, per Barwick CJ; *FCT v Citibank Limited & Ors* (1993) 44 FCR 434, 444, per Hill J; *Australian and New Zealand Banking Group Ltd v FCT* (1994) 48 FCR 268, 277-278, per Hill J.

⁵⁷ (1988) 88 ATC 4392; 79 ALR 181; 19 ATR 1241.

⁵⁸ Formerly s.51(1) ITAA 36.

⁵⁹ *Hooker Rex Pty Limited v FCT* (1988) 88 ATC 4392, 4399; 79 ALR 181, 189.

taxable income, to bring tax law into alignment with accounting principles.⁶⁰ If this measure is introduced, then accounting principles should become even more relevant.

The process for calculating tolling charges is complex. A tolling company could expect to incur considerable labour time and effort in making such a calculation. The first step in the process is for a tolling company to review all its accounting costs to ascertain the costs which are allowable deductions under the tax laws. Added to this are other allowable deductions not included in the accounting costs. Adjustments may then be required in relation to items such as movements in provisions,⁶¹ prepayments⁶² and inventories.⁶³ These tax adjustments account for timing differences⁶⁴ or permanent differences.⁶⁵

Timing differences are differences between the accounting result and taxable income that arise because the period in which an item is included in the accounting result does not coincide with the year of income in which that same item is included in the taxable income. For instance, a provision in respect of bad debts may reduce accounting profit but there may be no allowable deduction to the tolling company if a loss or outgoing is not 'incurred' in the relevant sense. Timing differences 'will result in the amount of income tax expense being either greater or less than the income tax payable for the [income year] in which the differences originate'.⁶⁶ For a tolling company, timing differences constitute the provision for future costs and credit allowances accounts (as identified earlier in this chapter). Tax timing differences comprise

⁶⁰ Refer chapter 2, p 43.

⁶¹ Provisions, such as in respect of bad debts etc are not deductions: Deutsch, *Australian Tax Handbook*, (1999), [22 180]. See also *Determination* TD 93/188 (for meaning of 'incurred').

⁶² The timing of the deductibility of a prepayment under s. 8-1 (1) ITAA 97 may be affected by ss. 82KZL - 82KZO ITAA 36. A prepayment for accounting purposes is governed by SAC 4, *Definition and Recognition of the Elements of Financial Statements*, (1995), paras. 14-47. It is noted that with effect from 21 September 1999, the 13 month prepayment rule was removed: see Treasurer, *The New Business Tax System*, Press Release No. 58, 21 September 1999.

⁶³ For ITAA 97 tax accounting purposes, s.70-5 provides for the purpose of tax accounting for trading stock and its valuation. The 'value' of trading stock on hand at the end of an income year may be determined at its cost, the market selling value or its replacement value: s. 70-45 ITAA 97. For accounting purposes, inventions are valued at the lower of cost and net realisable value: AAS 2, *Measurement and Preservation of Inventories in the Context of the Historical Cost System*, (1976), paras. 12-28.

⁶⁴ Deutsch (1994), 16-180.

⁶⁵ AAS 3, *Accounting for Income Tax (Tax-effect Accounting)*, (1975), para. 13.

⁶⁶ *Ibid*, para. 14.

mainly the differences between accounting and tax depreciation, movements in provisions, prepayments and realised/unrealised foreign exchange gains and losses, but may also include operating costs and depreciation claimed outright by the tolling company when the tolling company is established.⁶⁷

Permanent differences are differences between the accounting result and the 'taxable income' that arises because, under the tax law, certain revenue items which are included in the accounting result will never be included in the 'taxable income', and vice versa. Permanent differences therefore alter the incidence of income tax in relation to the pre-tax accounting result/profit or loss of the year of income in which they occur, but do not affect income tax calculations in respect of subsequent years of income,⁶⁸ such as the development allowance.⁶⁹ This is a special deduction equal to 10 percent of the amount of capital expenditure incurred on the construction/acquisition of eligible plant and equipment in certain large Australian projects which cost \$50 million or more and meet certain other criteria.⁷⁰ Permanent differences may arise where the figures for purchases or sales of trading stock are varied rather than the valuation of stock-on-hand, for instance, where the Commissioner has applied s.70-20 to purchases ('non-arm's length transactions'). Accordingly, the development allowance will never appear in the accounting result of the tolling company. For a tolling company, all permanent differences between accounting and tax values are reflected in the annual profit or loss.

Against this background, Example 6.1 advances a tax accounting model for the determination of tolling charges and specifically addresses how a tolling company's taxable income is nil. The example has been greatly simplified in an attempt to further explain the tolling charge concept and how it is used to ensure that a tolling company does not make any taxable income.⁷¹

⁶⁷ Ibid, paras. 14-25.

⁶⁸ Ibid, para. 13.

⁶⁹ See ss. 82AA - 82AQ ITAA 36.

⁷⁰ Section 82AAAA(1) ITAA 36.

⁷¹ Armstrong (1982), 409-410.

Example 6.1 Determination of tolling charge for tolling company

In its Business Activity Statement, a tolling company uses tax effect accounting to determine the tax deductible costs, using a Statement of Taxable Income calculation (see below). The total tax deductible costs become the tolling charge. The timing differences and the permanent differences are then identified. The timing differences are used to calculate the Provision for Future Costs. The permanent differences are used to calculate the profit. Therefore, all entries appear somewhere twice. This cost will not be in the accounting expenses but it will be in both the Provision for Future Costs and the tolling charge. Therefore, one cancels out the other. Another example is non-deductible costs. These costs will appear in the accounting expense and therefore accounting profit. Again, one cancels out the other. The figures are then 're-arranged' to give the Statement of Taxable Income.

Assume the only book entries for an income year are (in \$):

Tolling revenue	70
Non-deductible costs	140
Tax depreciation	70
Book depreciation	20

Accounting expenses for the year are \$160, provision for future costs is (\$50), and the profit is (\$140). Therefore the tolling company's Profit and Loss Statement would be as follows:

Tolling Revenue	70 = Tax deductible costs
Less Expenses	<u>160</u> = Accounting costs
Net profit before provision	(90)
Provision for future costs	<u>(50)</u>
Net Loss	<u>(140)</u>

To calculate the above, tax deductible costs must be determined, then the provision for future costs must be determined, then profit must be calculated. The last step is to put each of the individual components together and the Profit and Loss Statement balances. It can be seen that the Profit and Loss Statement cannot be viewed as income less expenses equals profit. The Statement of Taxable Income would be as follows:

STATEMENT OF TAXABLE INCOME

Profit	(140)
Add back:	
Provision for future costs	50
Book depreciation	20
Non-deductible costs	140
Less:	
Tax depreciation	<u>70</u>
Taxable income	<u>0</u>

Costs of assessing whether the 'carrying on business' test is satisfied

Compliance costs will arise in determining whether a tolling company is carrying on a

business. Tolling companies operate on the basis that at the end of each income year, the taxable income of the tolling company is zero,⁷² so therefore, at a practical level, they are 'break-even' companies. Until now, the assumption in this chapter has been that tolling companies carry on business and therefore, may recognise deductions. Whether or not a tolling company is carrying on a business will depend on whether the definition of 'business' in the ITAA 97 is satisfied.⁷³ Neither the ITAA 97 nor ITAA 36 define or explain the expression 'carrying on a business'.

To determine whether a tolling company's activities amount to the carrying on of a business will be critically important in arriving at a decision, as to whether the particular receipts of the tolling company will be of an income nature and, flowing from this, whether outgoings incurred in the course of the activities of a tolling company will be allowable deductions.⁷⁴ Hill J in *Ivans v FCT*,⁷⁵ said that the question of whether a particular activity constitutes a business is often a difficult one involving as it does questions of fact and degree and that no one factor is decisive of whether a particular activity constitutes a business.

Since the determination will involve difficult questions of fact and degree, tolling companies must turn to Australian cases for guidance. The court in *Ferguson v FCT*,⁷⁶ said that the nature of the activities carried on by the relevant taxpayer:

particularly whether they have the purpose of profit-making, may be important. However, an immediate purpose of profit-making in a particular income year does not appear to be essential. Certainly it may be held a person is carrying on business notwithstanding his profit is small or even where he is making a loss. Repetition and regularity of the activities is also important... Again, organisation of activities in a business-like manner, the keeping of books, records and the use of system may all serve to indicate that a business is being carried on... The volume of his operations and the amount of capital employed by him may be

⁷² Id.

⁷³ Section 995-1 ITAA 97 defines a 'business' as including 'any profession, trade, employment, vocation or calling, but does not include occupation as an employee.'

⁷⁴ Deutsch, *Australian Tax Handbook*, (1999), [7 010].

⁷⁵ (1989) 89 ATC 4540, 4554-4555; 20 ATR 922, 939.

⁷⁶ (1979) 37 FLR 310.

significant.⁷⁷

It is argued that a tolling company is likely to be engaged in a business notwithstanding it lacks profit motive. A profit motive is usually seen as no more than a factor in determining the existence of a business, and an absence of a profit motive does not necessarily mean that a tolling company cannot be carrying on a business.⁷⁸ Several factors point strongly in favour of this conclusion: the scale of operations involved, the commerciality of those operations, the skill and judgements required to be made to process raw material into finished product and the fact that the tolling company is just another step in the production process of the participants who are themselves carrying on their own separate businesses. There would be considerable fiscal uncertainty if a tolling company that incurs tens of millions of dollars in expenditures each year of income is denied deductions for them by reason only that the tolling company lacks a profit motive.

Can a tolling company be said to be carrying on a business notwithstanding there is no reasonable prospect that it will make a profit, either in the immediate future, or at all? The position of the New Zealand courts has been that the concept of a 'business' requires both an intention of making a profit and also a reasonable prospect of doing so.⁷⁹ Australian and United Kingdom courts have in the past taken a more liberal view, holding that a taxpayer may be carrying on a business notwithstanding there is no reasonable prospect of profits being made because 'an immediate purpose of profit-making in a particular income year does not appear to be essential'.⁸⁰ The underlying policy of the Australian courts is not to suggest:

that it is the function of income tax Acts, or of those who administer them to dictate to taxpayers in what business they shall engage or how to run their business profitably or economically. The Act must operate on the results of a taxpayer's activities as it finds them.⁸¹

⁷⁷ Ibid, 314.

