

PART IVA - A 2004 RETROSPECTIVE

by

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Author's prologue:

On 12 November 2012, some 31 years after Part IVA was introduced, the Gillard government released draft amendments that will apply retrospectively as from that date. I propose to carefully consider this draft legislation in the light of contemporary commentary. In the fullness of time, I will revisit this material and update it with my considered opinion/s.

Fred Rollo, January 2013

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Background

Just two months after the general anti-avoidance provision Part IVA was introduced into the Australian Income Tax Assessment Act, I presented a paper for the Tasmanian Branch of the Taxation Institute of Australia (Hobart, 24th July 1981). The paper was titled "*Part IVA of the Principal Act*". I was covering new ground, there were no seminal papers by leading commentators (although CCH had just released their first commentary on the new provision), and of course, there were no decided cases for guidance. Just three months after the Australian High Court's decision in the case of *FC of T v Spotless Services Ltd. & Anor. 96 ATC 4775*, I had the opportunity to revisit my original views in a paper presented to the Tax Institute's Goulburn Discussion Group (Goulburn NSW, 5th March 1997).

The Tax Institute did not publish my 1981 paper. I had refused to allow editing which would remove criticisms I had made regarding what I perceived to be the misleading words of the then Federal Treasurer's Second Reading Speech and of the Explanatory Memorandum prepared for the new legislation.

What follows here is an edited version of my original paper of July 1981, into which I have interposed the "benefit of hindsight" comments contained in the March 1997 paper with the hindsight of revisiting the issues as at January 2004. The editing (apart from some grammatical and stylistic changes), is largely limited to the omission of paragraphs which have become largely irrelevant as a result of subsequent amendments to the tax law.

PART IVA OF THE PRINCIPAL ACT

I. Introduction

Part IVA was introduced by the Income Tax Laws Amendment Bill (No. 2) 1981 and became effective on 27th May 1981, the day of its introduction.

The Part contains seven (7) sections (sections 177A to 177G inclusive). Consequential amendments have been made to section 80 (past year losses), section 148 (reinsurance with non-residents), and section 226 (additional taxes).

The Bill also amends section 260 to provide that the "... Section does not apply to any contract, agreement or arrangement made or entered into after 27th May 1981." Accordingly, the new provisions totally supersede section 260, which will effectively go out of the statute books in due course.

There is little doubt that some reform of the anti-avoidance provisions of the principal Act was well overdue. None of us can argue against that.

However, the proliferation of specific anti-avoidance provisions which have been inserted on a piece meal and ad hoc basis, in response to the discovery of particular types of tax avoidance arrangements, has been a most undesirable development for all concerned. These specific provisions have generally not been timely, because full details of the various schemes have only become known to the Treasury after the lodgement of tax returns for the relevant year and in some cases, only after further investigation. Obviously, that type of approach has done little to adequately protect the revenue.

The many specific and detailed anti-avoidance provisions have also made things very difficult for taxpayers and their advisers. Although it is apparent that in many situations where some of the provisions should apply, the Commissioner has chosen not to apply them, perhaps because blatant avoidance did not appear to be involved.

Unfortunately, this approach of "selective enforcement" may soon return to haunt the Australian Taxation Office. Take for

example, the "at risk" provisions of section 73CA inserted in 1990 in relation to syndicated research and development ("R&D") schemes. This provision does not appear to have been applied by the Commissioner, despite the fact that financial engineering on the back of "courageous" valuations of core technology (which was 100% deductible), allowed investors in R&D syndicates to earn guaranteed after tax returns upwards of 60% pa. In some cases, the cost to the revenue of the exploitation of these schemes was in excess of 200% of the R&D actually undertaken. It has been estimated that the abuse of the provisions in 1994 fiscal year alone may have cost the revenue some \$635 million. The Auditor-General's Efficiency Audit of R&D in 1993-94 revealed that the Commissioner did not keep records which would track the revenue cost of syndicated R&D, and concluded that monitoring of the scheme was deficient.

It is clear that the supposed strength of section 260 of the Act was significantly watered down by the decisions of the High Court under Sir Garfield Barwick. Such cases as *Mullens & Ors. V FC of T 76 ATC 4288*; *Cridland v FC of T 77 ATC 4538*; and *Kareena Hospital Pty Ltd v FC of T 78 ATC 4516*, served to severely limit the scope and application of the old section 260. However, the blame does not lie entirely at the door of the High Court.

Both the Treasury and the Government have been aware for some considerable number of years that the provisions of section 260 were not sufficiently well expressed to cope with a commercial world which was becoming increasingly sophisticated. One of the clearest warnings was given by Kitto, J. in the case of *FC of T v Newton (1957) CLR at p.496*, where he said:

"Section 260 is a difficult provision, inherited from earlier legislation, and long overdue for reform by someone who will take the trouble to analyse his ideas - and define his intentions with precision before putting pen to paper.

Successive governments and tax administrations ignored this message. They also chose to ignore developments in the United States and Europe in relation to the combating of sophisticated tax avoidance practices. The question of tax avoidance was discussed in detail at the 1965 conference of the International Fiscal Association, when the title of the principal subject for discussion was "*The interpretation of tax laws with special reference to form and substance*". This was a serious and scientific discussion of a problem then perceived to be of some considerable importance. The discussions involved both tax practitioners and tax administrators from around the world, but in those times, the Commissioner did not consider such studies to have any particular merit.

Whilst other western economies were seeking new remedies for the problem of sophisticated tax avoidance, in Australia, the tax authorities continued to

place reliance upon a provision which had become outmoded. The delays in following through with section 260 cases also meant that decisions were not timely (note that in *Cridland's Case*, the first relevant year of income was 1971, but the High Court's judgement was not until 1977).

This lack of timeliness has also bedevilled the interpretation of Part IVA. If anything, the delays have worsened. The case of *FC of T v Peabody 94 ATC 4663*, involving a 1986 transaction, was not finalised by the High Court until 1994. The case of *Spotless*, involving a 1987 transaction, was not decided by the High Court until 1996.

Additionally, it should be said that the Commissioner took on some cases under section 260 that were on the facts, too strongly in favour of the taxpayer. Examples would be *Slutzkin v FC of T 77 ATC 4076* and *Phillips v FC of T 77 ATC 4169*. These cases and others established precedents that were expanded in subsequent cases, where a more objective selection by the Commissioner may not have set such wide precedents.

Later decisions of the Federal Court, such as *Gulland v FC of T 84 ATC 4587*; *FC of T v Greghon Investments Pty Ltd & Ors. 87 ATC 4988*; and *Richard Walter Pty Ltd v FC of T 95 ATC 4440*, indicate that a more objective selection of section 260 cases by the Commissioner in earlier years may have resulted in a more appropriate line of precedents.

Unfortunately for most of those concerned, the new provisions of Part IVA do not appear likely to create good law. The ultimate admonition by Kitto, J. in *Newton's Case* has obviously been ignored in the drafting of the new provisions.

Several elements of the provisions are likely to cause the courts to read down the effect of the new part. The first is the overall uncertainty as to whom the provisions can be applied against.

The second is, that the provisions require objective conclusions to be made (eg., in section 177D(b)), for the Commissioner to form an opinion (sections 177E(1)(b) and 177F(3)), or for the Commissioner to make a determination (sections 177E(1)(c) and 177F(1)). The provisions do not contain comprehensive guidelines as to how these conclusions, opinions and determinations are to be arrived at. It can also be presumed that at least the more recent section 260 cases will not provide any useful guide to these matters, since they relate to principles which the new Part IVA seeks to negate.

In this regard, in the *Spotless Case*, the High Court majority stated that "Part IVA is to be construed and applied according to its terms, not under the influence of 'muffled echoes of old arguments' concerning other legislation."

The third (and perhaps most compelling) element likely to cause the courts to read down the sections is the extremely harsh penalty provided for in section 226. The concept of a 200% penalty being levied in a situation where a full and true disclosure has been made (and where the Commissioner can take his time to contemplate the possible reconstruction of transactions), should not be generally appealing to the courts.

The original oppressive Part IVA penalty regime has been considerably watered down. For the 1993 year of income and later years, the basic penalty rate was reduced to 50% of the relevant tax, or 25% if it is reasonably arguable that Part IVA does not apply. For earlier years, the basic rate was 200%, part of which may be remitted according to guidelines developed by the Commissioner.

It is possible that the Commissioner, in an over-zealous application of his new weapon, could find himself responsible for the creation of bad case law with Part IVA, in precisely the same manner as we saw happen with the old section 260.

In my view, the new sections still do not come to grips with the base problems of tax avoidance. There is no properly identified target, and the remedy provided (that is, a type of reconstruction provided for by section 177F), gives no guidance to the Commissioner as to the action that should be taken to remedy the situation. It also does not require the Commissioner to advise the taxpayer of the action taken. It is this aspect which could lead to difficulties in framing appropriate objections and appeals.

