RECENT AND POTENTIAL DEVELOPMENTS IN THE TAXATION OF MINING AND PETROLEUM VENTURES

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This paper falls into four separate parts, each covering activity by different functionaries.

Part I deals with what was for a few days the draftsman's latest refinement to the Income Tax Assessment Act, namely Subdivision B of Division 2A of Part III of the Act, "Calculation of Taxable Income Where Disqualifying Event Occurs". It sets out to explore the impact of Subdivision B on Division 10 of the Act.

Part 2, "New Wine and Old Bottles: Using Old Prospecting Companies", examines the use which successful mining companies might make of mining companies left stranded following the collapse of the mineral boom of a few years ago.

Part 3, "Section 122J. (3): A Problem — and the Wrong Answer" deals with the Commissioner's solution to a difficulty arising when an amendment to the Act fails to achieve what the Treasurer says it was intended to achieve.

Part 4 deals with recent activity by the High Court in deciding *Cliffs International Inc.* v. *F.C.T.*: a bright spot on a fairly cheerless horizon.

Each part then concerns mining and taxation. They have something else in common. All are, I confess, hard reading. I think it was King George the Third who, when a writer said he found writing easy, replied, "Your easy writing's damned hard reading". I can assure His Majesty, that sometimes damned hard reading was damned hard writing too.

1. EXPENDITURE, DEDUCTIONS, AND LOSSES: TIMING AND THE RELEVANCE OF CONTINUITY OF STATUS

A. Introduction

The Income Tax Assessment Act (No.4) 1978 has inserted into the Income Tax Assessment Act a new Subdivision B of Division 2A of Part III of the Act, "Calculation of Taxable Income Where Disqualifying Event Occurs".[1] It is useful to approach Subdivision B by first comparing, as regards timing and status,[2] the ways in which the tax benefits (consequences) of expenditure vary, according to whether one is applying the general provisions of the Act, as found in Division 3 of Part III, or the provisions of Division 10, "General Mining".

B. The General Provisions of the Act

Until recently, the normal result of relevant expenditure or losses under the general provisions of the Act has been:

(a) A right to a deduction

(i) against any assessable income;

(ii) in the year of expenditure or a series of years beginning with the year of expenditure;

(iii) but only in that year or those years;

(iv) without regard to continuity of status.

(b) If in any year there remained deductions not fully absorbed (if, that is, the

taxpayer showed a "tax loss"), the unabsorbed amount might be carried forward as a loss, for up to seven years, but subject to continuity of status tests: ss.80A-80F of the Act.

To that earlier position one now adds Subdivision B.

The more detailed position under the general provisions of principal practical relevance is as follows:

(a) Section 51 gives a right to deduct from the assessable income (from any source), revenue and trading stock expenditure (in relation to any income activity) incurred in the year of income. Subject to at least one exception (there may have been more than one, but I can only recall one), this right existed notwithstanding any changes in status during or after the year of income. Since 7 April 1978 this right has been subject to the effect of the continuity of status tests of Subdivision B.

(b) Section 54 gives a right to deduct from the assessable income (derived from any source), depreciation on plant or articles used during the year of income for the production of assessable income (from any activity). This deduction will normally be calculated from expenditure, which will normally have been incurred in the year of income in which the use of the plant first gives rise to the right to deduction. The continuing right to this deduction has until recently continued notwithstanding changes in status occurring after the expenditure. Since 7 April 1978 the right of deduction in the year of expenditure has been subject to the effect of the continuity of status tests of Subdivision B.

(c) Section 63 gives a deduction to a lender of money who in the year of income writes off money lent as a bad debt, and to any taxpayer who writes off a debt previously brought to account as income.

The provisions of ss.63A-63C of the Act, introduced by s.6 of the Income Tax Assessment Act 1973 (Act No.51 of 1973) deny a corporate taxpayer the right to a deduction of a bad debt unless continuity of status tests are met between the year of income in which the debt was incurred and the year of income in which the debt is written off. These provisions apply not only in relation to s.63 but also in relation to s.51 (thereby introducing the exceptional case mentioned in (a) above). Deductions resulting from bad debts are likewise now subject to the effect of the continuity of status tests of Subdivision B. But here those tests probably have little further effect.

(d) Sections 82AA-82AQ (the most recent "Investment Allowance" provisions) give a deduction in respect of "eligible expenditure" on new plant. The deduction is allowed not in the year of expenditure as such, but in the first year of income in which the plant is used or installed ready for use in producing assessable income. The deduction is available against assessable income from any source. The right to deduction has not depended on any continuity of status tests. Since 7 April 1978 this right has been subject to the effect of the continuity of status tests of Sub division B.

All the above provisions give a right to deduction, once only, in a prescribed year of income — normally the year of expenditure, but sometimes a different year (bad debts, investment allowance) or series of years (depreciation). The deduction cannot be held over to a more suitable year. If the deduction produces a loss, what the taxpayer thenceforth carries forward is that loss, to be dealt with under the rules relating to losses.

Those relevant provisions are:

(a) Section 80 gives a right to deduct from the assessable income (derived from any source) a "loss" (as defined in s.80(1) of the Act) incurred during the previous seven years.

(b) For corporate taxpayers, this right is subject to satisfying the "substantial continuity of beneficial ownership of shares" tests (ss.80A-80B), these tests being made more rigorous by s.80DA (compliance with tests not necessarily sufficient), and then in one respect being relaxed by s.80E (company carried on same business), with special rules being annexed by s.80F for losses arising from bad debts.

In relation to these general provisions the effect of Subdivision B is to reinforce the tests for allowing losses to be carried forward from one year to the next (ss.80A-80F), by introducing similar tests in relation to the right to the original deduction within the original and eventful year. From this point of view it is easy to see how the two sets of rules complement each other.

C. Under Division 10 of the Act

The position under Division 10 of the Act, "General Mining", has been very different to that under the general provisions. Broadly, it has been as follows:

(a) Section 122D and s.122DB give a right to deduct "allowable capital expenditure". The amount of the deduction in any one year is governed initially by a formula related to the life of the mine, with a built-in maximum. Subject to contrary election under s.122D(3) or s.122DB(3), the amount of the deduction is further limited to the taxpayer's taxable income, that is, so much of its assessable income as remains after deducting all other allowable deductions. Source of the assessable income is irrelevant. So much of the allowable capital expenditure as remains undeducted goes forward into the next year's calculation: and so on indefinitely.