⁷⁸ *IRC v Incorporated Council of Law Reporting* (1888) 22 QBD 279, 293 per Lord Coleridge; cf *Case M67* (1980) 80 ATC 479; *Griffiths v JP Harrison (Watford) Ltd* [1963] AC 1, 23-24 per Lord Morris; *John v FCT* (1989) 166 CLR 417, 429; *Ferguson v FCT* (1979) 37 FLR 310, 314.

⁷⁹ *Prosser v Commissioner of Inland Revenue (NZ)* (1973) 73 ATC 6006; *Golightly v Commissioner of Inland Revenue (NZ)* (1972) 1 TRNZ 135.

⁸⁰ *Ferguson v FCT* (1979) 37 FLR 310, 314 per Bowen C. and Franki J. See also *Tweedle v FCT* (1942) 180 CLR 1, 7, per Williams J.

⁸¹ *Tweedle v FCT* (1942) 180 CLR 1, 7, per Williams J.

It would seem, therefore, that in Australia, the mere fact that a tolling company makes only a small profit, say \$1,000 in any particular income year, would be sufficient to rebut an argument that the tolling company cannot be carrying on a business on grounds that profit-motive is lacking. Whether a tolling company is carrying on a business in circumstances where it is impossible for the tolling company to ever make a reasonable profit is less clear.⁸² *Case M67*⁸³ arguably stands for the proposition that notwithstanding a business undertaking can never succeed will not by itself automatically preclude a finding that the taxpayer is in business.

If the tolling company is carrying on business, then the tolling charges will constitute assessable income,⁸⁴ because they are revenue in nature. A tolling company's assessable income⁸⁵ includes ordinary income 'derived' directly or indirectly from worldwide sources during an income year.⁸⁶ The relevant statutory provision to determine whether a tolling company has *derived* an amount of ordinary income, and (if so) when the income was derived, provides that a tolling company is taken to have received an amount as soon as it is applied or dealt with in any way on the tolling company's behalf or as directed by it.⁸⁷ Useful guidance on the meaning of this provision can be obtained from judicial consideration of its predecessor provision.⁸⁸ The courts have traditionally considered income arising from the trading operations of a commercial undertaking as brought to account on an earnings or accrual basis.⁸⁹ Gibbs J in *J Rowe & Son Pty Ltd v FCT*,⁹⁰ said that for taxation,

⁸² See Slater (1978), 312; *Case J11* (1977) 77 ATC 101; *Case K9* (1978) 78 ATC 98; *Case L1* (1979) 79 ATC 1; *Case L22* (1979) 79 ATC 106; *Case M50* (1980) 80 ATC 349; *Case M93* (1980) 80 ATC 674.

⁸³ (1980) 80 ATC 479, *per* Mr Hogan, Drs P Gerber and G Beck.

⁸⁴ Section 19 ITAA 36; *FCT v Clarke* (1927) 40 CLR 246; *AAT Case 10,103* (1995) 30 ATR 1238; *Howell v FCT* (1994) 28 ATR 105; *Permanent Trustee Co of NSW Ltd v FCT* (1940) 2 ATR 109; *Brent v FCT* (1971) 2 ATR 563; *AAT Case 10,999* (1996) 33 ATR 1034.

⁸⁵ 'Assessable income' is defined by s. 6-1(1) ITAA 97.

⁸⁶ Section 6-5(2) ITAA 97.

⁸⁷ Section 6-5(4) ITAA 97.

⁸⁸ Section 19 ITAA 36.

⁸⁹ *Bowater Sales Co Limited v IR Commissioners* (1958) 38 TC 593; *Ballarat Brewing Co Limited v FCT* (1951) 82 CLR 364.

⁹⁰ (1971) 124 CLR 421.

as well as for business, purposes income of a trading business is derived when it is earned and the receipt of what is earned is not necessary to bring the proceeds of sale into account.⁹¹

As a corollary, the amount of trading income derived is the amount that has become recoverable by the tolling company.⁹² The Commissioner has in the past accepted the approach of the courts on this question.⁹³

The participants will be each entitled to an allowable deduction for tolling charges 'incurred' by each of them as a cost of production under s. 8-1(1) of the ITAA 97. 'Incurred' means 'incurred' as required by s. 8-1(1). The meaning of the word 'incurred' is best explained by considering some of the leading cases dealing with the interpretation of the predecessor provision of s. 8-1(1). It is clear that the participants need not actually have paid the tolling charge by the end of a year of income to have 'incurred' a loss or outgoing in the relevant sense. In *W Nevill & Co Ltd v FCT*,⁹⁴ Latham CJ observed that the word used:

is 'incurred' and not 'made' or 'paid'. The language lends colour to the suggestion that, if a liability to pay money as an outgoing comes into existence, [the section is satisfied] even though the liability has not been actually discharged at the relevant time... it is only the incurring of the outgoing that must be actual; the section does not say in terms that there must be an actual outgoing - a payment out.⁹⁵

In *Commonwealth Aluminium Corporation Limited v FCT*,⁹⁶ Newton J of the Supreme Court of Victoria made several important general points about the meaning of the word 'incurred', which are relevant for present purposes. First, a loss or outgoing may be 'incurred' by participants notwithstanding that it remains unpaid, provided the participant has completely subjected itself to the liability.⁹⁷ Secondly, a participant can completely subject itself to a

⁹¹ Ibid, 452.

⁹² *Gasparin v FCT* (1993) 93 ATC 4479; 115 ALR 707; 26 ATR 41; *FCT v Australian Gas Light Co & Anor* (1983) 74 FLR 13.

⁹³ *Draft Tax Ruling* TR 94/D4.

⁹⁴ (1937) 56 CLR 290.

⁹⁵ Ibid, 302.

⁹⁶ (1977) 32 FLR 210.

⁹⁷ This principle derives from *FCT v James Flood Pty Ltd* (1953) 88 CLR 492.

liability, notwithstanding that the quantum of the liability cannot be precisely ascertained, provided it is capable of reasonable estimation.⁹⁸ Thirdly, the quantum of a liability is capable of 'reasonable estimation' for these purposes if it is capable of approximate calculation based on probabilities.⁹⁹ Fourthly, a participant may completely subject itself to a liability notwithstanding that the liability is defeasible.¹⁰⁰ These principles have been confirmed in two leading cases decided since *Commonwealth Aluminium*; namely, *Nilsen Development Laboratories Pty Ltd & Ors v FCT*¹⁰¹ and *FCT v Australian Guarantee Corporation Ltd*.¹⁰²

If tolling charges are calculated during an income year using a budgeted rate, there should be no question of the tolling company miscalculating the quantum of assessable income derived on its revenue account or the participants miscalculating their losses or outgoings incurred, provided that before the end of the year of income, the actual tolling charge for that year is calculated and an adjustment is made to the last tolling invoice of the income year for any difference between the actual charges for the year and the estimated charge used for invoicing purposes used as the basis for invoicing during the year.

If the proposed cash flow/tax value methodology becomes law, then tolling charges will probably continue to be assessable income for the tolling company and deductible for the participant. This will arise from the application of the rules for taxing receipts and payments. The caveat is that the special rules for determining what is an asset and liability, which will ultimately be legislated into the new rules in some form, could lead to some other classification for tolling charges. As yet, there is no information to indicate that tolling charges will be taxed any differently to any other trading receipts or payments.

PART IVA CONSIDERATIONS

Part IVA should not apply to tolling companies because there will be no leakage of tax or

⁹⁸ (1977) 32 FLR 210, 223. This principle derives from *Texas Co (Australasia) Ltd v FCT* (1940) 63 CLR 382, 465-466; *RACV Insurance Pty Ltd v FCT* (1974) 22 FLR 385, 395.

⁹⁹ Id. This principle derives from *JJ Savage & Sons Pty Ltd v Blakney* (1970) 19 CLR 435, 442.

¹⁰⁰ Ibid, 4161; 223-224; 386. This principle derives from *FCT v James Flood Pty Ltd* (1953) 88 CLR 492, 506-507.

¹⁰¹ (1981) 144 CLR 616.

¹⁰² (1984) 2 FCR 483.

prospect of leakage from the structure. Example 6.1 demonstrates that the full incidence of tax is borne indirectly by each of the participants. Part IVA of the ITAA 36 is a general anti-avoidance provision. It is expressed to apply to schemes or parts of schemes that have the purpose of producing specified tax benefits.

In order for Pt IVA to operate, there must be a 'scheme',¹⁰³ the scheme must produce a 'tax benefit',¹⁰⁴ and the scheme must be entered into for the sole or dominant purpose of gaining the benefit.¹⁰⁵ Once these elements are satisfied, the Commissioner is empowered to reconstruct the transaction so as to modify or cancel the tax benefit.¹⁰⁶

There will ordinarily be no contravention of Pt IVA from the use of a tolling company, because a number of commercial reasons explain why participants enter into such structures. For instance, companies wishing to establish common production facilities might prefer to undertake this through a tolling company compared with using the conventional company. The motivation for pooling resources in a tolling company could be to obtain the processed product for each participant's own use rather than for commercial sales to third parties. This can be achieved pursuant to take-or-pay purchase contracts. The participants seek to retain the maximum flexibility they can over treating their rights, interests and obligations in the joint venture as separate rather than as joint and several subject to the constraints of the *Corporations Law*. The other perceived main advantages of tolling arrangements include the absence of characterisation risk and of the fiscal uncertainties associated with unincorporated joint ventures whilst retaining tax flow-through capabilities. The tolling structure is a well-suited vehicle to facilitate the management of each participant's own tax affairs, to provide flexibility in construction and operational financing of the production facilities and in dealing with expansions of the production facilities.

COMPLIANCE COSTS OF FINANCING TOLLING COMPANIES

Financing a tolling company arrangement will be likely to give rise to two types of compliance

¹⁰³ 'Scheme' is defined in s. 177A(1) ITAA 36.

¹⁰⁴ 'Tax benefit' is defined in s.177C ITAA 36.

¹⁰⁵ Section 177A(5) ITAA 36.

¹⁰⁶ Section 177F ITAA 36.

costs for a participant. The first type of cost relates to the compliance costs of entering into long-term supply contracts. The second is caused by the legal and effective complexity of complying with s. 51AD of the ITAA 36.

