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# The Impact of Property Law and Contractual Principles in Taxation Law

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**Abstract**
Many recent tax law decisions have depended on the application of basic principles in property law and contract. A thorough knowledge of principles in these areas is essential for taxation advisers. In general, a transaction must be valid in terms of property law for it to be valid in taxation law. Indeed, as we saw in *FCT v Everett*,[1] the courts have refused to find a separate set of principles unique to taxation law.

**Keywords**
contractual law, tax law

# THE IMPACT OF PROPERTY LAW AND CONTRACTUAL PRINCIPLES IN TAXATION LAW

*by Geoffrey Hart**

Many recent tax law decisions have depended on the application of basic principles in property law and contract. A thorough knowledge of principles in these areas is essential for taxation advisers. In general, a transaction must be valid in terms of property law for it to be valid in taxation law. Indeed, as we saw in *FCT v Everett*,[1] the courts have refused to find a separate set of principles unique to taxation law.

In the context of income splitting, if a transaction does not effectively transfer the property to an assignee the income derived therefrom will remain that of the assignor. So, the courts analyse the transaction to see if it is effective in property law before there is a need to apply the relevant taxation statute[1].[2] In *Norman v FCT*, the taxpayer failed to alienate the income earning source, because the subject matter of the purported gift was a mere expectancy, namely future undeclared dividends and interest on a collapsible loan. Such assignments, to be valid, require the recipient to have given executed consideration so as to bind the conscience of the assignor. The effect of such a transaction, when supported by executed consideration, is that the property on coming into existence vests immediately in the assignee, who consequently derives any income from the property by virtue of ownership. The

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1 *Norman v FCT* [1963] 109 CLR 9.

2 See also *Shepherd v FCT* [1965] 113 CLR 385. In the context of deductions, courts have not insisted on strict legality provided the outgoing is necessary and appropriate to the gaining of assessable income: *FCT v Emmalkel* (1990) 21 ATR 346, *Magna Alloys & Research Pty Ltd* (1980) 11 ATR 276, 295. Cf *FCT v Just Jeans Pty Ltd* (1987) 18 ATR 775, where the deduction was disallowed not just because of the legal ineffectiveness of the transaction which involved sale and licence back of goodwill without sale of the underlying business. The deduction was disallowed also because it was far removed from the ordinary course of the taxpayer's business and it was strange and artificial.

property assigned does not vest in the assignor immediately before transfer.[3] This means that CGT event A1 cannot apply to the assignment of an expectancy.

The making of pre-Everett assignments[4] was based on this principle - it was outside s 160 M( 6) of the 1936 Act and CGT event A1, thus necessitating the inclusion of CGT event E9; s 104-70.[5]

Thus, many of the leading cases on[6] equitable assignments were decided in a taxation context. The legislative response to this income splitting was not made until 20 September 1985 in s 160 ZD[2] of ITAA 1936 and now s 116-30 [2] of ITAA 1997, which deems non arm's length transfers of assets and gifts to be made for capital proceeds of market value, thus subjecting the transferor to the possibility of an immediate capital gain on any paper profit.

## Assignment of Intellectual Property

*Withers v Nethersole*[7] laid down the principles on the distinction between assignment and licensing in the intellectual property context. This again was a taxation decision. In the context of income on general principles, there is no distinction between an assignment and an exclusive licence, but the distinction remained significant because of the different treatment of assignments and licences in the capital gains tax regime. Dealings in intellectual property are now covered by Div 40 of ITAA 1997, where they are treated as depreciating assets.

## Derivation

Even basic questions such as when income is derived on a cash or accruals basis fall to be decided on fundamental contractual principles. Thus in *FCT v Firstenberg*[8] the trial judge held that in general, services provided by a solicitor are entire contracts

3 *Palette Shoes Pty Ltd v Krohn* (1937) 58 CLR 1.

4 The future partner would assign an interest in the future partnership before it was formed.

5 Though s 160 M (6) had been amended, prior to the 1997 Act, to deal with assignments of interests in future partnerships.

6 *Norman v FCT* (1963) 109 CLR 9, *Shepherd v FCT* (1965) 113 CLR 385, *FCT v Everett* (1980) 143 CLR 444, *Booth v FCT* (1987) 19 ATR 514 - the cases are equitable because the assignments were in respect of an expectancy or a fraction of a legal chose in action.

7 [1948] 1 All ER 400 (HL); [1946] 1 All ER 711(CA).

8 [1976] 6 ATR 297.

within the principle of Cutter v Powell[9] and therefore there could be no derivation for work in progress which had not been completed. Legislative intervention in s 70 of the Income Tax Assessment Act 1997 (Cth) in effect recognises increases in value which have not been realised in the context of trading stock as at the end of the financial year. The courts have aided this approach by applying the concept of full absorption costing,[10] but no such approach has been used in the context of services and the taxation of work in progress continues to provide problems: *Crommelin v DFCT*[11], and tax planning opportunities.

## Source

Problems of source for personal exertion income are generally determined by contractual principles which provide answers as to where a contract was negotiated, concluded and performed. The postal rule has been significant in this context, but now that instantaneous acceptance can be made by the fax and by email many non resident taxpayers may have unwittingly concluded their contracts in Australia since the postal rule is an exception to the general rule that a contract is concluded where the offeror receives the acceptance . It has not yet been decided where a contract is concluded where acceptance is made by an e-mail; though some of the problems with email commerce have been addressed in recent Commonwealth legislation.[12]

## Scope of the article

It is possible to go on giving examples of how general commercial law principles have determined the outcome of particular taxation cases - see Hill, Nicholson and Sundberg JJ in *Brooks v FCT*, [13] where they referred to *Masters v Cameron* [14]as a case so familiar for its discussion of the possibilities that may arise where an agreement is reached 'subject to contract' that it scarcely needs comment - but this article will concentrate on four areas where contract and property principles have determined the tax outcome: Firstly, the true nature of an option; second, the meaning of a sale of

9 [1795] 6 TR 320,101 ER 573 - a sailor who agreed to sale a ship from Jamaica to Liverpool and died seven weeks into the voyage was not entitled to any fractional payment under a quantum meruit because it was an entire contract.

10 *Philip Morris v FCT* (1979) 10 ATR 44.

11 [1998] 39 ATR 377, where the court held income is derived when work in progress is sold, which is now confirmed in s 15-50 ITAA97.

12 *Electronic Transactions Act (1999)* (Cth) and see: Simone W B Hill, 'Flogging a Dead Horse - The Postal Acceptance Rule and E-mail' (2001) 17 *Journal of Contract Law* 151.

13 (2000) 44 ATR 352.

14 (1954) 91 CLR 353.

goods contract in the context of taxation;[15] third, the timing rules for the derivation of income on dealing with trading stock;[16] and fourth the meaning of 'fixtures' in the context of[17] sale and leaseback agreements.

## Options[18]

Options are covered in CGT event D2 and the grant of an option which has not been exercised by 30 June results in the capital gain to the grantor of the capital proceeds minus expenditure incurred in the grant.[19] If the option is exercised in the year of grant then CGT event D2 is disregarded[20]. This would seem to indicate that options involve two contracts, the grant of an option which enables the grantee on exercise to enter into a second contract. On the other hand, if the grantee exercises the option, then there is no liability under the option and under section 134 of ITAA 1997 the transactions of grant of option and exercise merge into a single transaction. The approach in CGT event D2 is to treat options as involving two contracts, but the approach in section 134 is to treat the grant and exercise of the option as a single conditional contract. The statute does not endorse either the two contract theory or the single conditional contract theory. Contract law has not settled this issue. In taxation law it is important because where more than one contract is involved in respect of the acquisition/disposal of an asset the timing of the acquisition/disposal is determined by the time of entry into the contract that effects the acquisition/ disposal: *Elmslie v FCT*[21]; *FCT v Sara Lee Household & Body Care (Australia) Pty Ltd*.[22] This will have an effect on the year in which a capital gain/loss is made or the time the asset is acquired.[23]

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15 *Ashgrove Pty Ltd v DFCT* [1994] 28 ATR 512.