The purpose of this is to prevent the right to deduction being subjected to the seven-year constraint which s.80 applies where the deduction must be claimed in the prescribed year, and it leads to a "loss". The taxpayer can go down that route, by electing under s.122D(3) for total deduction in the year. But he need not, and normally does not.

But the advantage is not limited to the absence of the seven-year constraint. Section 122D and s.122DB contain no continuity of status tests. A complete change of shareholding leaves the right to continued deductions of allowable capital expenditure under ss.122D and 122DB unaffected.

(b) Section 122J gives a right to deduct exploration and prospecting expenditure on any mining tenement for minerals obtainable by prescribed mining operations, that is non-petroleum minerals the derivation of which leads to assessable income. Such expenditure I call "prospecting expenditure". Up to the whole of the expenditure incurred in the year of income may be deducted in that year, but only against (broadly) the taxable income derived from carrying on a mining business or businesses: s.122J(1)(2). The mining business need not be that in relation to which the prospecting expenditure was incurred.

To the extent that prospecting expenditure does not achieve deduction in the year of expenditure, the right to deduction remains in limbo until the first subsequent year of income in which the taxpayer "carries on prescribed mining operations": ss.122J(3) and 122J(4). Note the absence of any requirement of deriving taxable income from those operations.

What happens in that year depends on when the expenditure was incurred. If prior to 30 June 1974, s.122J(3) deems it to be allowable capital expenditure incurred in that subsequent year. The effect of this (as the Act is applied: see Part 3 of this paper) is to create under s.122D some right to deductions against taxable income from any source. So long as there has once been a carrying on of prescribed mining

operations, to trigger the transfer of the matter to s.122D, s.122J(3) becomes largely irrelevant. Thenceforth the matter is governed by s.122D and that does not require that mining operations be carried on.

If the prospecting expenditure was incurred after 30 June 1974, s.122J(4) treats it as being incurred during the first subsequent year of income in which the taxpayer carries on prescribed mining operations. This time there is no deemed change in the nature of the expenditure; merely a deemed change in the year in which it is incurred. Accordingly the right to deduction continued to be limited, as prescribed by s.122J(2), to deduction against taxable income derived from mining. The right to the potential deduction carries forward indefinitely.

Again there is an entire absence of continuity of status tests.

The Position Since Subdivision B

Mining companies are in no way exempt from Subdivision B. So acquisition, which will involve discontinuity of status, will constitute a "disqualifying event" leading to the taxable income for the year of income being calculated under that Subdivision. The effect of that will in general be as follows:

(a) Sections 122D and 122DB

In the absence of election under s.122D(3) or s. 122DB(3), deductions under these provisions are "full-year deductions" (s.50F(1)), and therefore do not get attributed to any "relevant period" and lost there because of inability to qualify a "notional loss" as an "eligible notional loss": c.f. ss.50C and 50D. In general then the position is as before but subject to at least one qualification, which may or may not lead to disadvantage — indeed will probably more often lead to advantage. The final right to deduction under s.122D and s.122DB depends on the presence in the year of income of a taxable income: s.122D(3) and s.122DB(3). To the extent that Subdivision B produces a greater taxable income by its treatment of other deductions, deductions under s.122D and s.122DB may expand to decrease that taxable income.

(b) Section 122J

The right to any s.122J(1) deduction otherwise available for prospecting expenditure will likewise be a full-year deduction: not a deduction attributable to the period of actual expenditure: s.50F(1). This is unlike the position with ordinary s.51 deductions. In any calculation of the taxable income for the year which Subdivision B will produce, it must be remembered that the s.122J(1) deduction will be a deduction for the year, not for a relevant period.

The right to a s.122J(4) deduction, for prospecting expenditure incurred after 30 June 1974 and carried forward into the relevant year, will likewise be a full-year amount. As it has been carried forward from an earlier year, that is what one would expect. As explained elsewhere, s.122J(3) gives, in relation to prospecting expenditure incurred before 30 June 1974, a right of resort to (in practice) s.122D. Any deduction thus made available to the company will likewise be a full-year deduction.

(c) Section 122K

If in the year of income the company disposes of property so as to bring s.122K into operation, its position will be different. The s.122K deduction is not a full-year deduction nor a divisible deduction. It is therefore an ordinary deduction. It will

therefore be taken into account in the calculation for the relevant period into which the date of its occurrence places it. If it produces within that period a notional loss, the effect of that loss will be lost except to an extent that that notional loss can be qualified as an eligible notional loss.

On the face of it this is a curious position. It is easy enough to see the general policy behind Subdivision B, in fields where there are continuity of status tests from one year to the next. But that is not the case with s.122K. A mining company can claim a deduction under s.122K notwithstanding the most complete change of shareholding since the original incurring of the relevant expenditure. It seems that only where the disposing of the property takes place in the same year as the break in continuity, will the break have relevance to that company's rights under s.122K.

The General Deduction Provisions

The position of mining companies under the general deduction of the Act is as for ordinary companies. As to the provisions of greatest practical relevance, the position is this. The s.51 deductions are ordinary deductions, attributable to the relevant period of actual expenditure; s.54 deductions are divisible deductions attributable between relevant periods by reference to lengths of time the particular plant was installed ready for use. Section 82AB deductions (Investment Allowance) do not appear as full-year or divisible deductions. So they must be ordinary deductions, attributable by reference to the date on which the entitlement arose. (I do not see why at present. But one often fails to comprehend such provisions as Subdivision B until one has greater familiarity with them than I yet have. There may be a reason.)

The position under s.51 and s.82AB means that any pattern of uneven trading activity or uneven plant purchases can again lead to one relevant period showing a notional loss not qualified as an eligible notional loss, and therefore lost to the company.

As the years pass and use of these new provisions gives one greater understanding of their operation and effect, one will see better how to avoid their pitfalls. But as one sees it at the present time, one precautionary lesson seems clear. If one is acquiring a mining company in a manner involving a break in continuity of status, one should seek to ensure that in the year of acquisition as far as possible its trading results are steady, and that the tax consequences of any disposal of a mining property and of any plant purchase have been investigated, so that as far as possible there is not in one relevant period a notional loss not capable of transmutation into an eligible notional loss.