Compliance costs of long term purchase contracts

If the construction of the processing facilities of a tolling company depends materially on construction finance, then the structure of a tolling company arrangement must meet financiers' requirements. Any number of methods and structures could be used for this financing, most of which can be or have been adapted for use by a tolling company. Traditionally, participants have organised the funding on the basis of a nominal amount by way of share capital with almost all of the funds provided by way of loans. In fact, it is not unusual for participants to take on a non-recourse financing arrangement to facilitate the construction of expensive facilities.¹⁰⁷ Because of this, tolling arrangements are unlikely to take place without a guarantee of a continuing relationship with the participants in the production chain. Long-term purchase contracts can provide this guarantee.¹⁰⁸ A simplified financing tolling structure is set out in Figure 6.2.

A financier is generally restricted to the assets to be constructed for its security. This will generally be inadequate security for the borrowings. As pointed out by one commentator,

because the assets are transaction-specific, although some of their value may be realised if sold, the specific nature of these assets means that their full value can only be recouped through participation in the transactions that originally motivated the investment.¹⁰⁹

It is therefore essential that a tolling company enters into take-or-pay long term purchase agreements that contain guaranteed purchase prices and income levels, regardless of output to ensure a sufficient income stream to service and repay the debt. In many circumstances, the

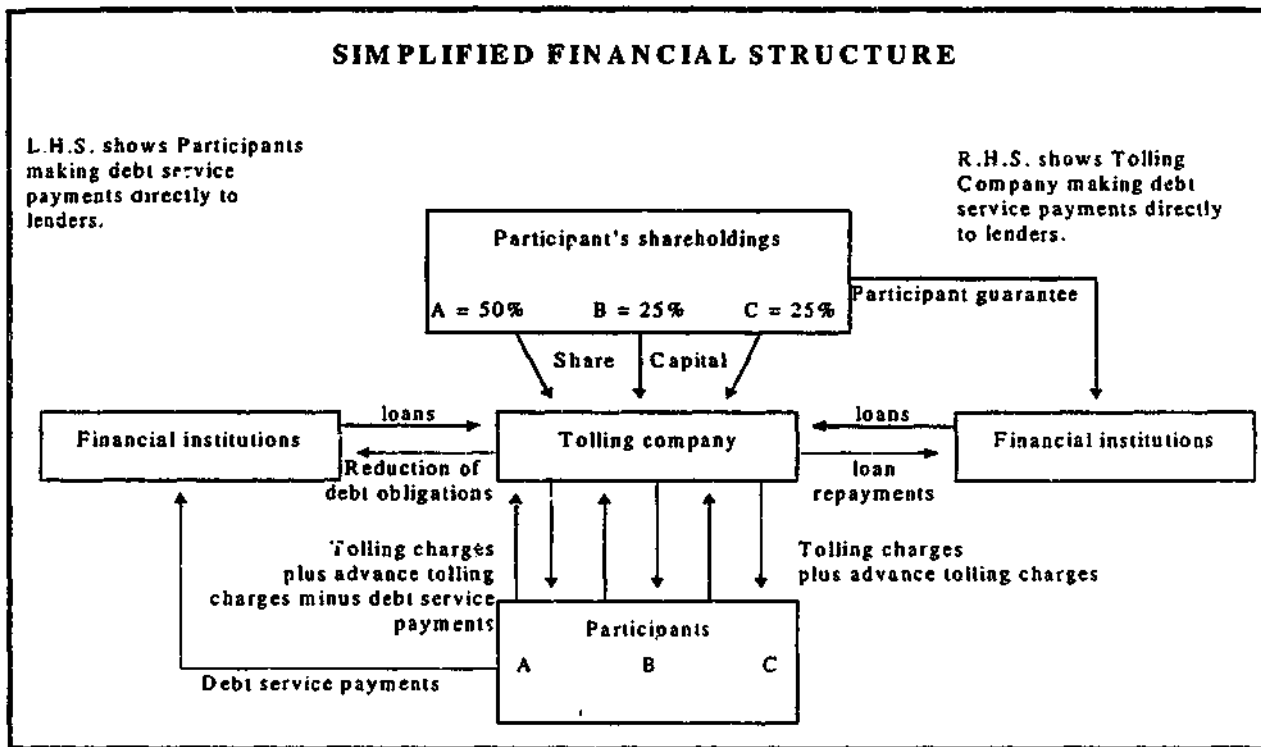
¹⁰⁷ Fahey (1990), 48.

¹⁰⁸ Williamson (1979), 239-242. An example of a long term supply contract can be found in the West Angelas Marra Mamba ore joint venture. The participants are North Limited (53%), Mitsui (33%), Nippon Steel (10.5%) and Sumitomo Metal Australia (3.5%). In March 2000, North Limited received letters of intent from Japanese steel mills for the purchase of the ore for an eight year period from 2002. It has been stated that 'the commitment from the Japanese steel mills effectively underwrites the proposed \$1 billion development': Anon, 'West Angelas: Japanese steelmakers sign up', *Prospect* (2000) March - May, 3.

¹⁰⁹ Industry Commission, *Study into the Australian Gas Industry*, (1995), 239.

end users will be the participants or their associates. Such an agreement ensures the protection of the tolling company and financier from cash-flow fluctuations caused by a reduction in supply of materials or lack of demand for the end product. In short, a 'guaranteed' income stream provides the necessary security to the financier and converts an otherwise unattractive financing arrangement into one that is as secure as the financial standing of the end users.¹¹⁰

Figure 6.2: Simplified Tolling Company Financing Structure¹¹¹



Nevertheless, there are significant transaction costs associated with these long term contracts: they have high enforcement and monitoring costs.¹¹² While it is relatively inexpensive and straightforward to obtain information about market conditions in the immediate future, uncertainty as to conditions in the more distant future mean that relevant information is often unavailable. As uncertainty surrounding future conditions increases, so too do the transaction costs of long-term contracts, as the likelihood of contractual breakdown increases.¹¹³

But it could be argued that because the high monitoring and enforcement costs of long term

¹¹⁰ Fahey (1990), 49.

¹¹¹ Reproduced from Armstrong (1982), Appendix 2.

¹¹² Industry Commission, *Study into the Australian Gas Industry*, (1995), 241.

¹¹³ Sutherland (1993), 1197.

purchase contracts are not 'costs to the economy that arise as a result of taxpayers complying with taxation,'¹¹⁴ they are not 'compliance costs' as defined in chapter 1 of this thesis. This argument is predicated on the basis that as the costs are avoidable costs, they must fall outside the definition of compliance costs. The author recognises the issue about whether tax planning costs should fall within the definition of compliance costs. For the reasons stated in chapter 1 of this thesis, the author considers that avoidable compliance costs of taxpayers are included in the definition of compliance costs.

Compliance costs of section 51AD

Section 51AD denies all deductions relating to property largely financed by non-recourse loans which are 'leased to or effectively controlled by' a tax-exempt entity. It is especially relevant in the context of tolling companies. In policy terms, s. 51AD of the ITAA 36 is relatively straightforward—it is an anti-avoidance, or punitive,¹¹⁵ measure directed at curtailing tax leakage, by dealing with tax benefit transfer arrangements.¹¹⁶ The Ralph Committee has recommended the abolition of this provision.¹¹⁷ The government supports this recommendation in principle, although no legislation has been passed yet.¹¹⁸

Section 51AD will apply to property acquired by a tolling company under a contract entered into on or after 24 June 1982,¹¹⁹ or constructed by a tolling company where construction commenced after that time. Section 51AD will not apply unless the cost of the acquisition or construction of the property by the tolling company is wholly or predominantly financed by non-recourse debt.¹²⁰ In context, non-recourse debt means that the rights of the financier in

¹¹⁴ Evans, *A Report into Taxpayer Costs of Compliance*, (1997), vii.

¹¹⁵ Mr Don Green of the Institute of Chartered Accountants stated at a meeting of the Commissioner's Taxation Liaison Group held on 27/11/1992 that s. 51AD does more than remove tax benefits, that it is punitive and goes against the concept of 'fiscal even-handedness': Minutes - 27/11/1991, 498-9.

¹¹⁶ See *id.*

¹¹⁷ See *A Tax System Redesigned*, recommendation 10.1 'Taxation of Rights over non-depreciable assets', and recommendation 10.9 'Abolition of section 51AD', 371-372, 392-393.

¹¹⁸ See Treasurer, *The New Business Tax System: Stage 2 Response*, Press Release no. 74, 11 November 1999, Attachment N.

¹¹⁹ See the definition of 'prescribed time' in s. 51AD(1) ITAA 36. See also s. 51AD(4) ITAA 36.

¹²⁰ Section 51AD(8) ITAA 36.

the event of default by the tolling company are predominantly limited to rights against the property itself, or against the income, goods or services generated by the property, or to rights in respect of a security over the property.¹²¹ A debt is also non-recourse if the financier would not have access to all the unsecured assets of the tolling company in a recovery action.¹²²

Where the conditions relating to time of acquisition and non-recourse debt are satisfied, s. 51AD will apply to property in either of two sets of circumstances. The first is where the property is leased and the lessee (or sub-lessee) is not a resident of Australia and the property is, or is to be, used wholly or principally outside Australia, the property is, or is to be, used otherwise than solely for producing assessable income or the property was owned and used, or held for use, by the lessee or sub-lessee before the end-user acquired it.¹²³

The second circumstance in which s. 51AD can apply to a tolling company concerns property that is owned by a tolling company but the use of which in the production, supply, carriage, transmission or delivery of goods or the provision of services is controlled by an end-user.¹²⁴ The end-user must be either a non-resident of Australia and the property is, or is to be, used wholly or principally outside Australia, uses the goods or services produced by means of the property otherwise than solely for the purpose of producing assessable income, derives no income, or derives income that is wholly or partially exempt, in providing those goods or services or owned and used the property, or held it for use, before the tolling company acquired it.¹²⁵ The critical question of who 'controls' the use of a power station will ultimately depend on the facts of each particular case.

If the provision is triggered, the tolling company is taken to not have used the relevant property for the purpose of producing assessable income or in carrying on a business for that purpose;¹²⁶ it is denied deductions attributable to the ownership of the property, including depreciation, repairs, interest on borrowings and other expenses. If this happens, it would

¹²¹ Section 51AD(8) ITAA 36.

¹²² Section 51AD(8)(c) ITAA 36.

¹²³ Section 51AD(4)(a) ITAA 36.

¹²⁴ Section 51AD(4)(b) ITAA 36.