Some of these difficulties that I predicted for the Commissioner were ultimately identified by the High Court in their decision in the case of *FC of T v Peabody 94 ATC 4663*. In this case, the Commissioner targeted the wrong taxpayer and could not properly identify the "tax benefit" that was necessary for Part IVA to apply.

There is no doubt that the problem could have been solved in a much cleaner fashion, without leaving so much to the Commissioner's discretion. Those discretions could prove to be as much a burden as a boon to the Commissioner in his administration of the Act. Certainly, the number of assessments referred to Boards of Review must necessarily increase dramatically.

In fact, the number of appeals going to the Administrative Appeals Tribunal did not increase dramatically. This may have been partly due to the Commissioner not pursuing potential Part IVA cases on a timely and vigorous basis and partly to the "in terrorem" aspect of provisions.

It is also obvious that the Government was well aware of the shortcomings of the new Part IVA, in view of the timing of the amendments to the Acts

Interpretation Act. This amendment seeks to require the High Court to take account of the intention of Parliament when interpreting Federal statutes. Perhaps the Government is trying to force the High Court into adopting a principle along the lines of the concept of "abus-de-droit" known to some European Court systems. That concept works upon the presumption that, no one is entitled to abuse the statutes by relying upon strict interpretations which do not accord with the overall thrust of the law. With respect, the device that is to be employed in the Acts Interpretation Act, is a very clumsy one. As yet, no guidelines have been provided as to what the High Court can have regard to in determining for itself, what Parliament intended.

In the event, the courts have not had much call to rely on the provisions of sections 15AA and 15AB of the Acts Interpretation Act. In general, the judiciary has tended to decline the opportunity of reviewing extrinsic materials where the words of the statute can be interpreted sensibly. *In Marsh & Anor v FC of T*, 85 ATC 4345 at p 4363, Ryan, J. examined the operation of sec 15AA but found it of no assistance. His Honour stated:

"The only sure guide to the intention of Parliament in enacting the legislation is the language which it has used to express that intention. It is required by sec 15AA of the Acts Interpretation Act 1901 that in the interpretation of a provision of an Act a construction that would promote the purpose or object underlying the Act is to be preferred to a construction that would not promote that purpose or object. But that provides no warrant for reading into the language of a provision limitations which are not to be found in it, or for refusing to give effect to the ordinary meaning of a provision by reason of some assumption as to the purpose or object underlying an Act."

Presumably, in making his various determinations, the Commissioner will also need to have regard to the intention of Parliament. That intention may change radically depending upon which political party is in power. In this regard, it is interesting to read the amendments proposed to the provisions of the new Part IVA by the Australian Labor Party. You may recall that Labor sought to insert a *purposive* clause, specifying that in interpreting Part IVA, regard should be had to *the social and redistributive purposes of the Tax Act*. This view would be in conflict with previous statutory and judicial approaches, which have proceeded upon the presumption that tax legislation is strictly related to the raising of revenue.

Of course, the Acts Interpretation Act provisions relate to the intention of Parliament at the time the relevant statute is introduced. Accordingly, to change the intention for the purposes of Part IVA, Labor would have needed to subsequently change the law. Despite gaining office within a

relatively short period and being in power for some thirteen (13) years, Labor did not see the need to amend Part IVA to include their proposed *purposive* interpretation clause.

It is apparent that the new Part IVA is almost entirely a creation of the Treasury. Certainly, the Treasurer has exhibited very little understanding of these matters, and relies almost entirely upon the advice of his Department. Although outside comments were sought (both from independent legal counsel and from the Taxation Advisory Committee), the briefs for advice were limited to the seeking of comments upon legislation drafted within Treasury. Those briefs did not seek any substantive advice on any of the alternative approaches that could have been taken.

The result is tax legislation written by the Commissioner, for the Commissioner. I fear that in practice, the provisions of Part IVA and the associated section 226 penalties will be used as an improper threat on occasions, to ensure that taxpayers structure their affairs to satisfy the Commissioner's concepts of what constitutes an ordinary business dealing.

There is little in the way of documentary evidence to support subsequent claims of the Commissioner using improper threats of the application of Part IVA. Most of the evidence regarding the use of threats is anecdotal. However, in one situation in which the writer was involved, an approach to the Commissioner for an informal ruling was met with a suggestion that Part IVA would apply. When the proposals were implemented (because it was considered that the likelihood of Part IVA applying was remote), the Commissioner subsequently disallowed deductions claimed, but did not seek to invoke the provisions of Part IVA. In the course of the subsequent appeal, counsel for the Commissioner advised the Court that if the assessments were not upheld, retrospective Part IVA determinations would be made and amended assessments issued to the relevant taxpayers.

One of the glaring omissions of the new Part IVA is that no provision is made for a taxpayer to obtain advance rulings in relation to proposed transactions. You must simply suck it and see. If you are wrong, you will suffer the 200% penalty. I must say, all my notions of fair play would lead me to conclude that some independent arbiter should have been provided, when such large arbitrary penalties are contemplated.

This unsatisfactory situation was not properly remedied until the Taxation Laws Amendment (Self Assessment) Act 1992 introduced a system of binding public and private rulings as from 1st July 1992. The legislation governing the public and private ruling systems are contained in Part IVAAA and Part IVAA respectively of the Taxation Administration Act.

The rulings system is a double-edged sword for taxpayers. Although it does provide some element of certainty, acting in contravention of an unfavourable ruling will expose the taxpayer to penalties. An unfavourable ruling can only be overcome by using the objection and appeal provisions. By the time that an incorrect unfavourable ruling is finally overturned, it is likely that the commercial opportunity to which it was intended to apply will have long disappeared. *Peabody* concerned a 1986 transaction - with court and related delays, the issue was not judicially resolved until 1994. *Spotless* concerned a 1987 transaction - it was not resolved until 1996. Delays of eight and nine years respectively. The temptation for the Commissioner to give a negative decision on contentious issues must be overwhelming in some cases.

There is another potential trap for taxpayers. In this regard, see the decision of the Full Federal Court in *CTC Resources NL v FC of T 94 ATC 4072*, where in relation to an objection against a private ruling decision, it was held that an objection or appeal could be rendered invalid by the effluxion of time. The relevant portion of the case headnote states:

"A person will only be 'dissatisfied' in the relevant sense if that person is a person to whom the ruling is still capable of having legal effect. In the case of a ruling relating to a proposed arrangement, that means that the arrangement must be one which, if entered into, will fall within the ruling. If the ruling relates to a year of income which has passed before the appeal is instituted (or perhaps before the appeal has been heard) so that the ruling cannot affect the taxation liability of a putative appellant, that person, no matter how discontented, will not be a 'person dissatisfied'. It follows that the appeal in respect of the first ruling was not validly instituted."

II. Specific Provisions

It should be noted that all of the specific anti-avoidance provisions continue to apply (see section 177B(4)), and that the new Part IVA is intended to be a fail safe, "catch all" provision.

This makes giving advice in relation to income tax law all the more hazardous an occupation. Not only do you have to consider the specific application of sections such as 50C, 80DA, 82KH, 100A and Division 9C (diverted income), etc., but you must now also consider what the intention of Parliament was at the time those sections were introduced.

The courts have subsequently determined that it is only necessary to have regard to extrinsic materials vide the provisions of sections 15AA and 15AB of the Acts

Interpretation Act, when the meaning of the words in the legislation are ambiguous, obscure or leads to a result that is manifestly absurd or unreasonable. As to this, see the joint decision of the Full High Court in *Re Australian Federation of Construction Contractors; Ex parte Billing (1986) 68 ALR 416 at 420*:

" Section 15AB of the Acts Interpretation Act 1901 (Cth), as amended, does not permit recourse to that [second-reading] speech for the purpose of departing from the ordinary meaning of the text unless either the meaning of the provision to be construed is ambiguous or obscure or in its ordinary meaning leads to a result that is manifestly absurd or is unreasonable."

Later, in his decision at first instance in *Peabody v FC of T (1992) 24 ATR 58*, O'Loughlin, J said:

"Such a submission inappropriately assumes that there is, or might be, some difficulty in ascertaining the meaning of the relevant provision; that is not the correct approach because s. 15AB is not to be called in aid unless and until there is a perceived need for assistance. As Hartigan J. said in Case W58, 89 ATC 524 at 533-534 when considering a similar submission in respect of the provisions of Part IVA of the Act:

'I am of the view that the primary source is the statute itself. The words of the statute are plain. I cannot use the Minister's words to displace the plain language of Parliament.'"

If you are able to find your way through those specific provisions relatively unscathed, Part IVA lies in wait to trap you. Therein is another problem. You can't really choose which section you would rather be trapped by. In a situation where, for example, section 82KH might adequately deal with a claim and simply disallow the deduction, there is nothing at all to prevent the Commissioner ignoring that specific provision and seeking to assess under section 177F, imposing the 200% additional tax provided for by section 226.

