IS THE AUSTRALIAN TAXATION OFFICE FAILING TO USE ALL ITS WEAPONS AGAINST AGGRESSIVE TAX PLANNING? – AN ANALYSIS AGAINST THE FACTS IN *PUZEY v FC OF T*

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Agreement on the outcome that should follow from the application of the general anti-avoidance rule ("GAAR") to a tax planning arrangement is not always achievable. The differing conclusions reached at various levels of the judicial hierarchy in a number of leading cases support this. In light of this unpredictability of outcome, the Australian Taxation Office ("ATO") should be using whatever non-GAAR, anti tax planning rules or tax principles that are available to attack what the ATO considers unacceptable tax planning. Indeed, the ATO has an obligation to test the reach of these rules or principles. The tax planning in Puzey v FC of T *was at the aggressive end on the tax-planning continuum, and it was struck down by the GAAR at each stage in the judicial hierarchy. However, less aggressive tax planning cases that the ATO finds unacceptable may escape the GAAR. In such cases, the ATO will need to place reliance on the non-GAAR rules and principles. This article examines four non-GAAR tax rules or principles that the ATO could have raised in* Puzey. *While the ATO did make a number of non-GAAR based arguments (eg arrangements were a sham), it failed to raise the four rules or principles canvassed in this article. The circumstances in* Puzey *presented the ideal factual background to test the four rules canvassed in this article. Three of these rules or principles rely on the seedlings purchased in* Puzey *being characterised as trading stock (eg capping the deduction to an arm's length purchase price). This article makes the argument that it is hard to see why the seedlings should not be characterised as trading stock. The fourth rule or principle not asserted by the ATO in* Puzey *was that the incurred concept under the general*

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deduction section does contain a cash-accruals dichotomy. The article also examines this issue.

1. INTRODUCTION

The application of Australia's general anti-avoidance rule ("GAAR") in Pt IVA of the *Income Tax Assessment Act 1936* (Cth) ("ITAA36") to a set of facts cannot be predicted with a high degree of certainty. Support for this can be gleaned from litigation where judges at various levels in the court hierarchy have disagreed on the outcome on application of the GAAR. Cases such as *FC of T v Spotless Services Ltd*,[1] *Eastern Nitrogen Ltd v FC of T*,[2] *FC of T v Sleight*[3] and *FC of T v Hart*[4] provide examples. The disagreement usually relates to the "dominant purpose" aspect of the GAAR.[5] However, there are times where the notion of, or the application of, a "tax benefit" also creates disagreement.[6]

Putting aside Australian Taxation Office ("ATO") objectives under the test case program, it is submitted that a prudent administrator of the public revenue should be seeking to defeat aggressive or unacceptable tax planning through use of the non-GAAR provisions of the income tax. After all, most of the non-GAAR specific anti-avoidance provisions embody a specific statement from Parliament on the degree of tolerance concerning the tax planning involved. The GAAR lacks that degree of specificity and direction from Parliament. Specific anti-avoidance rules in the

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[1] 93 ATC 4397 (Lockhart J); 95 ATC 4775 (Full Federal Court); and (1996) 186 CLR 404 (High Court).

[2] 99 ATC 5163 (Drummond J); and 2001 ATC 4164 (Full Federal Court).

[3] 2003 ATC 4801 (RD Nicholson J); and 2004 ATC 4477 (Full Federal Court).

[4] 2001 ATC 4708 (Gyles J); 2002 ATC 4608 (Full Federal Court); and (2004) 217 CLR 216 (High Court).

[5] The dominant purpose test in Pt IVA is contained in s 177D of the *Income Tax Assessment Act 1936* (Cth) ("ITAA36").

[6] The tax benefit test in Pt IVA is contained in ITAA36, s 177C. For example note the differing position taken to the notion of a tax benefit by Justice Dowsett in *FC of T v MacArthur* 2003 ATC 4826 compared to that taken by the Administrative Appeals Tribunal: *MacArthur v FC of T* 2002 ATC 2212.

income tax also provide a higher degree of certainty regarding the tax outcome compared to the GAAR.[7] Further, the ATO should be using appropriate cases to test the reach of provisions that are directed at protecting the revenue (eg anti-tax deferral provisions). There can be no doubt that the tax shelter arrangement in *Puzey v FC of T*[8] is at the aggressive end of the "tax-planning continuum".[9]

The main aim of this article is to examine four rules or principles under the income tax that could have been raised or mobilised by the ATO to support the defeat, or partial defeat, of the tax planning in *Puzey*.[10] Narrowly viewed, this may all be academic as the ATO did win on the GAAR issue in *Puzey*, both at first instance,[11] and in the Full Federal Court.[12] However, the issue assumes some importance where the GAAR would not apply to an arrangement that is not at the aggressive end of the "aggressive tax-planning continuum"; in other words, a case where the GAAR might not apply. A recent case where facts that share a number of features with those in *Puzey*, and where the GAAR was held not to apply is *FC of T v Cooke*.[13] This is where the failure of the ATO in raising all reasonably available arguments and specific anti-avoidance provisions can have a

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[7] It is of course well known that one major limitation of specific anti-avoidance provisions is their limited scope. In turn, this allows taxpayers to plan around them.

[8] *Puzey v FC of T* 2002 ATC 4853 (Lee J); and *Puzey v FC of T* 2003 ATC 4782 (Full Federal Court) ("*Puzey*"). Justices Hill and Carr wrote a joint judgment and Justice French agreed with their Honours' orders and reasons.

[9] See facts in Section 2.1 below.

[10] As a by-product of the main aim, the article also reveals some of the difficulties associated with some of the trading stock rules in their application to "managed investment schemes" and some traditional farming enterprises (eg wheat farming).

[11] 2002 ATC 4853.

[12] 2003 ATC 4782. Note, the taxpayer's application for special leave to appeal to the High Court was refused: *Puzey v FC of T* [2004] HCA Trans 426.

[13] *FC of T v Cooke* 2004 ATC 4268 ("*Cooke*") confirming the decision of Stone J at first instance: *Cooke v FC of T* 2002 ATC 4937. It should be noted that the ATO has indicated that it will not be seeking to appeal the decision to the High Court: see [23 April 2004] 16 *Weekly Tax Bulletin* [615].

practical outcome, which is generally detrimental to the general body of taxpayers, and favourable to the taxpayer involved.[14]

It should be noted that the ATO did make a number of non-GAAR based submissions in *Puzey* attacking the tax planning therein (eg arrangement was a sham, project was a profit making scheme (isolated business venture) whereby recognition for costs is given by subtracting them from the sale proceeds on final harvest of the trees). All of these submissions failed.[15]

Aside from this introduction and the conclusion, the article is in two sections. Section 2 contains an outline of the facts in *Puzey*. It also contains a short outline of the ATO's submissions in *Puzey*, and the response of the courts. The outline in Section 2 is sufficiently comprehensive so that readers can appreciate the scope and range of arguments put forward by the ATO in the course of the litigation. Section 3 of the article focuses on submissions that could have been made by the ATO. It is divided into four parts, each dealing with a separate submission. The overall conclusion from the article is that the ATO did have a number of other credible arguments or anti-avoidance provisions at its disposal to attack the tax planning in *Puzey*. While few, or even none of these, may ultimately have succeeded, they all had some (if not considerable) merit. More importantly, it is submitted that the ATO lost an opportunity, in some respects, another opportunity, to test the judicial scope of these arguments, principles and provisions.

[14] It is not clear whether any of the arguments raised in this article would have applied to deny the taxpayer a deduction in *Cooke* 2004 ATC 4268.

[15] Section 2.2 outlines each of these arguments. Strictly, the ATO did succeed on one of these arguments but even then that was only after the project was restructured: see Sections 2.1 and 2.2.2 below.

2. FACTS, ATO SUBMISSIONS AND DECISION IN *PUZEY*

2.1 Facts

The case involved a mass marketed tax shelter scheme involving the growing (and harvesting) of Indian sandalwood in the Kimberley region of Western Australia. The taxpayer, an employee meteorologist in Perth, was introduced to the scheme by a canvasser, a Mr Serra. Mr Serra was the proprietor of a business described as "Financial Services & Systems".[16] In May 1997, on seeking further information on the project, the taxpayer received a printout of a spreadsheet that suggested that a person who invested in two acres (which became the taxpayer's actual investment) could expect, in 15-years time, to receive a net return of $673,000 from the proceeds of the sale of the trees harvested.[17]

Along with some 310 other "investors", the taxpayer entered into a series of agreements, the overall aim being to give the impression that the taxpayer was carrying on a business of growing (and selling) Indian sandalwood. There were four key agreements. Their main features were:

1. agreement to lease an area of land (one acre) for $1,200 per year. The rent was reviewable annually.[18] The rent was expected to be $1,992 in the year 2011-2012. The earliest time at which the taxpayer could take possession of his leased area was 1 May 1998. This agreement was entered into in or around May 1997;
2. agreement to engage a plantation manager (Lincfel Enterprise Pty Ltd) to establish the plantation (including

[16] Mr Serra received a commission for introducing the taxpayer to the project.
[17] *Puzey* 2002 ATC 4853, 4857 (per Lee J).
[18] It appears that the promoter, Allrange Tree Farms Pty Ltd ("Allrange Tree Farms"), or an associated entity, was not the lessor of the land: *Puzey* 2002 ATC 4853, 4858 (per Lee J).

planting the seedlings) for the taxpayer on his leased land, and to maintain the trees through to harvest.[19] This agreement was also entered into in or around May 1997. The fee payable for establishment of the plantation was $2,000.[20] The annual plantation management fee was $800 and was expected to rise to $1,328 in the year 2012.[21] The first planting of seedlings was not scheduled to take place until May 1998;

3. agreement to purchase Indian sandalwood seedlings and host-tree seedlings (eg East African Ebony, Mahogany) from the promoter of the project, Allrange Tree Farms Pty Ltd ("Allrange Tree Farms"), at a cost of $40,000.[22] This agreement was entered into on 3 June 1997.[23] Evidence was given by an experienced forester "that the price charged by [Allrange Tree Farms] for the seedlings … was an extraordinary sum and that a reasonable price … would have been not much more than [$1,500]".[24] Further, some six months after the taxpayer purchased his seedlings for

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[19] Lincfel Enterprise Pty Ltd was not an associate of the promoter, Allrange Tree Farms.

[20] Presumably, this covers such things as ploughing the land, deep ripping, mounding, fertilising, etc.

[21] Presumably, this covers such things as conducting regular inspections of seedling growth, replanting if necessary, conduct inspections for weeds, eradicate weeds if necessary, maintain irrigation infrastructure, maintain firebreaks, etc.

[22] The Indian sandalwood tree is a parasitic tree and hence it is planted together with host trees: *Puzey* 2003 ATC 4782, 4784 (per Hill and Carr JJ). Allrange Tree Farms intended to obtain its Indian sandalwood seedlings from a nursery that it had contracted Lincfel Enterprise Pty Ltd to construct in an area close to the taxpayer's leased lot. A director of Lincfel Enterprise Pty Ltd, Mr Heading, was formerly an employee of the Department of Agriculture. In the course of this employment, Mr Heading had gained knowledge in the propagation of Indian sandalwood in the area.

[23] Strictly, the taxpayer initially purchased an option for $100 in May 1987 that conferred a right to enter into the purchase seedling agreement at a price of $40,000. The option fee was applied against the purchase price of the seedlings.

[24] *Puzey* 2002 ATC 4853, 4861 (per Lee J). The $1,500 figure relates to the first year of the project and an area of one acre. The figure was $3,000 for both years.

$40,000, the Department of Conservation and Land Management ("DCALM") offered to sell similar seedlings to a company associated with Allrange Tree Farms for between $925 and $1,188;[25] and

4. agreement for the taxpayer to borrow $40,000 (strictly, $39,900), to finance the purchase of the seedlings, from a $1 company, Sandalwood Finance Pty Ltd ("Sandalwood Finance"). Sandalwood Finance was 100% owned by the promoter of the project (ie Allrange Tree Farms). The taxpayer made a loan repayment of $14,000 some 6 weeks after taking out the loan (ie in May or June 1997).[26] The balance of the loan (ie $26,000) was expressed to be repayable on demand, with the proviso that demand for repayment could not be made before the earlier of two events. They were: (A) receipt by the taxpayer of the proceeds of the sale of timber to be grown. This was expected to occur in around 15 years (ie 2012) and (B) December 2012. Although the venture was based on legal obligations under the seedling purchase agreement and the loan agreement, the implication that arose from representations made to the taxpayer was that the $26,000 outstanding loan principal was only payable if the venture succeeded (ie requirement to repay the balance of the "loan"

[25] *Puzey* 2003 ATC 4782, 4787-4788 (per Hill and Carr JJ). The $925 and $1,188 figures relate to the first year of the project. The figures for both years are $1,850 and $2,375. Note also that the figures for both years relate to one hectare, rather than two acres. However, given that one hectare is around 2.47 acres, the difference is only slight. It will be ignored for the purposes of this article.

[26] By apparent arrangement with Allrange Trees Farms' bank, a "round robin" transaction was effected so as to put Sandalwood Finance in funds in order to be able to make a loan to investors. In short, "funds" were provided by Allrange Tree Farms to Sandalwood who then in turn made payments to Allrange Tree Farms on behalf of investors (ie effect the loan): *Puzey* 2002 ATC 4853, 4859 and 4861 (per Lee J). In spite of the fact that the taxpayer was liable to Sandalwood Finance as the finance provider, the taxpayer made his loan repayments to Allrange Tree Farms without a direction that they be remitted to Sandalwood Finance as part repayment of the money lent: *Puzey* 2002 ATC 4853, 4861 (per Lee J).

> was contingent on the realisation of proceeds from the harvest and sale of timber).[27] In short, the taxpayer only paid $14,000 up-front, and was not required to pay the balance, if at all, until 15 years later. Under the loan agreement, the taxpayer had an obligation to pay "interest". In this regard, the taxpayer had two options. Option 1 provided for interest at 7% per annum calculated daily and payable in monthly instalments in arrears. Option 2 provided for "interest" of 7% of the proceeds from the sale of the timber from the taxpayer's land and to be payable upon receipt of the sale proceeds.[28] Option 2 was recommended to the taxpayer, and this is what he chose.

The agreements above, aside from the lease and management agreements, related to the income year ending 30 June 1997. The taxpayer also entered into a similar seedling purchase agreement and loan in regard to the income year ending 30 June 1998.[29]

The pro forma letters prepared by Allrange Tree Farms and executed by the taxpayer (and Lincfel Enterprise Pty Ltd) were designed to convey the impression that each participant had independently made their own arrangements to lease land, purchase seedlings, enter management agreements, etc, with the hope that the Australian Securities Commission ("ASC") would grant an exemption to Allrange Tree Farms for the project from compliance with relevant provisions of the *Corporations Law* dealing with the

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[27] *Puzey* 2002 ATC 4853, 4857 and 4869-4870 (per Lee J); and *Puzey* 2003 ATC 4782, 4795 (per Hill and Carr JJ). The terms of Option 2 in regard to the payment of "interest" supports the analysis of the contingent nature of the loan suggested here.

[28] *Puzey* 2002 ATC 4853, 4857 (per Lee J). Note that "interest" was only payable under Option 2 if the proceeds from harvesting and sale of timber exceeded "all costs": *Puzey* 2002 ATC 4853, 4857 (per Lee J).

[29] The $40,000 purchase price for the seedlings in regard to the income year ending 30 June 1988 was payable on 15 July 1987 ($100) and on 30 June 1988 ($39,900). It appears that there may have been only one seedling purchase agreement that provided for the staggered purchase and payment dates: *Puzey* 2002 ATC 4853, 4858 (per Lee J).

issue of "prescribed interests".[30] ASC did grant an exemption provided certain conditions were met.[31] However, on 9 July 1997, ASC revoked the exemption granted to Allrange Tree Farms for the project on the ground that the conditions stipulated for the exemption were not satisfied.[32] Accordingly, the project became subject to the rules dealing with schemes for the offering of "prescribed interests" under the *Corporations Law*.

In May 1998, the project was restructured so that the taxpayer became a beneficiary in a trust (Kununurra Tropical Forestry Trust) that conducted the project.[33] The seedlings purchased by the taxpayer (and other participants) and the land leased by the taxpayer (and other participants) was made available to the trustee to carry out the project. In light of the restructure, the taxpayer's entitlement as a beneficiary was to a shared interest in the net proceeds of sale obtained by the trustee in the conduct of the project, and not the sale proceeds of timber from his own leased area.

Between July 1998 and December 1998, sandalwood and host-tree seedlings were planted on the leased areas. By October 1999, it was apparent that most of the seedlings on the leased areas had failed and that a replanting operation was required "over almost the entire plantation".[34]

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[30] Ibid.
[31] Ibid.
[32] Ibid 4860.
[33] After the Australian Securities Commission ("ASC") withdrew the exemption under the *Corporations Law*, participants, or growers, were given the option of: (1) withdrawing from the project and receiving a refund of all moneys invested and (2) participating in a project that would now operate as a scheme of mutual investment supervised and managed by a trustee. The taxpayer (and others) elected to participate in the mutual investment: *Puzey* 2002 ATC 4853, 4860 (per Lee J).
[34] Ibid 4861 (per Lee J). The quoted words were taken from a report prepared for the trustee by a consultant forester, Mr Underwood.