¹²⁵ Section 51AD(4)(b)(ii)(A), (B) and (C) ITAA 36.

¹²⁶ Section 51AD(10) ITAA 36.

reduce the quantum of the tolling charge. In turn, a reduction in the tolling charge would reduce the net present value of a project to the participants. The reduction in the net present value of a project to a participant would equal the dollar amount of the allowable deduction that that participant foregoes.¹²⁷

If the provision operates, the tolling company is taken to not have used the relevant property for the purpose of producing assessable income or in carrying on a business for that purpose;¹²⁸ it is denied deductions attributable to the ownership of the property, including depreciation, repairs, interest on borrowings and other expenses. If this happens, it would reduce the quantum of the tolling charge. In turn, a reduction in the tolling charge would reduce the net present value of a project to the participants. The size of the reduction in the net present value of a project would equal the dollar amount of the allowable deduction that a participant foregoes.

The Ralph Committee's recommendation to abolish s. 51AD is based on the provision's 'severe impact where it applies because all deductions are denied to the taxpayer but the associated income is still assessable. It has continually be criticised by State governments and infrastructure providers for its severe impact where it applies and the uncertainty it creates.'¹²⁹ Moreover, *A Tax System Redesigned* indicates that:

[s]ection 51AD has become even more problematical in recent years

¹²⁷ To illustrate, assume that a tolling company incurs \$300 million in outgoings for a year of income, \$100 million of which are attributable to the ownership of the property, including depreciation, repairs, interest on borrowings and other expenses. Participant A owns 50 percent of the shares in the tolling company, while Participants B and C each own 25 percent of the shares. If s. 51AD did not apply, the tolling company would charge Participants A, B and C a tolling charge of \$300 million, \$150 million of which would be to Participant A's account and a \$75 million to the account of each of Participants B and C. By incurring a tolling charge expense, each Participant would be entitled to allowable deductions in respect of their payments of \$150 million, \$75 million and \$75 million, respectively. If s. 51AD did apply, the tolling company would not be allowed to recognise an allowable deduction for the \$100 million in outgoings attributable to the ownership of the property, including depreciation, repairs, interest on borrowings and other expenses. Accordingly, its tolling charge would be reduced to \$200 million, \$100 million of which would be to Participant A's account and the rest to the account of each of Participants B and C in equal shares. Accordingly, each Participant would be entitled to allowable deductions in respect of their payments of \$100 million, \$50 million and \$50 million, respectively; that is, the net present value of the project to them would reduce. The reduction in the net present value of the project to Participant A would equal \$50 million in the relevant year of income. The reduction in the net present value of the project to each of Participants B and C would equal \$25 million in the relevant year of income.

¹²⁸ Section 51AD(10) ITAA 36.

¹²⁹ *A Tax System Redesigned*, 392.

because of increased levels of privatisation and outsourcing of government services which were not contemplated when it was first conceived.¹³⁰

It has also been argued that:

[t]he severe treatment of arrangements that are currently prohibited by section 51AD is unnecessary - and there is no reason why leases (and similar arrangements) involving tax exempts should be treated differently simply because they are financed using non-recourse finance - providing structural measures are in place to address potential structured non-payment of non-recourse finance, tax preference transfer to tax exempts and the timing advantages of delayed lease and service contract rentals... The Review believes that section 51AD can no longer be justified.¹³¹

If the Ralph Committee's proposal is introduced, then it will have the capacity to reduce the burden of compliance costs imposed by the provision on taxpayers whilst it remains in force.

In practical terms, s. 51AD issues may arise because of tolling companies' traditional dependence on contractual arrangements with suppliers of energy (eg electricity and gas) for processing operations, who in the past in Australia have been government entities.¹³²

While the effect of s. 51AD may be a simple concept, the provision is legally and effectively complex in its operation and this may potentially increase the compliance cost burden on a tolling company. This complexity will be illustrated by the following example. Assume that Australian resident Participants A, B and C, through their wholly-owned Australian resident tolling company, T, own a power station in Victoria, Australia financed by non-recourse debt.¹³³ The Participants supply coal to T, who in turn converts the coal into electricity, for use in an aluminium smelter owned severally by A, B and C as participants of an

¹³⁰ Id.

¹³¹ Id.

¹³² For instance, in September 1999, the Australian Bureau of Agricultural and Resource Economics stated that traditionally the location of primary aluminium production in Australia - from bauxite as opposed to secondary production from scrap, which consumes less electricity - 'is strongly influenced by the availability of cheap [energy]': N Hordern, 'Rising electricity prices to force aluminium producers offshore', *The Australian Financial Review*, 17 September 1999, 2. So much is evident in relation to the proposed Papua New Guinea gas pipeline for the construction of a gas pipeline from PNG to Queensland, Australia. Comalco, one of Australia's aluminium producers, and a potentially large customer of energy, has said in September 1999 that 'the price of gas, a key feedstock in producing alumina, is an important factor in deciding where to locate the refinery': G West, 'Comalco deal adds heat to gas rivalry', *The Australian Financial Review*, 17 September 1999, 53.

¹³³ 'Non-recourse debt' is defined in s. 51AD(8) ITAA 36.

unincorporated joint venture. T also sells a small portion of electricity produced into the Australian national electricity market (the *NEM*).

The tolling company, T, must first assess whether the conditions in the provision relating to time of acquisition and non-recourse debt are satisfied. Section 51AD will apply to property acquired by a tolling company under a contract entered into on or after 24 June 1982,¹³⁴ or constructed by a tolling company where construction commenced after that time. Section 51AD will not apply unless the cost of the acquisition or construction of the property by the tolling company is wholly or predominantly financed by non-recourse debt.¹³⁵ Non-recourse debt is debt in respect of which the rights of the financier in the event of default by the tolling company are predominantly limited to rights against the property itself, or against the income, goods or services generated by the property, or to rights in respect of a security over the property.¹³⁶ A debt is also non-recourse if the financier would not have access to all the unsecured assets of the tolling company in a recovery action.¹³⁷

If the conditions relating to time of acquisition and non-recourse debt are satisfied, a tolling company must determine whether one of two sets of circumstances are present. The first is where the property is leased and the lessee (or sub-lessee) is not an Australian resident and the property is, or is to be, used wholly or principally outside Australia, the property is, or is to be, used otherwise than solely for producing assessable income or the property was owned and used, or held for use, by the lessee or sub-lessee before the end-user acquired it.¹³⁸

The second circumstance in which s. 51AD can apply to T concerns property that is owned by a tolling company but the use of which (in the production, supply, carriage, transmission or delivery of goods or the provision of services) is *controlled* by an end-user.¹³⁹ The end-user must be either a non-resident of Australia and the property is, or is to be, used wholly or principally outside Australia, uses the goods or services produced by means of the property

¹³⁴ See the definition of 'prescribed time' in s. 51AD(1) ITAA 36. See also s. 51AD(4) ITAA 36.

¹³⁵ Section 51AD(8) ITAA 36.

¹³⁶ Section 51AD(8) ITAA 36.

¹³⁷ Section 51AD(8)(c) ITAA 36.

¹³⁸ Section 51AD(4)(a) ITAA 36.

¹³⁹ Section 51AD(4)(6) ITAA 36.

otherwise than solely for the purpose of producing assessable income, derives no income, or derives income that is wholly or partially exempt, in providing those goods or services or owned and used the property, or held it for use, before T acquired it.¹⁴⁰

A determination of the question of *control* is the principal cause of the legal and effective complexity of the provision. A determination of the end-user will be readily apparent from the facts of a case.¹⁴¹ For convenience of discussion, it is *assumed* that the tax exempt end-user in the above example is the National Electricity Market Management Company Limited (NEMMCO).¹⁴² NEMMCO is established to conduct the NEM efficiently in accordance with National Electricity Code (NEC) on a self-funding / break-even basis.¹⁴³

The concept of control is central to the operation of s. 51AD. In the section, 'control' is defined to mean 'effectively control'.¹⁴⁴ But the provision neither defines 'effectively control' nor sets out criteria to be used by taxpayers to determine whether the definition is satisfied. This does not appear to be a drafting issue peculiar to s. 51AD, because two other provisions of the ITAA 36 define 'control' in the same fashion.¹⁴⁵ The expression 'effectively control' is not defined in the ITAA 97 or ITAA 36. Therefore, a tolling company must interpret the expression based on its ordinary meaning.

A determination of the ordinary meaning of the provision will not always be an easy task. The Explanatory Memorandum accompanying the bill introducing s. 51AD states that to control effectively 'means to control in a practical sense whether or not, in a more formal sense, there

¹⁴⁰ Section 51AD(4)(6)(ii)(A), (B) and (C) ITAA 36.

¹⁴¹ Obvious examples of end-users are government bodies and public authorities, but there are less obvious examples, such as State or Territory Bodies (STB) for the purposes of Div. 1AB of Pt III of the ITAA 36. An entity is an STB if it is owned by one or more government entities, or if it has been established by legislation and a government entity either receives its profits or assets on winding up, has the power to appoint its governing person, or can direct its governing person, or if government entities hold all legal and beneficial interests in it and all rights to appoint, dismiss or direct its governing person (see ss. 24AO to 24AS ITAA 36).

¹⁴² As distinct from positively determining whether NEMMCO is a tax-exempt entity for s. 51AD purposes.

¹⁴³ Clause 1.6.2(a) *National Electricity Code*.

¹⁴⁴ Section 51AD(1) ITAA 36.

¹⁴⁵ See s. 82AHA(1) ('Goods or services used to produce exempt income') and s. 159GE(1) ('Certain arrangements relating to the use of property').

would be control'.¹⁴⁶ 'Control' has been defined as meaning 'to exercise restraint or direction over; dominate; command... the act or power of controlling; regulation; domination or command',¹⁴⁷ whilst 'effectively' is an adverb describing the ability to serve to effect the purpose.¹⁴⁸

Those definitions suggest that 'effectively' means that which actually causes something to happen, and 'control' is the power to decide what is to be done, how it will be done, when it will be done and where. The meaning of 'effectively control' may be usefully interpreted by reference to the central management and control test used to determine the residency status of corporations. Section 6(1) of the ITAA 36 defines resident as including 'a company which is incorporated in Australia, or which, not being incorporated in Australia, carries on business in Australia, or has either its central management and control in Australia or its voting power controlled by shareholders who are residents of Australia'.

