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The Tax Adviser's Guide to Part IVA

A practical guide to the application of the general anti-avoidance rule

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CHARTERED ACCOUNTANTS & ADVISORS

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Foreword

Part IVA of the *Income Tax Assessment Act 1936* (Cth) is Australia's general anti-avoidance rule (or GAAR as it is known in its acronym form). For that reason alone, it assumes a level of importance within the legislative framework of our tax system greater than most, if not all, other parts. Its perceived success or failure in cancelling the efficacy of those tax avoidance schemes to which its provisions are directed goes to the integrity of the tax system itself.

While Pt IVA has been amended from time-to-time to enlarge the scope of tax benefits to which it applies by amendments to s 177C, and to enlarge the types of schemes to which it applies by the insertion of ss 177EA and 177EB, it has, until last year, stood in the Assessment Act largely in the form it was introduced over 30 years ago.

Last year, Pt IVA was amended with a view to remedying what were perceived by Treasury and the Australian Taxation Office to be deficiencies in its application following decisions of the courts concerning the construction of its provisions and the application of those provisions so construed to the facts of those cases. Only time will tell whether these changes serve their intended purpose or whether, as some think, merely create even greater uncertainty.

Because of Pt IVA's role (as a general anti-avoidance provision) and the manner in which it has been administered in the past, its history over the last 30 years has not been without controversy. Part IVA in its original form has only been considered by the High Court on four occasions, and s 177EA on one occasion. This is not truly reflective of the controversy it has created, which I have no doubt will continue into the future.

With the advent of the changes made last year and the consultative process that was involved with these changes, it is not surprising that the number of Pt IVA cases coming before the courts over the last two years has dropped significantly. The tide has gone out so to speak but, as with the phases of the moon, there is no reason to think that it will not come back in.

There can be no doubt that Pt IVA has been highly successful in ridding the community of blatant artificial and contrived tax avoidance schemes, particularly those of the mass-marketed kind, and its success at that level is to be applauded. The controversy that Pt IVA has created lies outside that field, in the area where views will inevitably differ as to whether the scheme wears the badge of being blatant, artificial or contrived. The inherent uncertainty thereby created will continue the controversy going forward.

This work is not a book which is to be read from cover to cover. Rather, it is, as its opening pages strive to emphasise, a practical work designed to provide assistance to tax professionals who are called upon to advise their clients, day-in day-out and week-in week-out, on the application of Pt IVA to a myriad of situations, many of which will not have been the subject of any factual similarity in any anterior jurisprudence, to enable them to distil from that jurisprudence the principles that should determine the tenor of their advice.

It is certainly not intended as a substitute for a client or his professional adviser obtaining expert advice in a particular case, but it is designed to assist the professional adviser in guiding his client and setting him in the right direction. To the extent that it achieves that result, it will certainly serve its purpose. The labours and endeavours of the author in producing this fiscal aid are to be applauded and The Tax Institute is to be congratulated for lending its support to that cause.

As a tool of trade in a difficult area of statutory construction and application, it will hopefully provide a sounder path to overcome the traps that lie in wait for the unwary.

Justice Richard Edmonds
Federal Court of Australia
February 2014

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About the author

Greg is the director in charge of the Tax Services Division of William Buck Sydney. Greg's clients are predominantly private businesses, both Australian and foreign-owned, as well as higher wealth individuals and families. The work undertaken by Greg includes advising on issues and transactions such as restructuring, exit strategies, business acquisitions and international expansion, along with referrals from accountants, lawyers and other advisers.

About the publisher

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Australian Taxation Office

Unless specifically referenced to an Australian Taxation Office publication, the views expressed in this book are not endorsed by the Australian Taxation Office.

Preface

A key aim of mine in writing this guide is to de-mystify Pt IVA for general practitioners.

Part IVA is a fundamental part of our tax system, although one that many practitioners don't really understand in any detail. It is a provision that impacts every tax decision, every bit of planning, every piece of structuring, yet so often, practitioners don't know where to start when assessing the potential impact that Pt IVA could have. My objective, through this guide, is to provide practitioners with a robust, practical framework within which to approach Pt IVA issues.

This guide is different to the existing material that has been published on Pt IVA in that I have specifically set out to explain Pt IVA in a straightforward and understandable manner. The guide is intended to be practical, not technical, in its focus. It is also very much focused on the private business/SME taxpayer.