2. NEW WINE AND OLD BOTTLES: USING OLD PROSPECTING COMPANIES

Nickel International Consolidated Kincarra Ltd. — I profoundly hope I have not unwittingly taken the name of a real company — is affectionally remembered as NICK. NICK was incorporated on 2 February 1970. It was floated on 17 February 1970, issuing to the public 5 million 50 cent shares. It was most fortunately able to buy from its promoters for the sum of $1 million cash plus 1 million 50 cent shares a group of most promising prospecting rights. The promoters accepted seats on the Board, and were able to arrange for NICK to have the advantage of management services rendered by Company Operations Nominees Pty. Ltd. (CON), a company they owned. CON loyally stayed on the job until NICK had no money left.

The prospecting rights turned out less rewarding than expected. All that was found was sand — which shows that NICK is not a Western Australian company. The sand was not readily marketable. NICK continues to exist. There is no regular market for its shares. Their price is that of an equivalent area of high grade wall-paper; and that would be their only use. Or would it? May there somewhere be someone to whom NICK is worth something? Let us look at NICK in relation to the Act.

NICK genuinely did — in the years 1970-1974 — spend $1 million in exploring and prospecting its mining tenements; and not the less so because it paid CON excessive fees for arranging and supervising the work. That gave it a potential right to a deduction under s.122J(1) of the Act. But s.122J(2) permitted deduction of exploration and prospecting expenditure only from taxable income derived from a mining business. NICK never had even assessable income. So NICK never did use that potential deduction under s.122J(1).

The expenditure was incurred prior to 30 June 1974, so the governing provision has for some years been s.122J(3), standing ready to treat the "excess" expenditure as allowable capital expenditure incurred by NICK in the first year of income in which NICK "carries on prescribed mining operations". By definition in s.122(1), "prescribed mining operations" means "mining operations . . . for the extraction of minerals . . . from their natural site". NICK never did get to that stage and never did have a "subsequent year of income in which" it carried on prescribed mining operations. It was prospecting to the bitter end.

Never did have? Or has not yet? Prominent in today's mining world is Successful Mining Activities Relentlessly Through Australia (SMARTA). Say that SMARTA could acquire all the shares in NICK. It would not be beyond the wit of SMARTA's management to insert into NICK a successful small mining operation, from which NICK would derive assessable income. Let us say SMARTA does so.

The mining activity being established, NICK derives assessable income from the year of acquisition. NICK is carrying on prescribed mining operations from the moment it acquires that small mining activity.

That makes s.122J(3) deem the much earlier exploration and prospecting expenditure to be allowable capital expenditure incurred in the year NICK commenced that new mining activity. The dates are such that as the Act is administered (see Part 3 of this Paper) the expenditure goes to s.122C and enters into the calculation of residual previous capital expenditure.

Problems immediately arise. Section 122D(2) quantifies the initial entitlement to the deduction by reference to "the estimated life of the mine or proposed mine on the mining property". In the case of ordinary allowable capital expenditure the facts will link the expenditure to the relevant mining property. But the mining operations the carrying on of which satisfies the requirements of s.122J(3), may convert into allowable capital expenditure, exploration and prospecting expenditure which had nothing to do with the mining property on which those mining operations are being carried on. In telling us that the expenditure is deemed to be allowable capital expenditure, the draftsman has not told us enough.

As I see it there are at least five possibilities:

(a) Prospecting expenditure on Property A. New mine on Property A.

(b) Prospecting expenditure on Property A, still held by NICK. New mine on Property B.

(c) Prospecting expenditure on Property A, no longer held by NICK. New mine on Property B.

(d)/(e) As for (b) and (c), but two new mines, on Properties B and C.

In case (b), one might think that in the first year of the new mining operations NICK could dispose of the mining property on which it wasted the prospecting expenditure, and take under s.122K a balancing charge which would absorb the whole of the newly converted allowable capital expenditure (less of course anything received on the disposal).

But if that be right, what of case (c)? NICK cannot dispose of the original property in the year of income, because it has already actually disposed of it, or (more likely) because the property (the relevant prospecting right) no longer exists. NICK got no deduction when it made that disposal or suffered that loss, for the prospecting expenditure did not at that point give rise to deductions "allowed" or "allowable" within s.122K(1). And it cannot get a deduction this year, for it cannot again dispose of or lose the property.

So it looks as though, to find a workable scheme, one does link the prospecting expenditure to the life of the new mine, notwithstanding that the relevant mining properties are different. Probably, if once linked to a particular mining property, it stays there notwithstanding that NICK opens another mine on another mining property. What happens if in the first year of NICK's new mining operations it acquires a mine on each of two mining properties, I leave to the ingenuity of NICK's advisers and the Commissioner.

Will Subdivision B of Division 2A of Part III of the Act obstruct SMARTA's scheme? In general the answer is no. However it might affect the timing. Assume that the acquisition constitutes a disqualifying event, and that the facts prevent any notional loss being qualified as an eligible notional loss. Thus any pre-acquisition notional loss would not be available to set off against any post-acquisition profit. NICK is moribund, so probably there will be no pre-acquisition notional loss. In particular, the deduction under s.122J(3) and s.122D, springing into existence when NICK begins to carry on mining operations, will be a full-year deduction, not attributable to either relevant period. But do not, for example, let NICK buy new plant before the acquisition. Make sure it does not spring s.122K into operation before the acquisition. Check its depreciation position.)

Reasons may emerge for SMARTA to acquire at some particular point of the year of income, for example at the very end; or to acquire early but to make sure that profitable operations do not start until the very end or indeed until into the next year of income. Facts will vary. They will need to be checked against the provisions of Subdivision B.

It is important to remember that the Commissioner might deny recourse to s.122D. That possibility I deal with in Part 3.

3. SECTION 122J(3): A PROBLEM — AND THE WRONG ANSWER

Section 122J(1)(2) of the Act gives a limited right of deduction for exploration and prospecting expenditure in the year of expenditure. The details are given elsewhere in this paper. Section 122J(3) and (4) set out to deal with the "excess" of that year's expenditure over the amount allowed as a deduction. If the expenditure was incurred before 30 June 1974, the relevant provision is s.122J(3).

Section 122J(3) provides that the "excess":

> shall, except for the purposes of sections 122DA and 122E be deemed to be allowable capital expenditure incurred by the taxpayer in the first subsequent year of income in which the taxpayer carried on prescribed mining operations.

