COMMENTARY ON DRILLING FUNDS

By M.J. Walsh*

Michael Sharwood is to be congratulated upon producing a paper which is not only thorough and stimulating, but deals sensibly with a number of the problems which exist in relation to drilling funds in Australia.

It is difficult to imagine why past governments which have been persuaded to introduce incentives for taxpayers to invest in the search for petroleum, have placed so many obstructions in the way of investors, particularly in the Income Tax Assessment Act.

If the provisions of the Income Tax Assessment Act are intended to provide incentives, then it is almost beyond comprehension why it should be drafted in such a manner that only the very sophisticated would be tempted to make an investment into a drilling fund in Australia. Rephrased, it may be said that only those taxpayers who are so overwhelmed by the heavy incidence of personal taxation, will be motivated to invest.

Advisers are required to be satisfied of so many aspects of a fund, before they could advise that it is satisfactory to the investor, that their advice is likely to be very expensive and couched with many qualifications. As such it would be a deterrant to the investor. If the investor does not seek advice he or she is at risk, not only in respect of their investment, but with their potential taxation deduction as well.

It seems to me that investment exploration funds are to be encouraged rather than restricted but with governments so preoccupied with tax avoidance, I despair of any improvement in the near future.

Why, for example, there is a need for regulation under the Companies Code when the whole concept of drilling is one of great risk, without any certainty of return, is almost beyond the comprehension of man. There may be a case for requiring a minimum contribution to be made before the fund is to be free of regulation (for example, say $10,000) to protect the small unsophisticated investor but, if this country is to attract the proper amounts of risk capital for these ventures, some deregulation must take place.

The tax legislation must provide simple rules to enable the investor to be sure that his contribution will be tax deductible. As matters stand at present, he runs substantial risks that he will be denied a deduction. It seems to me that a very simple solution to governments is available. It does involve some regulation but would not have all of the conditions which presently attach. The golden rule should be whether the investor is 'at risk'. In my view, he will be at risk if he pays his money into a fund to be applied for prospecting and exploration in an approved project. Such a project should be one which a relevant authority can be satisfied is genuine. For example, a certificate that there is a mining permit or right and an auditor's report certifying the monies have been spent on oil drilling and prospecting.

In commenting upon Sharwood's paper, I believe that it is appropriate to select only two or three aspects of it and amplify some of these matters.

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WHO IS THE HOLDER OF A RIGHT?

Sharwood[1] has left the very interesting question namely, whether the holding of a right, as distinct from the right to earn an interest, is a prerequisite to expenditure being classified as expenditure on exploration or prospecting under sub-section 124AJ(1).

In general, a farm out agreement would provide that, in return for certain amounts of expenditure made by a farminee, he will become entitled to a particular interest in the right held by the farmor. If sub-section 124AJ(1) is strictly analyzed and applied, it will be necessary to determine if the farminee can be described as the holder of a right in the legal technical sense.

The farm-in agreement is a contract between the parties. It will provide that if an amount of money is spent, then the farmor will be obliged to transfer an interest in the right to the farminee. The nature of right held by the farmor will be important. This will depend to a large extent upon the legislation under which the right is granted. If the legislation prohibits the transfer of an interest in the right without the consent of a minister, then it is very likely as Sharwood observes[2] that an agreement to create such an interest will be void without that consent.

A 'petroleum prospecting or mining right' is widely defined by section 6 of the Income Tax Assessment Act. It means among other things an authority, permit or right to prospect, explore or mine for petroleum and includes an interest in any such authority, permit or right.

Clearly, therefore the holder of an interest in a right would be in the same position as the holder of the right, but it is still necessary to determine if the farminee who only enjoys the benefit of a covenant to assign is in the position of holding an interest. The answer may depend on the particular Act under which the right, authority or permit is granted.

An exploration or prospecting right could take the form of an authority to enter, a permit to prospect or a licence. It may not confer any interest in land. Dr. Crommellin has suggested that a statutory licence does not create any interest in land[3].

The Petroleum Act, 1967–1981 (W.A.) does not confer on the licencee a *profit à prendre* (*i.e.* it does not permit the removal of petroleum) and whilst it recognizes that legal and equitable interests may be created, sub-section 75(2) of the Act provides that an instrument creating such an interest has not any legal effect until the Minister has given consent and until an entry is made in the registry.[4]

In my view, therefore, if the right arises under that type of legislation an interest could not be created until there is actually an entry in the register which will not occur until the whole of the money has been spent.