The recent amendments to Pt IVA have created a high level of uncertainty as to how Pt IVA will be applied in the future. It will be many years before we receive guidance from the courts on how to interpret the new provisions. In the meantime, practitioners need to gain an understanding of the new provisions and how to apply them on a day-to-day basis. The likely approach of the ATO also needs to be understood and factored into how a Pt IVA issue is dealt with.

Over time, as our understanding of Pt IVA develops and evolves, I expect that this guide will also develop and evolve with the aim of continuing to provide practical and relevant guidance to tax practitioners dealing with tax issues for private business/SME taxpayers.

Greg Travers
William Buck
February 2014

Abbreviations

ATO	Australian Taxation Office
CGT	Capital gains tax
FBT	Fringe benefits tax
GST	Goods and services tax
ID	ATO interpretive decision
ITAA36	*Income Tax Assessment Act 1936 (Cth)*
ITAA97	*Income Tax Assessment Act 1997 (Cth)*
PAYG	Pay as you go instalment
PSB	Personal services business
PSI	Personal services income
PS LA	ATO law administration practice statement
SME	Small-to-medium enterprise
TD	ATO taxation determination
TR	ATO taxation ruling
UPE	Unpaid present entitlement

Section 1

A practical approach to Pt IVA

Part IVA of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) is a difficult provision, but it is also a provision that affects every taxpayer and applies in a broad range of circumstances. So, while it may be difficult, it is a provision that every tax adviser needs to understand.

There is no substitute for a full and detailed understanding and consideration of the terms of Pt IVA. However, since practitioners need to consider Pt IVA many times over the course of any day spent working on tax-related matters, a more general understanding and a practical way to approach Pt IVA are needed.

Beyond the smell test

The general anti-avoidance rule, both in its current form (Pt IVA) and its predecessors (eg s 260 ITAA36), has been colloquially referred to as "the smell test". The basic premise, if it is even necessary to explain, is that, if an arrangement "smells", then it would be struck down by the general anti-avoidance rule.

By "smell", it is meant smell of tax avoidance, ie there are features or aspects of the arrangement that give it the look and feel (and smell) of something that should be caught by the tax avoidance provisions.

In other instances, the question may be posed as to whether a taxpayer would enter into the scheme "but for" the tax benefit.

These shorthand methods are crude, but probably reasonably effective, approaches when dealing with the "blatant, artificial and contrived" set of arrangements that Pt IVA seeks to attack. If Pt IVA was limited to applying to blatant, artificial and contrived arrangements, then the smell test in its various incarnations may be sufficient, but Pt IVA is not limited in this way.

As transactions move into the grey area between legitimate tax planning and illegitimate tax avoidance, having a more detailed mechanism for assessing the application of Pt IVA is required.

A practical approach

This section of the guide provides a practical approach to the understanding and application of Pt IVA. The focus is on the key elements — scheme, tax benefit and purpose — with each being considered in a structured way:

- a worksheet and accompanying instructions are provided to assist in identifying the Pt IVA scheme;

- a series of flowcharts can be used to navigate through the process of determining the tax benefit; and
- a checklist of questions drawn from the case law is provided to enable an analysis of purpose to be undertaken and documented.

Also included in this section are two additional checklists:

- "red flags" drawn from the case law that may indicate a higher risk of Pt IVA applying; and
- "established positions" drawn from the case law and ATO rulings that can provide clearer direction on how Pt IVA may be applied.

Finally, commentary is provided on steps that can be taken to assist in mitigating the risk of Pt IVA being applied to deny a tax benefit.

Limitations of the practical approach

It is important to keep the practical approach in context.

A practical approach is appropriate at the advisory stage of most SME taxpayer matters. The aim is to accurately identify if there is a genuine Pt IVA risk so that an informed decision can be made on whether to proceed as planned, obtain further advice, or modify the transaction.

Once a situation enters the "dispute" phase, ie audit, objection or appeal, at some point the focus will need to shift from a practical approach to Pt IVA to a technical approach.

This will clearly be the case at the appeal stage, but it could also be earlier, particularly if the taxpayer is of a mind to appeal an adverse decision made by the ATO.

> A practitioner who does not have experience in dealing with Pt IVA should look to involve a specialist tax adviser with relevant Pt IVA experience in matters that are in (or are likely to enter) a dispute phase.