2.2 ATO's Submissions and Court's Response in *Puzey*

Seven key submissions were made by the ATO to Lee J at first instance in the Federal Court. Each submission is briefly set out. Some of these submissions were abandoned and others were collapsed/merged, on appeal to the Full Federal Court. The response of Lee J, and where applicable, the Full Federal Court is also briefly set out. The focus here is on the seedling purchase agreement.

2.2.1 Agreements Were a Sham

The ATO argued that the liability incurred by the taxpayer to pay $40,000 ($80,000 for two years) for the purchase of seedlings was a sham, and the purported payment of that amount by loans from Sandalwood Finance was a fiction.[35] In somewhat contradictory terms, the ATO further submitted that the true arrangement in respect of the seedlings was for a purchase price of $14,000 ($28,000 over two years), rather than $40,000 ($80,000 over two years). $14,000 was the actual cash payment made by the taxpayer for the seedlings.[36]

Justice Lee had little difficulty dismissing the sham submission. His Honour indicated that the seedling purchase agreement that was entered into and that stipulated a purchase price of $40,000, was intended to have binding effect on the parties.[37] Accordingly, the agreement was not a sham. His Honour also held that there was no evidence to support the conclusion that the taxpayer and Allrange Tree Farms had agreed that the cost of the seedlings would only be $14,000 and that it was their mutual intention to disguise the true agreement.[38] The ATO did not pursue the sham argument before the Full Federal Court.[39]

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[35] Ibid 4862.
[36] Ibid.
[37] Ibid 4863.
[38] Ibid 4862-4863.
[39] *Puzey* 2003 ATC 4782, 4788.

2.2.2 Taxpayer was not Carrying on a Business

This submission was directed to the second positive limb in the general deduction provision, namely, outgoings necessarily incurred in carrying on a business.[40] The submission seems to be based on the following:

A. as at 30 June 1997, the project was still in its formative stage;
B. the taxpayer could not take possession of the land leased to him until May 1998;
C. it was not suggested that the taxpayer could carry on a business as a sandalwood producer, solely, on the land he held on lease (ie without a similar business being pursued on adjoining land); and
D. the taxpayer did not involve himself in any activities associated with the "business" (ie taxpayer was a passive, and distant, investor).

While implicitly accepting that the ATO's submission was strong,[41] Lee J rejected it. In so holding, Lee J noted that the taxpayer did retain an interest in the trees growing on his leased land, that he had engaged a manager to plant and maintain the seedlings and that he could, at least in theory, control the harvest and sale of the timber on his leased land.[42] Thus, up until the project was restructured
(12 May 1998), the taxpayer had committed to a business venture and that at the time of execution of the agreements, the taxpayer commenced to carry on a business of Indian sandalwood production.[43] After noting that the present case was on the borderline

[40] ITAA36, s 51(1) and *Income Tax Assessment Act 1997* (Cth) ("ITAA97"), s 8-1(1)(b).
[41] *Puzey* 2002 ATC 4853, 4863-4864 (per Lee J).
[42] Ibid 4862-4864.
[43] Ibid.

(between a business and passive investor), the Full Federal Court agreed with Lee J.[44]

However, from 12 May 1998, the time at which the project was restructured in response to the ASC's revocation of the exemption from compliance with *Corporations Law* provisions dealing with prescribed interests, the taxpayer ceased to carry on the business of growing Indian sandalwood.[45] From that moment, the taxpayer became a passive investor (beneficiary in a unit trust) in the business carried on by the trustee of growing Indian sandalwood.[46]

Justice Lee did not deny the deduction for the seedling purchases under the general deduction provision even though his Honour held that the taxpayer was not carrying on business after 12 May 1998, which is before the time the seedling purchase agreement took effect in regard to the year of income ending 30 June 1998. However, the Full Federal Court held that this $40,000 liability for the purchase of seedlings was not deductible, as the taxpayer was not carrying on a business at the time this agreement took effect.[47]

2.2.3 No Relevant Assessable Income

This argument was directed at the first positive limb in the general deduction provision. The argument is basically the same as that outlined in Section 2.2.6 below in regard to the second positive limb in the general deduction provision. The ATO seems to have

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[44] *Puzey* 2003 ATC 4782, 4793 (per Hill and Carr JJ).

[45] *Puzey* 2002 ATC 4853, 4864 (per Lee J); and *Puzey* 2003 ATC 4782, 4793-4794 (per Hill and Carr JJ).

[46] *Puzey* 2002 ATC 4853, 4864 (per Lee J); and *Puzey* 2003 ATC 4782, 4794 (per Hill and Carr JJ).

[47] Presumably, the taxpayer incurred the liability for the $40,000 purchase of the seedlings at the time the lender, Sandalwood Finance, made a cheque payable for $40,000 (strictly, $39,900) to Allrange Tree Farms on behalf of the taxpayer. This occurred on 29 June 1988: *Puzey* 2002 ATC 4853, 4860-4861 (per Lee J). In regard to the year of income ending 30 June 1987, a similar transaction occurred on 27 June 1987: ibid 4859. The taxpayer's actual payments totaling $28,000 were made sometime between May 1987 and October 1988: ibid 4861.

asserted that the taxpayer was not going to derive assessable income, or was very unlikely to derive assessable income, from the project because the project appears to have been badly managed from the start.

Justice Lee held that in spite of concerns a participant may have had with the project (eg whether the promoter had the skill to operate the venture), the project, on its face, was not obviously devoid of prospect.[48] Further, his Honour held that notwithstanding concerns with the project, the proposal represented to a participant a reasonable expectation that assessable income could be gained from the project.[49] This argument does not appear to have been made in the Full Federal Court, and therefore was not addressed.

2.2.4 Profit and Loss Accounting Applied to the "Project", and Hence Deferral of Cost Recognition Until the End of the Project was Appropriate

This argument was also directed at the first positive limb in the general deduction provision. Put briefly, the ATO asserted that there is a distinction between: (a) the realisation of a profit from a venture and (b) the gaining of assessable income. The ATO asserted that the taxpayer's involvement in the Indian sandalwood project was a profit-making venture.[50] The significance is that the tax accounting applicable in the isolated business venture cases would apply to the taxpayer's involvement in this project. In particular, the costs of the taxpayer should be taken into account as a subtraction against the proceeds from the sale of the timber to determine the profit that has the character of income (or a loss that has the character of a deductible loss).[51]

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[48] Ibid 4865.
[49] Ibid.
[50] The ATO's position is foreshadowed at *Taxation Ruling* TR 2000/8, para 87.
[51] *Puzey* 2002 ATC 4853, 4865-4866 (per Lee J). The added attraction of this characterisation to the Australian Taxation Office ("ATO") was the possibility that deductions for the loss would be denied altogether on the basis that the taxpayer had

Justice Lee rejected the argument. His Honour said:

> … the return sought was not a capital accretion on a sum invested but a return from the growth, harvest and sale of a product purchased for resale, that return to be promoted by regular outgoings incurred for the purpose of producing the product for sale. Accordingly, the distribution [gross sale proceeds] to the applicant of moneys obtained as proceeds from the sale of timber harvested from the plantation would represent the gaining of assessable income according to ordinary concepts.[52]

And later:

> … the outgoings incurred for the purchase of seedlings were deductible under the first limb of s 51(1), or s 8-1, when incurred and were not the costs of an isolated venture, the profit of which fell to be calculated at the end of the venture.[53]

The Full Federal Court did not address the isolated business venture submission.

2.2.5 Outgoings Were of a Capital Nature

The ATO submitted that the amount payable under the seedling purchase agreement was the cost of obtaining rights in the venture, and in particular, rights under the trust deed.[54] These rights were of a capital nature, and therefore the outgoings were capital.[55]

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abandoned the project at the time the loss crystallised (ie loss does not arise from the carrying out of an isolated business venture): see *Kratzmann v FC of T* 70 ATC 4043, 4045 (per Menzies J). The abandonment conclusion was a real possibility given the highly speculative nature of the project from the start and the significant time period until realisation of proceeds from timber sales. See also *M Steinberg v FC of T; Trustee of Judith Steinberg No 2 Trust v FC of T; M D Steinberg v FC of T* (1975) 134 CLR 640, 714 (per Stephens J), but note that the legislative context was the second limb of ITAA36, s 26(a).

[52] *Puzey* 2002 ATC 4853, 4866 (per Lee J).

[53] Ibid.

[54] It is not clear what trust deed the ATO is referring to. It is hard to see how the ATO could be referring to the Indian sandalwood project, as it was not structured as a trust arrangement for the benefit of "investors". Rather, the project was largely

Justice Lee had little trouble dismissing this submission. His Honour held that the outgoings were not for the purchase of rights under the trust deed. Rather, the outgoings were for the purchase of seedlings to be used as part of a crop to be harvested after growth over a number of years and to provide a return from sale of the product.[56] Further, if the taxpayer was carrying on a business, as his Honour previously held, the outgoings were directed to the process of operating the business.[57] While the Full Federal Court did not expressly address the issue, it is clear that the Court considered the expense on purchase of the seedlings to be on revenue account.[58]

2.2.6 Outgoings Were Incurred for the Purpose of Obtaining Tax Deductions

The ATO submitted that the relationship between the outgoings and the production of assessable income was colourable and not genuine, and accordingly, deductibility ought to be denied under the first limb of the general deduction provision.[59] The disproportion between the outgoings and assessable income was said to demonstrate the colourable and non-genuine relationship. The grossly inflated price paid for the seedlings was the main basis for the ATO's submission.[60]

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based on contractual arrangements. Indeed, the project's only real chance at success, in tax terms, required this. Accordingly, it is likely that the ATO's submission was directed at the structure that arose after the ASC revoked the exemption from compliance with provisions dealing with prescribed interests.

[55] *Puzey* 2002 ATC 4853, 4866 (per Lee J). See s 51(1) and ITAA97, s 8-1(2)(a).

[56] *Puzey* 2002 ATC 4853, 4866 (per Lee J).

[57] Ibid.

[58] *Puzey* 2003 ATC 4782, 4794 (per Hill and Carr JJ).

[59] ITAA36, s 51(1) and ITAA97, s 8-1(1)(a). The argument is based on the High Court discussion of the general deduction provision in *Fletcher v FC of T* (1991) 173 CLR 1, 17-19 (per Mason CJ, Brennan, Deane, Dawson, Toohey, Gaudron and McHugh JJ).

[60] *Puzey* 2002 ATC 4853, 4867 (per Lee J). It was also asserted that the payments actually made by the taxpayer ($14,000) were totally funded out of tax savings: ibid.

It was held by Lee J that it had not been established that there was a disproportion between the outgoings and assessable income. Justice Lee noted that the worth of the venture was yet to be proved, and the long lead-time to production carried substantial risks for any participant.[61] Justice Lee continued, the fact a participant is naive or unquestioning as to the plausibility of the promoters claims does not necessarily establish a purpose other than the gaining of assessable income.[62] Further, even if the taxpayer were persuaded to make the investment because of the reduced cost as a result of the available deduction, this would not, on its own, deny deductibility, provided that, on its face, the project represented an opportunity to gain or produce income.[63]

In conclusion, Lee J noted:

> Once it is acknowledged that there was some prospect of obtaining assessable income, the amount of which would vary according to contingencies, it could not be said that assessable income to be gained was so disproportionate to the outgoings incurred to deny genuine anticipation of gaining such income. As long as outgoings of a revenue nature display sufficient connection with the gaining of assessable income they will be deductible notwithstanding that the time at which the outgoing is incurred may be not coincident with the gaining of the assessable income.[64]

Accordingly, Lee J rejected the ATO's submission.[65] To the extent that this argument was based on the grossly inflated price incurred for purchase of the seedlings, the ATO expressly disavowed the argument in the Full Federal Court.[66]

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[61] Ibid.
[62] Ibid.
[63] Ibid.
[64] Ibid.
[65] Ibid.
[66] *Puzey* 2003 ATC 4782, 4790 (per Hill and Carr JJ).

2.2.7 GAAR Applied

The ATO also submitted that the GAAR operated to deny the taxpayer deductions for the $40,000 outgoing ($80,000 for two years) on the purchase of the seedlings. The ATO put forward two alternative schemes. The first encompassed the purchase seedling agreement along with the loan agreement. The second version was the entry into the package of agreements.[67] Justice Lee identified the relevant "scheme" for the purpose of the GAAR as the seedling purchase agreement. The loan agreement was ancillary to the seedling purchase agreement.[68]

The "tax benefit" was the deduction for $40,000 as the price payable for the purchase of seedlings.[69] If the scheme is viewed more broadly (ie all of the agreements), then all deductions obtained under those agreements constitute a tax benefit. In regard to the purpose test, Lee J held that, objectively determined, the dominant purpose of the taxpayer in entering into or carrying out the scheme was to obtain a tax benefit of sufficient magnitude to provide tax "savings" to underwrite participation in the project.[70] Justice Lee also held that the dominant purpose of the promoter in entering into the scheme was to obtain a tax benefit for the taxpayer, albeit limited to $26,000 ($40,000 - $14,000) (ie borrowed sum under the seedling purchase agreement).[71] Justice Lee did not determine whether the ATO could make a compensating adjustment under s 177F(3) of the ITAA36 to allow a deduction of $14,000 to the taxpayer (ie amount actually paid/discharged on the purchase of seedlings).[72]

The Full Federal Court stated that it did not matter which of the two schemes put forward by the ATO, and canvassed by Lee J, is

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[67] Ibid.
[68] *Puzey* 2002 ATC 4853, 4867 (per Lee J); and *Puzey* 2003 ATC 4782, 4795 (per Hill and Carr JJ).
[69] *Puzey* 2002 ATC 4853, 4869 (per Lee J).
[70] Ibid 4871.
[71] Ibid.
[72] Ibid. The Full Federal Court did not raise the issue.

taken to be the relevant scheme. The tax benefit constituted all the deductions available to the taxpayer as a result of entry into the relevant scheme.[73] For present purposes, this included the cost of purchasing the seedlings in the year of income ending 30 June 1997. Finally, the Full Federal Court concluded that the taxpayer entered into the scheme with the dominant purpose of obtaining tax benefits.[74] Given this conclusion, there was no need to consider whether the promoter also entered into the scheme with the dominant purpose of enabling the taxpayer to obtain a tax benefit.[75]

3. SUBMISSIONS ATO COULD HAVE MADE IN *PUZEY*

There are four submissions that the ATO could have made. Even though there is some overlap, as far as possible, they are considered separately. They are:

1. denial of deduction for purchase price of trading stock above arm's length price;
2. deduction for trading stock purchases deferred until the stock is on hand or derivation of sale proceeds occurs;
3. deferred payment of part of liability/expense on seedlings has not been incurred, and therefore not deductible, as taxpayer may be on the cash basis of incurred; and

[73] It is reasonably clear that the scheme that the Full Federal Court focused on was all of the agreements under which deductions were obtained, rather than just the seedling purchase agreement: *Puzey* 2003 ATC 4782, 4794-4795 (per Hill and Carr JJ).
[74] Ibid 4797.
[75] Ibid. The outline above focused on the seedling purchase agreement. While the lease payments and the annual management fee were held to be deductible under the general deduction provision, the GAAR applied to deny the deduction: ibid 4794 and 4800. The plantation establishment fee was held to be on capital account and therefore not deductible: ibid 4800. The above was confirmed in *Puzey* [2004] FCAFC 23, a case where the Full Federal provided further reasons for the judgment given earlier.

4. additional benefit obtained from expenditure under tax avoidance arrangement and which exceeds a threshold is denied deductibility under s 82KL of the ITAA36.[76]

Note also that these four submissions focus on expenditure on the purchase of seedlings in the year of income ending 30 June 1997 (ie first year of project), and the income tax legislation as at that date.[77] It will be appreciated that the classification of the seedlings as trading stock becomes important to the success of a number of the submissions made.

3.1 Denial of Deduction for Purchase Price of Trading Stock above Arm's Length Price

In the context of discussing the deductibility of costs incurred by the taxpayer after the scheme was restructured, the Full Federal Court said:

> Outgoings such as rent and fees for services, if for the purpose of gaining and producing assessable income are deductible and not on capital account. The only question of any difficulty is whether a different result follows in respect of the purchase of seedlings. In our view once it is decided that Mr Puzey did not carry on a business it can no longer be said that the seedlings are *trading stock* (or as it is

[76] If the facts in *Puzey* occurred today, the ATO may have an extra weapon (aside from Pt IVA) to minimise the tax advantage from the project, namely, the loss quarantining rule that applies to "small businesses: ITAA97, s 35-10. However, in light of the fact that the ATO has exercised the discretion under ITAA97, s 35-55 in a number of product rulings dealing with managed investment schemes in the timber growing industry (eg para 59 of *Product Ruling* PR 2002/146, para 54 of *Product Ruling* PR 2003/67; and para 66 of *Product Ruling* PR 2004/11) it is possible that the ATO, or the Administrative Appeals Tribunal, would exercise the discretion on facts like those in *Puzey*.