16 *Gasparin v FCT* [1994] 28 ATR 130.

17 *Melluish [Inspector of Taxes] v BMI [No 3] Ltd* [1995] 4 All E R 453; [1996] AC 454.

18 See HK Lucke, 'Options' (1968) 3 *Adelaide Law Review* 197; CJ Rossiter, 'Options to acquire interests in land - Freehold and Leasehold' (1982) 56 *Australian Law Journal* 576; Farrands, *The Law of Options* 1992. Michael G Hains, 'Options Revisited' (1989) 5 *Australian Bar Review* 168.

19 Section 104-40.

20 Section 104-40.

21 (1993) 26 ATR 611.

22 (2000) 44 ATR 370.

23 The gain made on disposal of an asset by exercise of an option may be on revenue or capital account, depending on the nature of the taxpayer's activities. TD16 states, without citing authority, that the date of disposal/acquisition under the capital gains tax regime is the time of exercise of the option; see also ATO Interpretive Decision ID 2003/128. Section 134 - 1 and 116-65 do not provide a date for disposal/acquisition of the underlying asset.

The contract cases have arisen in the context of an option to purchase, ie a call option. There are two theories as to the nature of a call option, though the distinction may often, but not always,[24] lie in the intention of the parties as expressed in their drafting. On one theory, an option consists of an irrevocable offer supported by consideration to enter into a second contract of disposal,[25] with the consequence that CGT event A1 will not occur until entry into the second contract. On the other hand, if an option is a single conditional contract of acquisition, as suggested by Gibbs J in *Laybutt v Amoco Australia Pty Ltd*,[26] then acquisition will take place in the year of entry into a single contract.[27] In *Commissioner of Taxes (Queensland) v Camphin*,[28] Latham CJ, opting for the two contract theory, said:

> An option given for value is an offer, together with a contract that the offer will not be revoked during the time, if any, specified in the option. If the offer is accepted within the time specified a contract is made and the parties are bound. If the offeror, in breach of his agreement, purports to revoke his offer, his revocation is ineffectual to prevent the formation of a contract by the acceptance of the offer within the time specified (*Goldsborough Mort & Co Ltd v Quinn;* [29] *Gerraty v McGavin;*[30] *Carter v Hyde*[31]).

His Honour did point out that, under the two contract theory, the optionee[32] has an equitable interest in the subject matter of the contract. In *Braham v Walker*,[33] Dixon CJ said;

> This argument and the standing controversy which it reflects may be passed by, although perhaps the observation may be allowed that there does not seem to be much reason why parties if they choose may not throw an option

24 *Carter v Hyde* (1923) 33 CLR 115.

25 The two contract theory which is the more popular theory and is supported by Isaacs J in *Goldsbrough Mort & Company Ltd v Quinn* (1910) 10 CLR 674 and Latham C J in *Commissioner of Taxes (Queensland) v Camphin* (1937) 57 CLR 127.

26 (1974) 132 CLR 57, 71-3.

27 *Braham v Walker* (1961) 104 CLR 366, 376.

28 (1937) 57 CLR 127, 132.

29 (1910) 10 CLR 674.

30 (1914) 18 CLR at 163-4.

31 (1923) 33 CLR 115.

32 'Optionee' is the term used in the contract cases, though in the tax context 'grantee' is more appropriate: s 134 of ITAA97. It seems curious that an irrevocable offer can create an equitable interest in the 'grantee', though Isaacs J in *Goldsborough Mort* (above) so held without seeing any anomaly.

33 Above n 28, 376.

> into the form of a conditional contract of sale and not much reason why offer and acceptance in simple contract should form the basis of a contract under seal.

In *Laybutt v Amoco Australia Pty Ltd*[34] Gibbs J said;

> However, there is what Dixon CJ in Braham v Walker called a 'standing controversy' as to the true nature of an option to purchase. One view is that an option to purchase is 'a contract for valuable consideration, viz, to sell the property (or whatever the subject matter may be) upon condition that the other party shall within the stipulated time bind himself to perform the terms of the offer embodied in the contract': per Griffiths CJ in *Goldsbrough Mort & Co Ltd v Quinn*. The other view is that 'an option given for value is an offer, together with a contract that the offer will not be revoked during the time, if any, specified in the option': Latham CJ in *Commissioner of Taxes (Q) v Camphin* (supra). This difference of opinion is reflected in the judgments in Carter v Hyde[35] where it was held that the personal representatives of the grantee of an option to purchase a lease were, upon giving notice in writing as required by the option entitled to specific performance of a contract of sale. In that case the option took the form of an offer coupled with a promise not to revoke it. The majority of the court treated the option as being, in effect, a conditional contract of sale.

Gibbs J noted that there are three ways of expressing an option: (1) an irrevocable offer supported by consideration which permits the grantee to enter into a second contract; (2) a conditional contract which becomes binding on the grantee on exercise; and (3) where the grantor says 'I give you an option to purchase my asset'. The actual option in *Laybutt v Amoco* was expressed in the third of these alternatives. Whether there is one contract or two often depends on the wording of the particular option, though Gibbs J thought that the single conditional contract theory should be adopted on authority and in principle. He said that the actual wording of the option in *Carter v Hyde* was in the form of two contracts,[36] but the majority of Knox CJ and Higgins J construed the option as a single conditional contract. With regard to principle, Gibbs J said[37] that the weakness of the two contract theory is that an irrevocable offer could not create an equitable interest in the optionee, whereas a

34 Above n 27, 71-2.

35 (1923) 33 CLR 15.

36 'In consideration of £1 paid to me by Mr George Hyde I hereby place under offer to him the lease license furniture and goodwill of hotel premises known as the Lord Cardigan hotel for the sum of £1,500 pounds. And I further agree that this offer shall not be revoked by me for a period of three calendar months from this date'.

37 *Laybutt v Amoco*, above n 27, 76.

conditional contract would create a contingent equitable interest. A second reason for preferring the conditional contract theory is that any purported revocation of an option in breach of contract cannot bring the option to an end.[38] He observed that there is no general principle that an act may be disregarded simply because it is done in breach of contract.[39] If the only contract were not to revoke the offer, then damages would be a sufficient remedy for the purported wrongful revocation.

Prior to the implementation of the capital gains tax regime, it generally did not matter[40] which theory was adopted by the courts, though Gibbs J pointed out that there could be a difference from the perspective of a vendor who died before the option was exercised. An offer lapses with the death of the offeror, whereas a conditional contract would not.[41] The *Sara Lee case*[42] shows that the year of contract can be vital in CGT and no doubt the issue of the nature of an option will be litigated at Federal Court level[43] in the CGT context. With the advent of the CGT provisions there are now real consequences which flow from whatever theory was adopted because of the discount period under s 115, and the calculation of CGT liability in a particular year. Although *Re Van*[44] misinterpreted *Laybutt v Amoco*, the decision in

38 *Goldsbrough Mort & Co Ltd v Quinn* (1910) 10 CLR 674.

39 An illustration, in another context, of such effective action in breach occurs where a buyer wrongfully refuses to accept delivery of goods. The seller is not entitled to sue for price but only for damages, despite the fact that it is the buyer's wrongful act which has prevented the passing of property: *Automatic Fire Sprinklers Pty Ltd v* Watson (1946) 72 CLR 435, 463-64 per Dixon J.