How does one treat pre-30 June 1974 exploration and prospecting expenditure deemed by s.122J(3) to be allowable capital expenditure incurred in:
(a) The year 1973-1974?
(b) The year 1974-1975?
(c) The year 1975-1976, and any later year?

In general, allowable capital expenditure incurred on or before 17 August 1976 is dealt with by s.122C of the Act, and pursuant to that provision enters into the "residual previous capital expenditure". The consequent right of deduction is that given by s.122D. In general, allowable capital expenditure incurred after 17 August 1976 is dealt with by s.122DA of the Act, and pursuant to that provision enters into "residual capital expenditure". The consequent right to deduction is that given by s.122DB.

As the Act stood prior to the *Income Tax Assessment Amendment Act* (No.3) 1977 (Act No.127 of 1977), s.122J(3) did not make reference to 122DA. Accordingly, exploration and prospecting expenditure deemed by s.122J(3) to be incurred in the "first subsequent year of income" under s.122J(3) was, or ought to have been, treated as follows:

(a) If that "first subsequent year of income" was entirely prior to 18 August 1976, the expenditure was treated as "residual previous capital expenditure" within s.122C, falling for deduction under s.122D (at the rate appropriate to lesser of life of mine or twenty-five years).
(b) If that "first subsequent year of income" was entirely after 17 August 1976, the expenditure was treated as "residual capital expenditure" within s.122DA, falling for deduction under s.122DB (at the rate appropriate to lesser of life of mine or five years).
(c) If that "first subsequent year of income" straddled 17 August 1976, no one quite knew what to do, since s.122J(3) merely deems the excess expenditure to be incurred "in" the first subsequent year of income, without relating it to any particular of that year of income.

The purpose of amending s.122J(3) by inserting the reference s.122DA (which was effected by s.5(1)(a) of Act No.127 of 1977) was to ensure that all "excess" expenditure deemed by s.122J(3) to be allowable capital expenditure should be treated as entering into the calculation of "residual previous capital expenditure" within s.122C, deductible as provided by s.122D; and should not be treated as "residual capital expenditure" within s.122DA, deductible as provided by s.122DB: see the Treasurer's explanatory notes to Act No.127 of 1977.

The drafting device of inserting into s.122J(3) the reference to s.122DA, was utterly inappropriate when set with the fact that by its own terms s.122C applies only to expenditure incurred on or before 17 August 1976. At least, until the reference to s.122DA was inserted, one provision or another caught all "excess" expenditure except that deemed to be incurred in a year straddling 17 August 1976. Now, as the Act stands, the treatment of "excess" expenditure actually incurred before 30 June 1974, and deemed by s.122J(3) to be incurred in a subsequent year of income, ought to be as follows:

(a) If the "first subsequent year of income" is entirely prior to 18 August 1976 it should be treated as "residual previous capital expenditure" within s.122C. The Act operates as intended, and as before Act No. 127 of 1977.
(b) If the "first subsequent year of income" is entirely after 17 August 1976 there is no right to deduction, because:

(i) Section 122J(3) cannot take the deemed allowable capital expenditure to s.122DA, for the amendment provides that so far as s.122DA is concerned the excess of expenditure is not deemed to be incurred in the "first subsequent year of income"
(ii) When s.122J(3) takes the excess expenditure towards s.122C (which the Treasurer intended it to enter), it cannot get in, because it is deemed to be incurred in a year of income to which s.122C does not attach (that is, a year of income wholly after 18 August 1976).
(c) If the "first subsequent year of income" straddles 18 August 1976 the position is unclear but presumably the expenditure is not deductible. To get into s.122C the taxpayer must show that the expenditure was incurred prior to 18 August 1976. He cannot do this by showing merely that it is (deemed to be) incurred in a year of income which straddles 18 August 1976.

As regards situations (b) and (c) the result is utterly different from the intention, and the Act requires amendment.

The Australian Federal Tax Reporter says (p.35,742) that it is understood that the Commissioner intends to administer these provisions in accordance with the Act but with the Treasurer's explanatory notes, and as meaning that all s.122J(3) expenditure falls within s.122C.

Although it always seems reasonable and indeed courteous of the Commissioner to give to taxpayers a benefit which the material suggests the Act was intended to, one really ought not to gloss over the impropriety of acting in this way. The duty of the Commissioner is to administer "this Act", not ministerial statements: c.f. s.8. It is as wrong to allow a deduction for which the Act does not provide, as to deny one for which the Act does provide. If the draftsman is seen to have bungled, the remedy is to amend the Act, if necessary retrospectively (where the bungled provision was intended to benefit taxpayers). The remedy is not to ignore the statutory duty (and oath) to administer "this Act". It is one thing to have standard procedures by which to seek consistency in application of provisions which are in the Act. It is quite another to have procedures of ignoring the Act.

Quite apart from the fundamental objection that we are intended to be governed by Parliament, not Ministers or Commissioners, one particular evil is that such a provision becomes in practice a means of disapproving a taxpayer's conduct; a kind of poor man's s.260. It enables the Commissioner where he disapproves of what a taxpayer has done, to apply the Act (the terms of which have been left standing for the very reason that because normally not applied, there has been no call for amendment). That leaves the taxpayer concerned at the mercy of the Commissioner's administrative decision. He cannot appeal, because he has been treated in accordance with the Act. His complaint is that he has been treated differently from other taxpayers. But the court cannot ensure that he is treated the same as other taxpayers. All the court can do is to ensure that he is treated in accordance with the Act. The assessments of the other taxpayers, who (to their benefit) were treated otherwise than in accordance with the Act, the court never sees.