[77] The submissions are equally applicable to the seedling purchase agreement in the year of income ending 30 June 1998. Note however that there is another reason why the $40,000 incurred on purchase of the seedlings in 1998 were not deductible, namely, they were acquired to be contributed to the group investment scheme whereby they came to be used in the business of the trustee, rather than the taxpayer's business: *Puzey* 2003 ATC 4782, 4794 (per Hill and Carr JJ).

> sometimes called, the circulating capital) of his business for there is no business.[78]

The clear implication is that the seedlings were trading stock of the taxpayer's activity (business) right up until the time that the activity ceased to be a business and became a passive investment. There is no analysis supporting this trading stock conclusion. Justice Lee at first instance did not reach a trading stock conclusion regarding the seedlings. However, Lee J did make the following observations:

> The outgoings incurred by the [taxpayer] were not for the acquisition of an income bearing asset from which commodities for sale would be produced, but for products to be planted, in effect, as a crop to be matured and harvested for sale.[79]

And later:

> Therefore, the return sought was not a capital accretion on a sum invested but a return from the growth, harvest and sale of a product purchased for resale, that return to be promoted by regular outgoings incurred for the purpose of producing the product for sale.[80]

The question of whether the seedlings were trading stock at the time of purchase is relevant (and perhaps important) as the income tax legislation contains a rule that caps deductions, for the purchase of trading stock, to an arm's length amount. Section 31C of the ITAA36 applied for the income year ending 30 June 1997, and s 70-20 of the *Income Tax Assessment Act 1997* (Cth) ("ITAA97") applied for the income year ending 30 June 1998.[81] Section 31C is

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[78] Ibid (emphasis added).
[79] 2002 ATC 4853, 4865 (per Lee J).
[80] Ibid 4866.
[81] It is worth noting that ITAA36, s 51(2) (up until the income year ending 30 June 1997), and ITAA97, s 70-25 (after the income year ending 30 June 1997), ensures that the cost of purchasing trading stock will not give rise to a capital outgoing. It is arguable that in the absence of these provisions, the cost of purchasing trading stock could be on capital account: see *Investment & Merchant Finance Corporation Ltd v FC of T* (1971) 125 CLR 249, 263 (per Menzies J); *John v FC of T* (1989) 166 CLR

relevant to the taxpayer's first year of the project (ie income year ending 30 June 1997). However, putting aside the requirement that the item purchased is trading stock for the moment (see Section 3.1.3 below), there are two other requirements to satisfy before s 31C can apply.[82]

3.1.1 Transaction Must Not be a Dealing at Arm's Length

The ATO must be satisfied that the taxpayer and the vendor of the seedlings (Allrange Tree Farms) were not dealing with each other at arm's length in relation to the seedling purchase transaction.[83] The focus is on the dealing, not on the relationship between the parties per se.[84] In regard to an identically worded provision in the capital gains tax provisions,[85] Lee J noted in *Granby Pty Ltd v FC of T* that:

> … for the purpose of sub-s 160ZH(9) of the Act the term "at arm's length" means, at least, that the parties to a transaction have acted severally and independently in forming their bargain. Whether parties not at arm's length have dealt with each other at arm's length will be a matter of fact. As Hill J stated in *Furse* at 4015 [*The Trustee for the Estate of the late AW Furse No 5 Will Trust v FC of T* 91 ATC 4007], determination of the manner in which parties not at

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417, 428-429 (per Mason CJ, Wilson, Dawson, Toohey and Gaudron JJ) ("*John*"); *FC of T v Raymor (NSW) Pty Ltd* 90 ATC 4461, 4469-4471 (per Davies, Gummow and Hill JJ); and *Vincent v FC of T* 2002 ATC 4742, 4757 (per Hill, Tamberlin and Hely JJ) ("*Vincent*").

[82] It is worth noting that if the seedlings did change their character from trading stock to a capital asset as stated by the Full Federal Court (*Puzey* 2003 ATC 4782, 4794 (per Hill and Carr JJ)), ITAA97, s 70-110 would apply. Briefly, this section deems the taxpayer to have sold the trading stock in the ordinary course of business at an amount equal to its cost. In short, the inclusion in assessable income of the cost of the seedlings cancels out the deduction for the purchase cost. The section also deems the taxpayer to have re-acquired the item at an amount equal to its cost.

[83] ITAA36, s 31C(1)(b).

[84] *Barnsdall v FC of T* 88 ATC 4565, 4568 (per Davies J) ("*Barnsdall*"); *The Trustee for the Estate of the late AW Furse No 5 Will Trust v FC of T* 91 ATC 4007, 4014-4015 (per Hill J). Note, neither of these cases involved ITAA36, s 31C(1)(b). However, the wording of the provisions in issue was the same.

[85] ITAA36, s 160ZH(9)(c).

> arm's length have dealt with each other requires an assessment whether in respect of that dealing they dealt with each other as arm's length parties would normally do, so that the outcome of their dealing is a matter of real bargaining.
>
> If the parties to the transaction are at arm's length it will follow, usually, that the parties will have dealt with each other at arm's length. That is, the separate minds and wills of the parties will be applied to the bargaining process whatever the outcome of the bargain may be.
>
> That is not to say, however, that parties at arm's length will be dealing with each other at arm's length in a transaction in which they collude to achieve a particular result, or in which one of the parties submits the exercise of its will to the dictation of the other, perhaps, to promote the interests of the other.[86]

There is nothing in the context of s 31C of the ITAA36 to suggest that Lee J's analysis in *Granby Pty Ltd* is not relevant to s 31C.[87] The taxpayer in *Puzey* was not aware that the purchase price for the seedlings was an excessive price.[88] The taxpayer seems to have accepted the price payable for the seedlings without question. Presumably this was due to the fact that he only had to meet a portion of the purchase price with an immediate payment (ie $14,000 of the $40,000 purchase price). At worst for the taxpayer, the balance was deferred for some 15 years.[89]

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[86] *Granby Pty Ltd v FC of T* 95 ATC 4240, 4243-4244 ("*Granby*").

[87] Some of the comments of Lee J in *Granby* 95 ATC 4240, 4243-4244 extracted here have been referred to with approval in cases where the arm's length dealing formula appeared in a context outside of ITAA36, s 160ZH(9), namely, *Pontifex Jewellers (Wholesale) Pty Ltd v FC of T* 99 ATC 5324, 5327-5328 (per Burchett J) (sales tax legislation); and *Zoffanies Pty Ltd v FC of T* 2002 ATC 2129, 2149 (per RP Handley) (research and development expenditure deduction).

[88] *Puzey* 2003 ATC 4782, 4793 (per Hill and Carr JJ).

[89] See Section 2.1 above. It was near certain that the obligation to repay the balance of the loan was contingent on the realisation of a successful harvest: *Puzey* 2002 ATC 4853, 4857 and 4869-4870 (per Lee J); and *Puzey* 2003 ATC 4782, 4795 (per Hill and Carr JJ). Further support for this comes from the terms of Option 2

Clearly, the fact that one party to a transaction is offered a particular price on a take-it-or-leave-it basis is not sufficient to conclude that a transaction is not a dealing at arm's length. Were it otherwise, many purchases made by large retailers from wholesalers in this country would fail to be dealings at arm's length.[90] The key in these circumstances is the relative weakness and strength of the parties bargaining position. Further, the fact that a taxpayer remains ignorant, and perhaps chooses to remain ignorant, of a fair price to pay for something he or she has just acquired might not, on its own, be sufficient to conclude the dealing is not at arm's length. However, neither of these is a fair representation of what happened in *Puzey*.

The reality was rather that Allrange Tree Farms set the price of the seedlings at a level that would provide a sufficient deduction to the taxpayer so that the investment could be funded from the tax savings (tax refund) initially collected through the PAYE system of tax collection.[91] More particularly, the tax benefit, which is a product of the amount of the deduction multiplied by the taxpayer's marginal rate(s), sought was sufficiently high to cover the amount of cash the taxpayer was expected to contribute to the "investment" (ie $16,021 tax benefit compared to a $14,000 cash contribution).[92] In fact, the price was set at such a level that a cash flow surplus of $2,021 resulted. This surplus would not have been achieved if the price for the seedlings were only $20,000, instead of the $40,000 charged. A $20,000 price tag would still have been more than 10 times a reasonable price to pay for the seedlings.

In these circumstances, and even though the taxpayer and Allrange Tree Farms are not related parties, it is difficult to see how

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concerning the payment of "interest"; the option that was recommended to the taxpayer.

[90] Given the claim that retailers are "beating down prices", ITAA36, s 31C or ITAA97, s 70-20 would not be a problem in such cases.

[91] *Puzey* 2003 ATC 4782, 4788 (per Hill and Carr JJ).

[92] *Puzey* 2002 ATC 4853, 4856 (per Lee J); and *Puzey* 2003 ATC 4782, 4784 (per Hill and Carr JJ).

this transaction can be said to be a dealing at arm's length. Allrange Tree Farms dictated the terms of the agreement. It did so, so as to provide what turned out to be an irresistible incentive to the taxpayer to enter the agreements.[93] This was clearly in Allrange Tree Farms' commercial interest. Even though the taxpayer did not manifest express collusion with Allrange Tree Farms, it is arguable that he effectively colluded with Allrange Tree Farms through his conduct. The conduct that can be seen as collusion included silence and acquiescence in paying a price that was many times a reasonable price to pay for the seedlings. In any event, the taxpayer's indifference to the price charged for the seedlings is a strong indicator that he submitted the exercise of his will to that of Allrange Tree Farms' wishes.[94] Clearly, the amount actually paid (incurred) is a factor to take into account when determining the issue of the quality of the dealing.[95] The large discrepancy between the price charged and a reasonable price for the seedlings adds to the weight of evidence supporting the conclusion that the dealing was not at arm's length. Further, the dealing was in circumstances where it was unlikely that the taxpayer was purchasing an item that was part and parcel of his "everyday purchases". Parties at arm's length would not approach such a transaction in the manner the taxpayer and Allrange Tree Farms approached the seedling purchase transaction.

The better view is that the taxpayer and Allrange Tree Farms were not dealing with each other at arm's length in regard to the seedling purchase agreement.[96]

3.1.2 Purchase Price is Greater Than Arm's Length Price

More specifically, the purchase price must be greater than the purchase price would have been had the taxpayer and Allrange Tree

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[93] *Puzey* 2002 ATC 4853, 4869-4871 (per Lee J).
[94] *Collis v FC of T* 96 ATC 4831, 4837 (per Jenkinson J) ("*Collis*").
[95] *Barnsdall* 88 ATC 4565, 4569 (per Davies J).
[96] The decision in *Collis* 96 ATC 4831 provides strong support for the conclusion that the taxpayer was not dealing with Allrange Tree Farms at arm's length.

Farms been dealing with each other at arm's length.[97] Given the evidence presented by an experienced forester (Mr Underwood), and the DCALM, this requirement seems to be satisfied. Justice Lee held that "… a reasonable price to be paid for the seedlings supplied would have been not much more than [$1,500]".[98] The fact that there was no other supplier in the market, other than Allrange Tree Farms, at the time the taxpayer entered into his purchase agreement did not affect this.[99]

3.1.3 Are Seedlings Trading Stock?[100]

The key question here – as well as for other purposes[101] – is whether the seedlings purchased by the taxpayer are articles of trading stock?[102] As noted in Section 3.1 above, the Full Federal Court seems to think so but no reasoning is provided to support the conclusion. At first instance, Lee J did not reach this conclusion. However, some of his Honour's comments provide some basis to argue for such a conclusion.[103]

In a variety of rulings dealing with forestry issues and other produce that is planted and harvested after a period of tending for growth, the ATO has taken the position that seedlings are not to be regarded as trading stock of the grower. Unfortunately, these rulings do not provide a line of reasoning to support the conclusions

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[97] ITAA36, 31C(1)(c).
[98] *Puzey* 2002 ATC 4853, 4861 (per Lee J).
[99] *Puzey* 2003 ATC 4782, 4787-4788 (per Hill and Carr JJ).
[100] It is worth noting that the Review of Business Taxation recommended the enactment of a general arm's length rule and the repeal of the numerous specific arm's length provisions: Ralph Review, *A Tax System Redesigned: More Certain, Equitable and Durable – Overview, Recommendations, Estimated Impacts* 266 (Recommendations 6.17(a) and 6.17(b)). If such a rule existed at the time of the facts in *Puzey*, the deduction would automatically be capped at an arm's length amount and there would be no need to argue for the classification of the seedlings as trading stock. The Government has not acted on the recommendations.
[101] See Sections 3.2 and 3.4 below.
[102] ITAA36, s 31C(1)(a).
[103] See Section 3.1 above.

provided. However, the position taken in these rulings may provide some explanation as to why the ATO did not raise s 31C of the ITAA36 (or s 70-20 of the ITAA97) in *Puzey*. Relevant ATO rulings are now examined.

Taxation Ruling TR 95/6 deals with the taxation treatment of expenses and receipts in regard to the production and sale of timber (ie primary production and forestry). While the ruling deals fairly comprehensively with most matters concerning a forestry business, the treatment of the purchase of seedlings is brief. The ruling states that costs of establishing a plantation or forest are deductible.[104] One example of a deductible cost is stated as follows:

> Expenditure incurred on seedlings and planting costs is incidental and relevant to carrying on business and is deductible in the year of income in which it is incurred (*Income Tax Ruling* IT 2296).[105]

There is no mention as to whether the seedlings are trading stock. Nor does *Income Tax Ruling* IT 2296 mention trading stock.[106] Example five in *Taxation Ruling* TR 95/6 involves a taxpayer embarking on a forestry operation involving the planting of seedlings, tending them for growth and the ultimate felling of the trees for sale. The taxpayer incurs $80,000 of expenditure that includes an itemised $4,500 on the purchase of seedlings. The ATO states that the $4,500 is deductible along with most of the other costs.

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[104] *Taxation Ruling* TR 95/6, paras 30 and 106.

[105] Ibid para 107(e).

[106] *Income Tax Ruling* IT 2296 actually deals with the decision in *Case* 16 (1986) 29 CTBR (NS) 127. This case dealt with taxpayers in the business of growing blueberries. It will be appreciated that blueberries are a product of the blueberry shrub/plant that is not consumed in the process of harvesting the blueberries thereon (ie blueberry shrub is used to grow blueberries the following season). On the other hand, Indian sandalwood trees and the resulting timber emanates from growth of the seedlings planted. Harvesting of the trees does not leave the tree intact.

Importantly, there is no mention that the seedlings are trading stock.[107]

Taxation Ruling TR 93/9 deals with the deduction deferral rule for purchases of trading stock where the stock is not on hand at year-end, or assessable income has not been derived from the sale of the stock.[108] In this context, example one in the Ruling deals with a wheat farmer who incurs various expenditures on establishing a crop, including $1,000 expended on purchasing wheat seed for sewing. The ATO states that:

> Although seed might well be called stock, it does not constitute trading stock when it is held by a farmer for planting (see paragraph four of Income Tax Ruling No IT 147). Accordingly, in relation to the seed, the expenditure is not incurred by the farmer in acquiring stock which is trading stock.[109]

Income Tax Ruling IT 147, which deals with questions as to when a wheat farmer's wheat is trading stock and when is it on hand, contains the following statement: "any wheat retained on the property for use as feed or seed will also fall outside the definition of trading stock and may be ignored for income tax purposes".[110] The reference to wheat is pertinent as its nature is somewhat analogous to the nature of timber growing.[111]

It is worth noting that in most managed forestry production investments that require the purchase of seedlings for planting, no

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[107] Nor is there any mention that the deduction for the cost of the seedlings is deferred under the trading stock tax accounting regime.
[108] ITAA36, s 51(2A) and now, ITAA97, s 70-15.
[109] Part of extract in first bullet point in answer to the question in example one in *Taxation Ruling* TR 93/9.
[110] *Income Tax Ruling* IT 147, para 4.
[111] Wheat seedlings grow into a cereal grass that generates grains. The harvesting of the wheat grain (contained in the head of the cereal grass) essentially destroys the cereal grass, even though some farmers may use the grass for hay for feed. In other words, the same cereal grass cannot be used to generate a subsequent crop. Instead, new wheat seedlings must be planted for a subsequent crop.

amount is attributed to the seedlings. Often, the seedling purchase is bundled up with other obligations under the management agreement. The arrangements in *FC of T v Lau*,[112] *Product Ruling* PR 2001/131: Hardwood Timber Project,[113] and *Product Ruling* PR 2001/133: ITC Eucalypts 1999 West Australian Project provide examples.[114] Further, in most cases of forestry operations, the actual cost of seedlings is small. In such cases, the "bundling up" of that cost with management services may be appropriate as it would be *de minimis*.[115]

It is impossible to discern the basis for the ATO's view that the purchase of seedlings that will mature into the product intended for ultimate sale is not trading stock at the time of purchase. The view that an item can only be trading stock if it is in saleable form as intended by the taxpayer cannot provide the basis for not recognising the seedlings as trading stock. It is now well accepted that raw materials intended to be combined to produce a final product intended for sale, and which has/takes a quite different form to the raw materials comprising it, can be trading stock of the taxpayer.[116] Further, work in progress of a manufacturer can also amount to

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[112] *Lau v FC of T* 84 ATC 4618, 4620 (per Connolly J); and *FC of T v Lau* 84 ATC 4929, 4932 and 4934 (per Fox J) and 4938 (per Beaumont J) ("*Lau*").