But assuming that legislation does not contain such restraints there is still a question to be answered namely, whether the agreement to assign will create an equitable interest in the right such as to create the investor a holder? Mining claims and rights are fraught with considerable difficulty. In *Adamson v. Hayes*[5] the High

1 *Infra.* 151.
2 *Infra.* 159.
3 Crommellin M., Lang A.G. *Australian Mining and Petroleum Laws* (1979) para. 505.
4 See also Carr C.J.'s commentary on the judgment re *South Pacific Hotel Corporation Energy Pty. Ltd. v. Swan Resources & Anor.* (1982) 4 *A.M.P.L.J.* 432, 435.
5 130 CLR 276.

Court was split upon whether the agreement in that case, was an agreement to create an interest in land. The agreement involved a parol agreement granting an option with respect to certain mineral claims. The Court by a four to one majority held that the parol agreement purported to create an interest in land and therefore specific performance was not available. It is apparent that had the agreement been in writing, it would have been upheld because as Stephen J. said 'the oral agreement did, by its first term, seek to declare trusts ... thereby creating equitable interests . . .' in land.

However, if the nature of the right does not create any interest in land, would the contract create an interest in the right, by means of the covenant to assign prior to the monies to be provided by the investor being spent? The question, I believe, must be answered by reference to basic principles. Some statutes refer to the nature of some rights, as a chattel interest. That generic description may be some help in deciding whether an interest has been created in the investor.

A contract to assign for valuable consideration property, real or personal, effects in equity an immediate assignment of present property or if the subject matter is future property, immediately upon the property coming into existence.[6]

Lord Westbury L.C. in *Holroyd v. Marshall* said that this principle only applied to a contract of which a Court would grant specific performance. Whether the right to specific performance is necessary to the establishment of an equitable interest is doubted by Meagher, Gummow and Lehane,[8] and moreover it does not appear necessary in cases which involve a covenant, for valuable consideration, to assign after acquired property.[9]

The maxim, equity regards as done that which ought to be done is the principle which is often quoted to support the proposition that a covenant to assign is as good as an assignment. However, if the farminee has not yet spent the funds on the project, can it be said that whilst the contract is executing, the farminee investor has acquired a right. In my view, his position is really that of a person who has a right to obtain a right.

If the right is personal to the farmor, either because it is a mere or a licence for valuable consideration and either is not assignable or assignable only with permission, it may not be sufficient for the equitable maxim to apply, unless it were coupled with an interest in the subject matter of the licence.

It has been held that a licence without being coupled with an interest in the subject matter of the licence does not create a proprietary right or interest in the subject matter.[10] It would seem to follow that personal licences could not be assigned so as to create the assignee a holder of a right. Such a licence could not be protected by an injunction if it was to be revoked.[11]

Where the right is in the nature of a personal licence and a purported assignment could not be effective until an entry is made in a register after permission to transfer has been given, it seems, even more likely that such a

6 *Holroyd v. Marshall* (1862) 10 H.L.Cas. 191.
7 (1862) 10 H.L.Cas. 191, 1006.
8 Meagher R.P., Gummow M.W.C. and Lehane J.F.R. *Equity: Doctrines and Remedies* (1975) para. 2145.
9 *Op. cit.* 612–636.
10 *Op. cit.* 2152.
11 *Op. cit.* 2152.

purported assignment would give rise only to damages, if the contract were to be breached.

In those cases, where the statute describes the nature of the right as a chattel interest in its subject matter, then at least the necessary foundation for the creation of an equitable interest exists but if the statute denied the effectiveness of an assignment until registered, I believe that the assignee could not be described as having an interest in the subject matter. Accordingly, he could not be described as a holder for the purposes of section 124AJ of the Income Tax Assessment Act.

The right to explore or prospect may be statutory or contractual. Its only effect may be to protect the holder against an action for trespass although it may confer upon its holder a further right to apply for a lease. It is, at least, arguable that the latter right is a sufficient proprietary right to ensure that equity will give effect to the assignment but that it is not by any means clear. It may be said that all that the investor has, under an agreement to assign, is a contractual right obliging the farmor to act in respect of the licence or permission granted in a particular way. A breach of the agreement may only lead to an action for damages.