The amendments to the penalty provisions introduced by the Taxation Laws Amendment (Self Assessment) Act 1992 have overcome the most obnoxious aspects of the former penalty regime. The 1992 provisions introduced the concepts of "reasonable care" and "reasonably arguable", whereby the culpability component of penalties may be reduced to 25%, or even nil.

However, the Commissioner is still entitled to two bites at the cherry. If he chooses to attack a perceived tax avoidance transaction under specific provisions and loses on appeal, he

can nevertheless, still revert to Part IVA by making a determination in terms of section 177F(1) and issuing an amended assessment to give effect to that determination. He cannot revert to Part IVA to defend the same assessment (see *FC of T v Jackson*, 90 ATC 4990).

The CCH commentary on section 177F(1) states, in relation to the *Jackson Case*:

"The Court held that, where the Commissioner has more than one power to assess and, in making an assessment, exercises his power under one section and thereafter seeks to justify the exercise of that power under an assessing power contained in another section, he may be limited to supporting the assessment upon the original ground. The Court held also the Commissioner was required to issue an amended assessment to give effect to a sec 177F determination. It would only be by further amending the amended assessment, the Court said, that the taxable income and tax payable after making the sec 177F determination would remain the same with the consequence that the Commissioner could at the hearing rely on the sec 177F determination. Other reasons noted by the Court for requiring an amended assessment were:

if assessments were not issued, this could impact on the taxpayer's decision to appeal to the Court or proceed to the Tribunal, thus irrevocably affecting the taxpayer's right of administrative review on the merits which the Act plainly intended to provide at the taxpayer's election; and

otherwise the limitation period in sec 177G(1) might not apply uniformly to taxpayers who have been assessed on the basis that the scheme has produced a tax benefit and to taxpayers who have been assessed originally on the wrong basis that the scheme has been ineffective, quite apart from the operation of Pt IVA."

III. Intended Scope

In introducing the new Part IVA, the Treasurer, Mr. Howard, stated in his Second Reading speech that:

"The proposed provisions seek to give effect to a policy that such measures ought to strike down blatant, artificial or contrived arrangements, but not cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of opportunities available for the arrangement of their affairs"

And later, he said:

"In order to confine the scope of the proposed provisions to schemes of the 'blatant' or 'paper' variety, the measures in this Bill are expressed so as to render ineffective a scheme whereby a tax benefit is obtained and on an objective examination, having regard to the scheme itself and to its surrounding circumstances and practical results, leads to the conclusion that the scheme was entered into for the sole and dominant purpose of obtaining a tax benefit."

It is apparent from these comments that the Government's stated intention is to hit primarily at the mass-market type schemes. In the Explanatory Memorandum prepared by the Commissioner, it is stated that:

"The proposed new Part IVA, ...is designed to overcome these difficulties and provide - with paramount force in the income tax law - an effective general measure against those tax avoidance arrangements that - inexact though the words be in legal terms - are blatant, artificial or contrived. In other words, the new provisions are designed to apply where, on an objective view of the particular arrangement and its surrounding circumstances, it would be concluded that the arrangement was entered into for the sole or dominant purpose of obtaining a tax deduction or having an amount left out of assessable income.

That test for the application of the new provisions is intended to have the effect that arrangements of a normal business or family kind, including those of a tax planning nature, will be beyond the scope of Part IVA."

With due respect, Mr. Howard is either less than honest, or ignorant of the facts. Certainly, the words of the new legislation do not accord with either the assertions made by the Treasurer in his Second Reading speech, or with the Explanatory Memorandum quoted above.

This format for presenting tax legislation to the Parliament (which I believe may well have the effect of misleading both Parliament and the public at large), has developed to the stage where, not only do we not consider the matter to be a scandal, but we do not even make a real attempt to challenge the lie. In making this accusation, I am still mindful of the fact that some form of remedial legislation was way overdue.

Ultimately, my view of this misrepresentation of how the new Part IVA actually applied was borne out in the judgement of O'Laughlin, J. in his first instance decision in *Peabody v FC of T (1992) 24 ATR 58*, quoted Hartigan, J's. statement:

'I cannot use the Minister's words to displace the plain language of Parliament.' (emphasis added).

That being said, it should be clearly understood that the Part IVA legislation which we now have, will principally affect the very people the Treasurer, Mr. Howard, claims will not be affected. Make no mistake about it, the determined

tax avoiders have already found ways around the legislation and will no doubt continue to do so. For those people, the increased risks are simply an extra business cost factor to be considered.

My 1981 circumspection in relation to the determination of wealthy tax avoiders has been borne out. Over the last year, with the Government's admission that some 180 of Australia's wealthiest individuals have for many years been using trusts (including foreign trusts or beneficiaries), and other devices to ensure that they are treated as low income earners for tax purposes.

The institutionalised avoidance has not been limited to wealthy individuals. Artificially geared R&D syndication schemes have allowed high-income corporations to rort the tax system for up to \$635 million each year for the five years ending in 1996. Further, the Government recently scrapped the infrastructure bond concessions because applications for scheme registrations indicated a potential 1997 revenue cost of \$4 billion as a result of abuse of the scheme by high-income individuals and corporations.

Of course, it may very well be that deficiency in the provisions of Part IVA is not the problem here. Rather, it may be that taxpayers have entered into such schemes on the strength of "courageous" legal opinions about the scope of Part IVA, and that the lack of transparency involved in the self-assessment system has allowed such schemes to appear as if they are successful. There is a real danger some advisers and promoters have lost sight of the heavy responsibilities that self-assessment implies. With self-assessment, the responsibility does not lie with the Commissioner to inquire as to the true nature of a transaction - it is the responsibility of the taxpayer to make that inquiry for him and self assess accordingly. Even private rulings will not save the taxpayer that has been overly adventurous with their tax planning. It will be interesting to observe the Commissioner's response to recent revelations. It is to be hoped that selective enforcement techniques are not employed.

However, the small to medium businessman and his advisers, are at a distinct disadvantage. Take for example, the husband and wife proprietors of a business in a large country town. If they have a desire to change the vehicle for their business from a partnership to a company or trust, it is my view that you must be able to predicate that the change was principally and primarily motivated by considerations other than those related to income tax. If not, the new Part IVA could very well apply to defeat any tax benefits from that change.

In the case of tax planning involving the diversion of personal exertion income, The Commissioner made his position clear as far back as December 1984, when he issued Tax Ruling IT 2121 in response to the decision in his favour in ***Tupicoff v FC of T 84 ATC 4851***. In that ruling, the Commissioner advised he would seek to apply Part IVA to appropriate situations involving the diversion of personal exertion income to companies and trusts. It disturbs me to note that the message has not got through to many advisers and their clients. Much reliance seems to be put upon the non-disclosure option effectively provided by the self-assessment system.

Of course, personal exertion entities are perfectly valid, in their place. That place is where a business is being carried on by the entity. In that regard, we can contrast ***Tupicoff*** and ***Bunting v FC of T 89 ATC 5245*** (decided in the Commissioner's favour), with ***FC of T v Rippon 92 ATC 4689*** (which was decided in the taxpayer's favour). In ***Rippon***, the trust was actually carrying on business. Although the case was decided under section 260, the issues are relevant to Part IVA. To quote from the CCH head-note in ***Rippon's*** case:

1. The central question for determination by the primary judge was the proper characterisation of the structure adopted, that is, whether the overt acts that were done under the plan were fairly explicable without an inference being drawn that tax-avoidance was a purpose of the arrangement as a whole. Peate v FC of T (1962-1964) 111 CLR 443; (1964) 13 ATD 346 applied.

2. The taxpayer's arrangements could be characterised as having several purposes and effects, some unconnected with tax and some not. It was reasonably open to his Honour to conclude that, in all the circumstances, the arrangements did not on their face bear the stamp of tax avoidance. Accordingly, it was not appropriate to disturb his Honour's finding.

Cases involving the attempted diversion of personal service income have the added complication of section 19. Advisers or their clients should not overlook this issue. In particular, we should be cautious in relation to any requests by employee clients to take advantage of the NSW Supreme Court's decision in ***Vabu Pty. Ltd. v FC of T 96 ATC 4898***. The use of entities to receive income that might otherwise come home to an individual as personal exertion income is most definitely contra-indicated. In this connection, I have been amazed to recently discover that solicitors teaching as visiting lecturers within university law faculties are commonly having their family company or trust invoice the faculty for those services.

In my opinion, such arrangements would not stand the scrutiny of section 19, let alone that of Part IVA.

The Commissioner is presently focussing particularly upon the purported leakage of revenue by income splitting. In December, the Commissioner launched a special "Alienation of Personal Services Income Project", as a precursor to an all out attack on small business tax planning.