40 Isaacs J in *Carter v Hyde* (1923) 33 CLR 115, 123: 'it matters not a straw which view was right in *Goldsbrough Mort & Company Ltd v Quinn'*.

41 Whichever theory is adopted, both sides agree the option does not lapse on death, that it is generally transferable unless personal to the grantee, and that it creates an equitable interest in the grantee.

42 Above n 23.

43 In *Re Van and Federal Commissioner of Taxation* [2002] 51 ATR 1153 the AAT held that shares acquired by subscription on exercise of company issued options were only acquired at the time of exercise, the result being that the option period could not be included for calculating the 12 month period resulting in the discount under s 115 of ITAA 1997. The tribunal adopted the two contract theory which it strangely attributed to *Laybutt v Amoco Australia Pty Ltd* which clearly endorses the conditional contract theory.

44 *Re Van* dealt with the effect of company issued options to take up unissued shares. This is CGT event C3 and there are no consequences until failure to exercise, cancellation or release of the option at which time the company makes a capital gain. The taxpayer was held only to have acquired such shares at the time of exercise. It is suggested that there is no good reason to have the time of acquisition any different for options in general.

*Van's* case was correct. In *Spiro v Glencrown Properties Ltd*[45] Hofmann J, after noting that some English cases adopted the two contract theory and others the conditional contract theory, said that both theories were analogies and that an option was sui generis. Sometimes its nature may depend on the wording of the document, and in other cases it depended on the relevant statute. In *Spiro* the conditional contract theory was adopted, because the option to purchase land was in writing as required by the statute and it would have been pointless to insist that the exercise of the option also be in writing.

In ITAA 1997 the two contract theory is to be preferred. An option is defined as an asset in s 108, and the grant of an option is a CGT event D2 in s 104-40. If the option is exercised so that an underlying asset is transferred the transactions are merged under s 134 which will generally result in CGT event A1. The form of the statute is to suggest two contracts, and contract law suggests that the conditional contract theory in the taxation context could lead to absurd results. An option maybe granted for a nominal sum eg £1 in order to buy a £1500 asset as was the case in *Carter v Hyde*.[46] In the circumstances, where an option is granted for a nominal sum say five dollars to purchase an asset worth $500,000, a taxpayer may hold the option for 12 months, exercise the option on the next day and sell the asset for a discountable capital gain under s 115. This is a patently absurd result which would be brought about if the conditional contract theory is adopted in the income tax assessment act. For this reason, the two contract theory is to be preferred at least where the issue cannot be resolved from interpreting the contract.

## Sale of Goods

When Mr Keating, as Treasurer, announced the proposed enactment of CGT on 19 September 1985, it was said that there should be no retrospective application in its measures.[47] Thus any asset acquired by a taxpayer before 20 September 1985 was CGT exempt.[48]

45 [1991] Ch 536.

46 See also *Niesmann v Collingridge* (1921) 29 CLR 177, where the option fee was six pence, and the exercise price was £2800; *Cavallari v Premier Refrigeration Co Pty Ltd* (1952) 85 CLR 20, where the option fee was one shilling and the exercise price £32,000. Equity will grant specific performance where the option fee is nominal provided the exercise price is not nominal: *Mountford v Scott* [1975] Ch 258.

47 *Hansard* 23 May 1986 House of Representatives 3904: 'It is totally prospective … All farms owned on 19 September 1985 will be exempt'.

48 See the Commissioner's initial approach in ruling IT2561, where he regarded the grant of a profit à prendre after 19 September 1985 as part disposal of the land under s 160 R

It is an elementary principle of tax law that sales of standing timber can be made by a contract which does not create entitlement to assessable royalties.[49] In 1989,[50] the Commissioner of Taxation produced a ruling purporting to impose tax on sale of such timber under s 160 M [6],[51] because there was a post-CGT asset in the form of the contract of sale, or alternatively a profit à prendre had been created after the relevant date. The issue was not helped by the infelicitous drafting of s 160 M [6], which used the expression 'incorporeal asset', which is not a term of art. The Commissioner's argument had a certain legal attraction because although s 160 M [6] was subject to the other provisions governing CGT disposals, it should not be subject to disposals of assets acquired before 20 September 1985, because the other CGT provisions could not apply to such cases. Thus, a farmer who acquired land before 20 September 1985 could, on the sale of standing timber, be assessable on the entire proceeds, less a cost base confined to incidental costs of disposal.

This approach seems unfair and tax advisers were quite ingenious in their response. Since the timber was owned before 20 September 1985, it should be possible to draft the contract in such a way that it was a sale of goods and the value attributable to the goods was practically the whole of the consideration. Section 5 of the *Sale of Goods Act 1923* (NSW)[52] defines goods as including 'emblements and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale.' This definition had been interpreted in *Mills v Stokman*[53] contrasting it with a profit à prendre. Barwick CJ[54] said in the context of a sale of slate which had been lying on land:

> The agreement of 1955 went no further than to purport to sell the slate to the respondent and to give him a right to enter and remove it. He did not agree to do so. No doubt it is implicit in the terms of the agreement that both parties thought that the slate was already severed: they did purport to deal with it as if it were a chattel interest. But an agreement to sever cannot be constructed out of that assumption on the part of the parties.

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and s 160 M, leaving no room for the operation of s 160 M (6): Lehman and Coleman (LBC 1996, 4th ed) para 3.490, 723.

49 *Stanton v FCT* [1955] 92 CLR 630.

50 IT256,TD 93/81, TD 93/79, TR 95/6 which confirms that profits à prendre granted after 25 June are assessable under s 160 M(6).

51 The predecessor of CGT event D1.

52 *Sale of Goods Act 1896* (Qld) s 3.

53 [1967] 116 CLR 61.

54 Ibid 70.

Therefore, in the absence of a promise to sever, the transaction was not a sale of goods. To be legally effective, it had to satisfy the statutory requirements for the creation of an interest in land. It did not.

The practical significance of the distinction is that a sale of goods does not have to be in writing so that it is enforceable even if purely executory, whereas an oral profit à prendre is unenforceable unless it has been acted on in such a way as to invoke the doctrine of part performance.[55] In addition, a sale of goods only creates rights and duties between the parties whereas a profit à prendre, being an interest in land may create rights against subsequent purchasers of the land, provided there is compliance with the statutory requirements.

In the income tax context, this distinction would typically be used by advisers to create a contract for the sale of timber which was agreed to be severed for say $100,000, with an ancillary right of access to the land granted to the purchaser for $20. The ancillary right, being a profit à prendre created after 19 September 1985, would be subject to CGT liability, but the sale of timber being in respect of goods acquired before 20 September 1985 would be exempt. This distinction which arises from the *Sale of Goods Act 1923* (NSW) centres on the obligation to sever. In the tax context, that obligation is invariably placed on the purchaser, so that the seller will not be assessed on the grounds that cutting timber is part of their business. If the purchaser merely has a right, but no obligation, to enter the land and remove timber, there is no agreement to sever and the contract creates a profit à prendre,[56] where Mason J held that a prospectus offering rights in a pine plantation created right in the nature of a profit à prendre, even though there was an obligation to sever because the growers had a right to the trees when they were planted and to their further vegetation. In *Corporate Affairs Commission v ASC Timber*[57] Powell J said;

> That distinction is, not as is suggested in some of the cases, the existence - in which case there is said to be a sale - or non existence - in which case there is said to be a grant of a profit à prendre - of an obligation on either 'vendor' or 'purchaser' to fell and sever the trees … rather, so it seems to me, the distinction is be found to lie in the intention of the parties: is it the intention of the parties that the trees may be, or are to be, felled and removed within a reasonably short time -in which case the arrangement is one of sale - or is it

55 Meagher Gummow and Lehane, *Equity Doctrines and Remedies* (4th ed, Butterworths) paras [20-180] – [20-225].

56 *Mills v Stockman* (supra). Compare *Australian Softwood Forests Pty Ltd v Attorney General for the State of NSW* (1981) 148 CLR 121, 130 – 133.