It could be argued that in the context of s. 6(1), 'control means de facto control evidenced by overt acts and not merely the potential to control'.¹⁴⁹ Judicial authority supports this view. For example, in *Esquire Nominees v FCT*,¹⁵⁰ the taxpayer was incorporated in Norfolk Island. Its directors were all Norfolk residents and directors' meetings were held in Norfolk Island. An Australian chartered accounting firm prepared the agendas acting on behalf of Australian residents who were the beneficial owners of the taxpayer. The Commissioner argued that the directors merely carried out the instructions given by the accountants and therefore, real control of the company was in Australia. Gibbs J rejected this argument saying that although the company (via its directors) did what it was instructed to do, the accounting firm had power to exert influence, and perhaps strong influence but that is all. Gibbs J said that he believed that if the directors had been instructed to do something improper or inadvisable they would not have done it and therefore actual management and control of the company and therefore its residence, was in Norfolk Island. The High Court upheld this point on appeal.

¹⁴⁶ Explanatory Memorandum to *Income Tax Assessment Amendment Bill (No. 5) 1983* (Cth), clause 8.

¹⁴⁷ The Macquarie Dictionary, 410-411.

¹⁴⁸ Ibid, 575.

¹⁴⁹ Hamilton, *Guidebook to Australian International Taxation*, (1996), [2-16].

¹⁵⁰ (1972) 72 ATC 4076; 46 ALJR 345; 3 ATR 105 (Gibbs J); (1973) 73 ATC 4114 (Full High Court).

In *Unit Construction Co Ltd v Bullock*,¹⁵¹ management and control of subsidiaries was vested in directors who could meet anywhere outside the United Kingdom. The subsidiaries' directors acquiesced in decisions being taken in the United Kingdom by the parent company. The Court held that the subsidiaries were United Kingdom residents. The House of Lords stated that the actual place of management was the decisive question and the instant case was a straightforward question of de facto control in the United Kingdom.

Arguably the distinction between *Esquire Nominees* and *Unit Construction* turns on the action of the directors in *Unit Construction* standing aside while decisions were taken in the United Kingdom.

Although it was found in *Malayan Shipping Co Ltd v FCT*¹⁵² it was found (and conceded by the appellant) that two Singaporean persons were appointed directors and they met outside Australia, all decisions were taken by an Australian resident (with power to appoint and remove directors, veto resolutions, control company contracts and bank accounts, etc.) so that the entire management and control of the company was concentrated in his hands. The company was treated as a resident of Australia.

The case of *FCT v Commonwealth Aluminium Corporation Ltd*¹⁵³ may indicate some softening of approach on the degree of de facto control necessary to be shown. The case concerned the Commissioner's arbitrary assessment power under the former s. 136 of the ITAA 36. The majority of the High Court of Australia considered that the critical issue was who controlled the business as distinct from who controlled general meetings. While holding that the taxpayer's directors in Australia controlled the business, Stephen, Mason and Wilson JJ said that the word 'controlled':

refers to de facto control rather than to capacity to control...What is more, the notion of de facto control is appropriate when we consider that it is to the business carried on by a company, not to the company itself, that the word relates...

¹⁵¹ (1959) 38 TC 712; appld *Little Olympian Each Ways Ltd, In re* [1995] 1 WLR 560; cited in *Taxation Case LS7* (1979) 79 ATC 429; *Esquire Nominees Ltd v FCT* (1972) 72 ATC 4076; 46 ALJR 345; 3 ATR 105.

¹⁵² (1946) 71 CLR 156; refd to and cited in *Aktiebolaget Volvo v FCT* (1978) 36 FLR 334; *Taxation Case H14* (1976) 76 ATC 92.

¹⁵³ (1980) 143 CLR 646; appld *Connell v Lavender* (1991) 7 WAR 9.

The shareholders, through their power to control the company in general meeting and perhaps through their power to elect directors, may be said to "control" the company, but as a general rule they do not exercise de fact control of the company's business.¹⁵⁴

Therefore, more is required than simply looking at the strict legal rights attaching to the agreements or arrangements that may be entered into by a tolling company in relation to the management and control of a power station. Additional matters may come under scrutiny as well: to the extent that s. 51AD(4)(b)(ii) uses the words 'controls, will control, or is or will be able to control directly or indirectly' in relation to the use of T's property, it looks to de facto rather than legal control.

Accordingly, a determination of the question of control will require resources to be expended to examine power station management documents and associated arrangements (eg financial relationships), which could affect the question who effectively controls the operation of the power station. Any financial arrangements between T and others (generally, though, NEMMCO) may indicate economic dependency such that T, as the legal owner, may not as a practical matter, be capable of operating the power station otherwise than in accordance with the wishes or directions of those other persons or bodies.

TOLLING TRUSTS - AN ASSESSMENT

A unit 'tolling' trust might be an attractive option for participants,¹⁵⁵ and this is principally because of their flow through capabilities. Trusts allow arm's length participants to join together in an undertaking, with defined rights to a proportion of the income and capital of the trust fund and specified entitlements as against the trustee, without the requirement that the participants become co-shareholders in a tolling company.

Presently, the net income of the trust is not subject to the prevailing company income tax rate.¹⁵⁶ Flow-through tax advantages are the main reason for the widespread use of trusts and specifically the flow through of tax preferences.¹⁵⁷ Trusts are not now taxed at the entity

¹⁵⁴ Ibid, 659-660 apud in AAT Case 5789 (1990) 90 ATC 3323.

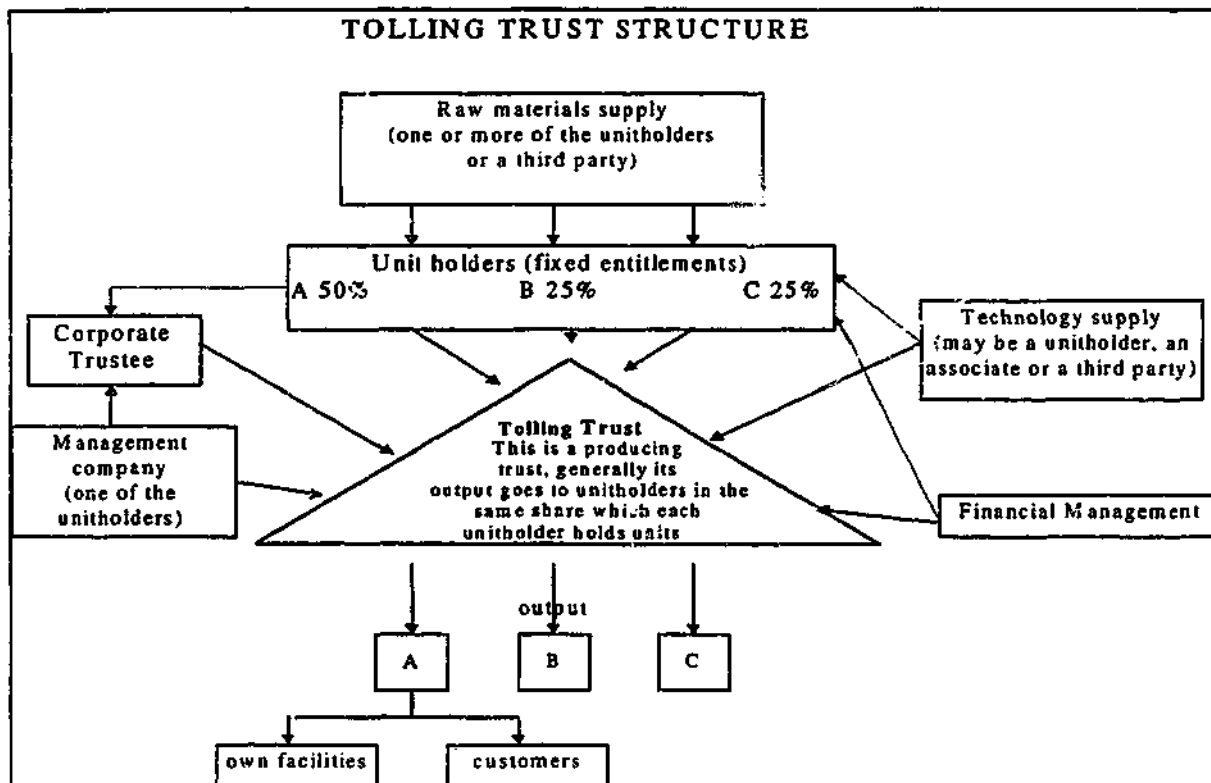
¹⁵⁵ For a detailed consideration of unit trusts, see Ford (1960) and Grbich, *Modern Trusts and Taxation*, (1978).

¹⁵⁶ Ladbury (1984), 329.

¹⁵⁷ Glover, 194; cf Schaub (1999).

level, 'trust law treats them as conduits to liabilities of beneficiaries and trustees'.¹⁵⁸ The trust is a conduit to presently entitled beneficiaries.¹⁵⁹ Figure 6.3 illustrates the inter-relationships that occur in a tolling trust structure and usefully demonstrates the obligations of the unitholders to the tolling trust and to the financiers.

Figure 6.3: Simplified Tolling Trust Structure



The concept of the tolling charge will not be contrary to the trust loss provisions inserted in Sch. 2F of the ITAA 36 pursuant to the *Taxation Laws Amendment (Trust Loss and Other Deductions) Act 1998* (Cth). Tax losses cannot be distributed under the law of trusts and are locked into the trust structure.¹⁶⁰ In the tolling trust concept, current year deductions are transferred from the trust to the participants. The participants will probably not be tax-avoiders.

In 2000, the Government released exposure draft legislation providing for the taxation of

¹⁵⁸ Id.

¹⁵⁹ See Longhouse (1999); Glover, 194.