It will not do to say that the Commissioner would not act in this way. In the first place, he ought not to have power to act in this way. In the second place, he has acted in this way. One transaction involved in *Commissioner of Taxation* v. *Patcorp Investments Ltd.* (1976) 76 A.T.C. 4225, (1977) 51 A.L.J.R. 40, involved the purchase of a number of taxpayer companies of shares in Austin Sales (Australia) Pty. Ltd. Each purchaser directed that the transfer of the shares be made to Patrick Nominees Pty. Ltd. on its behalf. The shares were so registered, and a dividend was then

declared and paid. The High Court held that the taxpayer companies were not entitled to a rebate under s.46 of the Act, because they were not "shareholders": see (1977) 51 A.L.J.R. 40, 41(F), 46(E) and 51(C). There is a further point, made by Jacobs J. at page 51(D), that the money received by each taxpayer company was not a "dividend" but merely a distribution of trust income made by a trustee which had received dividends. One has little quarrel with that. But in argument the point was made that very many millions of shares are registered in the name of nominee companies, and that no one had ever heard of the Commissioner denying an s.46 rebate to the corporate beneficial owners of shares so registered. The court asked for and received an assurance from the Commissioner that if his submission on this point were accepted then that rule would be applied to all cases where the point arose. For myself, I have yet to come across another case of rebate being denied on the basis that the shares concerned are held by a nominee. The "strict", that is correct, interpretation seems to be held in reserve for "errant" taxpayers while ordinary taxpayers continue to be given the benefit of the former and more relaxed approach. Rebate was denied to the Patcorp companies because they were involved in a tax-reduction device.

4. CLIFFS INTERNATIONAL INC. v. F.C.T.

Cliffs International Inc. v. *F.C.T.* (1979) 79 A.T.C. 4059 showed marked judicial cleavage. In the various courts, five judges held for the Commissioner, and four for the taxpayer. Luckily for the taxpayer, three of those four were in the High Court, which had the last say.

The factual pattern was simple enough, and in most respects probably not unusual. Howmet Corporation and Garrick Agnew Pty. Ltd. held all the shares in Basic Materials Co. Pty. Ltd. Basic had prospecting rights under temporary reserves allotted under the Mining Act 1904 (W.A.). Cliffs bought the shares in Basic under an agreement which provided that Cliffs should pay $200,000 cash and should also pay 15 cents per ton of iron ore at any time mined and transported from the reserves by Basic or its successor in interest. In the usual case one would expect to find the $200,000 labelled "purchase price" and the 15 cents per ton labelled "royalty". In this case Cliffs, in courteous, but in the event worrisome compliance with a last-minute request of Howmet, agreed to all the payments being described as part of the "purchase price", with the $200,000 being "an initial payment" and the 15 cents per ton being labelled as "deferred payments".

Eventually mining did proceed, through a consortium organised by Cliffs, and using rights derived through Basic. Cliffs received from the consortium royalties of 30 cents per ton of ore "mined transported and sold" by the consortium. It paid Howmet and Mt. Enid Iron Co. Pty. Ltd. (successor to Agnew Co.) 15 cents per ton "mined and transported". The liability of Cliffs to tax on the incoming royalties was conceded. But Cliffs claimed a right to deduct the outgoing 15 cents per ton, as an outgoing necessarily incurred in the gaining of the incoming royalties. This the Commissioner contested.

Putting to one side the labelling of the payments (something clearly relevant and probably unusual) and the fact that Cliffs got its income not from mining itself but from royalties from mining by others (a fact probably usual and clearly irrelevant), the factual pattern seems common enough — Person A holding a mining right of some kind, and selling it to Person B in return for a lump sum payment and a promise of further payments determined quantitatively by reference to future mining

activities. As is remarked in the Australian Income Tax Law and Practice Bulletin of 12 April 1979:

> The amazing thing about this decision is that a dispute on this type of facts has taken so long to surface. The payment of royalties in respect of ore mined as a consideration for obtaining the right to mine the area must surely have been a cost claimed as a deduction for many years.
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> Bulletin, p.87.

The practical reason why such cases have not arisen earlier has been, I think, that in most such transactions the periodic payments have been described as "royalties", and have been regarded by both payer and recipient as of a revenue nature. The payer's claim to a tax deduction has been matched by the recipient's admission of tax liability, and although there is no theoretical magic in that matching, it is undoubtedly of practical significance in the making of assessments.

Here, two differences emerged. The first was the labelling of the payments as "deferred payments" of a "purchase price". The second was that Howmet claimed — as I remember it there was no evidence as to what Mt. Enid did — that it was not assessable on the payments it received, on the ground that they were capital payments received on the sale of the shares in Basic. So Cliff's claim to a revenue outgoing was matched by Howmet's claim to a capital incoming. Not for the first time, the Commissioner assessed both parties adversely — he denied Cliffs the deduction for its outgoings (as being of a capital nature) and treated Howmet as assessable on its incomings (as being of a revenue nature). It was indicated that if either taxpayer gave way, or challenged unsuccessfully, the treatment of the other would be altered to match that result. Cliffs did not give way, and did challenge, and its assessment got to the courts first.

The case for the Commissioner was simple. The payments were made as part of the consideration for the acquisition of the shares in Basic. Those shares constituted a capital asset. *Colonial Mutual Life Assurance Society Ltd.* v. *F.C.T.* (1953) 89 C.L.R. 428 is authority for the proposition that moneys paid as the price for a capital asset are not deductible.

The majority judgments contain statements of interest well beyond the mining field.

Barwick C.J. said:

> (a) The proper conclusion in each case in this particular area of the law is peculiarly dependent upon the particular facts and circumstances of that case.
>
> 79 A.T.C. at p.4064.

This is indeed standard doctrine. The minority judges would accept it equally, as a statement. But at bottom it is inconsistent with the view that *Colonial Mutual* lays down a universal rule as to payments relating to acquisition of a capital asset.

> (b) The generalizations . . . which . . . have universal validity in relation to a decision whether a payment made in performance of a promise given as part of the consideration for the acquisition of a capital asset is itself of a capital or of a revenue nature . . . are to be found in the reasons for the judgment of this court in *Egerton-Warburton* v. *Deputy Federal Commissioner of Taxation* (1934) 51 C.L.R. 568 at 572-3.
>
> p.4064

This is a statement of which more will be heard. Two points require special mention. First, since Colonial Mutual, where *Egerton-Warburton* was described as "a case of a very exceptional character" (89 C.L.R. per Fullagar J. at p.457), *Egerton-Warburton* has been one of those cases often cited but always distinguished. It "has been

distinguished with more zest than it has been followed": c.f. the remark of Lord Birkenhead L.C. in *Portman* v. *Viscount Portman* (1922) 2 A.C. 711, 712. It has "become very distinguished indeed". One has cited it because it is there; but one has not cited it with hope. Now it is back in the main stream.