Chapter 1

Approaches to applying Pt IVA

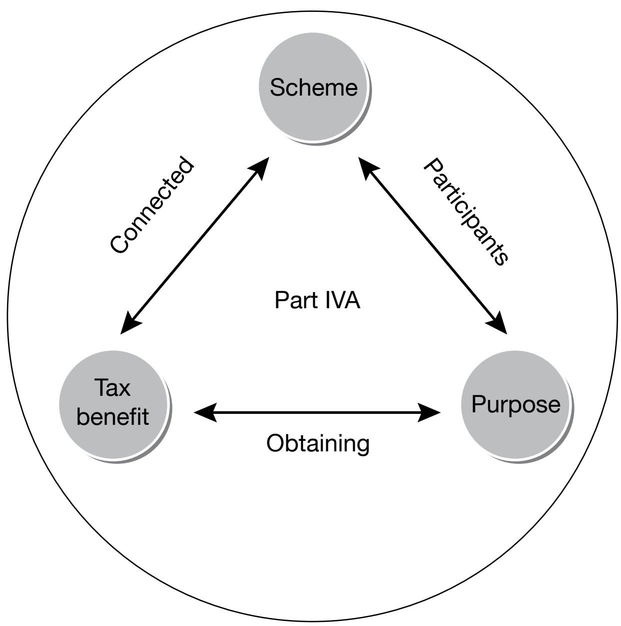
¶1-100 Part IVA as a whole

An inquiry or analysis as to whether Pt IVA applies to a situation is a holistic one — it needs to approach Pt IVA as a whole, rather than just a series of discrete questions.

There are three key elements of Pt IVA: scheme, tax benefit and purpose. They should be considered in an interdependent way.

Part IVA only applies if a tax benefit arises in respect of a scheme and a reasonable person would conclude, based on the eight factors in s 177D ITAA36, that the sole or dominant purpose of a participant in the scheme was to obtain the tax benefit for the taxpayer.

Scheme, tax benefit and purpose are the three elements that combine in s 177F ITAA36 to enable the Commissioner to make a determination to deny a tax benefit. Section 177F is the key section in Pt IVA. Scheme, tax benefit and purpose are the prequalifiers for the operation of s 177F.



¶1-105 Recent amendments

Effective from 16 November 2012, Pt IVA was substantially amended in response to perceived issues with regard to how Pt IVA was being applied by the courts.

First, it was perceived that the process for identifying the alternative postulate (to calculate the tax benefit) had been interpreted as permitting a broad-ranging inquiry into what might reasonably be expected to have happened absent the scheme.

The inquiry was unconstrained by the factors that needed to be considered when testing purpose (ie the eight factors in s 177D) or the limits of what it is that the scheme has achieved. It was viewed as an open-ended inquiry into what, if anything, the taxpayer might reasonably have done if it had not participated in the scheme.

The government considered that, from a policy perspective, the operation of Pt IVA as a general anti-avoidance provision would be better served if the inquiry focused on whether or not there were other ways in which the taxpayer might reasonably have achieved the substance and effect (tax implications aside) that it achieved from the scheme. That inquiry would assist in exposing the purposes of the participants in a scheme, and prevent taxpayers (who achieve substantive non-tax effects from a scheme) from avoiding the normal tax consequences of what they have actually done by arguing that they would have done something completely different, or done nothing at all (the so-called "do nothing counterfactual").

Second, an alternative course of action could be held to be unreasonable on the basis that the tax costs involved in undertaking that action would have caused the parties to do nothing, including deferring or abandoning a wider transaction of which the scheme was a part.

Again, from a policy perspective, having identified a postulate that is in other respects functionally substitutable for the scheme, it was thought to be undesirable to consider the tax consequences of that postulate to be a basis for disregarding it as unreasonable. To do so would be to allow the normal tax consequences of what it is that the taxpayer has achieved to function as a shield against the operation of Pt IVA.

Third, modifications were made to the existing provisions with the intent of placing the question of purpose at the centre of the Pt IVA analysis (or at least confirming its position at the centre of the analysis).

Last, a change was made to specifically identify two different bases for determining the tax benefit.