In *Spotless*, the High Court specifically rejected the notion that Part IVA only applies where there is a diversion of an existing income stream. The majority said, in response to a submission on behalf of the taxpayer, "... that Pt IVA was not applicable because the present was not a case where the taxpayers had diverted 'an existing income stream' in such a way that it would not attract tax. That may be so but, as will appear, the operation of Pt IVA is not so confined." Accordingly, much care needs to be taken when setting up the structure for a new family business. The non-tax considerations must be, and be seen to be, clearly dominant.

Even the desire to provide superannuation benefits may, in some circumstances, be seen by the Commissioner as being a scheme to obtain a tax benefit, and thus be subject to the provisions of Part IVA. The present attempt to distinguish between legitimate superannuation schemes and those that are supposedly illegitimate, must be of some concern. In this regard, it is understood that the Commissioner will be publishing completely new guidelines relating to superannuation funds in the near future.

Of course, as events have transpired, the taxation and related provisions governing superannuation trusts and contributions to them have undergone momentous changes during the past decade. The changes continue still. The impact of the various changes, involving as they do, rather stringent regulation of the management of superannuation funds, has been to effectively render Part IVA somewhat superfluous in this area.

The new issue that should exercise the mind of taxpayers and their advisers is the legitimacy of salary sacrifice arrangements to boost superannuation contributions. Such arrangements must clear two hurdles. The first and most difficult is section 19. This has always been an issue overlooked by many taxpayers, employers and advisers. Part IVA itself may only be an issue in the most blatant cases of abuse.

The advent of a 15% additional tax on superannuation contributions by or for taxpayers above the \$70,000 threshold will serve to minimise the importance of this issue. However, a related issue is salary sacrifice in favour of fringe benefits.

Fringe benefit packaging has the potential to allow taxpayers to bring themselves below the \$70,000 salary plus superannuation contributions threshold for the 15% additional tax. This whole salary sacrifice/fringe benefits issue is the subject of a current review by the Commissioner and a ruling is expected shortly.

It should also be borne in mind that the onus (section 190) would be very much upon the taxpayer to disprove the Commissioner's determinations under sections 177D and 177F. Having regard to the rather ethereal tests laid down in section 177D(b), this onus is likely to be very burdensome indeed.

The burden of proof issue (now encased in section 14ZZK of the Taxation Administration Act), has subsequently become a matter of considerable importance and difficulty for the taxpayer. The Full High Court's decision in *FC of T v Dalco 90 ATC 4088* reveals just how onerous is the burden on the taxpayer to disprove an unfavourable assessment. In prosecuting his appeals, Dalco found his attempts at first instance to fully argue the quantum and source of his cash flow resisted by Yeldam, J. of the NSW Supreme Court. Yeldam J made some very disparaging gratuitous remarks concerning what he perceived to be the moral and ethical standards displayed by Mr. Dalco. (In the light of facts that subsequently emerged concerning Yeldam J's own moral standards, these remarks might be seen as being particularly intemperate). The fruits of the arguments resisted by Yeldam J. were ultimately required by the High Court. Unfortunately, the grounds of Dalco's appeal from the decision of Yeldam, J. were not sufficiently all encompassing to allow him to properly revisit the quantum issue at the High Court. Dalco was, in the vernacular, up that proverbial creek without so much as a paddle. Ironically, the majority of the Full Federal Court had earlier found that:

"There was no basis for a judgment that in the 1976 tax year, income tax ought to be levied on the taxpayer in the amount assessed." And that "As each of the amended assessments had been made on a similar basis to the 1976 amended assessment, the taxpayer had demonstrated within sec. 190(b) that each of the assessments was excessive and the appeal against each assessment should be allowed."

IV. What Does It All Mean?

Part IVA is expressed to apply where there is a "scheme" (which encompasses almost anything apart from doing nothing) and it applies in addition to any other part of the Act. It applies where, having regard to the eight criteria set out in section 177D(b), it would be concluded, that the scheme was carried out

for the purpose of obtaining a tax benefit in connection with the scheme. In addition, the provisions apply where there has been a scheme of, or in the nature of, dividend stripping, resulting in the deeming of a tax benefit having been obtained.

Where the provisions apply, the Commissioner may in terms of section 177F, determine that an amount shall be included in the assessable income of a taxpayer, or that a deduction shall not be allowable to a taxpayer.

Having made such a determination, the Commissioner is required by the section to take such action as is necessary to give effect to the determination he has made.

If the Commissioner makes a determination in terms of section 177F, there is a mandatory 200% additional tax imposed by section 226(2A), which has been inserted contemporaneously with Part IVA. The only saver is that under the already existing section 226(3), the Commissioner has discretion to remit the additional tax, or any part thereof.

As indicated earlier above, the amendments to the penalty provisions introduced by the Taxation Laws Amendment (Self Assessment) Act 1992 have overcome the most obnoxious aspects of the former penalty regime. The 1992 provisions introduced the concepts of "reasonable care" and "reasonably arguable", whereby the culpability component of penalties may be reduced to 25% or even nil.

“Scheme”

All of the more important definitions are contained in section 177A. However, it could also be argued that section 177D is a definition section without formal definitions. Obviously, the most important definition is that of a real "scheme", which is:

any undertaking, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and

any scheme, plan, proposal, action, course of action or course of conduct;"

including -

" ... a unilateral scheme, plan, proposal, action, course of action or course of conduct, as the case may be."

It should be noted that the definition of "scheme" is exhaustive. That is,

anything which is not encompassed in the specific definition is not subject the new Part IVA. Of course, the definition itself is extremely wide and you may still need to have regard to the effect of the amendments to the Acts Interpretation Act, which may widen the effective definition of "scheme". Of course, on the other hand, it may serve to narrow the definition. We cannot be sure until the first cases are decided.

For all practical purposes, it is probably reasonable to work upon the assumption that any arrangement or action whatsoever, will involve a taxpayer in a "scheme" as defined. However, that is not the real problem. The question is, whether the scheme is one to which the new Part IVA applies.

The first and most relevant exclusion from the provisions is the one in the prologue to section 177D which states that -

"This part applies to any scheme that has been or is entered into after 27 May 1981 and to any scheme that has been or is carried out or commenced to be carried out after that date (other than a scheme that was entered into on or before that date)."

My interpretation of that final exclusion is that if the overall scheme was entered into before the 27th May 1981, it will not be caught by the new Part IVA unless in the operation of the scheme, or in the course of its administration, a new scheme is entered into. In this regard, I subscribe to the overall scheme theory, rather than the theory that every scheme consists of a series of schemes.

By way of explanation, I cannot perceive a scheme (even as so extensively and comprehensively defined), that would involve only a single action. To me, a scheme must necessarily involve a concerted course of action. That is, a number of actions and/or transactions that involve a commencement, a development and an end result.

I find support for this view in the words of Windeyer, J. in *Investment and Merchant Finance Corporation Ltd. v FC of T 70 ATC 4001* where at p.4007, he said, in relation to a section 26(a) matter:

"A scheme presupposes some program of action, a series of steps all directed to an end result."

And later

" ... whatever is done under the scheme or pursuant to the undertaking is done as a means to an end. There may, in one sense, be several transactions, but they are related because all directed to the attainment of the one end, (profit)."

Indeed, the words of section 177D add credence to that view, when they refer to a scheme that has been "carried out", and "entered into". To my mind, those words presuppose an overall plan or course of action, rather than the individual transactions or minutiae of actions that may combine to make up the overall plan or course of action.

Further support for this view can be found in the words of Gibbs, J. (as he then was), in *XCO Pty Ltd v FC of T 71 ATC 4152* at p.455, where he said, again in relation to a section 26(a) matter:

"The word 'scheme' simply means a plan, design or program of action."

In the XCO case, Gibbs, J. found that there was a scheme within a scheme. This was because the scheme of XCO for section 26(a) purposes was a profit making scheme. That scheme was separate from the overall scheme engaged in by other parties who were intent upon utilising the losses in the object company, Kenneth Wright Pty Ltd. However, this does not detract from the principle that I believe is involved. That is, a scheme relates to something overall: a plan; a design; or a course of action. It required continuity, it requires a beginning, a development and an outcome. A single action by itself could never, in my view constitute a scheme, whether for the purpose of the new Part IVA, or for any other purpose.

Thus I would, in principle, dismiss the argument raised in the CCH commentary just published, at p.48,470, where the editors state -

"... the wide definition of scheme may mean that something done after that date (ie., 27 May 1981) in the course of implementation of the arrangement may be a scheme;"

However, having said that I should emphasise that where a pre 27th May 1981 scheme is in existence, extreme care will need to be taken to ensure that a "new" scheme is not introduced and which may impugn the old existing scheme.

Section 177A(3) seeks to extend the definition of scheme to include a scheme or course of action that is taken unilaterally by a taxpayer. It is difficult to imagine how in practical circumstances, one could enter into a scheme or course of action, on a unilateral basis. Presumably, in seeking to introduce the concept of a unilateral scheme, the Commissioner has had regard to the possibilities, which exist for gifting, for trust arrangements with common trustees and such like.