Secondly, in the particular passage from *Egerton-Warburton* referred to by Barwick C.J. the matter under discussion was the nature of the payment in the hands of the recipient. The decision on that point is not the part of *Egerton-Warburton* which has become so distinguished. (The point was clearly made in *Colonial Mutual,* that a payment may bear a different nature in the hands of the recipient, from its nature when leaving the hands of the payer.) It is clear that Barwick C.J. regards the nature of the payment in the recipient's hands as very relevant to its nature when leaving the hands of the payer. This links with point (c) below.

(c) What quality they may have in the hands of the recipient will not determine their quality as disbursements by the appellant, though, for my part, that quality is not of necessity irrelevant.

p.4064.

But, however described, I would find it difficult to accept that the receipt of such a share, particularly by recurrent payments, measured in relation to the produce of the mining, was a capital receipt in the hands of the vendor. But of course, though relevant, that conclusion does not necessarily determine the first question.

p.4065.

It is difficult to deny that this makes sense. But particularly in the second passage, Barwick C.J. goes further than has been gone for some time.

(d) ... The fact that payments are made or received in performance of a promise given as part of the consideration for the acquisition of a capital asset does not necessarily mean that the payments are themselves of a capital nature.

p.4064.

No one could deny that while *Egerton-Warburton* stands. But it is clear that Barwick C.J. sees the issue as being less foreclosed by the nature of what is acquired, than have many judges.

(e) ... The relevant quality of these payments is to be determined ... in relation to the gaining of the income against which they are sought to be deducted.

p.4064.

(f) A direct consequence of the availability of that (royalty) income (of Cliffs), i.e. of the mining and transport of iron ore by the consortium, was a liability to make the payments sought to be deducted.

p.4064.

(g) (The shares) were acquired without making the payments in question. The recurrent payments were not made *for* the shares though it might properly be said that they were payable *as a consequence* of the purchase of the shares.

p.4065 (my emphasis)

(h) For its part, the appellant by agreeing to make the recurrent payments was prepared to admit the vendors of the shares to participation in the result of the mining of the iron ore. They were made, and necessarily made, by the appellants as disbursements in its business. They were none the less so by reason of the fact that the appellant had agreed to make them; nor does the fact that the agreement to make them formed part of the consideration for the purchase of the shares make them payments of a capital nature.

p.4065

(i) An analogy may be found in the grant of a licence to use a patent upon

> payment of a cash price and a continuing royalty on what might be produced by employment of the patent.
>
> p.4065

(j) It is unnecessary to decide whether *Colonial Mutual* was correctly decided.

p.4066

This is taking a side-swipe at a hallowed institution, with a vengeance. No one had challenged *Colonial Mutual* on its own facts. It is difficult to interpret this remark as other than an indication that if someone, sometime, seeks to challenge that decision, his task will not be foredoomed to failure.

Jacobs J. found it insufficient to describe the payments as being made pursuant to an obligation incurred under a contract for the acquisition of the shares.

> In order to solve the problem in a practical way it is necessary to look at the payments at the time each is made and to ask — what is that payment calculated to effect? Is it merely payment for the capital asset, the shares, already wholly acquired, and which are to be paid for over a period? Or is the purpose of the payment from the practical and business point of view to pay for the current mining operations?

79 A.T.C. at p.4076.

Jacobs J. found analogies with leases useful. His Honour found it difficult to accept that payments made under a sublease were paid on revenue account (because one is merely paying for use of someone else's rights) but that identical payments made under an assignment of the lease would be paid on capital account (because there one is paying for the acquisition of the capital asset, the lease). That would ill-accord with the repeated judicial strictures to look at the problem in a practical and business like way. His Honour pointed out that in no case had payments been held to be of a capital nature in the presence of all four of the following features:

(a) An asset of depreciating character and limited life;

(b) The payments continue throughout the life of the asset or of the entitlement of the payer to use it;

(c) Recurrent payments;

(d) Amount of payments dependent on use made or profit derived from the asset concerned.

p.4077.

His Honour went on to hold that in this case the preponderating factors were that the payments in respect of a depreciating asset, were recurrent, and over the life of the asset if so long used, and were proportioned to use. On that basis they were made on revenue account.

Murphy J.'s judgment is short but full of interest. His Honour took as the basic approach the necessity for a practical and business like view. The payments, if any were made, would be for currently exercising the right to mine the ore. The amount to be paid depended on the exercise of the rights to mine. There was a strong analogy with payment or rent under a lease as part of the consideration for acquisition of a lease. That the parties had called the payments "deferred payments" of a "purchase price" could not be decisive.

His Honour's approach may justly be seen as the obverse of his approach in relation to schemes using legal devices to avoid the "real" position: c.f. his Honour's dissent in *F.C.T.* v. *South Australian Battery Makers Pty. Ltd.* (1978) 78 A.T.C. 4412.

Counsel's delight in winning the decisive vote of Murphy J. on behalf of an American-based multi-national mining company taxpayer, is tempered by the reflection that the decision is in entire consistency with his Honour's earlier decisions.

It would be absurd to deny that Murphy J.'s approach is different from that of the other members of the court. What this case has interestingly confirmed is that that approach has its own internal consistency.

The minority judgments would — if they had prevailed — have been of concern to many taxpayers other than Cliffs. The judgment of Gibbs J. take the following steps. First, whether one looks to what was strictly bought, the shares in Basic, or to what they were sought to obtain, namely Basic's mining rights, what was acquired was a capital asset. (79 A.T.C. at p.4066.) Secondly, if the expenditure is truly to be characterized as payment of consideration for a capital asset, it will be of a capital nature, notwithstanding recurrence or anything else. (p.4066-4067.) Thirdly, the fact that the parties, in their negotiations, regarded the payments as being of the nature of royalties was irrelevant.

> Although there was evidence, which was accepted, that the parties regarded the payments as in the nature of royalties, the payments did not in truth have that character. The payees had no interest in the mineral leases, and could not either give or withhold permission to mine them.
>
> p.4068.

That, if correct, makes the parties' description of the payments as "deferred payments" of a "purchase price" irrelevant because that would have been their nature whatever the parties had said. That would render non-deductible sums paid as "royalties" wherever there had been an entire disposal of the mining rights from one person to another. That is an approach the Commissioner has never taken, and which would cause much heart-burning.