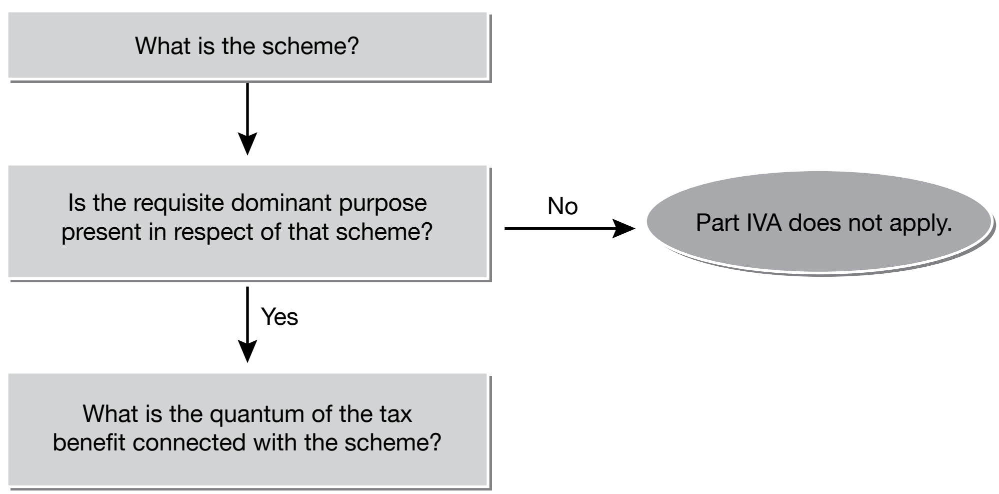
It will be some years before these amendments are tested in the courts.

Debate may continue on the need for these amendments and whether the amendments actually implement the policy objectives in an appropriate way, but focus will increasingly need to turn to applying the amended legislation to real transactions.

¶1-110 The preferred method: a purpose-based approach

One of the intentions behind the recent amendments to Pt IVA was to make a "purpose-based" approach to applying Pt IVA the appropriate approach to use. This is certainly the approach that the ATO and parliament are indicating they prefer. This purpose-based approach would involve considering the following steps:

- Step 1: What is the scheme? There will always be a scheme of some description.
- Step 2: What would a reasonable person consider to be the dominant purpose of participants in the scheme? Is it to obtain a tax benefit for the taxpayer? This is the key question.
- Step 3: If the requisite dominant purpose is present, what is the quantum of the tax benefit connected with that scheme?



Whether this approach is actually what is provided for by the legislation will ultimately be a question for the courts.

It would seem difficult to determine the question of purpose without actually understanding what the tax benefit is, as the purpose needs to be the obtaining of that tax benefit. But what the purpose-based approach does is put the question of purpose at the centre of the Pt IVA analysis and largely stops (or is intended to stop) the question of tax benefit from creating an "exit point" from the application of Pt IVA.

It is important to understand the purpose-based approach. If you are looking to take a practical approach to applying Pt IVA, the more you can structure your practical approach in accordance with the way that the ATO will approach the same situation, the better you will be able to identify the higher-risk cases. The ATO is clearly going to be focused on the question of purpose.

¶1-115 Alternative method: a tax mischief-based approach

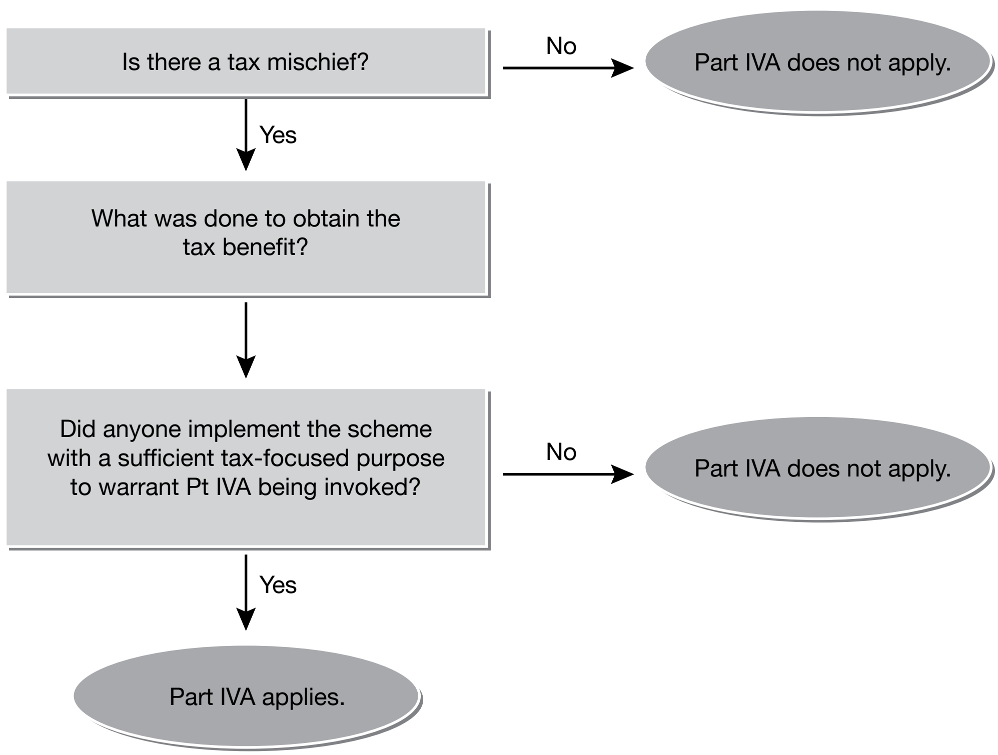
A similar but different approach is a tax mischief-based approach.[1] This method focuses on the intent behind Pt IVA, rather than (necessarily) the words of the legislation. From a practical perspective, this method can be a useful way of approaching many Pt IVA questions.