57 (1989) 14 NSW LR 577, 590.

> intended that the trees shall be retained for a considerable period of time while they grow to maturity - in which case the arrangement is one involving a grant of a profit à prendre.

So, the legal advisers were using distinctions that had been first created in the *Sale of Goods Act 1893* (UK). The matter came up for decision in *Ashgrove Pty Ltd v DFCT*,[58] where five Tasmanian farmers entered into agreements to sell standing timber on land acquired before 20 September 1985. In one of the cases, the taxpayer did not draft a Stanton[59] style agreement, and was assessable on royalties for the sale of timber. Hill J held that the definition of 'goods' in the *Sale of Goods* legislation was only applicable for the purposes of the legislation, and for all other purposes the common law definition of goods which existed before 1893 was the relevant test.
At common law there was a sale of goods, if the parties agreed that the thing sold should within a reasonably short time be felled and removed from the land. On the other hand, there was a profit à prendre if the purchaser should benefit not only from the existing timber but from further growth of the thing sold, because this benefit truly arose from an interest in the land.

Sutton, Sales and Consumer Law,[60] the leading Australian textbook on sale of goods, makes no mention of this distinction, and indeed fails to mention *Ashgrove*, and the decision of Powell J in *Corporate Affairs Commission v ASC*[61]. Sutton says, at 2.44, 'the sole test now appears to be whether the thing attached to the land has become by agreement goods by reason of the contemplation of severance from the soil'. This comment is inaccurate. It is not contemplation of severance that is vital under the statute but agreement, ie an obligation to sever, that is vital, according to *Mills v Stokman* (above). This obligation may be undertaken by the vendor or by the purchaser, but for taxation reasons the obligation will invariably be on the purchaser. The definition relied on by Hill J had been mentioned in *Australian Softwood Forests Pty Ltd v AG* [NSW].[62]

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58 [1994] 28 ATR 512.

59 In *Stanton v FCT* (1955) 6 AITR 216 a farmer sold standing timber for a lump sum payable by instalments which the purchaser promised to pay on due dates regardless of whether the timber was cut and removed. The High Court, distinguishing *McCauley v FCT* (1944) 3 AITR 67, held at the receipts were not assessable royalties as the purchaser's obligation to pay did not vary with the quantity of timber taken.

60 ($4^{th}$ ed, 1995, LBC) para 2.44-45.

61 (1989) NSW LR 577.

62 [1981] 148 CLR 121.

Although all the purchasers in *Ashgrove* agreed to sever the timber,[63] they would not have escaped liability under s 160 M [6], unless they had also satisfied the common law definition of goods. This definition could not be discovered from the leading Australian textbook on the subject either before or after the decision in *Ashgrove.* The decision of Hill J at first seems a little odd, because even if the agreement was a profit à prendre, might it still not be characterised as the part disposal of land acquired before 20 September 1985? His Honour does not discuss this possibility,[64] and was at pains to characterise the transaction as a sale of goods at common law. This was the submission of counsel for the taxpayer. This means that it is implicit in the decision that the creation of a profit à prendre cannot be regarded as a part disposal of the land.

A different approach was taken in the dictum of Deane J in *Hepples v FCT*:[65]

> it seems to me that the preferable approach is to treat section 160 R[66] as applying to a case where there has been a disposal, in the sense of change of ownership, of any part the rights involved in the ownership of an asset, those rights themselves constituting an asset for the purposes of Part IIIA. On that approach, the grant of an enforceable easement or profit à prendre would come within 160 R as a disposal of part of the pre-existing right to use or exploit and the calculation of any resulting capital gain would make allowance for any resulting diminution of the value of the subject property. On the other hand, if all that was involved was, for example, the creation of a personal right in relation to the use of the taxpayer's pre-existing asset in circumstances where the creation of that right did not involve any disposal of any the pre-existing right to ownership with resulting diminution in value of the residual asset (e.g. a mere personal licence to enter which was revocable at will), the case would be of a type which fell within the provisions of section 160 M (6).

The 1997 legislation attempts to put the particular issue in Ashgrove beyond doubt. Section 160 M [6] of ITAA36 has now been replaced in ITAA97 by CGT event D1

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63 Above n 59, 529. Hill J said, 'It goes without saying that if the matter falls to be determined by the reference to the definition of "goods" in the Sale of Goods Act, each of the present agreements provide for severance and would be an agreement for the sale of goods.' This is not beyond dispute - see clause 5 of annexure B, which could be construed as a right to sever within a finite time.

64 Above n 59, 531. It seems implicit that creation of a profit à prendre could not be regarded as a part disposal of the land.

65 (1991) 22 ATR 465, 480. See also Patrick Cussen, 'The Grant of Easements and CGT' (1994) 23 *Australian Tax Review* 64-84.

66 The approach in the 1997 Act in section 108 is to define part of an asset as an asset thus achieving the same result as section 160 R of the 1936 Act.

which, under s 104-35, happens if you create a contractual right or other legal or equitable right in another entity. The capital gain is the capital proceeds, less the incidental costs you incurred that relate to the event. Under s 104-35 [5], CGT event D1 does not happen if the right requires you to do something that is another CGT event that happens to you. A contract by a farmer for the sale of standing timber may result in the happening of CGT event A1 by disposal of a CGT asset: s 104-10 and s 108 where part of an asset is defined as an asset. What if the farmer acquired the land before 20 September 1985? Section 104-10 [5] provides that a capital gain or loss is disregarded if you acquired the asset before 20 September 1985, but despite this exception it is clear that CGT event A1 still happens so that CGT event D1 does not happen. Although this is clear in s 104-10, s 102-23[67] also provides that an event still happens even if a capital gain or loss is disregarded.

But the dilemma inherent in the judgment of Hill J in Ashgrove remains. Might it not be the case that a sale of timber which is not a sale of goods at common law and takes the form of a profit à prendre cannot be regarded as the disposal of an asset, so that CGT event A1 cannot apply, leaving CGT event D1 to apply despite the wording of s 104-10 and s 102-23?

The decision of Hill J in *Ashgrove* continues to remain a safe haven for farmers who wish to dispose of standing timber. Even where the land was acquired after 20 September 1985, the *Ashgrove* approach will give a substantial cost base to the farmer, such cost base to be calculated in accordance with s 112-30. If there had been an agreement to sever the slate in *Mills v Stockman* (above), there is authority to suggest that there would have been a sale of goods.[68]

## Trading Stock

The trading stock provisions are now in Division 70 of ITAA97. Trading stock provisions are a necessary accounting supplement to the general legal conception of income which fails to recognise unrealised gains. Thus, the income of the taxpayer in effect includes the value of trading stock on hand at the end of the year and

67 "A CGT event still happens even if:
(a) it does not result in a capital gain or capital loss; or
(b) a capital gain or capital loss from the event is disregarded."

68 *Amco Enterprises Pty Ltd v Wade* [1968] Qd R 445. This decision is regarded as wrong by Greig and Davis, *The Law of Contract* (1987) 690 on the ground that gravel could not be regarded as a thing attached to the land. If it were a sale of goods, it could be CGT event A1, but if it is not a sale of goods, then the transaction would fall within CGT event D1.

deductions of the taxpayer include the value of trading stock at the commencement of the year. Without such provisions there would be a distortion as to the taxpayer's income because the taxpayer would get deductions for all stock purchased with no corresponding income derived in respect of stock acquired but not disposed of in the current year.