Stephen J. took much the same approach. The payments were made not for the use of something but because of the obligation under the contract. The same is of course true of rental payments under a lease. That case, his Honour says, is distinguishable because there the payment of rent is made for the use of something owned by somebody else: 79 A.T.C. at p. 4070. The same is true of royalties: *ibid.* Here, there had been total acquisition, and so everything was "price" for a capital asset. What was acquired was an asset which, if not permanent, was by no means evanescent; it was "the nucleus of the taxpayer's profit-yielding subject": pp.4073, 4071.

It may be said of the minority view that its result is hard to reconcile with the idea of the test being "practical and business-like". Say that A has a mining right of some kind. He assigns it to B for a cash sum plus a further sum per ton of ore mined under it. B's outgoing is entirely capital. But if A had given B a perpetual licence, for the same cash sum plus a promise to make the same extra payments per ton of ore mined, B's periodical payments would be on revenue account. Yet B's licence would be just as much the "nucleus" of his "profit-yielding subject" in the one case as would his ownership of the right in the other. It is not easy to see why common sense and a practical approach lead to two so different tax consequences, in circumstances which in practical effects are close to identical.

Nor, more fundamentally, is it easy to see just why the nature of the asset acquired should have so decisive an effect on the nature of the outgoing. It is well-established that where a capital asset is sold, the nature of the incoming received for it is by no means governed by the nature of the asset sold. A capital asset can very easily be sold for money, as for example an annuity, which is received as income. I am not aware of any judicial explanation — as opposed to assertion that it is so — as to why the position is so very different in the case of acquisition of a capital asset.

As I see it, the minority would reach an identical result in all cases of payments made pursuant to a contract for the full acquisition of the relevant mining right. That would have been a much wider basis for decision than the basis on which the Commissioner in fact assessed Cliffs. Had the minority view prevailed, the cry of anguish would have been loud indeed — loud enough, one would suspect, to be heard across the Nullarbor Plain, and in the corridors of Canberra. That result has been avoided, but only by a short half-head.

One lesson for the mining industry is clear. The most secure position will be that in which the owner of the mining right keeps some reversionary interest in it — perhaps grants a sub-lease or licence for 99 or 999 years, for sums which, if structured as in Cliffs, are called "premium" and "royalties" or "rent". Where there is total acquisition, the position will be somewhat less secure. I say that in spite of the fact that the High Court normally and admirably stands loyally by its own revenue decisions, even if they came from a narrowly divided court. But this field is somewhat dangerous. All judges agree that in this field each case turns more than usually on its own particular facts. It would not necessarily be safe, in this field, to have adopted the structure and nomenclature of the Cliffs contract in circumstances different from those which existed there.

APPENDIX: SUBDIVISION B OF DIVISION 2A OF PART III OF THE ACT

1. Subdivision B of Division 2A of Part III of the Act has of course been inserted with the intention of driving decent people mad, and preventing anyone knowing where they stand. The official intention is to prevent "improper" use of "current year loss companies" (and, it appears, "current year profit companies").

Subdivision B applies where, and only where (as the draftsman would say) there has been, in the year of income, a "disqualifying event".

2. Section 50H sets out what a disqualifying event is (and fails adequately to tell us). It is necessary to look at several provisions separately.

Section 50H(1) states that subject to the other provisions of s.50H, a disqualifying event occurs at a "relevant time" if the Commissioner is satisfied:

(a) That between "immediately before" and "immediately after" the relevant time, there is discontinuity of status as regards rights of voting or receipt of dividends or receipt of capital on any distribution of capital: see s.50H(1)(a)-(c), derived from s.80A(1)(c)(d)(e). Here, it will be seen, the "relevant time" is a moment of time — which of course is what is required if the definition of "relevant period" in s.50B(1) is to work.

(b) That "at the relevant time" the voting power in the company was controlled or became capable of being controlled through companies trusts and partnerships by persons who did not control etc. at any time in the year of income before the relevant time, and the persons acquired the control etc. for the purpose of receiving any benefit or obtaining any advantage in relation to the Act: s.50H(1)(d), derived from s.80DA(1)(d).

(c) That immediately before the relevant time the company had an "available loss" and at the relevant time the company derived income it would not have derived if it had not had that available loss: s.50H(1)(e), derived from s.80DA(1)(a).

An "available loss" is a loss arrived at on the basis that if the year of income had ended immediately before the relevant time, then in the ordinary way the company would have had a tax loss for that period: s.50H(2).

This occurrence is not a disqualifying event if the shareholders immediately before and immediately after the derivation of the income will benefit from it to an extent that the Commissioner considers fair and reasonable: s.50H(3).

(d) That immediately before the relevant time the company had an "available profit" and at the relevant time it incurred a loss or outgoing which it would not have incurred had it not had an available profit: s.50H(1)(f), a new invention.

An "available profit" matches the concept of an "available loss". It exists where, if the year of income ended immediately before the relevant time, there would have been a taxable income.

Section 50H(4) makes an analogous qualification to that made by s.50H(3) on s.50H(1)(e).

(e) That immediately before the relevant time the company had an available profit or an available loss, and by an agreement or scheme etc. entered into at the relevant time, an agreement or scheme that would not have been entered into but for the available profit or available loss, some person other than the company will directly or indirectly receive a benefit or derive an advantage in relation to the application of the Act: s.50H(1)(g), derived from s.80DA(1)(b).

(f) That at the relevant time, the affairs of the company "were managed or conducted" without regard to the rights of the persons who controlled the voting power of the company or were through companies trustees and partnerships capable of controlling that voting power: s.50H(1)(h), derived from s.82DA(1)(c).

In determining this, regard shall be had to what has been done, and one is to ignore the purpose for which it was done, and ignore whether or not what was done was done in the course of ordinary family or business dealing: s.50H(8). How you can tell if something was done without regard to the rights of persons, without considering either the purpose for which it was done or whether what was done was done in the course of ordinary commercial dealing, or why one would wish to, I cannot tell. But there it is.

More fundamentally, at this point the relevant time seems to have ceased to be a moment of time, and to have become a period of time. Certainly any normal inquiry into such a matter would involve examination of affairs over a period of time: c.f. s.80DA(1)(c), "during the year of income". Any single event might be most misleading unless seen in the context in which it occurred.

And indeed the Treasurer explained that matters which would be looked at here would include the degree of participation by persons in the affairs of the company; the manner of appointment and removal of directors from office; the relationship between directors of the company and persons associated with the company's sources of income; and the circumstances under which and the sources from which the income is derived by the company. To the extent to which these things do not in themselves require looking at over a period, they in any event occur at different moments of time. I may be missing something, but I cannot see how s.50H(1)(h) can direct one to a single moment of time, capable of providing a "relevant time" for demarking two relevant periods.