Wherever, a person who is to possess a particular characteristic is referred to in the Income Tax Assessment Act, that characteristic is given a strict interpretation. A very useful example is that of a shareholder which has been held to mean only that person whose name is entered in the share register.

If the same strict meaning which was given to the meaning of 'shareholder' in *Patcorp Investments v. Federal Commissioner of Taxation*[12] for the purposes of section 46 of the Act, is applied to words 'holder of a petroleum prospecting or mining right', then it will be, very difficult for an investor to claim he is the holder. If an equitable interest in shares was insufficient to create a person a shareholder, then even an equitable right which is less than an equitable interest in a mining right will not be sufficient to create a person a holder for the purposes of section 124AJ.

What I believe is preferable, is for the farmor to transfer the interest to the investor upon execution of the agreement with a covenant by the investor to reassign should the work not be carried out. An appropriate power of attorney to the farmor could be included in the agreement. If the investor puts up the funds to do the work, that arrangement would not appear to be inconvenient.

SECTION 124AH

I agree with the comments of Sharwood in his analysis of paragraph 124AH(4C)(a) concerning the difficulties inherent in carrying on prescribed petroleum operations but I have some difficulty with the notion that a person who merely contributes funds to a budget to explore or prospect for petroleum is to be said to be carrying on a business of exploration or prospecting for petroleum. Carrying on a business very much depends on the analysis of the activities of the investor. He will not be engaged in a partnership and he cannot be said to be engaged in business through the holding of a unit in a unit trust, the trustee of which may carry on a business.

The average investor's primary objective will be to obtain a taxation deduction for his contribution. Usually he will not be a contributor to more than one fund. There is unlikely to be sufficient evidence that such an investment is to be

12 (1976) 10 A.L.R. 407.

the commencement of a business. In *Ferguson v. Federal Commissioner of Taxation*[13] to which Sharwood referred the Full Federal Court decided that Ferguson, a naval officer, was carrying on business by entering into lease arrangements with respect to cattle. There was considerable evidence that the leases were entered into for the purpose of building a herd to move onto a property to be eventually acquired by him and there were receipts for the sale of bull calves. The Commissioner argued very strongly that a business was not being carried on, but the evidence of the taxpayer was accepted.

In *Hanlon v. Federal Commissioner of Taxation*[14] the question before the Supreme Court of Victoria again involved a cattle leasing agreement. The taxpayer was a member of a syndicate which had as its object to establish on a commercial basis a pure bred simmental herd. The Court again accepted that the size and system of the activities were sufficient to constitute the carrying on of a commercial enterprise. The Court placed considerable weight upon the overall intention to continue the enterprise and its long term purpose. However, the New Zealand Court in *Grieve v. Inland Revenue Commissioner (N.Z.)*[15] decided a partnership of husband and wife in primary production unlikely even to produce a profit was not a business. But in *Walker v. Commissioner of Taxation (Cth.)*[16] a cattle leasing scheme was again upheld. As in the *Ferguson* and *Hanlon* cases, the evidence indicated a long term business purpose. I should add, however, that *Walker's* case has now been appealed by the Commissioner.

Each of the Australian cases demonstrates that if there was an overall business purpose the deduction will be allowed to the investor. There are a number of indicia of business purpose but the Commissioner has not been slow to argue that investors are not carrying on a business.

Where does that leave the investor? It is difficult to demonstrate that the average investor will have an overall business purpose when very few of the indicia of carrying on business are present. In my view, he should approach his investment carefully, investigate the prospect, have the documents carefully examined, and take an active part in the overall activity.

Another argument which the Commissioner may advance is that the expenditure is directed towards earning an interest in the mining right and is not made for the purpose of carrying on of a business. I am obliged to concede, however, that the words of sub-section 124AH(4C), exploration and prospecting may be carried on as a business.

I believe that what these comments demonstrate is that it cannot be regarded safe, that the investor will obtain a deduction by merely investing his money in a joint venture to explore a prospect for petroleum.

It may be argued that the operator will be the agent of the investor and that it is through this operator that the investor can be said to be carrying on business. It may be imagined that the operator will carry on his activities in a proper efficient and business like way.

I should add that I have been informed by persons who are closely associated with drilling funds, that the Commissioner of Taxation is prepared to

13 (1979) 79 ATC 4261.
14 81 ATC 4617.
15 (1982) 13 ATR 237.
16 (1983) 14 ATR 75.

agree that an investor is carrying on business but the evidence which I have seen does not make that clear.