Subsequently, the Commissioner began to focus upon the separate scheme thesis. In *Peabody*, the Full Court of the Federal Court took the view that it was not open to the court to take one step of a series of steps and classify it as a scheme in itself. Per Hill J (Ryan and Cooper JJ agreeing):

*"Where, as a matter of fact, a scheme consists of a series of steps or a course of action, the Commissioner may not isolate out of that course of action one step and classify that as a scheme. Reference in Pt IVA to 'part of a scheme' suggests that where a series of steps constitutes a scheme, that whole series of steps is to be considered. Further, the Full Federal Court was of the view that since the Commissioner exercised **his** discretion to make a determination under section 177F(1), it was not possible for the Commissioner (or the Court) to later substitute some other scheme in order to defeat the taxpayer's defence. The Commissioner then argued that the provisions of Part IVA cover not only a scheme, but any part of a scheme."*

Further, the Full Federal Court was of the view that since the Commissioner exercised **his** discretion to make a determination under section 177F(1), it was not possible for the Commissioner (or the Court) to later substitute some other scheme in order to defeat the taxpayer's defence. The Commissioner then argued that the provisions of Part IVA cover not only a scheme, but also any part of a scheme.

The High Court's response to this proposition was that Part IVA does not provide for a scheme to include part of a scheme. They pointed out that part of a scheme does not necessarily involve a "scheme" as defined. It seems that if the circumstances (of a part of a scheme) are incapable of standing on their own, without "*being robbed of all practical meaning*", it is not possible to say that the part of a scheme actually constitutes a "scheme" as defined. It may be that in some cases there will be a series of schemes involved in an arrangement, but each must involve "*...some program of action, a series of steps all directed to an end result.*", to be a "scheme" as defined.

Peabody emphasises the importance for the Commissioner of identifying not only the scheme but also the taxpayer who receives a tax benefit as a result of the scheme being entered into. In *Spotless*, the High Court did not see the need to add anything further to the discussion of what constitutes a "scheme" as defined.

I also find it difficult to accept another argument raised by the CCH editors at p.48,374 of their commentary. Here they suggest that a taxpayer who chooses to become a non-resident of Australia, could be caught by the new Part IVA, because the decision to emigrate would be a unilateral scheme with principally a tax avoidance purpose. At first blush, that argument could appear to be persuasive. But, even taking into account the application of the new provisions with "paramount force", I cannot see how Part IVA could over-ride sections

25(1) and 23r, which are basic to the whole question of the scope and application of the Act.

To my knowledge, neither CCH, nor the Commissioner nor anyone else for that matter, raised this particular red herring again.

In my view, once a taxpayer becomes a non-resident of Australia and so arranges his affairs that he derives only ex-Australian source income, it can never be predicated that an amount might otherwise have reasonably been expected to be included in the assessable income of that taxpayer. It is beyond my comprehension to understand how the new Part IVA could apply in those circumstances. There would be no nexus upon which an Australian revenue liability could be based. Further, I cannot conceive of the provisions applying, where a taxpayer so arranges his investment portfolio that a substantial part of his income is earned from ex-Australian sources and is subject to the exemption provided by section 23(q) of the Act.

In neither of those cases could any reasonable man conclude that those particular amounts could "reasonably be expected to have been included, in the assessable income of the taxpayer ...".

The taxpayer in *Spotless* relied heavily upon a form of the above argument. Of course, in *Spotless*, the taxpayer arranged his portfolio so there was only one investment and the decision could not be regarded as commercially reasonable unless the anticipated tax break provided by section 23(q) was factored in. The tax break in that case was not supplemental, it was crucial to the proposal. Without it, a different investment decision would no doubt have been made.

The High Court's "*reasonable person*" analysis in *Spotless* is not difficult to understand. This was not an "at risk" investment where the taxpayer was choosing between portfolio investments of uncertain ultimate return, where it would be more difficult for a "*reasonable person*" to postulate, what if? It was a fixed interest investment. Without factoring the tax break, it was always going to be a simple matter to predict what the interest income on an \$A deposit was going to be. I believe the fact that that taxpayer chose a complex investment with a commercial return 4% less than that otherwise available on a simple bank deposit in Australia, was a fatal flaw in the proposal.

Some commentators have criticised the High Courts "*reasonable expectation*" test as applied in *Spotless*. I have no such difficulty. The taxpayers were, on their own admission, determined to place the \$A40 million in short-term investment. Unless the taxpayers were prepared to place their

funds at interest in foreign currencies, the applicable market rates of interest available for the period contemplated, would be within a narrow band. Given that *Spotless* was a public company whose business was primarily conducted in A\$, it would have been prudent for any alternative foreign currency investment to be hedged. The cost of hedging would have brought the net interest return back within the \$A narrow band of interest rates available. Whichever way the taxpayer turned, he was faced with a clearly identifiable amount that could "reasonably be expected to have been included, in the assessable income of the taxpayer...".

On the other hand, what if the taxpayer had been somewhat less greedy? What would have been the outcome had they invested in an \$A account with the Hong Kong branch of an international bank, at the prevailing rates of interest for bank deposits? At that time, Hong Kong interest tax of 10% would have been payable, and the section 23(q) exemption would have been triggered. Would Part IVA have applied in those circumstances? In my opinion, it would not have. But we will need to later look at the issue of "dominant purpose", to see why not.

"Taxpayer"

"Taxpayer" is defined in section 177A(1) to include "a taxpayer in the capacity of a trustee". Sub-section (2) specifies that the definition "shall not be taken to affect in any way the interpretation of that expression where it is used in this Act other than this Part". Since Part IVA can only apply to a "taxpayer", it is important to appreciate what the term "taxpayer" means and to resolve what are the wider implications of the use of the word "taxpayer" throughout the new part.

Section 6(1) defines a taxpayer to mean "a person deriving income". The immediate question that comes to mind is if a person never derives income, how can the new part apply to the income he never derives? I just throw that in as an interesting point of semantics.

The real problem that will face the Commissioner, is to decide which taxpayer is the one which might have been expected to receive the income. In this regard, individuals are not the only taxpayers. Companies are taxpayers and trustees can be taxpayers. The problem of pinpointing the correct taxpayer will be extremely difficult for the Commissioner in many instances, particularly where for example, a new business has been commenced.

The taxpayer identification aspect became one of the major issues to haunt the Commissioner in *Peabody*.

I have no doubt that where a new business is commenced, that business can be

commenced in whatever structure may be the most appropriate. However, a great deal of care should be taken to ensure that the business is commenced in that appropriate structure, from the inception.

A note of caution should be sounded here. It is not clear whether the High Court has implied a "but for" test in relation to Part IVA. If it is that the "*reasonable person*" is expected to have full regard to the Privy Council's advice in *Newton v FC of T (1958) 11 ATD 442*, it may be that new business structures which were "*implemented in that particular way so as to avoid tax*" will fall foul of Part IVA.

In this connection, it must be remembered that in *Spotless*, the High Court specifically rejected the notion that Part IVA only applies where there is a diversion of an existing income stream. The majority said, in response to a submission on behalf of the taxpayer, "... *that Pt IVA was not applicable because the present was not a case where the taxpayers had diverted 'an existing income stream' in such a way that it would not attract tax. That may be so but, as will appear, the operation of Pt IVA is not so confined.*"

"Tax Benefit"

A "tax benefit" in relation to a scheme, is defined in section 177C. In a rather long winded fashion, the section defines a tax benefit to be equivalent to the amount of income not included in a taxpayer's assessable income, which it could be predicated might otherwise have been included if the scheme had not been entered into, or equivalent to the amount of the deduction allowable, which it could be predicated might not otherwise have been allowable if the scheme had not been entered into.

Once the taxpayer has been identified and it is established that he has (or would have) obtained a tax benefit in relation to a scheme, the Commissioner may (in terms of section 177F) take whatever action he considers necessary to bring income to account, or to disallow deductions. It should be noted that even if the Commissioner is of the opinion that the new Part IVA be applicable, he is under no obligation to apply section 177F or the penalty provisions of section 226.

In these circumstances, the new Part IVA is likely to be used as a threat more often than it is actually applied. The possibilities for misuse by overly aggressive taxation officials are readily apparent. The Commissioner can choose whether or not to apply the provisions and in fact, could choose to apply it against "X" in exactly the same circumstances as he chooses not to apply it to "Y". That situation does not appear to be very satisfactory in any respect.