Section 70-35 requires a comparison between the value of all your trading stock on hand at the start of the income year and at the end of the income year. Under s 70-10, trading stock is defined as including 'anything produced, manufactured or acquired that is held for purposes of manufacture, sale or exchange in the ordinary course of a business'. It is clear that this is an inclusive definition and shares and land have also been held to be trading stock. In the case of shares, it was the taxpayer who argued that they were trading stock, as this would facilitate dividend stripping schemes under which the shares in the target company could be sold for a revenue loss after the taxpayer had received a rebateable dividend from the target company.[69] In *FCT v St. Hubert's Island Pty Ltd. [in Liq]*[70] the Commissioner successfully argued that land acquired for the purpose of subdivision was trading stock on hand with the effect that when the taxpayer went into liquidation there was a disposal outside the ordinary course of business and the taxpayer derived the market value of the land at that time instead of at the time of realisation by the sole shareholder. *Philip Morris Ltd v FCT*[71] provides that a taxpayer who uses cost must use full absorption costing thereby accelerating the derivation of income into years prior to realisation. If a land developer is to be profitable, the sale price will exceed full absorption cost, so the problem has arisen where the taxpayer has contracted to sell land in one financial year and conveyed the land in a subsequent year. Is the land 'on hand' at the end of the financial year when it is subject to a binding contract of sale? If so, the taxpayer is advantaged because, although it uses full absorption cost, this will be less than the full market value of the land which would otherwise be derived on an accruals basis.

Cases which have depended on basic contractual principles are: *Farnsworth v FCT* [72] - no creation of a debt at the time of delivery though the taxpayer had lost dispositive power; *FCT v Raymor*[73] - time of passing of property in unascertained goods was not within the financial year; *All States Frozen Foods Pty Ltd v FCT* [74] - time of passing of property in a CIF contract was delivery of documents thus ensuring goods were on

69 *Investment & Merchant Finance Corporation Ltd v FCT* (1971) 125 CLR 249; 2 ATR 361.

70 [1978] 8 ATR 452.

71 (1979) 10 ATR 44.

72 [1949] 78 CLR 504.

73 [1990] 21 ATR 458.

74 [1990] 20 ATR 1874.

hand; and *Gasparin v FCT*[75] - time of passing of property in sale of land. All these cases involved the meaning of the expression 'trading stock on hand'.

The cases provide that the issue of whether stock was on hand, was to be settled by asking whether the taxpayer had lost 'dispositive power'. If the taxpayer had lost dispositive power, the stock was no longer on hand.[76]

In *Farnsworth v FCT*, the taxpayer was a farmer who grew fruit and delivered it under a pooling scheme to a central packing house for grading and selling. After delivery, the fruit lost its identity as belonging to a particular taxpayer, to be replaced with an as yet unquantified entitlement to part of the proceeds. Thus, the taxpayer did not accrue a debt, because there was no sale price, and the goods were not on hand, because they were neither owned nor possessed by the taxpayer. It was said that the fruit was not on hand because the taxpayer had lost dispositive power. In the case of an ordinary sale of goods, the vendor loses dispositive power at the time of contract, because at that time the vendor cannot sell to any other person.

*The Sale of Goods Act 1923 (*NSW) contains provisions concerning the passing of property. Section 22 provides that property passes for specific or ascertained goods at such time as the parties to the contract intend it to be transferred. Section 23 then gives presumptions in the form of rules for the ascertaining of that intention. Rule 1 provides that unless a different intention appears, in an unconditional contract for goods in a deliverable state, the property passes when the contract is made. In a consumer sale, this intention is displaced and property will generally pass on delivery. Clearly, the vendor loses dispositive power on the passing of property, and in a commercial context this generally occurs at the time of contract. But, it is the passing of property that is vital, not the making of the contract. This distinction does not clearly appear in *J Rowe & Son Pty Ltd v FCT*,[77] since in the usual case of goods sold in a department store entry into the contract and the passing of property occur simultaneously at the cash register.

When does the taxpayer who is a property developer lose dispositive power? Can the vendor who is contractually bound to sell land to a particular purchaser be said to retain dispositive power, even though the purchaser acquires an equitable interest

75 [1994] 28 ATR 130.
76 *Farnsworth v FCT* (1949) 78 CLR 504.
77 (1971) 2 ATR 497.

in the property? In *Bunny Industries Ltd v FSW Enterprises Pty Ltd*,[78] dealing with the sale of land, Connolly J stated the following principles:

> 1 On the execution of the contract the vendor becomes a trustee for the purchaser. He is not however a bare trustee for he has a personal and substantial interest to the extent of the unpaid purchase monies. He is "in progress towards" bare trusteeship and finally becomes such when the whole the purchase monies are paid and he is bound to convey….
>
> 2 The purchaser may devise, alienate and charge his equitable interest so that it is plainly not a mere right in contract.
>
> 3 The extent of the equitable interest is measured by the amount of the purchase monies paid. Thus to the extent of the payments the purchaser acquires a lien exactly as if the vendor had given a mortgage to secure them…
>
> 4 Where there is a clear and undisputed contract, the court will not permit the vendor to transfer the legal estate to a third person and the reason for this was explained… as being because in equity the property was transferred to the purchaser.
>
> 5 The incidents of trusteeship exist only if so far as a Court of Equity would in all the circumstances of the case grant specific performance of the contract.

The question of the loss of dispositive power cannot be solved by the issue of whether the purchaser has an equitable interest. This is shown by the Full Federal Court decision in *Gasparin v FCT*,[79] and the decision was based on contractual principles relating to termination for breach of contract, though the court did recognise the purchaser's equitable interest in the land created at the time of contract.

In that case the taxpayer was a property developer and the question was whether land contracted to be sold prior to 30 June was still 'on hand' when legal property had not passed before that date. Did the taxpayer still have dispositive power when he had entered into a binding contract of sale in the relevant year? This was not treated as being merely a linguistic exercise. Once again the Federal Court had recourse to basic contractual principles, as expounded by the High Court in *McDonald v Dennys Lascelles Ltd*[80] and *Sunbird Plaza Pty Ltd v Maloney*.[81]

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78 [1982] Qd R 712.
79 [1994] 28 ATR 130.
80 [1933] 48 CLR 457, 475-76.
81 (1987-88) 166 CLR 245.

In the ordinary contract for sale of land the purchase money (apart from the deposit) is agreed to be paid on the day of completion of the contract by conveyance. Therefore, there is no debt prior to conveyance. Exceptionally, the purchaser may agree to pay on a fixed date, regardless of conveyance in which case there will be a debt at the time of contract. Equity may in these circumstances give relief against forfeiture: *McDonald v Dennys Lascelles*.

In the general case, where payment is to be made on conveyance, the vendor's rights on prior default by the purchaser depend on the vendor's election. No party can end a contract by their own wrongful act. The innocent party, in this case the vendor, is given an election to terminate. If the purchaser repudiates the contract before conveyance day, the vendor may accept the repudiation and elect to terminate the contract, keep the deposit and sell the land to a third party and sue for damages which are the difference between the original sale price and market at the time of resale. This shows that the vendor, who is still the registered owner of the land, has not lost all dispositive power even after a binding contract of sale has been concluded. The vendor has not ceased to have any proprietary interest in the land.

In *Gasparin*, the court recognised that prior to settlement the purchasers acquired an interest in equity and rights to specific performance. Though the purchaser's right was only contingent and, because of its substantial interests in the land, the vendor was not a bare trustee. The Court may have been trying to achieve a realistic commercial outcome by holding the stock was on hand where there was not yet the creation of a debt. The taxpayer can only write off a debt under s 25-35 of ITAA97, so that if the court in *Gasparin* had held that the taxpayer derived the purchase price, and the purchaser subsequently failed to pay, there would be no mechanism in the Act to reflect this.[82] In the unusual circumstances of Farnsworth's case, the stock was neither on hand nor was there an accrual since no debt was created.