Where the investor can be said to be the holder of a petroleum or mining right and he pays another to carry out the work (for example, the operator) his expenditure will be deemed by section 124AJ to be expenditure incurred by him in the carrying on of exploration and prospecting but that does not make it expenditure incurred in the course of carrying on a business.

This section was inserted in the Act in 1974 prior to the introduction of sub-section 124AH(4C) in 1976. Section 124AH allows expenditure on exploration and for expenditure to be deducted if it conforms to the provisions of that section. All that sub-section 124AJ(1) is designed to do is to ensure that expenditure or income is allocated to the person who actually incurs expenditure and obtains the benefit of the work. If it were otherwise, an explorer may derive income by working on mining rights of others and claim all of his expenses as a deduction under section 124AH. Alternatively it would enable the actual holder of a right, to claim a deduction for the expenditure, even though he had transferred an interest in the right to the other person in return for the performance of the work. In the context of a drilling fund, the section prevents the farmor from claiming a deduction for funds provided by investors.

Moreover, the expenditure, it should be noted, in the absence of section 124AH would not be in general, deductible. It would be primarily capital expenditure, which formerly, could only be deducted against assessable income from petroleum. It was extended subsequently in 1976, in a limited way, to permit a deduction against other business income, but it is still necessary to demonstrate that a business of exploration or prospecting in Australia is being carried on by the taxpayer. Section 124AJ does not resolve that dilemma.

LIABILITY OF THE INVESTOR

The next group of comments which I wish to make relate to the potential liability of the investor under the suggested drilling fund outlined by Sharwood.[17] There are a number of potential areas of liability. These are liabilities which arise:

1. under the operating agreement to which the manager of the unit trust will become a party; I have assumed that a subsidiary of the farmor will be the manager;
2. under the management agreement;
3. under the unit trust for the acts of the trustee;
4. under the farm-in agreement; and

in addition the investor will need to consider the stability of the manager and the title to the mining right.

Most, if not all of these liabilities or risks, could be covered by suitable warranties or covenants, but they may be little comfort to the investor if something goes wrong.

An appropriate starting point may be the joint venture agreement existing between the farmor and the other holders of the right to explore or prospect. Suppose the farmor itself has entered into a farm-in agreement under which it may

17 *Infra.* 157.

have the right to earn an interest in the permit and it proposes to satisfy its obligations by raising funds from investors. Such an arrangement makes the proposition extremely risky for the investor. Apart from the problem of being a holder of a right, to which I have referred, if the necessary total funds are not raised, the question will be, can the farmor afford the cost of its remaining obligations? The rights of the investor will sound only in contract against the farmor and not against the holders of the exploration or prospecting right.

If the farmor is the holder of the right to prospect either alone or with others, is the title in good standing? In other words have the minimum work requirements been performed to date? If they have not, then a covenant to assign may be of little value because the title to the right to prospect may be voidable.

If the farmor is the holder of only a part interest in the right to prospect, is it likely to be forfeited because of a failure to contribute to a budget established by the farmor and his co-holder? The other co-holders may hold the total right to prospect in trust for the farmor and himself subject to certain conditions. If the conditions have not been performed, the trust may be brought to an end, resulting in a loss for the farmor as well as the investor.

Assuming the farmor has a good title to the right to prospect, but has entered into a joint venture agreement with his co-owners and they have appointed an operator, the rights under the operating agreement are contemplated to be assigned to a trustee for the benefit of the investor.

Most operating agreements will provide that the operator is not to exceed the operating budget but a provision for cost overruns is quite normal. This provision will limit the amount to a fixed percentage, say 10%. The operator is the agent of the farmor and his co-venturers. Very often, the operator will be the wholly owned subsidiary of one of the venturers and will have limited capital. Suppose as agent, it expends more than the budget by incurring debts to third parties. The operator would be personally liable, but if it has insufficient assets to meet the liability could the amount be recovered against others? I believe the answer is yes. As agent the operator will have ostensible authority to bind the investors and co-venturers to third parties. If it cannot pay the debts contracted, it may be that the investor could be liable. Although the operator may have exceeded its authority the fact is that its acts are the acts of its principals for which the principals are liable. The farmor may give a warranty to the investor but that is only as good as the value of the assets of the farmor at any time.