It also appears that there is no way in which "X" could even gain the

satisfaction of requiring the Commissioner to accord "Y" the same treatment in identical circumstances. In that regard, the recent House of Lords decision in *IRC v National Federation of Self Employed & Small Businesses Ltd* is of great interest. Quoting from CCH's Federal Tax Reporter Bulletin 429 -

"For many years the casual employees of English newspapers had evaded tax by using false names when drawing their wages. The English revenue authorities became aware of the situation and eventually negotiated a compromise under which the workers submitted tax returns for the two previous years and agreed to comply with the law in future in return for which the revenue gave them an "amnesty" from all other back taxes. The National Federation of Self-Employed and Small Businesses Ltd claimed that the revenue had acted unlawfully in making the arrangement and sought a declaration to that effect and an order to compel the revenue to assess and collect tax on the casual workers as required by law.

Their Lordships - overturning a decision of the Court of Appeal - held in favour of the revenue. The revenue was genuinely acting in the care and management of taxes and the agreement was within its powers. In addition, tax legislation requires total confidentiality of assessments and negotiations between individuals and the revenue, and a taxpayer has no right (express or implied) to inquire about, or challenge, another taxpayer's tax; and a group of taxpayers has no greater right."

The position continues to be unsatisfactory. There is anecdotal evidence that the provisions are being applied selectively. It is possible that Part IVA is a weapon most often used against what might be described as "middle class" taxpayers. If the taxpayer is a large public company engaging in a blatant, contrived and artificially geared R&D syndication scheme, or an ultra-wealthy individual utilising an offshore trust strip structure, is it less likely that the Commissioner will exercise his discretion to give effect to Part IVA?

V. What Does It Catch?

It is clear that the new Part IVA only operates where there is a "tax benefit", obtained in connection with a scheme. A tax benefit relates to the non-inclusion of amounts in assessable income, or a deduction being allowable.

In *Peabody*, the High Court emphasised (at p.4670) that:

"... the question in every case must be whether a tax benefit which the Commissioner has purported to cancel is in fact a tax benefit obtained in connection with a Pt IVA scheme and

so susceptible to cancellation at the discretion of the Commissioner."

And at p.4671 that:

"There is no reason to suppose, and the Commissioner was unable to demonstrate, that, had the devaluation not taken place and had that profit been made by Loftway, it would have flowed, or could reasonably be expected to have flowed, to TEP Holdings and hence to Mrs. Peabody in the year ended 30 June 1986."

The "reasonable expectation" test has featured in the High Court's decisions in both *Peabody* and *Spotless*. In *Peabody*, (at p.4671) the High Court said:

"A reasonable expectation requires more than a possibility. It involves a prediction as to events which would have taken place if the relevant scheme had not been entered into or carried out and the prediction must be sufficiently reliable for it to be regarded as reasonable."

The claiming of a rebate is not prima facie caught by the new part. Of course, that does not detract from the need to ensure that any rebate proposal conforms to the requirements of the particular provisions concerned. In this regard, a "sham" transaction bears the risk of collapsing, in any event.

It is likely that some forms of income diversion will not be caught. In the case of a discretionary trust, it may be difficult to predicate in which potential beneficiaries' hands the income might reasonably have been expected to be included.

This problem appeared for the Commissioner in *Peabody*, but the High Court did not find it necessary to consider the specific of discretionary trust beneficiaries. In this regard, at p.4671/4672, the court said:

"...there was no reasonable expectation that Loftway would have declared dividends which would have reached the Peabody Family Trust in that year of income."

Hill, J. in his majority judgement in the Full Federal Court (*93 ATC 4104*), went closer to addressing the discretionary trust issue, but again, he did not need to directly consider the question. He said at p.4117:

"The hypothesis that if the scheme had not been entered into or carried out, the purchaser would have been TEP Holdings Ltd

is, in my view, one that can properly be described as unreasonable or irrational. The only expectation, on reasonable grounds, that can be formed is that a corporation would have been the purchaser and that TEP Holdings Ltd, a trustee, would not have been. Accordingly, if the scheme had not been entered into or carried out, it could not reasonably be expected that any amount would, in the year of income, have been included in the assessable income of Mrs Peabody or any of the other two beneficiaries in the Peabody Family Trust, arising to them under the provisions of s. 97 of the Act."

The only specific exclusions provided for, are where income is not included, or a deduction is allowed, as a result of the taxpayer making a declaration, election, selection, notice, or option, which is expressly provided for by the principal Act. However, in sections 177C(2)(a)(ii) and 177C(2)(b)(ii), a taxpayer is precluded from taking advantage of the declaration, election, etc., if he enters into a scheme for the purpose of creating the circumstances or state of affairs necessary to enable the declaration, election, etc., to be made.

Thus, it would appear from the wording of these sections, that you can only take advantage of an election, etc., by falling into the relevant circumstances, rather than by ensuring that the appropriate circumstances arise. An example could be the case of a section 36A election on the formation or variation of a partnership. It would seem that under Part IVA, the new partnership must come about in the normal course of business. If it could be shown that the **participants sought to create** the partnership primarily for the purpose of spreading a sales profit over several additional taxpayers by using the section 36A election, the scheme to take advantage of the election would likely be caught by the new Part IVA. This would have the result that the effect of the election could be negated at the Commissioner's discretion.

Of course, the reference "the participants sought to create" above reflected the author's own difficulty in fully coming to grips with the new provisions and his unwillingness to give up the notion of the subjective tests such as the intention of the parties. As had been recognised elsewhere in the original paper, it is only the conclusion of a "reasonable person" that is relevant, because the analysis of section 177D is purely objective.

*The taxpayer in **Spotless** could not validly raise the declaration/election issue in defence, because section 23(q) does not fall within any of the option type actions indicated. However, they did make the submission - "that Part IVA was not applicable because the present was not a case where the taxpayers had diverted 'an existing income stream' in such a way that it would not attract tax."*

As indicated previously, the majority of the High Court in

Spotless has now specifically rejected this "existing income stream" argument.

It is clear that the proposed effect of these sub-sections is to effectively limit the old choice principle that applied under section 260. In the circumstances, it is difficult to contemplate the manner in which these particular aspects will finally operate. Certainly, no real guidance can be gained from the Treasurer's comments in his Second reading Speech, where he said:

"But I do assert that taxpayers who simply take advantage of concessions for the purposes for which they were put in the law cannot and will not be affected by the new provisions.

Specifically, for example, Part IVA will not deny to people who simply respond to our concessions for investment in Australian films the benefit of the tax advantages that are part of those concessions.

But I think it incontrovertible that blatant misuse of those and other 'incentive' concessions ought to be within the scope of Part IVA."

The High Court in *Spotless* has confirmed that the so called choice principle is no longer applicable. In the words of the majority:

"Part IVA is to be construed and applied according to its terms, not under the influence of 'muffled echoes of old arguments' concerning other legislation."

Later in the same paragraph, the majority specifically referred to the famous dictum of Lord Tomlin in *Inland Revenue Commissioners v Duke of Westminster (1936) AC 1 at p.19* that -"everyman is entitled if he can to so order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be". In this passage his Lordship rejected the Revenue's submission that legal form should be disregarded in favour of "the substance of the matter". Judicial embellishment of this statement in Australia, eventually helped bring about the effective demise of the old section 260. The High Court majority stated in relation to Lord Tomlin's obiter dicta, that:

"His remarks have no significance for the present appeal. Part IVA is as much part of the statute under which liability to income tax is assessed as any other provision thereof. In circumstances where 177D applies, regard is to be had to both form and substance (s 177D(b)(ii))."

7-12. These paragraphs in the original paper dealt with the dividend stripping provisions contained in section 177E. The mischief against which this section was directed has largely been neutralised by the repeal of the old Division 7 sufficient distribution provisions, and the introduction of dividend imputation. Indeed, the section has not been the subject of any dispute heard by a court or tribunal since its introduction. Accordingly, the discussion originally reflected in these paragraphs has not been revisited.

VI. The Predication of Section 177D

The matters laid down in section 177D(b), and which are to be taken into account in deciding whether any person (not necessarily the taxpayer), entered into or carried out a scheme, for the purpose of enabling the relevant taxpayer to obtain a tax benefit from the scheme, are as follows:

(i) the manner in which the scheme was entered into or carried out;

(ii) the form and substance of the scheme;

(iii) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;

(iv) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;

(v) any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;

(vi) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme;

(vii) any other consequence for the relevant taxpayer, or for any person referred to in subparagraph (vi), of the scheme having been entered into or carried out; and

the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in subparagraph (vi),

These matters would not, considered separately, be of outstanding significance, except perhaps for the question of form and substance. However,

when taken together, the facts which come to light when the questions are put, are likely to give a fair indication in most instances, of the primary purpose of any relevant scheme or plan.

The High Court in *Spotless* focussed upon the question of form and substance when they dismissed the taxpayer arguments regarding the old choice principle. See above - "*In circumstances where 177D applies, regard is to be had to both form and substance*".