[113] *Product Ruling* PR 2001/131, paras 28 and 35.

[114] Ibid para 20. It is worth noting that in the context of a tea-tree oil cultivation project, the taxpayer was charged a separate amount, albeit small, for the cost of tea-tree seedlings: *Sleight v FC of T* 2003 ATC 4801, 4807 (per RD Nicholson J); and *FC of T v Sleight* 2004 ATC 4477, 4480 (per Hill J) and 4501 (per Carr J) ("*Sleight*").

[115] In *Taxation Ruling* TR 2000/8, paras 148-152 the ATO considers that there will be times where obligations under the management agreement require examination. Such examination may reveal that part of the management fee can be identified with a particular item of expenditure that will not be on revenue account (eg land clearing).

[116] *FC of T v St Hubert's Island Pty Ltd* (1978) 138 CLR 210, 216 (per Stephen J), 226-229 (per Mason J), 235 (per Jacobs J) and 241 (per Aickin J) ("*St Hubert's Island*"). Justice Murphy generally agreed with the judgments of Mason and Jacobs JJ: ibid 238; *Taxation Ruling* TR 98/2, paras 2 and 14-16.

trading stock.[117] Admittedly, however, the authorities dealing with raw materials and work in progress were not contemplating the purchase of seedlings for placement in the ground and tending for growth to produce the finished product. They predominantly focus on a manufacturer of tangible goods.[118] It should be noted that if seedlings are viewed as being consumed in the course of the business, this on its own should not preclude a finding of trading stock.[119]

The ATO concedes that trees (timber) once severed from the land and available for sale in the ordinary course of business are trading stock of the grower.[120] However, according to the ATO, while they are standing on the land, they form part of the land and are not trading stock of the grower.[121] It seems strange that an item (trees/timber) can be trading stock in circumstances where the raw material (ie seedlings) from which the admitted trading stock grew, is not trading stock.[122] In the circumstances of a taxpayer in *Puzey*,

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[117] *St Hubert's Island* (1978) 138 CLR 210, 226-229 (per Mason J), 235 (per Jacobs J) and 245 (per Aickin J). Justice Murphy generally agreed with the judgments of Mason and Jacobs JJ: ibid 238.

[118] For example, see the comments of Mason J in ibid 226-229.

[119] Ibid 226 (per Mason J), 235 (per Jacobs J) and 241 (per Aickin J). Justice Murphy generally agreed with the judgments of Mason and Jacobs JJ: ibid 238; *Taxation Ruling* TR 98/2, para 15; and *Taxation Ruling* TR 98/7, para 53.

[120] *Taxation Ruling* TR 95/6, para 52; and *Taxation Ruling* TR 2000/8, para 159.

[121] Ibid. The ATO takes the same approach in regard to ore taken from the ground by a gold miner. That is, "… the ore to be included in trading stock is to be included as soon as it is severed from the land … Ore which remains attached to the land is not trading stock, …": *Taxation Ruling* TR 93/3, para 16.

[122] It is submitted that the judgment of Aickin J in *St Hubert's Island* (1978) 138 CLR 210 lends weight to the reservation expressed here. His Honour refused to accept: "… that individual allotments of a subdivisional estate, which were ready for sale and which might lawfully be sold, would be trading stock when the work was completed in circumstances in which the original land acquired in globo was not trading stock": ibid 246. While Aickin J dissented from the majority in terms of the decision in *St Hubert's Island* (1978) 138 CLR 210, his Honour's analysis on the point made here was not contradicted by other justices. It is submitted that the identity between the in globo land and the resulting individual subdivided allotments

the seedlings will, with tending, grow into an item that is available to be sold for income. The ground (land) in which the seedlings grow to maturity can be viewed as a "venue", much like a traditional factory, where growth of the product takes place to reach the form in which it will be sold. Another way to put it is that the ground provides nothing more than a warehouse for the "manufacture" or "production" of the trading stock. Like rented factory premises, it is somewhat difficult to see the lessor's land, which hosts the seedlings and the growers activities, in a different light.

The position taken in *Income Tax Ruling* IT 33 tends to undermine the ATO's conclusion that seedlings whilst growing in the ground and which are intended for sale on reaching full growth cannot be trading stock. *Income Tax Ruling* IT 33 deals with the application of the trading stock rules to stock held by a nursery business. In short, a nursery business grows for sale stocks of plants in containers. These are referred to as greenstock. A nursery business also grows for sale stocks of plants in the traditional way, namely, in the ground. The ATO concludes that greenstock while growing is trading stock of the nursery even though it has not reached maturity (ie stage where it would ordinarily be sold).[123] However, according to the ATO, a stock of plants grown in the ground by the same nursery business operator would not be trading stock while growing in the ground.[124] Presumably, this position holds even if the plants are identical to greenstock grown by the operator and which is treated as trading stock. The implication from *Income Tax Ruling* IT 33 is that if an Indian sandalwood tree can be grown in a pot, it will be trading stock of the taxpayer (grower). However, if the ground is required to grow the Indian sandalwood tree, it will not be trading stock. Given the deduction deferral effect of a trading stock

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is at the heart of Aickin J's reasoning. It is also submitted that the identity between the seedlings and, albeit many years later, the resulting trees, is analogous.

[123] *Income Tax Ruling* IT 33, para 8.

[124] Ibid.

conclusion,[125] it is hard to see why new technological developments in tree/plant growing techniques ought to be discriminated against. Users of these techniques are discriminated against because the cost for the item in the pot is denied immediate deductibility as a result of its characterisation as trading stock. Yet, no deduction deferral applies to the item grown in the ground.[126]

The ATO's approach of not treating seedlings as trading stock, and yet, treating the matured seedlings (ie trees) once severed from the land as trading stock, can lead to bunching of taxable income, distortions and inequities. Once the trees are severed from the land, they become trading stock of the taxpayer. If on hand at year-end, the appropriate valuation of the trees will be included in assessable income through the trading stock tax accounting regime. On the ATO's view, the seedlings would not have been on hand at the beginning of the year. Accordingly, there will be no opening stock valuation for the trees. Assuming the taxpayer chooses the cost valuation method for the trees, the whole cost of the trees will be included in assessable income upon severance of the trees. This would not have been the case if the seedlings while growing in the ground were regarded as trading stock of the taxpayer (and were regarded as on hand). In this case, there would have been a value for opening stock and therefore less or nil assessable income.

This bunching of taxable income is a "cost" the taxpayer may be content to bear in return for immediate deductibility for the cost of seedlings and the cost of maturing the seedlings into trees during the growth period. It should be noted that the same bunching or distortion effect arises if the trees are sold soon after severance; all of the proceeds are included in assessable income without any

[125] The deduction deferral effect comes about through the interaction of the general deduction provision and the trading stock tax accounting regime in ITAA97, s 70-35. Sections 3.1.3.1 and 3.2 below set out in more detail the mechanics of the interaction of these regimes.

[126] Sections 3.1.3.1 and 3.2 below set out the tax accounting regime concerning trading stock.

associated cost falling into the same income year. Indeed, assuming the sale price of the trees is greater than their cost, the bunching and distortion can be worse in the case of a sale as the sale amount is bunched into one income year.

Where there is only a "short gap" between the purchase of, and planting of, seedlings and their harvest (eg annual wheat crop), and the taxpayer has continuing operations, the bunching and distortion problem may not be significant. This is likely to be the case in the traditional farming sector where annual crops are usual. However, the bunching and distortion is significant where there is a "long gap" between the purchase of, and planting of, seedlings and their harvest. This was the case in *Puzey*, and it will be the same in all timber-growing operations. The degree of bunching and distortion will be a product of a number of things. They are: (1) the cost properly attributed to the seedlings; (2) the trading stock valuation options available to the taxpayer for seedlings growing in the ground; (3) the trading stock valuation option chosen by the taxpayer for seedlings growing in the ground; (4) the fact that costs are absorbed into the cost of the seedlings; and (5) the time gap between purchase of, and planting of, seedlings and their harvest. In terms of the fairness (equity) of the ATO's view, the reader is referred to the comments above concerning *Income Tax Ruling* IT 33.

3.1.3.1 Property Law Principles: Profit à Prendre-Goods Dichotomy

On property law principles, the warehouse/factory analysis for seedlings in the ground may run into difficulty. Clearly, the taxpayer in *Puzey* has an interest in land in the form of a lease,[127] albeit with some constraint on the permitted use of the leased land. It is submitted that the taxpayer's lease is not necessarily inconsistent with the proposition that the taxpayer may also have a concurrent

[127] See Section 2.1 above.

interest in goods in the form of seedlings/trees in the ground of the leased land.[128]

The trading stock analysis is more difficult if the taxpayer's interest in the land in *Puzey* also amounts to an interest in land in the form of a profit à prendre at common law, as opposed to merely an interest in goods or chattels housed in the land. At common law, "a profit à prendre is generally described as a right to take something off another person's land … or to take something out of the soil, including portion of the soil itself".[129] It is widely accepted that where property in the seedlings/trees is vested in the purchaser (grower) and the seedlings/trees are to remain in the ground for further growth, the agreement will usually amount to the grant of a profit à prendre. On the other hand, where the taking of the trees is required or expected within a short period so that further growth in the thing to be taken does not accrue to the purchaser, the purchaser's interest will not be a profit à prendre.[130] Given that the seedlings in the leased land will take some 15 years to mature to the point of intended harvest, clearly the seedlings are to benefit from the

[128] GW Hinde, DW McMorland and PBA Sim, *Land Law* (Vol 2, 1979) 713-714. It should be noted that this text deals with the law in New Zealand. The Australian texts distinguish between a profit à prendre and a mere contractual licence to enter land and take away produce: see eg, P Butt, *Land Law* (4th ed, 2001) 422 ("Butt 4"). The distinction between a profit à prendre and a mere lease is not made. However, as a matter of logic, it is hard to see why the distinction made in New Zealand cannot arise in Australia.

[129] *Australian Softwood Forests Pty Ltd v Attorney-General for New South Wales; ex rel Corporate Affairs Commission* (1980) 148 CLR 121, 130-133 (per Mason J) ("*Australian Softwood Forests*"). See also, P Butt, *Land Law* (2nd ed, 1988) 326 ("Butt 2").

[130] *Australian Softwood Forests* (1980) 148 CLR 121, 131 (per Mason J); *Corporate Affairs Commission v ASC Timber Pty Ltd* (1989) 18 NSWLR 577, 590 (per Powell J) ("*ASC Timber*"); *Ashgrove Pty Ltd v FC of T* 94 ATC 4549, 4558-4560 (per Hill J); and Butt 4, above n 128, 54.

nutrients supplied by the land to allow for that further growth. Accordingly, the taxpayer's rights look like a profit à prendre.[131]

Another common way of analysing an interest related to land is through the fructus naturales-fructus industriales dichotomy.[132] There is an argument that the taxpayer's interest is not a profit à prendre as it cannot be characterised as "fructus naturales". Rather, the proper classification may be "fructus industriales". Fructus naturales are generally regarded as land, and fructus industriales are regarded as chattels or goods.[133] The following comment by Butt draws the distinction:

> Fructus naturales are crops and trees which are the natural produce of the soil; the term also includes the produce of those crops and trees which may require attention when planted but do not require it each year to produce a crop; examples are fruit trees and their fruit, turf, underwood, pecan, black walnut and chestnut trees, and grapevines and their grapes. Fructus industriales are annual crops which require periodical labour for their production; examples are wheat, corn and potatoes.[134]

In *Permanent Trustee Australia Ltd v Shand*, Young J had to decide whether licences to "plant, grow, tend, harvest and prepare for sale macadamia nut trees" granted to "growers" amounted to an interest in land being a profit à prendre.[135] His Honour said:

> [T]he rule governing profits à prendre is that it is only the right to remove a crop which does not require attention after initial planting that qualifies as a profit [profit à prendre]. This is the distinction often made between fructus industriales, that is, fruit produced by the

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[131] It should be noted that in two cases with similar facts to those in *Puzey*, the Courts concluded that the growers' interests were only in the nature of a profit à prendre: *Australian Softwood Forests* (1980) 148 CLR 121, 133 (per Mason J); and *ASC Timber* (1989) 18 NSWLR 577, 590-591 (per Powell J).

[132] Fructus naturales are fruits of nature, and fructus industriales are fruits of industry.

[133] Butt 4, above n 128, 54.

[134] Ibid.

[135] *Permanent Trustee Australia Ltd v Shand* (1992) 27 NSWLR 426 ("*Shand*").

> industry of mankind, and fructus naturales, that is, fruit which is naturally produced without mankind's intervention, except for the first planting.[136]

Given that the seedlings in *Puzey* required ongoing tending during the growth period,[137] there is an argument that the taxpayer's interest was not a profit à prendre as the trees involved fructus industriales. On the other hand, it could be said that Indian sandalwood trees are not an annual crop, as they require a 15 year growth period/cycle. It is not clear whether the annual requirement is an indispensable requirement of fructus industriales. In *Corporate Affairs Commission v ASC Timber Pty Ltd*, a case involving facts not dissimilar to those in *Puzey*, Powell J expressed the opinion that the growers had rights in the nature of a profit à prendre.[138] Justice Powell did not address the fructus industriales issue concerning annual crops. The better view though is that the taxpayer in *Puzey* had an interest properly described as fructus naturales.

However, in *Ellison v Vukicevic*,[139] Young J indicated that a sale of goods includes all sales of fructus naturales or other parts of the realty which the purchaser is under a contractual obligation to sever.[140] Indeed, his Honour limited a profit à prendre to fructus naturales where the purchaser has merely a right or option to sever, and not an obligation. Justice Young's formulation is not inconsistent with the authorities on the definition of a profit à prendre in regard to a right or option to sever.[141] Indeed, in *Australian Softwood Forests Pty Ltd v Attorney-General for New South Wales; ex rel Corporate Affairs Commission*, Mason J (as he then was) indicated that he had

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[136] Ibid 432.
[137] The existence of the plantation management agreement supports this.
[138] *ASC Timber* (1989) 18 NSWLR 577, 590-591.
[139] *Ellison v Vukicevic* (1986) 7 NSWLR 104 ("*Ellison*").
[140] Ibid 116. Young J adopted the formulation of the distinction between a profit à prendre and the sale of goods set out in Hinde et al, above n 128, 715.
[141] *Australian Softwood Forests* (1980) 148 CLR 121, 130-133 (per Mason J); *Mills v Stokman* (1966) 116 CLR 61, 71 (per Barwick CJ) and 79 (per Menzies J); and Butt 2, above n 129, 326.

"not been able to discover a case in which an obligation to take something off a person's land has been considered to be a profit à prendre".[142] However, his Honour went on to say that he did "not think that this negates the possibility that the grower's rights amount to an interest in the nature of a profit à prendre".[143]

The author does not know whether the taxpayer in *Puzey* had an obligation to sever the trees in around 15 years time. However, in the ordinary course of things, a lessor of land would want his or her land for another use, and therefore would have placed an obligation on the lessee to sever the trees.[144] Accordingly, the inference is open that the taxpayer would have had an obligation to sever the trees. If this were the case, the taxpayer's interest may not amount, in the strict sense, to a profit à prendre. However, on the authority of Mason J in *Australian Softwood Forests*, it is likely that the taxpayer in *Puzey* had rights in the nature of a profit à prendre.

3.1.3.2 Property Law Principles: Fixtures-Chattels Dichotomy

If property law principles or the categories relevant under property law principles are considered to be of some importance, another way to view the issue is through the law dealing with fixtures and chattels. Admittedly though, the fixtures-chattels dichotomy is predominantly used in regard to non-biological or non-living assets.[145] The dichotomy is rarely relevant to biological or self-generating assets like seedlings or trees.

The question would be, can the seedlings be viewed as fixtures or chattels after planting on the leased land? The seedlings are clearly

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[142] *Australian Softwood Forests* (1980) 148 CLR 121, 132.
[143] Ibid 132-133.
[144] The "investor" or "grower" had an obligation to sever the trees under the scheme dealt with in *Australian Softwood Forests* (1980) 148 CLR 121, 127 (per Mason J). The scheme in this case was similar to that in *Puzey*.
[145] See the cases discussed in Butt 2, above n 129, 16-23; and AJ Bradbrook, SV MacCallum and AP Moore, *Australian Real Property Law* (1991) 518-522.

chattels before planting.[146] The classic common law statement providing guidance for determining whether chattels have become fixtures upon annexation to land or buildings is that of Jordan CJ in *Australian Provincial Assurance Co Ltd v Coroneo*.[147] His Honour said:

> The test of whether a chattel which has been to some extent fixed to land is a fixture is whether it has been fixed with the intention that is shall remain in position permanently or for an indefinite or substantial period, or whether it has been fixed with the intent that it shall remain in position only for some temporary purpose. In the former case, it is a fixture, whether it has been fixed for the better enjoyment of the land or building, or fixed merely to steady the thing itself, for the better use or enjoyment of the thing fixed. If it is proved to have been fixed merely for a temporary purpose it is not a fixture. The intention of the person fixing it must be gathered from the purpose for which and the time during which user in the fixed position is contemplated. If a thing has been securely fixed, and in particular if it has been so fixed that is cannot be detached without substantial injury to the thing itself or to that to which it is attached, this supplies strong but not necessarily conclusive evidence that a permanent fixing was intended. On the other hand, the fact that the fixing is very slight helps to support an inference that it was not intended to be permanent. But each case depends on its own facts.[148]

It is submitted that the conclusion that the seedlings in the ground remain chattels is inescapable. Accordingly, this removes a barrier to the seedlings being treated as trading stock. Both objectively and subjectively, the taxpayer's intention in *Puzey* was to remove the trees that had grown from the seedlings from the lessor's land in around 15-years. The taxpayer never intended to make a gift of the seedlings, and ultimately the trees and logs, to the lessor. There was

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[146] The seedlings are chattels as they amount to property, and they are personal property: PE Nygh and P Butt (eds), *Butterworths Australian Legal Dictionary* (1997) 185-186 and 940.