¹⁶⁰ See Glover, 194.

trusts like companies.¹⁶¹ The exposure draft legislation provided that all resident non-fixed trusts would be taxed like companies unless they were specifically excluded. The proposed general rule was that unless the trust was a fixed trust, only non-fixed trusts created or settled as a legal requirement would be excluded. The exposure draft legislation provided for the intended preservation of conduit taxation for fixed trusts on the introduction of the entity taxation regime. That is, conduit tax treatment for fixed tolling trusts would have continued under the entity taxation regime.¹⁶² The government announced the withdrawal of the exposure draft legislation in 2001.¹⁶³

FLOW-THROUGH TAXATION - AN INTERNATIONAL ASSESSMENT

In Canada and the United States, royalty trusts achieve a similar fiscal outcome for the investors as for tolling companies in Australia. But unlike tolling companies, the benefit of conduit taxation of royalty trusts is that the tax preferences associated with the ownership of assets like real property are passed through to ultimate investors with their tax status's intact.¹⁶⁴

Flow-through taxation in Canada

Canadian royalty trusts are a useful conduit entity for taxpayers with significant investments in mining and petroleum assets, such as mature oil and natural gas properties, producing oil facilities, pipelines and gas processing facilities.¹⁶⁵ Despite the complexities of royalty trusts and the restrictions in the Canadian *Income Tax Act*¹⁶⁶ on unit trusts and mutual fund trusts, they can be utilised as a flexible vehicle to achieve desirable economic results. In general, a trust is taxed in Canada as an individual on its income for each tax year without benefit of

¹⁶¹ Refer *Exposure Draft: New Business Tax System (Entity Taxation) Bill 2000* (Cth).

¹⁶² Id.

¹⁶³ On 27 February 2001, the Treasurer announced the withdrawal of *Exposure Draft: New Business Tax System (Entity Taxation) Bill 2000* (Cth). The Treasurer stated that the government would 'begin a new round of consultations on principles which can protect legitimate small business and farming arrangements whilst addressing any tax abuse in the trust area': *Entity Taxation*, Press Release no. 008, 27 February 2001.

¹⁶⁴ For example, US investment allowances and depreciation deductions.

¹⁶⁵ Brussa (1997), 314.

¹⁶⁶ R.S.C. 1985 (5th Supp.), c. 1.

personal deductions.¹⁶⁷

Royalty trusts must satisfy the definitions under the *Income Tax Act* of a 'unit trust'¹⁶⁸ and a 'mutual fund trust'.¹⁶⁹ In effect, this means that four broad requirements must be satisfied. First, the trust may acquire and hold virtually any type of asset, provided that the holding is essentially passive.¹⁷⁰ Secondly, a mutual fund trust must have units which are qualified for distribution to the public under applicable securities law and must have reasonable dispersal of ownership (ie at least 150 unit holders).¹⁷¹ Thirdly, if a mutual fund trust is to invest more than 10 percent of its funds in securities of one issuer (other than the Crown), units must have a defined and reasonable redemption feature. Conversely, if the trust restricts its investments to certain types of property, including royalties on petroleum, natural gas or mineral production, it will qualify without a redemption feature.¹⁷² Fourthly, the trust must maintain restrictions on ownership by non-residents to ensure that less than half of its units are owned thereby.¹⁷³

Classic royalty trusts

A classic royalty trust is a mutual fund trust which acquires an interest in the proceeds of petroleum production from a special purpose corporation. The classic royalty trust structure creates a resource-based passive revenue stream, giving the trust all of the benefits (and risks) of carrying on an oil and gas business.¹⁷⁴ This is achieved by carving out a percentage of the 'net revenue' generated from the output of a petroleum and natural gas working interest (whether production leasehold interests or freehold title to mines or minerals) as a 'royalty'.

¹⁶⁷ Sections 104(2), (3) *Income Tax Act*.

¹⁶⁸ A unit trust is defined in s. 108(2) of the *Income Tax Act* as an *inter vivos* trust which has certain defined attributes, and where the interest of each beneficiary therein is subdivided into units. The concept of a 'unit' is not defined under the *Income Tax Act*.

¹⁶⁹ See s. 132(6) *Income Tax Act*.

¹⁷⁰ Section 132(6) *Income Tax Act*.

¹⁷¹ C.R.C., c. 945, s. 4801 *Income Tax Regulations*.

¹⁷² Refer s. 132(7) *Income Tax Act*.

¹⁷³ Section 132(7) *Income Tax Act*.

¹⁷⁴ Brussa (1997), 320.

The method whereby the royalty trust, as a mutual fund trust is able to capture the taxation benefits of carrying on an active oil and gas business is complex and is a function of the structure used.¹⁷⁵

The basic structure involves the establishment of an operating company—OpCo—the entity which will carry on the oil and gas business. This will be relatively inexpensive to establish. OpCo will essentially be a flow-through vehicle to the royalty trust. Ownership of shares in OpCo is not economically significant. In order to separate the business being carried on, and the passive investment required of the royalty trust, the OpCo's shares are typically owned by the manager of the business, M, which earns a management fee for its management efforts.¹⁷⁶

OpCo then purchases the petroleum and natural gas working interests from the relevant vendor. The royalty trust finances the acquisition of the production leasehold interests by OpCo from issuing shares to the public. The capital generated by the share issue provides the funds to acquire the interests.

From an economic perspective, the royalty is intended to vest in the royalty trust the net profit from the petroleum and natural gas production business carried on by OpCo. For Canadian taxation purposes, the royalty is intended to create a deduction in OpCo of its net income, being its gross revenue less any available deductions that it may have.¹⁷⁷

This result could be contrasted with the income tax consequences of a distribution by OpCo of its profits to shareholders, which would not be deductible to OpCo (because it is a dividend payment), thereby imposing an intervening level of taxation between the source of the income and the ultimate recipient. Therefore, the royalty granted by OpCo to the royalty trust will achieve a flow-through of OpCo's income to the trust, itself a flow-through vehicle for unit-holders, thereby achieving the same result as in the tolling trust. Basically, 'royalty' income consists of the excess of gross revenue from production, including the share reserved to the

¹⁷⁵ Id.

¹⁷⁶ Ibid, 321.

¹⁷⁷ For example, costs of operation, fees paid to M, tax depreciation against any depreciable property and interest expense in respect of outstanding borrowings.

Crown less the aggregate of costs.¹⁷⁸

If OpCo is left without resources to remit the Crown's share of production from the working interest, the royalty trust will agree to reimburse OpCo for its Crown royalty obligations. The royalty trust could do this by agreeing to allow OpCo to offset the amount owed under the reimbursement obligation against OpCo's liability to pay the royalty.

The reimbursement mechanism operates under s. 80 of the *Income Tax Act* to shift the burden of non-deductibility and the partial offset created under the resource allowance to the royalty trust, where the excess of the non-deductible Crown royalties over resource allowance can be allocated to unit-holders under s. 104(29) of the *Income Tax Act*. Therefore, OpCo acts as a flow-through vehicle, with all of the taxable profit from its operations being distributed to the royalty trust. The royalty trust, as the income recipient, is also the repository of the cost for tax purposes of the bulk of the business expenditures, being the purchase price of the working interest.

The classic royalty trust creates a vehicle whereby an investor receives revenue without an intervening level of taxation (by virtue of the flow-through nature of both OpCo and the royalty trust).

Flow-through taxation in the United States

Oil and gas royalty trusts, found in the U.S. oil producing states, are tax-driven entities.¹⁷⁹ In a typical transaction, a company that has developed an oil field (or some other extractive asset) will transfer ownership to a trust, distributing beneficial interests in the trust to the company's shareholders. As owner of the royalty-bearing asset, the trust distributes directly to the beneficiaries of the trust the royalty income that the trust asset generates. The

¹⁷⁸ Costs include: all costs of production, all costs of transportation and marketing of production, any capital expenditures financed other than through borrowing, any interest or principal due to the lender, any corporate tax of OpCo in respect of its production and any corporate overhead, including the fee payable to M.

¹⁷⁹ In addition to dispensing with corporate-level taxation, some oil and gas royalty trusts are structured as tax credit royalty trusts under I.R.C. 29 to maintain the benefits of tax credits awarded for the production of unconventional fuels. See Crain (1994), 12.04, 12.17-12.25. Illustrative transactions are discussed in industry journals. See, eg Robinson (1994).

beneficiaries then escape corporate-level taxation.¹⁸⁰ These trust interests are marketable, and a number of the larger royalty trusts are stock-exchange traded.¹⁸¹ A royalty trust may pass production profits tax-free to shareholders.¹⁸² Income from oil and gas royalty interests is not treated as rent from real property for the purposes of qualifying as a real estate investment trust,¹⁸³ nor would such income be of the type necessary to qualify as a regulated investment company.¹⁸⁴

Oil and gas royalty trusts are utilised in two different types of mineral royalty transactions. The first type consists of a distribution in kind of income producing property to the shareholders. If this happens, no corporate income taxes are imposed on future royalty income. To illustrate, a company, by utilising royalty interests¹⁸⁵ on all or a portion of its mineral properties, transfers the royalties to a trust. It is intended that the trust will constitute a royalty trust rather than a separate taxable entity, and that the shareholders will be treated as

¹⁸⁰ On the mechanics, see Crichton (1982); Dollinger (1981). For a comparison with the partnership structure, see Crain (1987).

¹⁸¹ See Crain (reporting more than 20 publicly traded oil and gas royalty trusts created since 1976, most of which are still trading).

¹⁸² Gordon (1994), 164.

¹⁸³ Sections 856(c)(6)(C), 856(d)(1)(A) of the *Internal Revenue Code*. Real estate investment trusts (REITs) are mutual funds that invest in real property. The United States does not have integrated corporation and shareholder taxation: see *An International Perspective* (1998), 112. Mutual funds play a large role in the U.S. economy and have become of late almost the preferred means by which domestic individuals invest in stocks and shares (see Langbein (1995), n. 40: approximately 2345 mutual funds reported to the Investment Company Institute in 1997 with assets of nearly \$US1 trillion; see also Yin, 128). About half the number of mutual funds take the form of trusts and the other half are corporations (see Langbein (1995), n. 41). Parts I and II of Sub chapter M of the United States *Internal Revenue Code of 1986* provide a code of conduit tax treatment for mutual funds (see Sections 13(a), 27, 48(e)(1)(D) *US Revenue Act of 1936*, see Clark (1975), 1624). It has been said that function, rather than structure determines eligibility for conduit treatment (see Glover, 199). This accords with the Canadian regime. Investments made by mutual funds must be diversified and be passive and non-controlling interests (see *2 A Platform for Consultation*, para. 16.25). At least 90 percent of the ordinary income of mutual funds must be distributed to members (exclusive of capital gains). An oil and gas royalty trust may hold the title of an oilfield, or other extractive asset, enabling royalty income that the asset generates to be distributed directly to beneficiaries without passing through any level of corporate taxation. The United States does not have integrated corporation and shareholder taxation (see *An International Perspective* (1998), 112).