No doubt there will be some grey areas, but in most cases it should be possible to observe the weight of the facts one way or the other. One thing is for certain, professional advice in relation to the financial affairs of clients will now need to be framed in much more careful terms. This will particularly need to be the case where reorganisations, etc., are involved. It is probably not necessary to ignore all reference to the income tax implications of any recommended course of action, but it would be most advisable to make any advice in relation to taxation aspects a very minor part of the relevant advice.

The High Court found no great difficulty in observing the relative weight of the facts in making its decision regarding the operation of Part IVA in *Spotless*. It should be noted that the court did not find it necessary to consider all (or even a majority), of the criteria set down in section 177D(b). Ultimately, they focussed only upon the first three of the criteria.

On the issue of the relevance of each of the section 177D criteria, Lockhart, J. in his first instance decision in *Peabody*, said (at p.4597), that:

"..before the powers in s. 177F can be utilised, regard must be had to the eight matters that are set out in paragraph 177D(b). I do not consider that there must be a finding that is adverse to the taxpayer in each of eight inquiries; it will be enough if the presence of one is sufficient to bring about the conclusion that is contemplated in the last part of the section."

In reviewing the evidence, the High Court in *Spotless* and the Federal Court in the more recent case of *CC (New South Wales) Pty Ltd v FC of T 97 ATC 4123*, have given some significant attention to the decision making process of the taxpayers and their advisers. The apparent dominant preoccupation of the decision makers with taxation issues, rather than with business or commercial issues, does appear to have been a factor in the court's decision in each case.

In considering whether the scheme was entered into for the purpose of obtaining a tax benefit, section 177A(5) provides that where a scheme is

entered into with more than one purpose, the relevant purpose will be the dominant purpose.

It is my view that the "*purpose*" or "*dominant purpose*" test is pre-eminent. By that I mean if the facts suggest a clear purpose of obtaining a tax benefit that intention is likely to overwhelm an argument that there would otherwise be no reasonable expectation of an amount being included in assessable income. The very words "*reasonable expectation*" envisage a weighing up of the facts by an objective observer. In my opinion, the conclusion reached by the High Court on this issue in *Spotless*, was clearly open to it on the facts.

In this regard, the majority of the High Court in *Spotless* said that:

"The eight categories set out in par (b) of s 177D as matters to which regard is to be had 'are posited as objective facts'. That construction is supported by the employment in s 177D of the phrase 'it would be concluded that ...'. This phrase also indicates that the conclusion reached, having regard to the matters in par (b), as to the dominant purpose of a person or one of the persons who entered into or carried out the scheme or any part thereof, is the conclusion of a reasonable person. In the present case, the question is whether, having regard, as objective facts, to the matters answering the description in par (b), a reasonable person would conclude that the taxpayers entered into or carried out the scheme for the dominant purpose of enabling the taxpayers to obtain a benefit in connection with the scheme."

VII. Penalties/Defences

1-7 This section has now been omitted because the substantive problems foreseen in relation to the mandatory 200% penalty provisions have, in the main, been addressed. Initially, by the issue by the Commissioner of several rulings outlining scales of penalties for various transgressions, and subsequently (as indicated above), by amendments to the penalty provisions introduced by the Taxation Laws Amendment (Self Assessment) Act 1992.

VIII. Applicable Precedents

If any precedent cases decided before the Introduction of Part IVA are to have any bearing upon the interpretation of that new part, it is likely that the classical section 260 case of *Newton v FC of T (1958) 11 ATD 442* will be to the forefront. The Privy Council said in this case, at 11 ATD p.445:

"In order to bring the arrangement within the section you must be able to predicate - by looking at the overt acts by which it was implemented - that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax, then the agreement does not come within the section."

In this brief paragraph, their Lordships enshrined both the "predication" test and the "ordinary business or family dealing" test. This last test was also considered by the High Court in *Hancock v FC of T (1961) 12 ATD 312*, where Kitto, J. said, in relation to the overt acts by which a particular arrangement was implemented:

"If those acts are capable of explanation by reference to ordinary dealing, such as business or family dealing, without necessarily being labelled as a means to avoid tax, the arrangement does not come within the section (*ie.*, section 260). An example would be a simple sale or gift of shares, even though the motive of the seller or donor may have been to avoid receiving future dividends and incurring the liability to income tax which the receipt of them would have entailed."

It is likely that these two tests will regain prominence as aspects of the new Part IVA are litigated. However, it is possible that it will take several decided cases before discernible principles become evident. Unfortunately, in the meantime, uncertainty may prove to be costly for some taxpayers.

Uncertainty has indeed proved costly for those taxpayers whose advisers placed store in the words of the then Treasurer and the Commissioner when Part IVA was introduced. They may well have fared better had they heeded the plain words of the new provision and of the Privy Council and High Court (as quoted above). One might venture the opinion that the "overt acts" of the taxpayer in *Spotless* would not have passed the "predication" or "ordinary dealing" tests espoused in the *Newton* and *Hancock* cases.

The decisions in the *Newton* and *Hancock* cases have not in fact been referred to in the High Court's decisions in either *Peabody* or *Spotless*. However, they are in the writers view, a most useful guide to the way in which the objective "purpose" tests of section 177D(b) actually operate.

Apart from *Newton's Case*, there do not appear to be any precedent principles which would provide substantive assistance in trying to decide, in what situations the result of a consideration of the eight criteria in section 177D(b) will result in a conclusion that there was a dominant tax avoidance purpose.

Without judicial assistance, it is not really possible to foresee the relative weighting's of each of the matters to be considered, with any degree of authority.

The "predication" test in *Newton's Case* was effectively formalised into Part IVA by the inclusion of the eight criteria of section 177D(b), which are to be "*posited as objective facts*". The "ordinary dealing" test was supplanted by the "purpose" test of section 177D(b), as expanded by the definition in section 177A(5). In the *Peabody* and *Spotless* cases, the High Court has confirmed the importance of the new "predication" and "dominant purpose" tests of Part IVA. The "predication" test is actually a sub-set of the "dominant purpose" test, and both are to be determined as being the conclusion of a mythical "reasonable person" considering the eight criteria, be "*posited as objective facts*".

My own predication is that there are three matters, out of the eight criteria set down in section 177D(b), which will rise to eventual prominence, these are:

(i) the manner in which the scheme was entered into or carried out;

(ii) the form and substance of the scheme;

.....

the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;"

Basically I suppose, we are in practice likely to move back to the old "smell test". It only remains to be seen whether the High Court agrees with my view.

When I made my March 1997 presentation to the Tax Institute's Goulburn Discussion Group, I made the observation that my original suggestion of a "smell test" had been translated by the High Court as the conclusion of a "reasonable person".

Later that month I attended the Taxation Institute's 13th National Convention in Melbourne. The opening keynote speaker was Michael Carmody, the current Commissioner of Taxation. In seeking to set out a "rule of thumb" for determining when Part IVA might apply, he said:

*"After giving a speech on the implications of the *Spotless* decision, one of my colleagues was asked by someone in the*

audience for a simple test he could apply in reviewing arrangements. My colleague suggested that he apply the 'smell test'".

As to my ultimate comment above, I believe that I can take some comfort that my very early predictions as to the true scope and effect of Part IVA have been fairly close to the mark, at least so far as the High Court's determinations have so far indicated. Of course, I have in the interim lost a significant amount of advisory work to accounting and legal advisers who elected to take a more courageous approach and give arrangements that do not pass the "smell test", their imprimatur. Many such courageous opinions were justified by reference to the comments in then Treasurer's Second Reading Speech and the Explanatory Memorandum accompanying the Bill introducing Part IVA.

The advisers who gave such courageous opinions (at least until the decision in *Spotless*), bring to mind the Earl of Gloucester in Shakespeare's *King Lear*, against whom Lear cries (in Act IV, Scene VI):

"Get thee glass eyes; and like a scurvy politician, seem to see things thou dost not."

IX. Where To Now?

The logical point on which to finish up this topic, is to consider what the future of tax planning might be. The first, and perhaps the most important consideration, is that artificial schemes, and sophisticated planning is now only suitable for the type of client who has the fortitude to withstand the rigours of an attack by the Commissioner, including any drawn out court contests.

This fortitude will be required on two fronts - the first and most important is strong nerves - the second is adequate finances to meet the tax demand if necessary, but still have the monetary reserves to carry on the fight.

Professional advisers will need to take a great deal more care in future, not only in choosing the appropriate tax plan, but also in choosing the appropriate clients to introduce to those plans. A client who gets cold feet part way through the implementation of a plan or any subsequent dispute, will be more trouble to the adviser than their fee is worth.

In making these comments, I am presupposing that tax minimisation proposals will continue to be made available to the marketplace by those with fertile minds. These suppositions are made with the advantage of experience in recent weeks. A number of plans are in fact presently being developed. However, the new generation of plans will, by and large, be more expensive

than they have been in the past. They will also likely be offered by a smaller number of promoters. Indeed, in Sydney, many of the so called "tax consultants" selling tax schemes are already back selling used cars or life insurance.