[147] *Australian Provincial Assurance Co Ltd v Coroneo* (1938) 38 SR (NSW) 700 ("*Coroneo*").

[148] Ibid 712-713.

never any intention to make a permanent improvement to the lessor's land.[149] The seedlings were not planted in order for the taxpayer to better enjoy the leased land. Rather, the seedlings were planted on the land for the purpose of "steadying" the seedlings, and for providing the seedlings with an environment directed to ensuring that they prospered and matured (ie better use and enjoyment of the seedlings). Practically speaking, placement in the ground was the only way to grow the seedlings into trees. This was the purpose of the taxpayer's annexation of the seedlings to the ground. Severance of the trees from the land would not, in the relevant sense, have damaged the trees. Further, severance would not cause substantial injury to the lessor's land. The 15 year gap between the annexation of the seedlings and the severance of the trees cannot, in the relevant sense, be regarded as permanent. In any event, the duration of the annexation is but one factor to consider.[150]

In any event, and contrary to the better view, let it be accepted for the moment that the seedlings in the ground amount to a fixture, and that therefore "ownership" belongs to the landowner. However, it is clear that the seedlings would amount to a tenant's fixture. The reasons for this conclusion are that: (1) the seedlings come within the category of a trade fixture and (2) the taxpayer in *Puzey* did not intend to make a permanent improvement to the lessor's land by planting the seedlings.[151] Given the conclusion that the seedlings in the ground are tenant's fixtures, the taxpayer will have a right to

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[149] A person with a limited interest in land and who has affixed a thing to the land is less likely to have intended to make a permanent improvement to the land compared to a person with an unlimited interest in the land: Butt 2, above n 129, 20 and 293.
[150] Ibid 22.
[151] See *Wardall v Usher* (1841) 10 LJCP 316; 5 Jur 802. In this case, shrubs and plants were planted by a nurseryman on land he occupied as a tenant. On determination of the tenancy, the tenant, amongst other things, removed the shrubs and plants. It was accepted by the Court that the tenant had the right "… to remove [and retain the shrubs and plants] in the known course of his trade as a nurseryman". See also Butt 2, above n 129, 293-296; and J Gray and B Edgeworth, *Property Law in New South Wales* (2003) 44.

remove the seedlings or trees.[152] For all practical purposes, the right to remove the seedlings is tantamount to ownership.

Whether or not the taxpayer in *Puzey* had an interest in the lessor's land and/or whether the seedlings had become a fixture, it is not clear why property law principles, that are directed at addressing quite different questions,[153] and which at times can contain quite fine distinctions, should govern the character of an "item" for the purposes of the income tax. It is submitted that property law principles should not be determinative in resolving questions concerning the character of an item (ie trading stock) under the income tax. Having an interest in land, on its own, should not be a barrier to that interest attracting the characterisation of trading stock. Freehold land can be trading stock.[154] On principle, there is no reason to think that a lesser interest in land cannot also be trading stock.

In any event, the taxpayer's interest in land is of limited scope. The scope of the interest is limited to using the land as a "place" in

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[152] See also Butt 2, above n 129, 293-296; and Gray and Edgeworth, above n 151, 44.

[153] The question as to whether a person has rights that amount to an interest in another's land usually arises in the context of determining priority of claimants to an asset in circumstances where funds are insufficient to meet debts. Another function of property law principles in the current context is that the creation of an interest in land ensures that the taxpayer's interest survives a change in ownership of the freehold. Overall, the question as to whether an agreement creates a profit à prendre, as opposed to a mere licence to enter the land of another, comes down to the question as to whether an interest in land is required to give effect to the intention of the parties to the agreement. In other words, if the conclusion that a mere licence was created could frustrate the intention of the parties (eg no legal guarantee of access to land on which an "investor" is growing seedlings for ultimate harvest), then this militates in favour of the conclusion that a profit à prendre was created: see for example the discussion in *ASC Timber* (1989) 18 NSWLR 577, 590-591 (per Powell J**)**.

[154] *St Hubert's Island* (1978) 139 CLR 210, 220 (per Stephen J), 228-229 (per Mason J), 235 (per Jacobs J) and 246 (per Aickin J); *Gasparin v FC of T* 94 ATC 4280 ("*Gasparin*"); and *FC of T v Kurts Development Ltd* 98 ATC 4877, 4883 (per Emmett J) ("*Kurts*").

which to mature the Indian sandalwood seedlings (and host seedlings) to the stage where they can be harvested for sale. The taxpayer's use of, or rights over, the lessor's land is limited to purposes that facilitate this aim. In short, the legal interest in the lessor's land (if there be one) is only to facilitate the growth of a commodity that belongs to the taxpayer. Indeed, Lee J noted that the taxpayer did retain an interest in *the trees* growing on his leased land and that *those trees became his property*.[155] This is the commercial or business reality of the situation.[156]

3.1.3.3 Inclusive Definition of Trading Stock under the ITAA36

At the relevant time in *Puzey*, "trading stock" was defined, under s 6(1) of the ITAA36, as "anything produced, manufactured, acquired or purchased for purposes of manufacture, sale or exchange, and also includes live stock".[157] The definition is inclusive and therefore the ordinary meaning of the term also comes within the definition.[158] However, putting aside the reference to live stock, it

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[155] *Puzey* 2002 ATC 4853, 4864 (per Lee J).

[156] The author does not have a copy of the lease agreement in *Puzey*. However, if the lease agreement contains provisions similar to those appearing in the *2003 Timbercorp Eucalypts Project: Replacement Prospectus*, the trading stock analysis is even stronger. Paragraph 7(b) under the heading **Grower's Rights** reads as follows: "the parties acknowledge and agree that the Trees are and will remain the property of the Grower until the end of the Term." Further, at paragraph 12.1 under the heading **Ownership of the Trees**, there is repeated the statement that the trees are the property of the grower. It should also be noted that under the heading **The Grower's Obligation**, para 5(a) reads as follows: "The Grower agrees … [to] use the Woodlots solely for the purpose of growing, tending and harvesting a plantation or plantations of eucalyptus trees."

[157] The current definition is contained in ITAA97, s 70-10. It reads: "'trading stock' includes (a) anything produced, manufactured or acquired that is held for purposes of manufacture, sale or exchange in the ordinary course of a *business and (b) *live stock".

[158] *St Hubert's Island Pty Ltd* (1978) 139 CLR 210, 216-217 (per Stephen J) and 224-225 and 229 (per Mason J); and *FC of T v Suttons Motors (Chullora) Wholesale Pty Ltd* (1985) 157 CLR 277, 281 (per Gibbs CJ, Wilson, Deane and Dawson JJ) ("*Suttons Motors*").

may be that the extended definition does no more than express the ordinary meaning of the term.[159]

In *John v FC of T*, the High Court said of the definition of trading stock that: "It presupposes that the person by whom they are produced, manufactured, acquired or purchased is or will be engaged in trade in those goods".[160] Clearly, the taxpayer in *Puzey* will be engaged in trading in the timber (logs) that grows from the seedlings, albeit in 15 years. This delay before sales occur will not necessarily militate against a finding of trading.[161] The greater difficulty is adapting aspects of the definition of trading stock from its focus on traditional tangible commodities to a commodity that grows in the ground before ultimate sale. Again, it is arguable that it is appropriate to describe the seedlings after purchase but before planting as raw materials that are trading stock. After planting on the lessor's land, the description of the seedlings/trees as work in progress also seems appropriate.

Assuming that the seedlings cannot be regarded as the same thing as the timber ultimately sold,[162] the definition of "manufacture" in the definition becomes important. The reason is that the purchased seedlings were not acquired or purchased for purposes of sale or exchange. Section 6(1) of the ITAA36 does not define the term "manufacture". No doubt, this term is normally associated with the making of tangible consumer commodities, rather than the generation of timber from seedlings.[163] The relevant part of the definition in the *Macquarie Dictionary* is as follows:

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[159] *St Hubert's Island* (1978) 138 CLR 210, 224-225 (per Mason J).
[160] (1989) 166 CLR 417, 429 (per Mason CJ, Wilson, Dawson, Toohey and Gaudron JJ).
[161] See eg the comments of Jacobs J in *St Hubert's Island* (1978) 138 CLR 210, 236-238.
[162] The Full Federal Court made the comment that "the seedlings here are what is both acquired and sold": *Puzey* 2003 ATC 4782, 4794 (per Hill and Carr JJ).
[163] In *MP Metals Pty Ltd v FC of T* (1967) 117 CLR 631, 637, Windeyer J stated that "it has become common for some purposes to distinguish between manufactured goods and agricultural products".

"**manufacture**…**1.** the making of goods or wares by manual labour or by machinery, especially on a large scale **2.** the making of anything. **3.** the thing or material manufactured".[164] In the context of a dispute concerning sales tax legislation, Dixon J (as he then was) in *FC of T v Jack Zinader Pty Ltd* adopted the following statement from a United Kingdom case: "the essence of making or of manufacturing is that what is made shall be a different thing from that out of which it is made".[165] In the same case, Williams J said: "the ordinary meaning of the verb manufacture is to work up materials into forms suitable for use".[166]

The ATO considers the process of refining mined ore as being a manufacturing process within the trading stock definition.[167] Indeed, the inference drawn by the ATO in light of the decision in *FC of T v St Hubert's Island Pty Ltd*[168] that a partly developed land subdivision is work in progress, is that the word "manufacture" is either to be read in a broad sense or the notion of work in progress is in no way limited to manufacturing.[169] The ATO was responding to an argument that work in progress is limited to what would commonly be understood to be manufacturing, and should therefore not apply to a mining business.[170] The ATO stated that:

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[164] *Macquarie Dictionary* (3rd rev ed, 2003).
[165] *FC of T v Jack Zinader Pty Ltd* (1949) 78 CLR 336, 343 (per Dixon J) ("*Jack Zinader*"). The quote was taken from *McNicol v Pinch* (1906) 2 KB 352, 361 (per Darling J).
[166] *Jack Zinader* (1949) 78 CLR 336, 350 (per Williams J). In *Case* Q106 83 ATC 547, 551, Dr Gerber after noting that the concept of manufacture is elusive, made the following comment: "I have concluded that the essence of 'manufacture' involves a *transformation*", … the process of manufacture involves the production of articles for use from raw or prepared materials which gives these materials a new form, quality and/or property which they did not possess before".
[167] *Taxation Ruling* TR 93/3, para 15.
[168] *St Hubert's Island* (1978) 138 CLR 210, 228-229 (per Mason J) and 235 (per Jacobs J).
[169] *Taxation Ruling* TR 93/3, para 13.
[170] Ibid.

> Support for a broad view of the meaning of "manufacture" can be drawn from Case Q106 83 ATC 547, where Dr Gerber found that the construction of houses under a contract for work and materials was manufacture. He said that "the process of manufacture involves the production of articles for use from raw materials which gives these materials a new form, quality and/or property which they did not possess before" (at 550).[171]

It is arguable that the planting and tending of seedlings so that they mature into trees for timber can be described as a process of "manufacture" (ie transformation of a thing). The main obstacles to that characterisation seem to be: (a) historical (ie traditionally only applies to goods outside the agricultural sector) and (b) the fact that the seedlings are housed in land, rather than a factory building, during the "production" or growth phase. That is, the seedlings while growing do not have a separate existence from the land. This point may be even stronger where the taxpayer growing the seedlings does not own the freehold land. Further, the ATO may have taken the position that deferral of deductions for seedlings ought not be deferred until the income year of sale of the produce. This is generally the intended outcome of characterising seedlings for planting as trading stock.[172]

The above assumed that the seedlings cannot be regarded as the same thing as the timber ultimately sold. In the context of discussing a United Kingdom case concerning the revenue-capital distinction as it applied to the purchase of coal contracts for the purpose of buying coal under them and selling the coal,[173] the Full Federal Court in *Puzey* indicated that: "there is the difference, and it is not unimportant, that the seedlings here [Puzey] are what is both acquired and sold".[174] There is no explanation of the basis for this comment. However, if a high degree of identity exists between the

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[171] Ibid para 14.
[172] This is discussed in Sections 3.1.3.1 and 3.2 below.
[173] *John Smith & Son v Moore* [1921] 2 AC 13.
[174] *Puzey* 2003 ATC 4782, 4794 (per Hill and Carr JJ).

seedlings and the timber ultimately sold, the argument opens up that the taxpayer in *Puzey* could be seen as a trader in the "seedlings". This would open up another part of the trading stock definition (ie anything acquired or purchased for purposes of sale). In fairness, and with respect to the alternative viewpoint, it is unrealistic to view the taxpayer's operations as one of trading. This line of reasoning ought to be rejected.

The above comments focused on the Indian sandalwood seedlings. As noted in Section 2.1 above, the taxpayer in *Puzey* also purchased some host seedlings for planting (eg East African Ebony, Mahogany). The purchase price was not allocated between the various seedling types. While a key aim of the host seedlings is to help facilitate the growth of the Indian sandalwood trees, the host trees are also capable of growing to a marketable size in their own right.[175] If the timber obtained from the host trees can be viewed as part of the taxpayer's ordinary business, it can be viewed as a joint product or a necessary by-product of the business of growing Indian sandalwood trees. Joint products and by-products of an activity should be viewed in the same light as the central activity.[176] Accordingly, the host tree seedlings should be treated in the same manner as the Indian sandalwood seedlings.

The ATO's immediate deductibility approach to the cost of the seedlings, in effect, treats the seedlings as consumables. It is true that the seedlings at some point lose their identity as seedlings. It is submitted that this does not occur on planting. Rather, the loss of identity as seedlings happens at some time when sufficient maturation has occurred in order that the description of a tree becomes apt. It is not appropriate to treat this process of growth on

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[175] See *Product Ruling* PR 2002/107 (Income Tax: East Kimberley Sandalwood Project No. 1, 1999), paras 21 and 35.

[176] *Ferguson v FC of T* 79 ATC 4261, 4271 (per Fisher J) (sale of unwanted male calves were sales of the by-product of the venture and an inevitable feature of the business) ("*Ferguson*"); and *Taxation Ruling* TR 94/13, para 4.

analogous terms to the use of a consumable. Clearly, a tree emerges from the growth process.

3.1.3.4 Ordinary Meaning of Trading Stock

Recall that the definition of trading stock in s 6(1) of the ITAA36 is an inclusive definition (ie trading stock includes). This usually indicates that an item that comes within the ordinary meaning, and perhaps falls outside the extended or inclusive meaning, would also amount to trading stock under s 6(1) of the ITAA36.[177] Given that trading stock is a central part of the commercial world and that accountants have primary responsibility for reporting on the financial performance of many entities operating in the commercial world, the best place to obtain guidance on the ordinary meaning of trading stock is in the accounting standards. Accounting standards clearly represent guides or statements that have evolved in the business community for the very purpose of reflecting received opinions as to the sound view to take of particular kinds of items.[178]

At the time of the facts in *Puzey*, the accounting standard, *AAS 2 Valuation and Presentation of Inventories in the Context of the Historical Cost System* ("AAS 2") dealt with the recognition and measurement of inventories. The definition of inventories in para 5(a) of AAS 2 was as follows:

> "**Inventories"** means goods, other property and services-
>
> (i) held for sale in the ordinary course of business, or
>
> (ii) in the process of production for such sale,
>
> (iii) to be used up in the production of goods, other property or services for sale including consumable stores and supplies, but is not to be read as a reference to depreciable assets …

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[177] *St Hubert's Island* (1978) 138 CLR 210, 216-217 (per Stephen J) and 224-225 and 229 (per Mason J); and *Suttons Motors* (1985) 157 CLR 277, 281 (per Gibbs CJ, Wilson, Deane and Dawson JJ).

[178] *Arthur Murray (NSW) Pty Ltd v FC of T* (1965) 114 CLR 314, 318 (per Barwick CJ, Kitto and Taylor JJ).