¹⁸⁴ Section 851(b)(2) of the *Internal Revenue Code*.

¹⁸⁵ Any nonoperating economic interest in mineral property (or combinations thereof) could be used. For example, an overriding royalty, a net profits interest or a production payment, the proceeds of which are pledged for exploration or development, could be transferred to a trust. Refer chapter 4.

the owners of the trust property.¹⁸⁶

If the income stream is no longer subject to federal income taxes at the corporate level, the shareholders would be taxed directly on the royalty income paid to the trust. If the shareholders are treated as owning the underlying property of the trust, they would be entitled to depletion deductions on the income.¹⁸⁷

The second type of royalty trust transaction provides corporations with a method for raising capital without issuing additional debt or equity by applying the royalty trust concept to a traditional financing vehicle in the oil and gas industry.¹⁸⁸ These trusts often involve an initial public offering. At the closing of the offering, the trust purchases royalties on a designated portion of the corporation's mineral properties.¹⁸⁹ The corporation generally recognises a taxable gain on the sale, and the investors, as owners of the trust property, are taxed directly on the royalty income and are entitled to the same tax benefits available in a shareholder distribution transaction—depletion deductions.¹⁹⁰

¹⁸⁶ Gelinas (1982), 226.

¹⁸⁷ See ss. 613, 613A, 165 of the *Internal Revenue Code*. Percentage depletion is a statutory deduction allowed to the owner of an economic interest in minerals. Under this method of depletion, the allowance is computed on a specific percentage of the gross income derived from the property. Oil and gas income qualified for this deduction prior to the *Tax Reduction Act* (1975). The Act, however, repealed the percentage depletion deduction on oil and gas income, subject to a number of exceptions. One of these exceptions permits independent producers and royalty owners to claim percentage depletion on limited quantities of annual production. See *Eagle v Commissioner* 677 F.2d 594 (7th Cir 1982), *Glass v Commissioner* 76 TC 949 (1981).

¹⁸⁸ The creation and sale of a royalty interest, which is carved out of, and burdens, the working interest in an oil and gas property is a traditional financing technique in the oil and gas industry. Refer chapter 4.

¹⁸⁹ This type of transaction was developed in 1980 by Houston Oil & Minerals Corporation, which obtained a favourable letter ruling from the Service: LTR 8113068 (Dec. 31, 1980). See Houston Oil & Minerals Corporation, Prospectus (15 April 1980).

¹⁹⁰ Gelinas (1982), 230.

CONCLUSIONS

This chapter sets out the major findings of this thesis. The purpose of this thesis was to examine and analyse systematically the taxation of mining and petroleum joint ventures in Australia by using the data of the compliance costs of taxing expected returns and recognising expenditures associated with the returns as key determinants of the choice of joint venture structure. The role of the data of compliance costs of Australia's tax laws has proved to be a significant factor affecting the choice of joint venture structure. The methodology employed in this thesis has involved utilising compliance costs as a model to assess the effect of fiscal uncertainty, characterisation risk and fiscal complexity on the choice of joint venture structure.

COMPLIANCE COSTS WILL DIFFER FOR EACH MINING AND PETROLEUM JOINT VENTURE STRUCTURE

Compliance costs will differ for each joint venture structure because the ownership interests of participants of unincorporated joint ventures differ from the ownership interests of equity participants of equity joint ventures and participants of tolling companies. Two areas where a difference in these costs is most apparent are the compliance costs in respect of characterisation risk and compliance costs of using tolling companies.

Compliance costs in respect of characterisation risk

We have seen that participants of unincorporated joint ventures will face a compliance cost because of characterisation risk. Participants are subject to these compliance costs for four reasons.¹

Taxpayers and their advisors cannot assume that the Commissioner will always apply

¹ First, an unincorporated joint venture is not formally recognised by Australia's tax legislation, either as a taxpayer in its own right or as a tax reporting entity (refer pp 25-39). Secondly, the High Court's decision in *Brian's case* (1985) 157 CLR 1 causes fiscal uncertainty (refer pp 14-15). Thirdly, participants may be treated as partners when they finance their project (refer pp 78-79). Fourthly, the grant by a participant of an overriding royalty could expose it to characterisation risk (refer pp 145-148).

Australia's tax laws benevolently to participants of unincorporated joint ventures. Recent cases demonstrate it is not axiomatic that the Commissioner will always act consistently or that taxpayers can prevent the Commissioner from applying the law in a literal manner.² This compounds the fiscal uncertainty participants face arising from characterisation risk. Therefore, to the extent that participants expend funds—in isolation or regularly—to acquire knowledge to determine the extent and significance of characterisation risk, compliance costs for them may increase as a result.³

By contrast, the ITAA 97 treats SPVs of equity joint ventures and tolling companies as taxpayers in their own right. In this respect, they differ significantly from unincorporated joint ventures. Characterisation risk is low to negligible for SPVs and tolling companies. Accordingly, equity joint ventures and tolling companies have a comparative compliance cost advantage compared to unincorporated joint ventures in this area. The cost advantage equals the compliance costs expended by a participant of an unincorporated joint venture because of characterisation risk.

Compliance costs of tolling companies

Notwithstanding that participants of tolling companies incur no compliance costs in respect of characterisation risk, compliance costs will arise for them in four other areas. First, in determining the quantum of the tolling charge;⁴ secondly, in determining whether a tolling company is 'carrying on a business';⁵ thirdly, when long-term supply contracts are entered into;⁶ and fourthly because of the legal and effective complexity of complying with s. 51AD of the ITAA 36.⁷

² Refer *Bellinz v FCT* (1998) 84 FCR 154 and *David Jones Finance and Investments Pty Ltd v FCT* (1991) 28 FCR 484.

³ Participants may incur ongoing compliance costs in an unincorporated joint venture to manage characterisation risk throughout the project. For instance, costs might be incurred regular to manage any sales contracts to which the participant is a party to ensure that at all times the participant does not sell product jointly with any other participants of the unincorporated joint venture.

⁴ Refer pp 232-235.

⁵ Refer p 233.

⁶ Refer pp 244-246.

⁷ Refer pp 246-254.

Compliance costs to determine the tolling charge are in addition to the compliance costs a tolling company will incur to determine its taxable income (or loss) annually. The former will arise because the process for calculating tolling charges is complex: a tolling company could expect to incur considerable labour time and effort, and hence cost, to make this calculation. Compliance costs will arise to determine whether a tolling company is carrying on a business. This determination requires an understanding of Australian cases and will involve difficult questions of fact and degree. There are also significant transaction costs associated with long term supply contracts: they have high enforcement and monitoring costs⁸ and entering into such contracts cannot be avoided because the guaranteed purchase price and income provisions in them ensure that the tolling company will earn a sufficient income stream to service and repay its debt. As well, s. 51AD is legally complex in its operation and this may potentially increase the compliance cost burden on a tolling company.⁹ Lastly, we saw that in Canada and the United States, royalty trusts achieve a similar fiscal outcome for the investors as for tolling companies in Australia, however, unlike tolling companies, the conduit taxation of royalty trusts means the passing through of tax preferences associated with the ownership of assets like real property to ultimate investors with their tax statuses intact.¹⁰

The higher the compliance costs of using a tolling company, the lower the net fiscal benefits from its use. At the point where compliance costs equal the fiscal benefits derived, all fiscal benefits from the use of a tolling company structure disappear. If that happens, then from a revenue law perspective, all justification for using a tolling company in preference to other joint venture structures will also disappear.

THE TAXPAYER THAT WILL INCUR COMPLIANCE COSTS IS SPECIFIC TO EACH JOINT VENTURE STRUCTURE

The taxpayer who will incur compliance costs is specific to each joint venture structure and this is attributable to the degree of fiscal transparency of a mining and petroleum joint venture structure. In fiscally transparent mining and petroleum joint venture structures, participants will bear the compliance cost burden. In other joint ventures, the compliance cost burden will

⁸ Refer Industry Commission, *Study into the Australian Gas Industry*, (1995), 241.

⁹ It is noted that the Ralph Committee has recommended the abolition of section 51AD, and the government supports this recommendation in principle. Refer pp 248, 249.

¹⁰ For example, US investment allowances and depreciation deductions. Refer pp 256-261.

be borne by the applicable corporate entity, unless the structure is a tolling arrangement.

Accordingly, participants incur the compliance costs of carrying on unincorporated joint ventures whereas the compliance costs of carrying on equity joint ventures are incurred by the SPV. Unincorporated joint ventures are fiscally transparent because they are not recognised as taxpayers by Australia's tax laws whereas SPVs are so recognised.¹¹ Although tolling companies are recognised by Australia's tax laws, the calculation of the tolling charge pursuant to the tolling agreement will ensure that all tax deductible compliance costs of carrying on a tolling company are borne ultimately borne by the participants.

THE COMPLIANCE COSTS OF TAXING FINANCING DECISIONS ARE PECULIAR TO THE JOINT VENTURE STRUCTURE

The compliance costs of taxing financing decisions are peculiar to the joint venture structure.¹² Therefore, the manner by which a joint venture is financed will play a role in influencing and shaping the joint venture structure that is used. Notwithstanding that in general, Australia's laws for taxing financing joint ventures is comprehensive, it is far from certain and coherent.¹³ We saw from the compliance costs of traditional debt financing, leveraged leasing, sales and leasebacks, as well as the fiscal uncertainty of using drilling funds and of the thin capitalisation rules and the complexity of the interest withholding tax provisions that these costs are peculiar to the joint venture structure.

With traditional debt finance, a borrowing participant will incur compliance costs to determine whether interest expenses are deductible or not.¹⁴ These costs arise because of the distinction tax laws make between interest expenses incurred on capital account and interest incurred on revenue account, and the distinction between interest incurred before and during the income producing activity. Tax laws do not 'eliminate many sources of tax avoidance'.¹⁵ Costs are incurred because of the effective complexity of tax laws. Accordingly, borrowing participants

¹¹ Tang (1999), 1.

¹² Burges (1986), 24.

¹³ 1 *A Platform for Consultation*, para. 3.5.

¹⁴ Refer pp 85-93.