Instead of terminating the contract for breach, the vendor may affirm the contract and sue for specific performance, which will involve suing for the contract price which will be awarded when the property is conveyed. At that point a debt will be created and the vendor's dispositive power will be lost and the land will no longer be 'on hand'. The policy behind these rules is that no party is entitled to have both the land and any part of the purchase price, excepting the deposit, without performing

82 *BHP Billiton Petroleum (Bass Strait) Pty Ltd v FCT* (2002) 51 ATR 520, 534 per Hill and Heerey JJ.

their side of the contract: *McDonald v Dennys Lascelles*. Therefore, there can be no debt and hence no accrual until the conveyance of the land.

## The doctrine of fixtures

One of the most common methods of tax planning involves a technique known as tax arbitrage, whereby two or more taxpayers combine in a joint venture to take advantage of their different tax treatment under the Act. Examples include dividend streaming, whereby shareholders most able to take advantage of franked dividends have such dividends streamed to them. This can no longer be achieved at company level, but it can still be achieved at trust level, where the shareholder is a discretionary trust. Other examples include leverage leases, which enabled tax concessions to be passed on to tax exempt persons such as State Governments or non residents. The advantages of such leases have been ended by s 51 AD of the 1936 Act. In addition, most pre payment schemes:[83] and the schemes prevented by section 82 KK of ITAA 1936 are examples of tax arbitrage.

There are some taxpayers who are favourably treated: superannuation funds are taxed at 15% on income and 10% on capital gains; and State Governments are tax exempt. What is the position where one of these entities wishes to enter into a joint venture with a corporate taxpayer subject to a 30% rate to develop land for housing commission purposes, or to erect an income earning building? The building itself is eligible under Division 43 of ITAA 1997 for building allowance of 4% per annum, and the plant within the structure can account for about 30% of the entire value. Thus there are substantial tax deductions in such a venture, but where the building and land are equally owned by both venturers the tax deductions will effectively be halved. In 1987 an investment called New South Wales Rental Property Trust [RPT] was offered to the public. Unit holders were not assessable on the inflation component of capital gains, and trust income which is in excess of tax income could also be distributed tax free to unit holders[84]. So where tax income is less than trust income, tax free distributions can be made to unit holders during the life of the investment. Tax income is likely to be less because of building allowance and the depreciation provisions of the 1997 Act. The 'RPT' investment offered a pre-tax income of 11% consisting of the inflation component of capital gains and building allowance which gave an after tax return of 11%.

83 *FCT v Raymor (NSW) Pty Ltd* (1990) 21 ATR 458, the result of this case has been overcome by s 70-15 of ITAA97.

84 CGT event E 4, s 104 - 70 of the 1997 Act would apply, but this is a tax deferral measure.

Does property law allow such an investment to be structured, so that the tax exempt party owns the land, and the taxpayer trust owns the building and the plant? Certainly the ATO resisted such structures through the 1980's on the basis of the doctrine of fixtures. Under that doctrine, whatever is attached to land becomes part of it and is realty rather than personalty. Whether there is such attachment depends on two tests: (1) the degree of annexation; and (2) the purpose of annexation to be determined by objective test.[85] The importance of the doctrine of 'fixtures' arises in the contexts of vendor and purchaser, mortgagor/mortgagee, beneficiaries under a will, landlord/tenant.

Sackville and Neave[86] tentatively suggest that the doctrine of fixtures owes its origins to a desire to conserve community resources by vesting land and fixtures in the one person. If objects firmly annexed to land remained personalty the beneficiary may not have owned the land and this would involve the wasteful process of dismantling such objects or demolishing buildings. Surely such a policy would not be frustrated by a provision in a joint venture agreement whereby a building was owned by a taxpayer and the land was owned with by a tax exempt party during the venture, but on its cessation the land and building was to vest in one party only. The venture in the form of a trust must, of course, come to an end, because of the rule against perpetuities.

But it is apparent that the modern doctrine has other purposes. If an object is firmly attached to land, a mortgagee may lend money on the strength of its value, but the vendor of the object may not have been paid in full and the contract of sale may contain a reservation of title clause so that property will not pass to the purchaser/mortgagor until full payment, the vendor retaining a right to enter the property and remove the object upon default. Can the ownership at law of the object be determined by the subjective intention of the vendor/purchaser, when the mortgagee acting in good faith simply sees an object firmly attached to the land? In other words the doctrine has implications beyond the preservation of community assets.

The issue in the tax context was recently analysed by the House of Lords in *Melluish [Inspector of Taxes] v BMI [No 3] Ltd.*[87] The taxpayer companies hired out plant and machinery to local government authorities, who owned the freehold where the plant was installed. The lease between the taxpayer and the local authorities characterised

85 *Hobson v Gorringe* [1897] 1 Ch 182, 193.
86 *Property Law* (2004, Butterworths, 7th ed) para 1.130.
87 [1995] 4 All ER 453; [1996] AC 454.

the equipment as personal property owned by the lessor. The items could not be depreciated by the lessor unless, in terms of the UK legislation, they 'belonged' to it.[88] It was held that the items became fixtures and, although they could be removed at the end of the lease, they did not 'belong' to the lessor during the period of the lease. The House overruled the decision in *Simmons v Midford*,[89] where Buckley J held that an underground drain had not become part of the land, because of the particular language of the parties in their agreement, which showed an intention that its ownership should not be vested in the owner of the soil. This decision was held to be per incurium, as the decision in *Hobson v Gorringe*[90]was not cited to the Court.

The House affirmed the proposition that the intention of the parties as to ownership of an affixed chattel can only be presumed from the degree and object of annexation. Lord Browne-Wilkinson said:

> The terms expressly or implicitly agreed between the fixer of the chattel and the owner of the land cannot affect the determination of the question whether, in law, the chattel has become a fixture and therefore in law belongs to the owner of the soil: see [1897] 1 Ch 182 at 192—3. The terms of such agreement will regulate the contractual rights to sever the chattel from the land as between the parties to that contract and, where an equitable right is conferred by the contract, as against certain third parties. But such an agreement cannot prevent the chattel, once fixed, becoming in law part of the land and as such owned by the owner of the land so long as it remains fixed. (460)

The House also rejected submissions that the taxpayer had entered into a sale and leaseback arrangement,[91] since there was nothing in the documents to justify such a finding. They also refused to find a trust arrangement whereby the taxpayer had an equitable interest in the land.

In Australia the issue has again become important in the context of sale and leaseback of fixtures. Sale and leaseback has become a popular method of finance in Australia

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88 Section 40-40, item 2 and item 4 of the 1997 Act gives the holder of a depreciating asset that is fixed to land the right to depreciate provided the owner of the right has a right to remove the asset.

89 [1969] 2 All E R 1269; [1969] 2 Ch 415.

90 [1897] 1 Ch 182.