3. Assume that there is seen to have been a disqualifying event. Let us say one only.

Now we have two "relevant periods": s.50B(1):

(a) From the beginning of the year of income, to the moment immediately before the disqualifying event;

(b) From the moment of the disqualifying event until the end of the year of income.

4. Now we must distinguish three types of income and three types of deductions:

Income

(a) "Full-year amount": s.50B(1)

This is so much of the income included in the company's assessable income by virtue of s.97 of the Act, as is not a "divisible amount". Income of this kind is left as income of the whole year, and is not income of any relevant period.

(b) "Divisible amount": s.50E(1)

Income included in the assessable income by virtue of a miscellany of provisions, namely s.26B, 26BA(6)(b), s.36(1) (where there has been an s.36(3) election); s.36(3A)(b), s.36AAA(2)(c) or (d); s.36AA(2)(a) (if there has been a s.36AA(1) election); s.36AA(2)(c); s.92; and that part of the amount included in the assessable income by virtue of s.97, as was derived from income derived by a company during a relevant period of that company.

Except for s.92 (partnership income) and s.97 (trust income), these are all sums which the taxpayer can elect to bring to tax over a period of years. Income of this kind is attributed to each relevant period as set out in s.50E(2), principally according to comparative lengths of the periods in relation to the whole year or to an event within the year.

(c) Ordinary amounts

Assessable income not being a full-year amount or a divisible amount (which are together described as "excepted amounts").

Deductions

(a) Full-year deductions: s.50F(1).

(i) A s.51 deduction for a bad debt;
(ii) For a leasing company, a deduction under Subdivision B of Division 3 in respect of a unit of eligible property leased to another person;
(iii) Deductions allowable under ss.63, 77B, 78, 80 or 80AA, Subdivision BA of Division 3, Division 10AA (other than under s.124AM), and Division 16C.
(iv) Division 10 deductions other than under s.122K, except a deduction under s.122D or s.122DB in respect of which the company has made an election (to take the full available deduction in the year, and not just to the extent to which it can be set against (broadly) taxable income).

These deductions are all attributed to the year as a whole, and not to any relevant period.

(b) Divisible deductions: s.50G(1)

(i) Deductions under ss.54, 57AA, 57AB, 62A, 67, 70, 73A(2), 75A, 88, 92, Division 10AAA (other than s.123C), Division 10A (other than s.134G or s.124JB), and Division 10B (other than s.124N);

(ii) Where the company has made an election in relation to the year of income under s.122D or s.122DB, any deduction allowable to the company under that section in relation to the year of income.

These are deductions which it is thought appropriate to attribute to a relevant period by reference to the length of the relevant period as compared with the whole of the year or some other period less than the whole year, or by reference to some other appropriate criterion (as for example with s.54, by the number of days the plant was ready for use within the relevant period as compared with the number of days the plant was ready for use within the year): s.50G(2).

(c) Ordinary Deductions

Deductions not being full-year deductions or divisible deductions (which together are called "excepted deductions").

Now one comes to calculate the company's taxable income. It is necessary first to turn to each of the two relevant periods.

For each relevant period, the assessable income consists of the "ordinary amounts" attributable to that period on normal principles plus so much of the divisible amounts as under s.50E are attributed to that period; for each relevant period, the deductions consist of the "ordinary deductions" attributable to that period on normal principles plus so much of the divisible deductions as under s.50G are attributed to that period.

The result will be a "notional taxable income" or a "notional loss". (See on all this s.50B(2)-(5).)

In relation to the taxable income itself, one adds together the notional taxable incomes from any relevant period. One adds any full-year amount. One deducts any full-year deduction under s.51 or s.63 (bad debts), but subject of course to the pre-existing rules of ss.63A-63C. And the "notional loss"? One deducts only the "eligible notional loss". That is what all this is about.

The "eligible notional loss" is defined in s.50D. It is unnecessary to examine it in detail and very luckily so, since although I see the general picture I am sure I see it as a child, through a glass darkly. It is to do with comparing loss periods and income periods, and seeing if tests of continuity of status or continuity of business tests are met. If they are, the stipulated portions of the notional loss become portions of the eligible notional loss. If they are not, then there is no eligible notional loss.

With the eligible notional loss ascertained, one returns to s.50C, and adds it to the deductions from the taxable incomes and the full-year amounts.

It will be seen that although there are many full-year deductions, we have brought into the calculation only those under s.51 and 63 (bad debts). If there results a taxable income, and there are full-year deductions not so far brought in, the company can now bring those in, in prescribed order, but only so far as necessary to erode the taxable income: s.50C(3). If the full-year deduction is of a type allowable only in the year of income, then it is lost forever if not so used. If it is of a type which carries forward if not used, it may be of use in future years.

I am sure that somewhere in the Taxation Department there is someone who understands all these provisions. (I am sure there is no one in the Cabinet.) I have spent a good part of fifteen years attending to taxation matters. I do not begin to have an intellectual comprehension of these provisions. Give or take the odd skilled lawyer or accountant, there is not a taxpayer in this country who has the faintest hope of understanding them. I do not believe that more than a small handful of

Parliamentarians had any understanding of what they were supporting or opposing. I have never had much time for totally artificial schemes (though plenty of time for sensible total planning). I sympathise with the Government in its desire to destroy the totally artificial scheme. But I cannot believe, will not believe, that this type of legislation, with the draftsman spawning one-off definitions as he drifts from concept to concept, can possibly be necessary.

The result is that if any private company changes hands during a year of income it will, no matter that the change of hands had nothing to do with taxation, be thrown into Subdivision B. The company's own accountant will perforce be quite incompetent to deal with its tax position as would anyone who had not lived through a previous bout of this disease. Perfectly ordinary, perfectly reputable companies will be quite unable to handle their own affairs. Life was not meant to be easy. But I do not think it was meant to be as hard as this.

FOOTNOTES

1. An attempt to explain how Subdivision B works will be found in the Appendix to this Paper.
2. I use "status" and "continuity of status" to refer to the subject matter of tests of the kind imposed by ss.80A-80F of the Act on a corporate taxpayer's right to carry tax losses forward to future years.