¹⁵ Conwell (1999), 246.

may incur costs to assess whether a capital raising is such a recurrent event in its business life that it qualifies as a revenue expense.¹⁶ A determination of whether interest expenses incurred by a borrowing participant are deductible or not may require expertise to interpret and apply the law.¹⁷

For leveraged leases, compliance costs will arise for lessee participants due to the regulatory burden,¹⁸ the differing characterisations of rental payments,¹⁹ regulatory uncertainty and the potential operation of Pt IVA on leveraged lease arrangements.²⁰ There is a significant 'paper burden' or administrative costs to lessee participants to comply with and/or report on the regulatory requirements for a leveraged lease. The painstaking detail and effort required by lessee participants in adhering to tax laws are a major impediment to the efficient operation of the economy.²¹ Vendor participants of sales and leasebacks similarly incur the same costs as lessee participants of leveraged leases, but vendor participants' costs are counterbalanced by the removal of the balancing charge offset and the removal of plant from the capital gains provisions of the law.

Section 8-1(1) of the ITAA 97 will impose an administrative burden in characterising rental payments. There is also considerable uncertainty about the extent to which the proposed Divs 240 and 243 of the ITAA 97²² and the Ralph Committee's proposed lease reforms will affect the level of activity in leveraged leases. Moreover, lessee participants may incur

¹⁶ See *Texas Co (Australasia) Ltd v FCT* (1940) 63 CLR 382, 468 per Dixon J and *GP International Pipecoaters Pty Ltd v FCT* (1990) 170 CLR 124, 137 where the High Court recognised that the character of expenditure is ordinarily determined by reference to the nature of the asset acquired or the liability discharged, but added that the chief factor in determining the character of the payment is the character of the advantage sought by making the expenditure.

¹⁷ See *Steele v FCT* (1999) 197 CLR 459.

¹⁸ Refer pp 96-100.

¹⁹ Refer pp 101-103.

²⁰ Refer p 106-107.

²¹ ACCI, *What Business Seeks from the Next Government of Australia: ACCI Review No. 18*, (1996), 4. For example, leveraged lease transactions may be subject to additional provisions because they involve sale and lease back arrangements (See for example *Ruling* TR 95/30), or because non-resident lessee participants are involved (Refer s. 51AD and Div 16D of the ITAA 36, *Ruling* TR 96/22 and draft *Ruling* TR 94/D25. Note that the Ralph Committee has recommended that s. 51AD be repealed: *A Tax System Redesigned*, 392).

²² The proposed new rules are contained in *Taxation Laws Amendment Bill (No 5) 1999* (Cth).

compliance costs in considering the potential application of Pt IVA of the ITAA 36.²³

Then there is the fiscal uncertainty of drilling funds²⁴ and the thin capitalisation rules.²⁵ ITAA 97 provisions are ill-equipped to meet the objectives of the average drilling fund investor and there are no indications that the Federal Government intends to legislate to improve the position. An average drilling fund investor's primary objective will be to obtain an allowable deduction for his contribution,²⁶ but existing tax laws are difficult to reconcile with this objective because of the uncertainty surrounding whether the conditions of s. 330-15(1) and (2) of the ITAA 97 will be satisfied. The investigation in chapter 3 into the meaning of the expression 'accumulated profits' has demonstrated the fiscal uncertainty of the current thin capitalisation rules.²⁷ Considerable fiscal complexities and uncertainties could potentially arise when IWT questions must be resolved. This complexity and uncertainty adds to the compliance burden on taxpayers involved in joint ventures.

Questions for a participant of an unincorporated joint venture concerning traditional debt financing, leveraged leasing, sales and leasebacks, drilling funds, the thin capitalisation rules or the complexity of the interest withholding tax provisions, will arise at the level of the participant, unless the participants have incorporated a SPFC, in which case the issue will be centralised. Equity joint ventures will always incur these compliance costs at the level of the SPV. This increases the comparative cost of using one joint venture structure compared to another. For taxpayers of joint venture structures, fiscal uncertainty increases the complexity of the law, which in turn may increase compliance costs.

²³ Costs would likely take the form of legal costs or a private ruling. Refer p 104.

²⁴ Refer pp 113-117.

²⁵ Refer pp 125-128.

²⁶ Walsh (1983), 171.

²⁷ See, in particular, pp 128-131.

THE COMPLIANCE COSTS OF TAXING FARMOUTS AND DEALINGS IN JOINT VENTURE INTERESTS ARE PECULIAR TO THE FARMOUT STRUCTURE OR STRUCTURE OF THE DEALING

Compliance costs of taxing asset farmouts and asset sales are higher than for share farmouts and share sales. This is attributable to the nature of farmor's and transferor participant's interests in the joint venture assets and the complexity and sheer number of tax laws applicable to the former compared to the latter. Farmouts and dealing in joint venture interests are part of the business landscape for mining and petroleum taxpayers.

Tax law does not easily apply to asset farmouts and asset sales. There are primarily four reasons underscoring the compliance costs participants will incur whenever they enter into asset farmouts or asset sales. Tax laws distinguish between proceeds on revenue and capital account. The trading stock provisions are uncertain. Depreciation and mining and petroleum balancing adjustments are complex. Capital gains provisions are complex to apply. Costs incurred will relate to labour/time consumed in completion of tax activities, external advice and incidental expenses incurred to complete tax activities.²⁸

Share farmouts and share sales impose a lower compliance cost burden than asset farmouts and asset sales because of the absence of complex provisions requiring interpretation and comparatively fewer laws to apply. This does not mean *ipso facto* that a participant who enters into a share farmout will ultimately incur less compliance costs than a asset farmout.²⁹

Asset farmouts and asset sales may require farmors and transferor participants to apply the trading stock provisions. For farmors, the central question is whether those provisions apply to prospecting entitlements. For transferor participants, the issue is whether a disposal by a transferor participant of its trading stock could be treated as a notional disposal of the trading stock by all the other participants. If so, then all affected participants will incur

²⁸ See Evans, *A Report into Taxpayer Costs of Compliance*, (1997), 3.

²⁹ For instance, the introduction of the consolidation regime as recommended by the Ralph Committee could negate a participant's compliance cost savings from a share farmout or share sale. If a participant enters into a share farmout the company whose shares change ownership will no longer be 100 percent commonly owned. A company must satisfy this ownership test to enter the consolidated regime. A participant which cannot consolidate its tax position into a consolidated group will incur compliance costs on its own account, rather than having those compliance costs consolidated at the group level: *A Tax System Redesigned*, 517.

compliance costs in terms of labour time and expenses in order to comply with this law.³⁰ Added to that, the law about the ownership of trading stock of unincorporated joint ventures is legally complex. The two views on the question of the first recognition of the joint venture product as trading stock of each participant could be resolved by an appropriate amendment to the ITAA 97.

The balancing adjustment provisions of Australia's tax laws add an additional layer of fiscal complexity for farmers and transferor participants. In particular, we have seen that transferor participants must interpret and apply complicated balancing adjustment provisions of the tax law. The additional compliance burden for farmers and transferor participants will involve labour costs and perhaps external advisor costs. In particular, unexpected depreciation balancing adjustment complications may arise if the farmer and 'farmees' intentions are not sufficiently clearly documented in the farmout agreement; the legal ownership test does not accommodate all farmout structures. However, these costs would disappear if a farmout or sale was structured as a share farmout or share sale instead.

Transferor participants do not share the difficulties faced by farmers in applying Pt 3-1 of the ITAA 97 to farmouts. Farmees not under or only a limited obligation to earn an interest will face fiscal uncertainty about whether they have an executory equitable interest in property the subject of the farmout. Farmers must incur compliance costs to determine whether prospecting information constitutes an 'asset' for capital gains purposes, as well as which CGT event to apply, its timing and cost base, when an asset is disposed of. Further, there are no legislative guidelines on factors to take into account to determine market value.³¹ The recent commercial transactions valuation method is unsustainable to the extent it is

³⁰ If a transferor participant disposes of its trading stock and one of the participants who owned the property before the change has an interest in the property after the change, then s. 70-100(3) applies as if the participants who owned the property before the change had disposed of the property to the persons who own it after the change (where the participants unanimously agree). For the section to apply, one of the participants who owned the trading stock before and after the change must have an interest in the property of not less than 25 percent of the value of the property. A number of restrictions on the availability of the election are provided for in s. 70-100(4). Section 70-100 prescribes the timing of making an election. There is obviously a compliance burden on participants imposed by s. 70-100.

³¹ The uncertainty of valuing exploration expenditure was most recently put in these terms:

[a]pplying the recommended treatment of expenditure and assets without recognising the valuation difficulties associated with the results of exploration and prospecting expenditure would mean that the tax treatment of this expenditure would depend on the results of the exploration or prospecting activity: *A Tax System Redesigned*, 167. [emphasis added]

inconsistent with the principle laid down in *Spencer v The Commonwealth*.³² The question of majority underlying ownership and sales of interests in interposed entities provisions may also pose a compliance burden in farmout transactions. By contrast, transferor participants can expect to incur administration costs to comply with the capital gains provisions, but these provisions will not in general impose any particularly onerous compliance costs on them.

Compliance costs of share sales affect three kinds of taxpayers: transferor equity participants, transferee equity participants and target companies. Transferor equity participants' compliance costs will be lower than transferor participants' compliance costs of entering into an asset sale. However, transferee equity participants and target companies face higher compliance costs than transferor equity participants.

Transferor equity participants' compliance costs will mainly relate to administering the capital gains provisions. Such costs will be incurred because the sale of shares by a transferor equity participant is likely to attract immediately the operation of the capital gains provisions. Transferee equity participants compliance cost burden under the capital gains provisions will not be immediate. Costs to transferee equity participants to interpret and apply the capital gains provisions will arise when shares in the target company are eventually disposed of. However, costs might arise sooner for a transferee equity participant to determine whether prior year tax losses can be transferred between companies in the same wholly-owned group.³³ Target companies may face compliance costs to determine the deductibility of prior year tax losses, and where there has been a change in the persons that held the majority underlying interests in the target company on 19 September 1985 or where the value of the CGT exempt assets of the target company, or any of its subsidiaries, has fallen below the 25 percent net value of the relevant threshold.

Summary

It can be concluded with reasonable certainty that for as long as there are compliance cost differences for unincorporated joint ventures, equity joint ventures and tolling companies, compliance costs will continue to play a role in determining the choice of joint venture

³² (1907) 5 CLR 418.

³³ This is because of the legal complexity of determining whether a taxpayer has a right, power or option or is able to affect the rights of the transferee equity participant in relation to the target company.

structure for mining and petroleum projects.

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