91 In *Eastern Nitrogen Ltd v FCT* (1999) 43 ATR 112, 123, Drummond J says that there was a purported sale leaseback in *Melluish* (above), but this was the submission of counsel. Lord Browne Wilkinson said at 461: 'the documentation to which we were referred discloses no shred of an intention to enter into such a sale and leaseback transaction'.

in recent years. Since all leases are operating leases for taxation purposes,[92] the rental payments are fully deductible. The alternative method of financing would be to mortgage business premises, in which case the repayments would be split into principal and interest and only the interest would be deductible. Thus, it is easy to see the tax benefit and the alternative course of action to a sale and leaseback. However, sale and leaseback has commercial advantages over borrowing which are not tax driven. These advantages were noted by Emmett J In *Metal Manufactures Ltd v FCT*[93] and consisted of increased reported profits, improved cash flows and improved balance sheet. In particular, although borrowing on security of the asset, and sale and leaseback both create a debt in the profit and loss account,[94] sale and leaseback also creates an asset in that account, where it is a finance lease under accounting principles, which must be amortised over the period of the lease.[95]

The commissioner, in ruling tr 95/30, said that, in general, where the owner of an asset sold it to a financier (lessor), who then leased it back to the original owner (lessee), that lessee could tax deduct the lease payments and the lessor could depreciate the asset. This meant that the original owner/lessee could obtain finance at rates cheaper than the going commercial rate. The whole of the lease payments are deductible where the selling price of the chattel is at market value and its residual value at the end of the lease is also market, and the lessee has no right to purchase the asset at the end of the lease.[96] as drummond j notes,[97] a common practice in these sale

92 *Citibank v FCT* (1993) 26 ATR 423.

93 (1999) 43 ATR 375, 386, 388.

94 Now referred to as the statement of financial performance.

95 Accounting Standard AAS17.

96 In *Austin v United Dominions Corp* Ltd (1984) 2 NSW LR 612, 623-4, Priestley JA referred to 'the commercial practice of lessors of chattels whereby their rental charges and residual values are so calculated that if a leasing agreement runs its full course and on its conclusion the lessee buys the chattel from the lessor (there having been no pre-existing obligation upon the lessor to sell if requested) the lessor will have been reimbursed by the receipt of the rental instalments and the residual value for the capital laid out on the chattel and commercial rates of interest on that sum for the period of the lease, in a way analogous to that in which it is finally reimbursed at the conclusion of a hire purchase agreement. Thus, in a leasing transaction of this kind the residual value will be a balancing figure which, when added to the rental instalments, will produce a figure equal to a return of the lessor's capital plus the desired return of interest over the period for the outlay of its capital. It will thus bear no necessary relation to the market value of the chattel at the end of the lease, although presumably the lessor would tend to calculate it at a lower figure than market value (difficult though this might be to predict in regard to some types of chattel) to ensure that if the lessee did not indicate any wish to buy it at the end of the term it could then be sold without detriment to the

and leaseback arrangements is that the lessee inevitably purchases the chattel at the end of the lease. In commercial effect, part of the lease payments are capital, because the residual value is inevitably below market at the time of expiry, and the lessee is nearly always the purchaser of the asset. Since the courts do not use[98] 'economic equivalence', these lease payments cannot be described as partly consisting of an acquisition cost of a capital asset, because the lessee has no right within the documents[99] to purchase the asset at any time. The economic effect of these arrangements in respect of chattels is that the lessee is permitted to deduct what is in commercial effect capital. A taxpayer who adheres rigidly to the conditions in TR 95/30 would be entitled to the benefits in s 170BA of the 1936 Act.[100]

If the dominant purpose is to achieve cheaper finance, then no problems arise under Part IVA, but if the dominant purpose is to obtain a tax benefit in the form of a tax deduction there could be problems under part IVA, though this article will not include an analysis of that Part.

In TR 95/30 the Commissioner referred to the problem where the asset which the taxpayer purported to sell to the financier/lessor was a fixture.[101] Paragraph 17 stated that such fixtures could not be sold separately from the land and all the financier

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lessor's original calculations. In some cases this approach would require the rental payments to be at a higher rate than what would be the market rate for the rental of goods which was to be expected to be returned to the owner at the end of the lease. In a lease arrangement this kind, a lessor needs some provision in the lease agreement to bring about the result, when the agreement is terminated mid-term, that the lessor will be in the position of recovering its capital together with the calculated rate of interest for the shortened term.'

97 43 ATR 112, 126.

98 *Europa Oil (NZ) Ltd v IRC (NZ) (No 2)* (1976) 5 ATR 744, 751: 'Taxation by end result, or by economic equivalence, is not what the section achieves.'

99 In *Granby Pty Ltd v FCT* (1985) 30 ATR 440, 404, Lee J said that residual values were below current market values, so that lessor corporations could safeguard the capital they as financiers invested in the chattel purchase and lease transactions they entered into and their decisions to accept consideration below market was an inducement to the lessee to care for the property.

100 The Commissioner does not extend this indulgence to the taxpayer who purports to enter into a sale leaseback arrangement with respect to a fixture, so the taxpayer cannot rely on the economic philosophy of the ruling to extend it to sales of a fixture: *Bellinz v FCT* (1998) 39 ATR 198, 207, 211.

101 A taxpayer will not mind selling a fixture since there will generally be no CGT liability, but may not wish to sell the underlying land, because this could involve CGT liability or loss of the shelter of a pre-CGT asset.

acquires is a mere contractual right to use the asset. At para 45, he conceded that something less than formal legal ownership may suffice to depreciate plant, but he said in para 17 that to attempt to depreciate such a fixture would be 'stretching the form of a sale and leaseback arrangement too far', because the financier has a 'mere right to use that asset'.

In para 45, he states; 'An alternative view advanced is that a purported sale and leaseback involving fixtures … grants to the purchaser a right to sever and remove the fixture (at which time legal ownership would pass)' and that the purchaser obtains a contractual right, an equitable title to the fixture and an ancillary equitable interest in the land, and that these rights would amount to sufficient ownership by the purchaser for the purposes of claiming depreciation under s 54[102] of the 1936 Act.

> However, in the context of a sale and leaseback where neither possession nor legal interests in the asset pass to the lessor there is not sufficient ownership for the purposes of section 54.

The Commissioner cites no case as authority in this context but the statements in *Melluish*[103] support this approach.

Two cases at first instance in the Federal Court, and in the full Federal Court, addressed this issue. In *Eastern Nitrogen Ltd v FCT*[104] the taxpayer owned land on which was situated an ammonia plant. The taxpayer/lessee purported to sell the plant, but not the land, to a financier/lessor, who then leased it back to the taxpayer. The taxpayer then sought to deduct in full the lease payments in respect of the plant. The Commissioner rejected most of the deductions, arguing that the transaction was ineffective since the lease payments related to a fixture which still belonged to the taxpayer. He also rejected the claim on the basis of Part IVA.

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102 Now Div 40 of ITAA97 (Cth).

103 Though *Melluish* was not dealing with sale and leaseback. Emmett J, at first instance in *Metal Manufactures Ltd v Commissioner of Taxation* (1999) 43 ATR 375, 417 held that at common law fixtures could not be sold separately from the land, though the landowner could create by sale an equitable property in a financier sufficient to justify the deduction of rent. This view about the common law is supported in *Melluish, Emanuel v Commissioner of Stamps* (1986) 41 SASR 122 and the full Federal Court in *Bellinz Pty Ltd v FCT* (1998) 155 ALR 220. Butt, (2000) 74 ALJ 130 thought there was no reason in principle why at common law a landowner could not dispose of fixtures separately, since at common law an owner is entitled to dispose of part of their interest.

104 (1999) 43 ATR 112.

Drummond J found that the plant was a fixture, on the basis of the objective intention of the parties. He conceded that the fact that it remained a fixture did not necessarily prevent the payments from being deductible; but the fact that the plant was a fixture was an important consideration in the question of the proper characterisation of the rental payments for the purposes of s 51 (1). He said in para 27:

> So the financiers never acquired the legal title to the plant and thus were never in the position of being able to deny Eastern Nitrogen possession or use of the plant. It follows that the rental payments cannot be characterised, even in part, as outgoings within s 51 (1).

The taxpayer further submitted that the financiers acquired certain rights under the sale and leaseback transaction which were sufficient to make the rental payments of *Eastern Nitrogen* deductible as revenue outgoings.