Suppose the joint venture exploration agreement between the farmor and other co-venturers provides for the establishment of a series of annual budgets with provision that in the case of a co-venturer not contributing his interest will be diluted or extinguished. The investor will have little protection for his investment in those circumstances unless the farmor is a reputable corporation.

Assume the rights of the farmor under the operating agreement are assigned to a trustee for the investor and the farmor, and in pursuance of the agreement, the operator carries out the work. Could the investor be liable for a proportion of the costs assuming the farmor did not satisfy them? The probability is that he will not because there would not be a privity of contract between the investor and the operator. Although, in the case of third parties, as I observed earlier, the operator may be able to bind the investor as an agent.

Until holders of a unit trust can incur liability for the acts of the trustee[18]

18 *Hardoon v. Belilios* [1901] A.C. 118.

particularly where the trustee acts in accordance with the wishes of the beneficiaries of the trust or where they have authorized it to act in that manner.[19] Most deeds will clearly limit the right of the trustee to an indemnity to the assets of the trust for the time being and would prohibit the trustee from acting except in strict accordance with the Deed. However, a trustee which acts to protect the trust property will usually have a right to recover against the trust property or the beneficiaries the unit holders. This right should also be limited by the Deed.

It seems essential for the investor or the investors to have a voice on the management committee established under the joint venture agreement to oversee the operator. Sensibly this ought to be the trustee of the unit trust whose duties will be to the investors and not to the manager. If that is impracticable, then clearly the manager must be independent of the farmor. This will be difficult in many cases because joint venturers will not be too keen to have many representatives at management committee meetings, but unless the investor is represented in that manner, he will be exposed to the liabilities to which I have adverted.

After the expenditure on exploration and prospecting has been made, there is, of course, the continuing expenditure to maintain the right to prospect and the investor will be in danger of losing his interest if that expenditure is not met. Moreover, his interest may be lost, if there is continuing exploration and he does not wish to participate further.

These are problems which a person structuring a drilling fund must address. Whilst it may be assumed that exploration and prospecting is risky, nevertheless investors will be seldom, if ever, interested only in obtaining a tax deduction. They will require assurances as to their liabilities, their rights and their ongoing obligations.

RECOUPMENT OF EXPENDITURE PROBLEMS

My last comment relates to the further problems of the investor may have in obtaining his deduction for expenditure. Sharwood has properly drawn attention to the problem of dilution. He suggests a possible solution by giving the farmor a right to acquire the interest of the investor in return for a royalty or perhaps shares in the capital of the farmor. Whilst I agree that as subdivision D Division 3 Part III of the Income Tax Assessment Act presently is drafted it does not apply to that type of arrangement because the expenditure of the investor is not by the terms of section 82KH made relevant expenditure for the purpose of that subdivision. Nevertheless, the agreement of the investor to invest could be a tax avoidance agreement as defined by section 82KH and an additional benefit referred in section 82KL for the investor may be obtained.

Subdivision D is designed to exclude deductions for expenditure otherwise deductible if the subdivision applies. It can apply to deny rebates under section 160ACA relating to rebates on monies paid on shares for the purpose of Offshore petroleum exploration and also to section 78 which, in part, relates to a deduction for calls paid on afforestation shares. The former Treasurer in September 1978 made it very clear that if any sections of the Act (other than those referred to in section 82KH) were to be exploited for tax avoidance purposes, the subdivision would be extended to cover them retrospectively. The present Treasurer has echoed these sentiments.

19 See also s.68 of the Trustee Act 1958 (Vic.).

My point is simply this; if the fund is to be promoted upon the basis that the investor will be bought out for a royalty or capital in the farmor, a recoupment could occur in respect of his investment and it may be that the subdivision will be extended to bring the arrangement within its terms. I believe that it is more appropriate to consider some form of dilution, if the investor does not want to remain a party after the initial expenditure has occurred, or alternatively, provide in the agreement that the investors will pool their holdings into a separate company. I have not adverted to Part IVA, the relatively new anti-avoidance provisions. These will also need to be considered in the case of any drilling fund.

I believe that it will be hard enough to convince the Commissioner that the fund is acceptable without this added difficulty. The principle that the investor should be 'at risk' in all respects would appear to be the 'guiding star' in the formulation and promotion of these funds.