It is generally understood that the term "inventories" is equivalent to "trading stock".[179] It is submitted that the seedlings in *Puzey*, both before and after planting on the lessor's land, do come within the definition of inventories in AAS 2. The seedlings are clearly goods or property before being planted.[180] And, they are to be "used up" in the production of goods: para 5(a)(iii). That is, the seedlings will lose their identity as seedlings at some time in the process of becoming a tree available for harvesting into logs. It hardly needs to be said that AAS 2 deals not only with inventories that are finished goods, it also deals with raw materials and work in progress that are on their way to becoming finished goods.[181]

There is an argument that once planted, the seedlings lose their identity as goods or property. This issue was discussed in Sections 3.1.3.1 and 3.1.3.2 above. The better view is that on the facts in *Puzey*, the seedlings continue to be goods even though they are housed in the lessor's land.[182]

Once planted on the lessor's land, it is impossible to conclude that the seedlings are held for sale in the ordinary course of business in circumstances where the intent is to nurture and tender them for some 15 years until harvest and sale. Paragraph 5(a)(i) clearly

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[179] The terms stock on hand, stock in trade or simply stock are used interchangeably with the term inventories: R Clift and N Roberts, *Australian Accounting Principles* (1990) 132; and J Hoggett and L Edwards, *Accounting in Australia* (1987) 211.

[180] The seedlings have all the features associated with the existence of property in the physical sense, namely, a person can have the right to use and enjoy the seedlings, the right to alienate the seedlings and the right to exclude others from possessing the seedlings: Nygh and Butt, above n 146, 940.

[181] *AAS 2 Valuation and Presentation of Inventories in the Context of the Historical Cost System* ("AAS 2") superseded Statement D2: Treatment of Stock in Trade and Work in Progress in Financial Accounts from 30 June 1976. Also, a number of paragraphs in AAS 2 indicate that the term inventories applies to the raw materials and the work in progress of manufacturers: see eg, paras 5, 28 and 32.

[182] It should be noted that the modern definition of "inventories" refers to assets, as opposed to goods, property, etc: para 6 of *AASB 102 Inventories* ("AASB 102"). Indeed, in all other respects, the definition of inventories in AASB 102 is very similar to that in AAS 2.

focuses on finished goods. The seedlings in the ground are not finished goods. However, the seedlings in the ground can be viewed as goods or raw materials in the process of production, and therefore come within para 5(a)(ii). As noted above, the seedlings are in the process of losing their identity as seedlings and of becoming a tree available for harvesting into logs. During this process, the seedlings/tree can accurately be described as work in progress. Alternatively, and in accordance with para 5(a)(iii), the seedlings could be viewed as being used up in the process of producing the trees (logs). Either way, the seedlings/trees in the ground are inventories, and they are within the control of the taxpayer in *Puzey*.[183]

Paragraph 4 of AAS 2 provided that: "this statement applies to valuation and presentation of all inventories except the following: (a) livestock and forestry inventories … ". That is, forestry inventories were specifically excluded. There was no other accounting standard dealing with forestry inventories in 1987. However, an exposure draft had been issued, namely, *ED 83 Self-Generating and Regenerating Assets* ("ED 83"). This exposure draft dealt with, among other things, forestry inventories. Comments on this exposure draft were open until December 1997.

Two main points can be made. First, the exclusion of livestock and forestry inventories was not from the definition of inventories. Rather, the exclusion related to the rules in AAS 2 (eg lower of cost and net realisable value applies to the valuation of inventories, assumptions as to stock movements for purposes of valuing inventories) not being applicable to livestock and forestry inventories. This is a fairly strong indication that in the absence of

[183] A major role of accounting standards is to identify the time at which assets, liabilities, revenues, expenses, etc, are recognised and recorded in financial accounts. In the area of assets, recognition is generally only to be made when, amongst other things, an entity has control over the future economic benefits embodied in the asset: *SAC 4 Definition and Recognition of the Elements of Financial Statements*, paras 12-15 and 22-28 ("SAC 4").

the exclusion in para 4 of AAS 2, forestry inventories would have come within AAS 2.[184]

Secondly, subsequent developments in the area of forestry inventories, indicate that the major issue in the area was one of valuation and the timing of revenue recognition, rather than the identity and characterisation of assets. *AASB 1037 Self-Generating and Regenerating Assets* ("AASB 1037") was issued in August 1998. This accounting standard took account of submissions made in regard to ED 83. AASB 1037 dealt with self-generating and regenerating assets ("SGARAs").[185] SGARAs were defined to mean "a non-human living asset".[186] Seedlings, especially after planting in the ground, come within this term. Indeed, it is clear that operations directed at growing plantations were designed to come within AASB 1037.[187] More specifically, it is clear that while the seedlings are going through the maturation process in the ground, the entity controlling the seedlings/trees is subject to the accounting rules in AASB 1037. The key rule was that the entity had to bring to account SGARAs at their "net market value" (ie gains and losses in value were to be accounted for as revenue or expense in the profit and loss statement).[188] The usual rule with inventory is to value it at the lower of cost and net realisable value. This is the position in AAS 2.[189] Accordingly, unrealised losses can be recognised but unrealised gains cannot. On the other hand, AASB 1037 contemplated that unrealised gains would be recognised. This was the controversy with

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[184] While only a minor point, the use of the term "forestry inventories" gives some indication that seedlings/trees in the ground were to retain their character as inventories.

[185] *AASB 1037 Self-Generating and Regenerating Assets*, para 2.1(a) ("AASB 1037").

[186] Ibid para 10.1.

[187] See eg, AASB 1037, above n 185, paras 5.3.2, 5.6.1 and 6.1.1 and App 2.

[188] Ibid para 5.2. Net market value is generally defined to mean the amount the entity could expect to receive for the disposal of the self-generating and regenerating asset ("SGARA") less the costs of sale: ibid para 10.1.

[189] AAS 2, above n 181, para 25.

AASB 1037 and before it, ED 83.[190] The treatment of SGARAs as inventory was never the controversy.

The non-living produce of an SGARA is to be accounted for under *AASB 1019 Inventories* ("AASB 1019").[191] AASB 1019 is broadly the same as AAS 2. Trees severed from land on which they have grown, and which are now logs, is an example of non-living produce of an SGARA (tree). Accordingly, the logs will be dealt with under the accounting standard dealing with inventories generally. The cost attributed to the logs for the purpose of the inventory standard will be the net market value immediately after it becomes non-living (time of severance).[192] The clear implication is that a separate accounting standard was considered necessary to deal with the special type of inventory presented by SGARAs, but only during the growth period of the SGARA.[193] The current accounting standards applicable to inventories and SGARAs also take the approach outlined above in the earlier standards even though the terminology has changed slightly: see *AASB 102 Inventories* and *AASB 141 Agriculture*.

The taxpayer in *Puzey* was not required to adopt AAS 2 in compiling his financial statements as he would not be a reporting entity.[194] However, the fact that the taxpayer in *Puzey* will not have been required to comply with an accounting standard does not

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[190] See para 7 under "Development of the Standard" in AASB 1037, above n 185.
[191] Ibid para 5.6; and *AASB 1019 Inventories*, para 2.1.1.
[192] AASB 1037, above n 185, para 5.6.
[193] The main point is captured in the following statement:

> The Boards believe that net market value best reflects the future economic benefits embedded in SGARAs because it captures the value of biological transformation which is not adequately reflected in historical costs: paragraph 7 under "Development of the Standard" in *AASB 1037 Self-Generating and Regenerating Assets*.

Using the lower of cost and net realisable value, which is the approach set out in AAS 2, above n 181, would have involved the use of historical cost where the SGARA increased in value.
[194] *Foreword to Statements of Accounting Concepts and Statements of Accounting Standards*, para 11.

undermine the contribution AAS 2 makes to discovering the ordinary meaning of the term "trading stock". The non-application of AAS 2 to the taxpayer in *Puzey* is a matter that goes to the scope of application of the accounting standard. It does not mean that the definitions in the accounting standard are not appropriate, or are somehow defective. The definitions in AAS 2 evolved in the business community and the accounting profession after an extensive process of consultation and analysis.[195]

3.1.4 Difficulties Under the Trading Stock Tax Accounting Regime if Seedlings are Characterised as Trading Stock

If the seedlings (both before and after planting) are to be regarded as trading stock, they will be subject to, or at least should be capable of being subject to, the trading stock tax accounting regime. Broadly, that regime, much like the financial accounting regime for trading stock (inventories), defers recognition (deductions) for the cost of purchasing or manufacturing trading stock until the year in which the stock is sold.[196] If considerable difficulties exist in bringing the seedlings within this regime, their presence would tend to militate against the characterisation of the seedlings as trading stock. Further, if significant anomalies arise, this would also militate against the characterisation of the seedlings as trading stock.

The trading stock tax accounting regime provides a deduction for the cost of purchasing trading stock,[197] and provides for inclusion in assessable income of the gross proceeds of sale of trading stock.[198] The value of trading stock on hand at the beginning of the year is compared with that on hand at the end of the income year. If the closing stock is greater than opening stock, then the excess is

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[195] Ibid.

[196] See GS Cooper, "Tax Accounting for Deductions" (1988) 5 *Australian Tax Forum* 23, 124.

[197] ITAA36, s 51(1). After 30 June 1997, the relevant provisions are ITAA97, s 8-1 and if required, ITAA97, s 70-25.

[198] ITAA36, s 25(1). After 30 June 1997, the relevant provision is ITAA97, s 6-5.

included in assessable income.[199] If opening stock is greater than closing stock, then the excess is a deduction.[200]

There are two areas that may cause difficulty, namely, the requirement that the trading stock be "on hand" at year-end, and the methods of valuing trading stock. As indicated in Section 3.2 below, given that the seedlings were not delivered to the taxpayer in *Puzey* until April 1998, there is no "on hand" issue in regard to the income year ending 30 June 1997.[201] Accordingly, the focus of the on hand issue is on subsequent income years.

3.1.4.1 On Hand Requirement

The trading stock tax accounting regime presupposes that an item claimed to be trading stock can be on hand to the relevant taxpayer. The test as to whether an item of trading stock is on hand is whether the taxpayer has power of disposition over the item on the relevant date (ie 30 June).[202] The difficulty with partly grown seedlings in the ground of the owner of the freehold is that the taxpayer does not intend to sell the partly grown seedlings, and in all probability would not be able to find a buyer for partly grown seedlings. Accordingly, it may be difficult to conclude that the taxpayer in *Puzey* had power of disposal over the seedlings.

However, it is hard to see why the on hand requirement should be influenced by the realisability of the thing alleged to be on hand.

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[199] ITAA36, s 28(2). After 30 June 1997, the relevant provision is ITAA97, s 70-35(2).

[200] ITAA36, s 28(3) of the. After 30 June 1997, the relevant provision is ITAA97, s 70-35(3).

[201] If the seedlings were trading stock, ITAA36, s 51(2A) would have denied the taxpayer a deduction for the purchase price in the income year ending 30 June 1997 because the seedlings were not on hand as at 30 June 1997 and the taxpayer had not derived any proceeds from a sale of the seedlings during the income year ending 30 June 1997. See Section 3.2 below for a fuller explanation.

[202] *Suttons Motors* (1985) 157 CLR 277, 282-284 (per Gibbs CJ, Wilson, Deane and Dawson JJ); *All States Frozen Foods Pty Ltd v FC of T* 90 ATC 4175; and *Gasparin* 94 ATC 4280, 4285-4287 (per von Doussa J and Jenkinson and Spender JJ agreeing).

The on hand requirement forms part of the deduction deferral mechanism concerning the cost of trading stock. It is hard to see how realisability should have a determinative role in this context. In any event, partly grown seedlings are analogous to work in progress of a manufacturer. Generally, there is no intention on the part of a manufacturer that it will sell work in progress. Yet, no one seriously argues that a manufacturer does not have power of disposal over work in progress on the manufacturing line on a given date and that accordingly, work in progress is on hand. Even if realisability was regarded as having some importance, the taxpayer may be able to assign his interest in the trees (or contractual rights under the various agreements) to another person. In short, the on hand requirement that is an essential part of the trading stock tax accounting regime should not pose any difficulty in regard to the taxpayer's seedlings growing in the ground where the freehold is held by another entity.

3.1.4.2 Trading Stock Valuation Methods

The valuation difficulty may have two aspects to it. First, a taxpayer has the option to value each item of trading stock on hand at year-end under one of the three bases set out in s 70-45 of the ITAA97, namely, cost, market selling value and replacement value.[203] The first aspect is that it is now clear that an item can still be trading stock of a taxpayer even if one of the methods for valuing it cannot be applied. In the context of a land developer who sought to use the market selling value method of valuing parts of a block of land (ie land scheduled for special use (eg school, arterial road)), while at the same time using the cost method for other parts of the same block (ie land scheduled to be residential blocks), Rogers J in *Barina Corp Ltd v FC of T*,[204] said:

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[203] ITAA36, s 31(1) was the previous provision. Section 31(1) referred to replacement price, which meant cost of replacing the item. For present purposes, it can be accepted that replacement value in ITAA97, s 70-45 has the same meaning as replacement price in ITAA36, s 31(1).

[204] *Barina Corp Ltd v FC of T* 85 ATC 4847 ("*Barina Corp*").

> Absent marketability there can be no market selling value. If absence of marketability is due to the fact that the land has not yet been converted to a subdivisible state, then I do not think that its individual but unidentifiable and non-segregated components can be said to be each an "article" of trading stock distinct from the land in globo.[205]

It is arguable that the decision in *Barina Corp* is merely based on a rejection that each part of the *in globo* land claimed to be trading stock was not in fact trading stock.[206] Even if this is accepted, the statement of Rogers J is unequivocal, logical and in accord with authority. In *Australasian Jam Co Pty Ltd v FC of T*,[207] Fullagar J stated that:

> But it is not to be supposed that the expression "market selling value" contemplates a sale on the most disadvantageous terms conceivable. It contemplates, in my opinion, a sale or sales in the ordinary course of the company's business – *such sales as are in fact effected*.[208]

It is submitted that items that are claimed to be trading stock and are claimed to be capable of valuation under the market selling value method on the valuation date, should be in a state ready for sale, or at least in a state where the taxpayer contemplates that a sale may take place. In regard to seedlings in the ground, the taxpayer in *Puzey* does not intend to sell them in this condition. The taxpayer's only contemplation is a sale on maturity of the seedlings (ie trees).[209] Accordingly, it is submitted that the market selling value method will not be available to the taxpayer in *Puzey*.

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[205] Ibid 4855.

[206] Just before the extracted quote of Rogers J, his Honour had stated that "it seems to me that proper effect can be given both to the text and to the legislative purpose if one regards, in the context of land proposed to be sold by subdivision, an article as trading stock only where the block of land is, in fact, marketable": ibid.

[207] *Australasian Jam Co Pty Ltd v FC of T* (1953) 88 CLR 23 ("*Australasian Jam*").

[208] Ibid 31.

[209] The lack of liquidity or the lack of a secondary market for such "investments" supports this.

There is little judicial guidance on the replacement value method of valuing trading stock on hand. However, Gobbo J in *Parfew Nominees Pty Ltd v FC of T*,[210] made the following comment:

> Where there is replacement stock available I am of the view that replacement price is in the great majority of cases to be ascertained by identifying the price that is to be paid to secure that replacement item. This needs to reflect a price that is the relevant one for the particular taxpayer.[211]

Clearly, there is little or no market in which the taxpayer could purchase trading stock comprising seedlings growing in the ground. Indeed, the taxpayer did not even obtain his trading stock comprised of seedlings in the ground through acquisition. He "manufactured" his trading stock. There is nothing in what Gobbo J said in *Parfew* that the replacement value method is restricted to taxpayers that acquire their trading stock.[212] Further, it does not defy business reality to contemplate the notional cost of obtaining similar Indian sandalwood seedlings (and host seedlings) and maturing them to the state they are in as at the relevant 30 June.[213] Accordingly, the replacement value method should be available to the taxpayer. Given a level of inflation, the amount of replacement costs is likely to be the same or greater than the actual cost incurred in getting the seedlings into their current state. Given this, the taxpayer is unlikely to choose the replacement value method (over the cost method), as this would involve bringing forward the recognition of assessable

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[210] *Parfew Nominees Pty Ltd v FC of T* 86 ATC 4673 ("*Parfew*").
[211] Ibid 4677.
[212] The fact that Gobbo J went on, by way of dicta, to attribute an amount to the replacement value of the strata title units constructed by the taxpayer provides strong support for the proposition that the replacement value method also applies to manufacturers, and is not limited to just traders: ibid 4678-4680.
[213] The decision in *Parfew* 86 ATC 4673 is distinguishable. Gobbo J held that the replacement value method was not available to the taxpayer. The main factor was "… the unreality implicit in a notional redevelopment of a series of separate and different strata title units, which can only have cost arrived at by an apportionment of a larger development, only parts of which are the items of trading stock under consideration": ibid 4678.

income. However, if the taxpayer chose the replacement value method, the difficulties of valuation would be similar to those in dealing with the cost method (see immediately below).

Assuming the unavailability of the market selling value method, and the taxpayer's choice not to use the replacement value method, the cost method applies. This provides the second aspect of the valuation problem. In particular, the problem concerns the attribution of costs to the seedlings in the ground. Of the two methods accepted for accounting purposes for attributing costs to manufactured inventories (trading stock) on hand, the better view is that absorption costing is the appropriate method for income tax purposes.[214] The only difference – assuming it to be a difference – between the taxpayer's seedlings in *Puzey* and the hard goods of a traditional manufacturer is that the former taxpayer's trading stock is "housed" in the ground, whereas the latter's trading stock is "housed" in a factory. All the difficulties associated with the application of the absorption costing method are present in both situations. Indeed, given the lesser range of expenses involved in growing seedlings, it could be argued that the application of the absorption costing method is simpler in the case of the seedlings.