Under Clause 4.8 of the lease agreement, Eastern Nitrogen acknowledged that the goods shall at all times be and remain personal property. Drummond J rightly held that this could not prevent the plant from being a fixture, because of the objective nature of the test for determining whether an item was a fixture.

He next considered the submission whether the financier's right of severance conferred under the agreement would rank as an interest in land. *Jarvis v Jarvis*[105]was cited by Palmer and McKendrick as authority for this proposition. Drummond J held that the case did not support the proposition. At para 40, he said that if there were any such interest it must be equitable, since the entire legal title to a fixture not agreed to be severed remains with the owner of the freehold. Any such equitable interest must be limited to the right to protect the fixtures against interference by the owner of the freehold or anyone else during the term of the lease and the right as against original purchaser of the freehold and any subsequent purchaser with notice of the right of removal to remove the fixtures at its end. Although the financier/lessor acquired an equitable interest[106] and contractual rights, ownership still remained with the taxpayer/ lessee. But the right of severance only arose on default by the taxpayer or termination of the lease. This contingent right could not deny Eastern Nitrogen access to the plant during the lease, so the lease payments were unnecessary for the taxpayer's use of the fixture. At para 49, he noted that

105 (1893) 63 LJ Ch 10.

106 The content of this equitable interest was limited to the right to protect the fixtures against interference by the owner of the freehold or third parties during the lease, and as against the original purchaser of the freehold and any subsequent purchaser with notice of the right of removal, to remove the fixtures at the end.

mistakes of fact or law did not necessarily prevent a deduction: *Magna Alloys & Research Pty Ltd v FCT*[107], and *FCT v Just Jeans Pty Ltd*.[108] The full Federal Court in *Eastern Nitrogen v FCT*[109] and *FCT v Metal Manufactures Ltd*,[110] endorsing the views of Emmett J at first instance, held there was sufficient equitable title in the financier to justify the deductibility of payments made to the financier.[111] The equitable interest arose from the documents which provided that in the event of default the financier could enter the premises, sever and remove the fixtures. The approach of Drummond J was incorrect as a matter of property law. If the view of Drummond J were adopted, it would lead to the curious result that the taxpayer who in effect has been advanced funds by a financier on the security of a fixture, and who agreed to pay money in respect of that transaction, could not get any deduction for payments which were working expenses.

His Honour made an additional finding that the dominant purpose of the taxpayer was to obtain a tax benefit.[112] He based this, in part, on the subjective intention[113] of the directors of the taxpayer, where the minutes showed no discussion of cheaper finance available under the sale and leaseback.

107 (1980) 11 ATR 276, 295.

108 (1987) 18 ATR 775.

109 (2001) 46 ATR 474.

110 (2001) 46 ATR 497.

111 *Hobson v Gorringe* [1897] 1 Ch 182; *Re Samuel Allen & Sons Ltd* [1907] 1 Ch 575; *Re Morrison Jones & Taylor Ltd* [1914]1 Ch 50; *Kay's Leasing Corporation Pty Ltd v CSR Provident Fund Nominees Pty Ltd [*1962] VR 429; *Sanwa Australia Leasing Ltd v National Westminster Finance Australia* (1988) 4 BPR 9514. The taxpayer had agreed to do everything that was necessary on its part to vest ownership in the financier. It had not achieved its object but it remained subject to a continuing obligation to do so. A court of equity would treat as having been done that which ought to have been done. These cases show that such an equitable interest is subject to the rules of priorities. Thus if there are two equitable interests the first in time will prevail providing the equities are equal, and an equitable interest will be postponed to a bona fide purchaser for value of the legal interest who takes without notice of the equitable interest. The Commissioner conceded in argument in the full Federal Court in *Metal Manufactures* that there was sufficient equitable title to justify the deductibility of the rental payments.

112 A somewhat strange finding given the nontax reasons for sale and leaseback, and given that it has been a normal method of financing sanctioned by the Commissioner's ruling TR 95/30 when fixtures are not involved.

113 Only the objective intention is relevant under Part IVA: *FCT v Spotless Ltd* (1996) 186 CLR 404, 421-2.

But his Honour held that, under the agreement, the bank was entitled to require the taxpayer to vest legal ownership of the plant and equipment in the bank. The parties had agreed that no part of the plant or equipment would be treated as a fixture. The bank also had full right and licence to enter the premises for the purposes of repossessing the plant. The bank of course acquired no legal interest since that was vested in the owner of the land.

The question remains whether the sale and leaseback of a fixture in a document which purports to vest contractual and equitable rights in the financier/ lessor can create sufficient title in the financier so that the financier can be said to own the plant for the purposes of s 40-40 of ITAA 1997. That was a question in *Melluish* [114]; whereas the question in *Eastern Nitrogen* and *Metals Manufactures* was whether they had divested themselves of ownership so that they could deduct the lease payments. It is suggested this is the same question as arose in *Melluish* since the issue is whether sufficient ownership of a fixture can be vested in a person who does not own the land at law.

The answer in *Melluish* was that the ownership of a fixture for these purposes is vested in the owner of the land[115]. All three cases and Megarry & Wade[116] recognise that an equitable interest will vest in the person who purports to purchase a fixture. The reasons are given in *Melluish* that the decision to find no sale and leaseback was based on the construction of the relevant documents. Whereas in the two Australian cases there was express provision for a sale and leaseback. In *Melluish* the House of Lords referred to *Re Samuel Allen & Sons Ltd*[117], *Re Morrison, Jones & Taylor Ltd*[118], but these cases did not give sufficient ownership, because the equitable right was a right to enter the land in the event of default and remove the equipment. Such an event which may occur in the future should not govern the taxpayer's right to deduct in a particular year. This is a contingent right not sufficient to constitute 'belonging' under the *UK Finance Act 1971*. It had no right of possession, unless and until there

114 [1996] AC 454.

115 The position has been altered by statute so that a quasi-owner in the position of *Melluish* could get a deduction for capital allowances by virtue of being a holder under section 40-40 item 2 of ITAA 1997.

116 5th ed; see also Butt, Note in (2000) 74 ALJ 130 and Note (2001) 75 ALJ 405, where he endorses the full Federal Court's views in *Eastern Nitrogen and Metals Manufactures Ltd*, and goes on to suggest that sufficient title at common law could be vested in the financier to justify the rental payments.

117 [1907] 1 Ch 575.

118 [1914] 1 Ch 50.

was a default. Artificial questions could arise, such as who owned the airspace during the currency of the fixture and after its removal.

## Conclusion

The Australian approach in the Full Court in *Eastern Nitrogen* and *Metal Manufactures* is preferable to that in the House of Lords in *Melluish,* which, in any event, did not rule on the efficacy on sale and leaseback of a fixture. Sale and leaseback is a perfectly normal method of financing which, although tax effective, has sound commercial reasons that are not related to tax, and legal structures should not hamper commerce. The purchaser of a fixture acquires contractual and contingent equitable rights over that fixture in the event of a default, and this constitutes sufficient ownership for the lessee to deduct rental payments. The efficacy of financing by sale and leaseback depends in part on the vendors' ability to deduct rental payments.

In both *Eastern Nitrogen* and *Metal Manufactures* the taxpayers had a genuine purpose of raising finance, and trying to do it at rates below the current interest rate where that was generally permitted in respect of sale and leaseback of chattels. What they did was legally permissible, despite the finding to the contrary in *Eastern Nitrogen* at first instance. It may be the case that Professor Butt's view that the land owner can sell fixtures at law without selling the underlying land will come to be accepted. In the meantime, it is certain that a land owner can create an equitable interest in a financier in a sale and leaseback arrangement, and this equitable interest is sufficient to justify the deduction of rental payments.