I believe that in the coming years, you will see a movement toward investment planning for clients, whereby a proportion of their available funds will again be directed to investments which provide capital gains, rather than income, or which have some other inbuilt tax effect. The recent removal of overseas equity investment limits will serve to accelerate this trend.

As an indication of the areas that might be involved in this regard, many clients will become involved in gold mining, primary production, afforestation, real estate and film schemes. In addition, a proportion of the investment portfolio of a number of taxpayers will be committed to overseas business projects.

My predictions as to the future for tax planning appear to have been borne out by developments over the past 15 years. Of course, the introduction of capital gains tax in 1985 and the several intervening recessions have somewhat taken the shine off the holding of assets for their capital gain value. However, primary production, afforestation and film schemes have flourished with relatively little hindrance by the Commissioner.

Surprisingly, the art of financial engineering has very much come to the fore. I say surprisingly, because many of the heavily geared deferral based schemes would not appear to fare particularly well when measured against the objective tests set down in section 177D(b). Some, such as the R&D syndication schemes involving tax free sinking funds created on the back of courageous core technology valuations, would appear to fall foul of the specific provisions of section 73B, even before the possible application of Part IVA is considered. Indeed, more than one of the syndications that I have reviewed would have difficulty in avoiding categorisation as a sham, since the commercial outcomes nominated are in fact little more than warpaint. Most of the investors in those schemes fully expect to access the sinking funds set up to provide the relevant financial guarantees upon which the schemes were sold. The same can be said for many "guaranteed" return film production services schemes

Medium to long term planning for clients should now concentrate more forcefully upon the increasing of net wealth, rather than upon the maximisation of net annual income.

On the question of appropriate structures for new businesses, I have been

recommending trusts as a vehicle for a number of years now, on the basis that all of the important advantages of incorporation can be achieved, without many of the disadvantages. I think that this advice is even more appropriate in the light of the new Part IVA. There is no doubt in my mind, that minimisation opportunities will continue to be evolved for trusts.

The advantages that trusts then held over corporate structures for normal tax planning, have been somewhat reduced over the past 15 years. The introduction of special tax rates for infant beneficiaries, the introduction of dividend imputation and the reduction of the corporate tax rate have all contributed to a balancing of the scales. Further, the asset protection benefits of trusts have been judicially eroded in the Family Law and Testator's Family Maintenance jurisdictions.

Some trust stripping schemes continued post Part IVA. However, legislative responses such as the *Trust Recoupment Tax Assessment Act 1985*, have tended to somewhat inhibit such adventurous tax planning. Although offshore trust strips may still be effective if properly structured, their efficacy must be considered to be limited to particular types of clients involved in short term business activities in Australia.

X. Conclusion

Spotless not only confirms that the anti-avoidance provisions of Part IVA have teeth, but also that the High Court is quite prepared to draw together its convoluted and unwieldy structure so as to ensure that those provisions work as intended.

An important issue to remember is that the evidence and war-paint of the taxpayer, or any other person who entered into the scheme, may not be particularly relevant to the question of whether "*one of the persons, who entered into or carried out the scheme did so for the purpose of enabling the relevant taxpayer to obtain a tax benefit*". The test of section 177D is purely objective, and is to be the conclusion of the mythical "*reasonable person*".

Who is this mythical "*reasonable person*"? Lord Justice Greer, in *Hall v Brooklands Auto Racing Club [1933] 1 KB 205, 224*), suggested that it could be "*the man in the Clapham omnibus*". A quaint turn of phrase to be sure, but is it relevant to Australian tax law in the 21st century? Since it is clear the majority of the Full Federal Court got it wrong in their decision at second instance in *Spotless*, one might postulate for the purposes of Part IVA, that the only reasonable person qualified to determine the issues would be a judge of the High Court! However, I do not think the issue is quite so difficult. Like any other question of fact, the matter involves a weighing of the evidence and the coming to a rational or reasonable conclusion, uninhibited by prejudices. After all, every day we leave the determination of momentous issues of fact to

lay juries. The members of those juries are no different to "*the man in the Clapham omnibus*".

That leads us to the question, what is a "*dominant purpose*". The High Court has provided an important insight into how that question should be answered. The majority said, "*Much turns upon the identification, among various purposes, of that which is 'dominant'. In its ordinary meaning, dominant indicates that purpose which was the ruling, prevailing or most influential purpose.*" At an earlier point, they said, "*A person may enter into or carry out a scheme, within the meaning of Part IVA, for the dominant purpose of enabling the relevant taxpayer to obtain a tax benefit where that dominant purpose is consistent with the pursuit of commercial gain in the course of carrying on a business.*" Later, they commented, "*A particular course of action may be,, both 'tax driven' and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine the answer to the question of whether, within the meaning of Part IVA, a person entered into or carried out a 'scheme' for the 'dominant purpose' of enabling a taxpayer to obtain a 'tax benefit'.*"

Some commentators have expressed surprise at the High Court's comments on the commerciality issue. They seem to have been under the misapprehension that the mere nominal commerciality of a scheme would act as a shield against the application of Part IVA. Indeed, I understand a number of opinions of learned counsel have fallen into this trap. Perhaps they were lulled into a false sense of security by the comments of the then Treasurer in his Second Reading Speech at the time the provisions were introduced. Remember the Treasurer said that the measures should "*.. not cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of opportunities available for the arrangement of their affairs.*"

However, it should be remembered that the "*ordinary family or business dealing*" test of *Newton's Case* (to which the Treasurer referred with approval in his speech), did not preclude the application of the old section 260 to a commercial situation. If we look carefully at the words of Lord Denning in that case, we can see that section 177D(b) enshrines the concept. Denning said, "*In order to bring the arrangement within the section you must be able to predicate - by looking at the overt acts by which it was implemented - that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without being labelled as a means to avoid tax, then the arrangement does not come within the section.*" Nothing in this statement suggests that mere commerciality should prevent the application of section 260.

Commerciality does have a role. It need not even be the dominant purpose, but it must, when taken together with other purposes, be such that there is no room for a conclusion that there was a dominant purpose of obtaining a tax benefit. Let me set out an example.

Assume investors are invited to consider the merits of investing in a "tax effective" syndicate. They will be likely compare the features of the proposals with competing public investment products. There will be numerous packaged investment products that could be considered to be "competitive", in what might generally be categorised as partly secured and partly at risk investments. Investment in some of those products will involve favourable tax implications, as a collateral advantage. If it could be concluded that it is this collateral advantage "... which provided the key to the whole transaction and gave it its particular commercial attraction", as in *Spotless*, Part IVA is likely to apply to the transaction.

However, what if individual investors in the subject syndicate have no input into the manner in which the proposals are carried out, the form and substance of the investment structure, or the length of the period for which the investment proposals are to run. They invest in a pre-packaged proposal offered by way of prospectus, on a "take it or leave it" basis. If they are otherwise indifferent between the commercial attractions of syndicate proposals and some or all of any competing investments, it may be that a perceived more favourable tax outcome of one proposal as against the others, could tip the scales toward the investment product with that more favourable tax outcome. A decision to choose a more tax efficient investment over an investment of otherwise equivalent expected commercial outcomes, would not appear to fall within the ambit of the guidelines that the High Court appears to be setting out in *Spotless*.

In my opinion, that would be consistent with the objective of Part IVA, because the "dominant purpose" is still based in commerciality. The perceived "tax benefit" is purely supplementary. This is why I earlier expressed the opinion that the taxpayer in *Spotless* would have succeeded if they had done no more than deposit A\$ in Hong Kong at prevailing commercial interest rates. By taking the convoluted route that they did, and losing 4% on the deal from a commercial perspective, they clearly demonstrated a deficiency of commerciality.

In his "Practitioner Article" on *Spotless* in the 13 December issue of CCH's "Tax Week", Associate Professor Stephen Barkoczy concluded: "*Part IVA should be limited to only apply where the obtaining of a tax advantage is the 'key' to the whole transaction. It is submitted that this restricted reading can be applied to the Full High Court decision and should be adopted by the Commissioner in his practical application of the Pt IVA provisions.*" I believe that Professor Barkoczy's conclusion is appropriate.

To conclude, having regard to the guidance now given by the High Court in relation to the way that Part IVA operates, we must expect that the Commissioner will seek to target cases in which he can use the provisions to unwind many arrangements entered into by business taxpayers. Some of those attempts may involve testing the envelope - to see just how far he can go. As advisers, we will need to be vigilant, particularly in the course of managing any audit where it is suspected that Part IVA could become an issue.

The documentation (including professional opinions), surrounding or supporting any business plan or structure involving significant taxation efficiencies, should be given particular attention. All parties associated with the taxpayer, should properly understand the commercial and other reasons for choosing a particular business structure or form of transaction, and the arguments as to why those factors outweigh any tax considerations.

END