The purchase cost of the seedlings would clearly be absorbed into the value of the seedlings as the cost of materials.[215] Importantly, it would be the cost obtained after application of s 31C of the ITAA36 (ie amount of cost capped to arm's length price).[216] The seedlings would be regarded as work in progress. The fee payable for establishment of the plantation should also be absorbed

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[214] *Philip Morris Ltd v FC of T* 79 ATC 4352, 4360 ("*Philip Morris*"). Understandably, the ATO also supports the absorption costing method in regard to a manufacturing business: *Income Tax Ruling* IT 2350, para 6.

[215] *Philip Morris* 79 ATC 4352; *Kurts* 98 ATC 4877, 4884 (per Emmett J); and *Income Tax Ruling* IT 2350, paras 5 and 7.

[216] ITAA36, s 31C(1) is stated to apply "… for all purposes of the application of this Act … (ITAA36)". The trading stock valuation provision dealing with cost comes within this description. Even though the wording is slightly different, ITAA97, s 70-20 is to the same effect.

into the value of the seedlings. This cost is analogous to the cost of the seedlings. The lease expenses incurred by the taxpayer in *Puzey* ought to be treated in the same manner as factory rental expenses. That is, they ought to be absorbed into the value of the seedlings as a manufacturing or production overhead.[217] The ongoing plantation management fee presumably covers activities such as watering, the conduct of inspections for insect infestation, spraying if required, weed eradication, etc. It is submitted that these costs would also be absorbed into the value of the seedlings.[218] Interest on the loan to purchase the seedlings would not be absorbed into the value of the seedlings.[219]

In the end, the fact that one of the valuation methodologies within the trading stock provisions is not available to the taxpayer in regard to the item alleged to be trading stock ought not preclude the item attracting the characterisation as trading stock.[220] Further, the fact that there may be some difficulty in applying the absorption costing valuation methodology to the seedlings in the ground ought not be a barrier to the item attracting the characterisation as trading stock.

There are some obstacles in concluding that the seedlings in *Puzey* are trading stock. However, they are not insurmountable. The policy position taken by the ATO may be that deduction deferral for

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[217] It is submitted that the lease expenses come within the test outlined in *Philip Morris* 79 ATC 4352, 4360 (per Jenkinson J) (ie expenditure incurred in the course of manufacturing activities to bring the article to the state it is in when it became trading stock on hand). See also *Kurts* 98 ATC 4877, 4884 (per Emmett J) and the second bullet point in *Income Tax Ruling* IT 2350, para 11.

[218] *Philip Morris* 79 ATC 4352, 4360 (per Jenkinson J) (wages of inspectors who watch the operation of machines and materials involved in the manufacturing process), 4361 (removal and disposal of waste products resulting from the manufacturing process) and 4362 (controlling insect infestation of raw tobacco which is a raw material that forms part of the finished good).

[219] *Income Tax Ruling* IT 2350, para 13.

[220] *St Hubert's Island* (1978) 138 CLR 210, 218 (per Stephens J); *Parfew* 86 ATC 4673, 4678 (per Gobbo J); and *Barina Corp* 85 ATC 4847, 4855 (per Rogers J).

the cost of seedlings ought not be required in the "traditional farming sector" (eg wheat farming). This could be the consequence of a conclusion that the seedlings were trading stock in *Puzey*. In short, it becomes difficult to have a different rule for the traditional farming sector compared to the "new farming sector" (eg passive growers of trees).[221] This might not be acceptable to the ATO.[222] If the seedlings in *Puzey* were trading stock, the deduction to the taxpayer, by operation of s 31C of the ITAA36, would be reduced to $1,500.[223]

3.2 Deduction for Trading Stock Purchases Deferred Until the Stock is on Hand or Derivation of Sale Proceeds Occurs

In terms of legal rights, the taxpayer in *Puzey* would have control and possession of the seedlings during their growth period. Contractually, the taxpayer can prevent the owner of the freehold (ie lessor) from taking the seedlings for its own purposes. In fact, as at 30 June 1997, while the taxpayer had incurred $40,000 on the purchase of seedlings, the seedlings were not yet planted. Indeed,

[221] Public rulings can be used by the ATO to "give up" taxing rights: ITAA36, s 170BA(3). For example, a public ruling could be issued stating that seedlings planted for growth and harvest will not be trading stock for farmers operating in the "traditional farming sector". However, this approach would be blatant discrimination against "farmers" in the "new farming sector".

[222] "The consequences for other taxpayers or other provisions in the range of laws administered by the ATO weigh heavily on our deliberations [in formulating arguments put to courts].": Australian Taxation Office (Michael D'Ascenzo and Steve Martin), *A unique taxation partnership for the benefit of the Australian community: ATO/AGS/Counsel Workshop*, 3 April 2004, p 4. This document is available at: http://www.ato.gov.au/corporate/content.asp?doc=/content/43415.htm.

[223] Importantly, the assessable income to the vendor of the seedlings (Allrange Tree Farms) from the sale of the seedlings to the taxpayer would also be reduced to $1,500, assuming that the seedlings are trading stock from the vendor's hands: ITAA36, s 31C(1). After 30 June 1997, the operative provision from the vendor's perspective is ITAA97, s 70-20.

they had not been delivered to the taxpayer as at 30 June 1997 and they were still unascertainable goods at that date.[224]

Section 51(2A) of the ITAA36 provides for a deferral of deductions attributable to the acquisition of trading stock. The deferral is to the income year in which the stock becomes trading stock on hand of the taxpayer,[225] or the income year in which the taxpayer derives income from the sale of the stock.[226] There is nothing to indicate that the term "trading stock" in s 51(2A) of the ITAA36 is not used in its defined sense under s 6(1) of the ITAA36. Accordingly, s 51(2A) of the ITAA36 can only apply if the seedlings are trading stock. Section 3.1.3 above contains a discussion of this issue. However, assuming that the seedlings are trading stock, can s 51(2A) of the ITAA36 provide for deferral of a deduction? Clearly, the taxpayer in *Puzey* did not derive income from the sale of the seedlings before 30 June 1997. Further, it cannot be said that the seedlings were on hand as at 30 June 1997. The reason is that as at that date, not only were the seedlings not delivered to the taxpayer, the seedlings were still unascertained goods or future goods.[227] On the face of it, and assuming the seedlings are trading stock, the section seems to apply to deny the taxpayer the $40,000 deduction in the income year ending 30 June 1997.

In *Taxation Ruling* TR 93/9, the ATO makes the following statement:

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[224] Delivery of the seedlings was not planned to occur until until May 1998. They seemed to have been delivered in April 1998: *Puzey* 2003 ATC 4782, 4786 (per Hill and Carr JJ).

[225] ITAA36, s 51(2A)(d).

[226] ITAA36, s 51(2A)(e).

[227] In regard to the delivery of seedlings to the taxpayer, the facts in *Puzey* are similar to those in *Raymor (NSW) Pty Ltd v FC of T* 89 ATC 5173 (per Lockhart J). Put briefly, the taxpayer incurred expenditure on purchasing trading stock (plumbing supplies) that the taxpayer traded in. The expenditure for purchase of the trading stock was incurred on 29 June 1984, however, the stock was not delivered until July and the succeeding months. The parties agreed that the stock was future goods or unascertained goods: ibid 5178.

> … [Section 51(2A) of the ITAA 1936] cannot apply to expenditure incurred in bringing trading stock into existence through manufacturing or production processes of the taxpayer, except to the extent that the expenditure relates to the acquisition of inputs to the manufacturing or production process which are themselves trading stock … [228]

The ATO's reasoning is that the definition of trading stock in s 6(1) of the ITAA36 refers to "acquisition", "manufacture" and "production", whereas s 51(2A)(a) of the ITAA36 only refers to "acquisition".[229] Secondly, the words "will become" in s 51(2A)(a) of the ITAA36 do not describe a process by which stock becomes trading stock by changing its nature in some way.[230] In regard to the specific question as to whether s 51(2A) of the ITAA36 applies to expenditure of a primary producer on seed for planting, the answer provided by the ATO is no. However, given the extract from *Taxation Ruling* TR 93/9 above and example four in *Taxation Ruling* TR 93/9, it is clear that the ATO's perceived barrier to s 51(2A) of the ITAA36 applying to seedlings for planting is that the seedlings in *Puzey* are not trading stock. Example four involves the purchase of raw materials by a manufacturer to combine with other inputs to produce a finished product. The ATO states that s 51(2A) of the ITAA36 applies to the purchase of the raw materials. Example one further supports the proposition that, in the ATO's view, it is the failure to characterise seedlings as trading stock that prevents s 51(2A) of the ITAA36 from operating.[231] Accordingly, the ATO's comments concerning s 51(2A) in *Taxation Ruling* TR 93/9 appear to be limited to costs incurred in producing or transforming trading stock, aside from the purchase cost of the raw materials that goes

[228] *Taxation Ruling* TR 93/9, para 2.
[229] Ibid para 7.
[230] Ibid.
[231] Example one in *Taxation Ruling* TR 93/9 involves the purchase of wheat seed by a wheat farmer for sowing. The ATO indicates that the seeds are not trading stock.

into the trading stock (eg fuel, labour, factory costs of a manufacturer).[232]

The function of s 51(2A) is to contribute to the scheme (or complete the scheme) for the taxation treatment of trading stock. That scheme defers the deduction for the purchase of trading stock until the income year in which the taxpayer derives income from the sale of the stock. This way, the loss or gain on the sale falls into the income year of sale.[233] The failure to characterise the seedlings in *Puzey* as trading stock, and the unwillingness of the ATO to assert a characterisation of seedlings in similar circumstances (eg wheat farming sector) as trading stock, denies s 51(2A) an operation. In effect, in this area, the ATO appears to accept the timing mismatch that can arise in the absence of, or non-application of, s 51(2A).[234] Again, the policy position taken by the ATO may be that deduction deferral for the cost of seedlings ought not be required in the traditional farming sector, it being hard to have a different rule in that sector from that applying in the new farming sector (eg passive growers of trees).

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[232] The three items in the example are taken from example four in *Taxation Ruling* TR 93/9. See also example one where the ATO states that expenditure on fertiliser and irrigation incurred by a wheat farmer would not be subject to ITAA36, s 51(2A).

[233] See Cooper, above n 196, 124. Strictly, it is wrong to talk about a loss or gain on sale of trading stock in terms of the operation of the income tax rules, as opposed to the economics of the transaction. The reason is that the income tax rules do not contemplate the subtraction of the costs of purchasing (or manufacturing) trading stock against the sale proceeds to give a net amount: *J Rowe & Son Pty Ltd v FC of T* (1971) 124 CLR 421, 448-450 (per Menzies J). Rather, the gross cost of purchase and the gross sale proceeds are deductible and assessable respectively.

[234] The decision of Lockhart J in *Raymor (NSW) Pty Ltd v FC of T* 89 ATC 5173 provides an example of the mismatch that can arise in the absence of ITAA36, s 51(2A). The decision was affirmed on appeal: *FC of T v Raymor (NSW) Pty Ltd* 90 ATC 4461 (Full Federal Court).

3.3 Deferred Payment of Part of Liability/Expense on Seedlings Has Not Been Incurred and Therefore Not Deductible, as Taxpayer May Be on the Cash Basis of Incurred[235]

The taxpayer in *Puzey* actually paid $14,000 of the $40,000 price for the seedlings in regard to the 1997 "investment". The balance of the purchase price ($26,000) was deferred for some 15 years. And, as noted in Section 2.1 above, it was near certain from the outset that the taxpayer would never be called on to make the $26,000 payment. It is true that in terms of the legal relationship between the taxpayer and the vendor of the seedlings (ie Allrange Tree Farms), the taxpayer did make the $26,000 payment.[236] However, this $26,000 payment was borrowed from Sandalwood Finance. The effect is that the taxpayer still owes an amount of $26,000. The amount owing is no longer for seedlings as the "vendor of seedlings has received payment". Rather, it is now just a principal sum owed to a lender. However, from the taxpayer's perspective, and as a matter of substance, he still owes an amount for the purchase of seedlings.

The argument here involves two steps. First, the ATO would have to convince a superior court – ultimately, the High Court - that the notion of incurred under the general deduction provision of the income tax contains a cash basis-accruals basis dichotomy, along similar lines to the cash basis-accruals basis dichotomy under the

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[235] The point(s) made here derive from D Boccabella, "Was the ATO Too Quick in Rejecting a Cash Basis of 'Incurred'? – Analysis of ATO's Rejection Against the Background of a Standard Split Loan" (2003) 32 *Australian Tax Review* 103. Given that this article deals fairly comprehensively with the submission discussed in Section 3.3, the analysis here can be brief.

[236] This view of the facts is somewhat generous to the taxpayer. The reason is that the lender, Sandalwood Finance, did not in fact have any funds to forward to Allrange Tree Farms, the vendor of the seedlings. The so-called payments were effected by way of "round-robin" cheques apparently under an arrangement with Allrange Tree Farms' bank. Support for this comes from the fact that it was only the actual cash payment ($14,000) made by the taxpayer that was available for the project: *Puzey* 2002 ATC 4853, 4859 (per Lee J).

derivation concept under the ordinary income provision.[237] Secondly, the court would have to be satisfied that the taxpayer in *Puzey* is properly on the cash basis of incurred. If these two conditions were met, the ATO could properly deny the taxpayer a deduction for the $26,000 on the basis that it has not been paid. The fact that an amount has actually been paid to the vendor of the seedlings ought not stand in the way of this. In short, the character of the loan taken out by the taxpayer should be identified with the use of the loan funds (ie purchase of seedlings). As far as is possible with a fungible like money, this is the approach taken in regard to the tests for deductibility of interest.[238]

Some could argue that this is a mere timing advantage to the ATO. In certain cases, this may be correct. However, the *Puzey* situation would provide an example where the issue would not be one of "mere timing". It is submitted that the requirements of the general deduction provision (eg expenditure must be a cost of carrying on a business, expenditure must not be on capital account) must be met at the time a loss or outgoing is incurred.[239] Given the strong probability of economic failure of the venture, it is very unlikely that the taxpayer will have been obliged to make the $26,000 payment at all. Even if he was obliged to make the payment, it is very unlikely that all the conditions for deductibility would be present at the time of payment (eg if the venture was to proceed, it

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[237] ITAA36, s 25(1) and ITAA97, s 6-5.

[238] *Steele v FC of T* (1999) 197 CLR 459, 468-470 (per Gleeson CJ, Gaudron and Gummow JJ); *Riverside Road Pty Ltd (in liq) v FC of T* 90 ATC 4031 (per French J) and 90 ATC 4567 (Full Federal Court); and *FC of T v JD Roberts; FC of T v Smith* 92 ATC 4380.

[239] There does not appear to be direct authority for this proposition. However, the proposition that the question as to whether a taxpayer is carrying on a business is to be judged by the circumstances prevailing at the time an activity commences, rather than later with the benefit of the occurrence of actual events, provides considerable support for the proposition: *Ferguson* 79 ATC 4261, 4264 (per Bowen CJ and Franki J). Further, the proposition that a receipt is to be characterised at the moment of receipt also provides indirect support: *Constable v FC of T* (1952) 86 CLR 402. See also Cooper, above n 196, 32-34.

was likely that it would be carried out on behalf of the taxpayer but not as the taxpayer's business).[240]

Unfortunately, the ATO, in *Taxation Ruling* TR 97/7, has declared that there is no cash basis-accruals basis dichotomy under the incurred concept in the general deduction section.[241] This position contrasts with the cash basis-accruals basis dichotomy established under the derivation concept in the ordinary income section.[242] Regrettably, the ATO's stated reasons for rejecting a cash basis-accruals basis dichotomy have very little merit. They are fully analysed in another article.[243] The following closing comment from that article summarises the position:

> … *Closing Comment on Cash Basis-Accrual Basis Dichotomy under Incurred Concept*
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> The reasons put forward by the ATO as a basis for rejecting a cash basis-accruals basis dichotomy under the incurred concept have little if any merit. Further, no better reasons than those stated by the ATO suggest themselves at to why such a dichotomy should not be part of the incurred concept. The legislature has largely endorsed the cash basis-accruals basis dichotomy in a couple of areas in which it has chosen to legislate, namely the STS regime and the GST regime. Some three years earlier, the ATO itself endorsed the cash basis-accruals basis dichotomy as a matter of practice in regard to small

[240] Indeed, this is what in fact happened. The project was restructured in May 1998 so that the taxpayer became a beneficiary in a trust (Kununurra Tropical Forestry Trust) that conducted the project.
[241] *Taxation Ruling* TR 97/7, paras 9 and 32.
[242] ITAA97, s 6-5. *Taxation Ruling* TR 98/1 sets out the guidelines from the authorities for determining whether a taxpayer's activity is on the cash or accruals basis of income derivation. Most other charging sections use the cash basis of assessable income recognition (eg ITAA97, s 15-10: bounty or subsidy "received"; ITAA97, s 15-20: royalty "received"; ITAA97, s 15-25: "receipt" of an amount under a lease obligation to repair covenant).
[243] Boccabella, above n 235.

> businesses and non-business taxpayers. In these circumstances, the ATO's rejection of such a dichotomy is puzzling to say the least.[244]

Assuming that a cash basis-accruals basis dichotomy does exist, the next step would be to establish the proper basis for the taxpayer's activity in *Puzey*. Put shortly, the incurred basis will or should follow the income derivation basis. Outside of the area of personal exertion income (eg employment income), generally, an "active income activity" (eg business) is on an accruals basis and a "passive income activity" (eg ownership of one rental property) is on a cash basis.[245] Justice Lee made a finding that the taxpayer was carrying on a business albeit through agents.[246] However, Lee J did note the passive role of the taxpayer in the business.[247] Indeed, it is clear that the finding of carrying on a business was largely based on the legal rights conferred on the taxpayer (eg taxpayer retained an interest in the trees grown on the lot he held on lease, taxpayer could control the harvest and sale of the timber on his lot) rather than on the activity actually undertaken by the taxpayer in carrying on the business.[248]

If the classification of a business governs the tax accounting issue, the taxpayer would be on the accruals basis of income derivation and therefore the accruals basis of incurred. However, it is submitted that the conclusion that a taxpayer is in business per se ought not govern the tax accounting derivation issue. The issue ought to be one of substance. In reality, the taxpayer's income activity was a passive activity in that he had little involvement, and planned to have little involvement, with his leased lot either physically, or in decision-making.[249] Further, returns from the harvest and sale of

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[244] Ibid 118-119.
[245] See *Taxation Ruling* TR 98/1 for a good summary of the position under case law.
[246] *Puzey* 2002 ATC 4853, 4864 (per Lee J).
[247] Ibid.
[248] Ibid.
[249] It is worth noting the observation of Hill J in *Sleight* 2004 ATC 4477, a case involving an "investment" sharing considerable features with the investment in *Puzey*. In the context of a discussion of s 177D(b)(ii) (ie form and substance of a scheme), his Honour said that: "… in substance the [taxpayer] is a mere passive

timber to the taxpayer were of a highly speculative nature. Given the above, the cash basis of income derivation ought to be applicable. Accordingly, the cash basis of incurred ought also to apply.

It should be noted that the ATO did make the argument that the true purchase price for the seedlings was $14,000 rather than the $40,000 asserted by the taxpayer.[250] However, this ATO argument was not based on the establishment of a cash basis-accruals basis dichotomy under the incurred concept. Rather, it was based on a particular view of the seedling purchase agreement and the "practical obligations" of the taxpayer.

Finally, it should be noted that many of the mass marketed schemes involve deferred payment arrangements of the kind that existed in *Puzey*.[251] It is not clear why the ATO has not attempted to test the cash basis-accruals basis dichotomy in these cases. Mass marketed scheme cases seem to provide the ideal background for a submission along the lines set out above, especially when the tax leverage obtained from the unpaid amount is the very thing that provides the objectionable and aggressive tax planning in such cases.[252] Given the binding nature of public rulings, while the ATO retains its position as set out in *Taxation Ruling* TR 97/7, the submission made here remains academic.[253]

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investor in what, once the tax features are removed, is a managed fund …": ibid 4494.

[250] *Puzey* 2002 ATC 4853, 4862-4863 (per Lee J).

[251] See eg, *Howland-Rose & Ors v FC of T* 2002 ATC 4200; and *Vincent* 2002 ATC 4742.

[252] Indeed, Hill J noted in *Sleight* 2004 ATC 4477, 4499:

> In the present case, if there had … been no gearing of the management fees, for example, it would have been unlikely that the conclusion of dominant purpose required under s 177D could have been reached and likewise the cash actually expended, to the extent it was of a revenue nature would have been clearly deductible.

[253] See the binding effect of ITAA36, s 170BA(3).

3.4 Additional Benefit Obtained from Expenditure Under Tax Avoidance Arrangement and which Exceeds a Threshold is Denied Deductibility Under s 82KL of the ITAA36[254]

Section 82KL(1) of the ITAA36 denies a deduction for expenditure (eligible relevant expenditure) where the sum of:

A. the expected tax saving in relation to the amount of eligible relevant expenditure; and
B. the amount or value of additional benefit in relation to the eligible relevant expenditure,

is equal to, or greater than, the amount of the eligible relevant expenditure. If s 82KL(1) applies, the whole of the eligible relevant expenditure will be denied deductibility. There is no room for apportionment.[255] Assuming the presence of eligible relevant expenditure for the moment, the taxpayer's expected tax saving is $16,021.[256] The amount of eligible relevant expenditure is $40,000. Accordingly, for s 82KL(1) to apply, the additional benefit, if any, must be equal to or more than $23,979.

There are some obstacles in the path of s 82KL(1) applying. First, in order for a taxpayer to have "eligible relevant expenditure", it first must have "relevant expenditure".[257] Relevant expenditure is defined in s 82KH(1) by reference to an exhaustive list of 18 items containing a description of the expenditure, and the provision under which the expenditure attracts a deduction. There is only one item

[254] ITAA36, s 82KL is sometimes referred to as a provision dealing with the recoupment of expenditure under a tax avoidance arrangement (eg para 167 of *Taxation Ruling* TR 2000/8). Note also, that the following analysis deals with s 82KL and related provisions (eg ITAA36, s 82KH) in the form they were in at the time of the facts in *Puzey*.
[255] See the closing words in ITAA36, s 82KL(1), especially the reference to "any part of that amount of eligible relevant expenditure".
[256] ITAA36, s 82KH(1B). See *Puzey* 2002 ATC 4853, 4856 (per Lee J).
[257] ITAA36, s 82KH(1F).

that may capture the $40,000 seedling purchase agreement in *Puzey*, namely, the item dealing with trading stock.[258] Certainly, the item dealing with a loss or outgoing incurred in respect of the growing, care and supervision of trees cannot apply in regard to the seedling purchase agreement.[259] The management agreement dealt with these services. As a result, if the seedlings are not trading stock, s 82KL(1) of the ITAA36 cannot apply because there is no eligible relevant expenditure. There is nothing to indicate that the term trading stock is not used in its defined sense in s 82KH(1). The trading stock issue was dealt with in Section 3.1.3 above. For present purposes, we will assume the seedlings are trading stock.

There are other requirements to be met before relevant expenditure amounts to eligible relevant expenditure. In *Puzey*, the expenditure on seedlings was incurred after 24 September 1978.[260] Further, the expenditure was incurred as part of a "tax avoidance arrangement".[261] The reason, put briefly, is that the seedling purchase agreement was entered into for a purpose of securing a lower income tax liability for the taxpayer.[262] The remaining issue is whether the taxpayer obtained an "additional benefit" from the expenditure.[263] In *FC of T v Lau*, Fox J said: "put shortly, the inquiry is one as to what benefits, if any, were additional to those for which the relevant expenditure was incurred".[264] The ATO's approach is similar: "an additional benefit … is, broadly speaking, a benefit received which is additional to the benefit for which the expenditure

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[258] Paragraph (c) of definition of "relevant expenditure" in ITAA36, s 82KH(1).
[259] Paragraph (p) of definition of "relevant expenditure" in ITAA36, s 82KH(1).
[260] ITAA36, para 82KH(1F)(a).
[261] ITAA36, para 82KH(1F)(a).
[262] Definition of "tax avoidance arrangement" in ITAA36, s 82KH(1) and s 82KH(1A). See also *Lau* 84 ATC 4618, 4624 (per Connolly J); *Case* W2 89 ATC 107, 122 (per PM Roach (Senior Member)); and *Cooke* 2004 ATC 4268, 4294 (per Lee, Sandberg and Conti JJ).
[263] ITAA36, para 82KH(1F)(b)(i) and definition of "additional benefit" in ITAA36, s 82KH(1).
[264] *Lau* 84 ATC 4929, 4935 (per Fox J). See ITAA36, s 82KH(1G)(c) in regard to the purchase of trading stock.

is ostensibly incurred".[265] The benefit ostensibly obtained from the $40,000 expenditure is the seedlings.

A taxpayer shall be deemed to have obtained an additional benefit where, in relation to the relevant expenditure, the taxpayer owes a debt and it may reasonably be expected that the person to whom the debt is owed will release, abandon or fail to demand payment of the debt.[266] The question on the facts in *Puzey* is whether Sandalwood Finance would release the taxpayer from repaying the $26,000 (ie $40,000 less $14,000 payment) outstanding on the loan made? This requires more than a possibility. It requires a prediction as to future events that is sufficiently reliable for the expectation to be regarded as reasonable.[267] While repayment of the loan appears to be contingent on the successful harvest and sale of timber,[268] there is no evidence that Sandalwood Finance will release the debt, which is a requirement of the deemed additional benefit provision.[269] Accordingly, there is no deemed additional benefit in regard to release of the loan principal by Sandalwood Finance.

The question then becomes, whether there is any other additional benefit on ordinary concepts. The loan in *Puzey* was not expressly stated to be a non-recourse or limited recourse loan.[270] However, and as noted in Section 2.1 above, based on representations made to the taxpayer, the repayment of the loan amount of $26,000 was

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[265] *Taxation Ruling* TR 2000/8, para 169.
[266] ITAA36, s 82KH(1J).
[267] *Taxation Ruling* TR 2000/8, para 175. The ATO cites from the judgment of the High Court in *FC of T v Peabody* (1994) 181 CLR 359, 385 (per Mason CJ, Brennan, Deane, Dawson, Toohey, Gaudron and McHugh JJ) that dealt with the GAAR.
[268] *Puzey* 2002 ATC 4853, 4857 and 4869 (per Lee J); and *Puzey* 2003 ATC 4782, 4795 (per Hill and Carr JJ). The terms of Option 2 in regard to the payment of "interest" support the analysis of the contingent nature of the loan suggested here.
[269] *Case* W2 89 ATC 107, 124 (per PM Roach (Senior Member)).
[270] This is unlike the position in *Case* W2 89 ATC 107. In this case, the loan made to taxpayer was a non-recourse loan. PM Roach (Senior Member) had little difficulty in concluding that the taxpayer had obtained an additional benefit: ibid 124.

contingent on the successful harvest and sale of timber in some 15 years. Given that: (1) the promoter failed to make sufficient capital available to meet contingencies of the venture; (2) the promoter failed to undertake sufficient depth of planning for the venture; and (3) the promoter failed to employ a person with expertise in forestry to provide services to the venture, it is more likely than not that the venture was doomed to fail from the beginning.[271] Indeed, it could be said that failure was near certain to occur so that a harvest would not eventuate. This is in fact what happened.[272] As a result, it is near certain that the taxpayer would not be required to repay the $26,000 outstanding on the loan. This is a benefit obtained by the taxpayer in addition to the seedlings obtained from the $40,000 incurred. Accordingly, the $26,000 is an additional benefit.[273] A similar analysis can be made in regard to the "interest" payable under Option 2. Valuation of the additional benefit in regard to the interest is more problematical than the loan principal.[274]

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[271] *Puzey* 2002 ATC 4853, 4861 (per Lee J); and *Puzey* 2003 ATC 4782, 4787 (per Hill and Carr JJ).

[272] *Puzey* 2002 ATC 4853, 4861 (per Lee J). There is an argument that events occurring after the income year can be taken into account in determining whether an additional benefit has been obtained from expenditure. The wording in ITAA36, s 82KH(1F)(b) is "has obtained" and not "will obtain".

[273] It may be interesting to speculate whether ITAA36, s 82KL(1) would apply if the taxpayer were held to have derived $26,000 at the time it became "clear" that he would not have to discharge the balance of the loan. The question can be avoided because, in spite of the case law on the ordinary income concept dealing with the release or discharge of liabilities on revenue account (eg *FC of T v Unilever Australia Securities Ltd* 95 ATC 4117; *FC of T v Orica Ltd* (1998) 194 CLR 500; *Warner Music Australia Pty Ltd v FC of T* 96 ATC 5046; and *Integrated Insurance Planning Pty Ltd v FC of T* 2004 ATC 4054), it is submitted that the case law, as presently stated, does not contain a proposition broad enough to capture the situation in *Puzey*.

[274] Under Option 2 in regard to interest on the loan, the option chosen by the taxpayer, the taxpayer is not required to pay interest during the currency of the loan. Rather, interest is only payable at the time of receipt of the sale proceeds from the timber, and the amount of "interest" is equal to 7% of the sale proceeds net of costs. Indeed, based on representations made to the taxpayer, if the harvest and sale of timber does not occur, then no liability for interest arises in any event. The fact that

It is submitted that the decision in *Lau*[275] is distinguishable from the facts in *Puzey*. In *Lau*, the various justices refused to attribute an additional benefit to the possibility that the harvest would realise less than the loan outstanding in circumstances where the lender was obliged to accept proceeds of the harvest in full settlement of the loan.[276] The refusal was based on an unwillingness to pursue conjecture as to whether the project would succeed. However, in *Lau*, there was considerable evidence to support the conclusion that the venture would run its full course and that a harvest would take place.[277] Even though there is some conjecture involved in the facts in *Puzey* concerning the venture, the better view based on the evidence was that it was near certain from the beginning that the venture would fail.[278]

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no interest is payable during the currency of the loan per se cannot give rise to an additional benefit. The fact that "interest" may be payable as a percentage of the sale proceeds must be taken into account. Indeed, a comparison of the current value of these two is required. While an interest free loan of $26,000 for some 15 years can be valued, there are difficulties in putting a value on the payment of 7% of the sale proceeds from the harvest and sale of timber. However, the ATO could argue that only a nominal amount should be placed on this given that the project was doomed to failure from the beginning. On the other hand, it could be argued that some value should be placed on the possibility that the taxpayer may be required to make some payment.

[275] 84 ATC 4618; 84 ATC 4929 (Full Federal Court).

[276] 84 ATC 4618, 4626 (per Connolly J); and 84 ATC 4929, 4936 (per Fox J).

[277] Indeed, Connolly J stated that: "I pause to say that on the evidence before me there is no reason to suppose that the scheme will not run its course": 84 ATC 4618, 4624. Indeed, by the time of the Court hearing in front of Connolly J, the taxpayer had met his quarterly interest commitments over some three years. It should also be noted that the promoters of the venture in *Lau* had promoted a similar scheme 10 years earlier. Connolly J stated that: "[This scheme] is operating and presents external indications of success": 84 ATC 4618, 4624.

[278] In the context of discussing the ATO's submission that there was no relevant assessable income, and that therefore deductions should be denied, Lee J noted that: "On its face it was not a project obviously devoid of prospect": *Puzey* 2002 ATC 4853, 4865. And later, Lee J noted: "… the proposal represented to a participant a reasonable expectation that assessable income could be gained therefrom": ibid. It is submitted that these observations are not inconsistent with the view expressed in this

If the additional benefit is limited to $26,000 (ie ignore fact that interest might give rise to an additional benefit), the sum of this amount and the tax saving ($16,021) is greater than the eligible relevant expenditure of $40,000. Accordingly, and assuming that the trading stock classification can be made for the seedlings, it is strongly arguable that s 82KL(1) should have applied to deny the taxpayer the $40,000 deduction otherwise available under s 51(1) of the ITAA36.

4. CONCLUSION

The facts in *Puzey* were at the aggressive end of the tax-planning continuum. Aside from the GAAR, the ATO presented a number of arguments in its attempt to defeat the tax planning in *Puzey*. All of the non-GAAR arguments failed. This article suggested that the ATO had another four non-GAAR arguments at its disposal. These arguments were examined against the facts in *Puzey*. Each of these arguments was found to have some probability of succeeding. More importantly, in terms of the development of Australia's income tax system, facts like those in *Puzey* provide an ideal forum to test the scope of the arguments and provisions put forward in this article. It might be some time before such facts arise. There is a strong argument that it is incumbent on the ATO to "grab" the opportunity to test provisions of the income tax directed at curtailing aggressive tax-planning.

On the other hand, there may be good reasons as to why the ATO did not run the arguments suggested in this article. The main one is the difficulty in preventing the application of deduction deferral rule regarding trading stock spilling over into the traditional farm sector.

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article that it was near certain that the venture would fail. Even if there is some inconsistency, it is only minor and in any event, one of degree. In any event, Lee J's analysis regarding the no relevant assessable income submission is largely based on the perspective of the taxpayer, who, for whatever reasons, had limited information concerning the project. On the other hand, it is submitted that the analysis, and the conclusion required, under ITAA36, s 82KH(1F)(b) is not to be shaped by the taxpayer's state of knowledge.

Obviously, a judgment as to the probability of success of each argument may also have been a factor. Further, and in spite of the non-GAAR arguments presented by the ATO, there is some basis to the proposition that the ATO's main aim out of *Puzey* was to test the GAAR and add to the jurisprudence on the GAAR. Given the extreme facts in *Puzey* (ie incurring $40,000 for something worth $1,500), this may have been a good strategy as the case stands as a clear victory for the ATO on the GAAR. On the other hand, given the extreme facts in *Puzey*, it cannot be a source of principles that will assist the ATO in "borderline cases". That is, the ability to generalise from *Puzey* is limited. All the more reason for a prudent tax administration to make full use of specific anti-avoidance provisions.