The tax mischief-based approach is based on the view that the essential task of Pt IVA is to prevent the obtaining of a fiscal (tax) outcome which is inappropriate to the commercial or personal transaction being undertaken. When approaching the potential application of Pt IVA, the perspective of the tax auditor should be adopted, essentially by asking three questions:

(1) Is there a tax mischief and, if so, what exactly is it? What outcome needs remedying? (This is the tax benefit.)

(2) What was done to obtain the tax benefit? (This is the scheme.)

(3) Did anyone implement the scheme with a sufficient purpose of procuring the tax benefit to warrant Pt IVA being invoked? (This is the dominant purpose.)

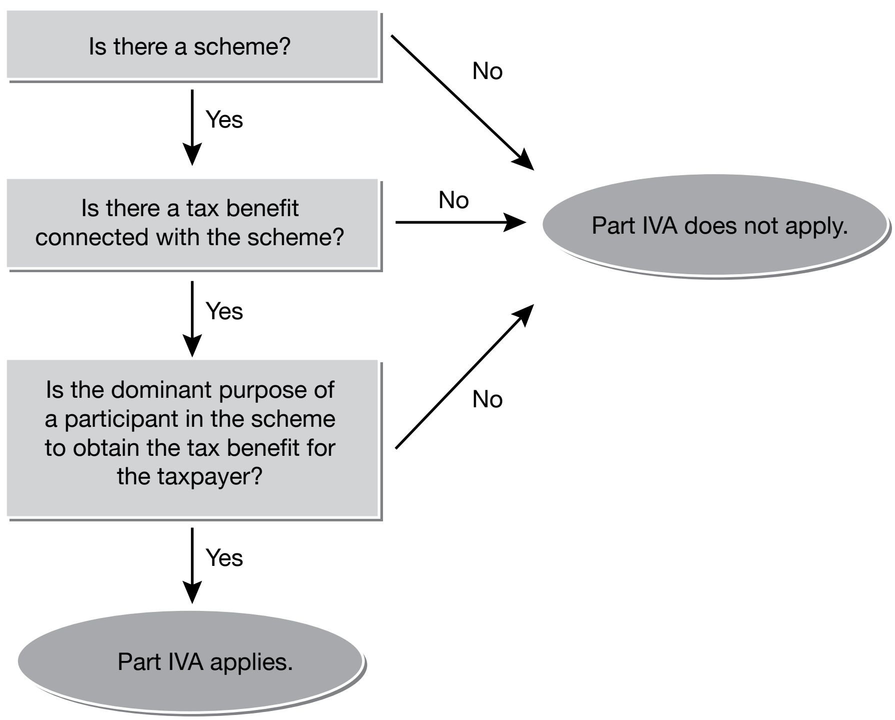


1 AH Slater, Part IVA reform paper, National Division, The Tax Institute, 13 March 2013.

¶1-120 The old method: a tax benefit-focused approach

Prior to the recent amendments, the consideration of scheme, tax benefit and purpose had become focused on the identification of a tax benefit and, only after this, the consideration of the question of purpose. This approach is essentially a linear one:

- Step 1: Is there a scheme? If not, Pt IVA does not apply.
- Step 2: Is there a tax benefit in connection with the scheme? If not, Pt IVA does not apply.
- Step 3: Is the requisite dominant purpose present in respect of the tax benefit in connection with the scheme? If not, Pt IVA does not apply.



Approached in this way, scheme, and more commonly tax benefit, become "exit points" in Pt IVA. If there is no tax benefit, as defined, Pt IVA does not apply even if the dominant purpose of participants in the scheme was to obtain for the taxpayer the tax advantages of the scheme.

Whether the tax benefit-focused approach is right or wrong (and it is submitted that this approach is probably consistent with the way that the legislation is drafted), it is clear that the ATO and parliament do not believe that this is the appropriate way to approach the application of Pt IVA.

According to Gummow and Hayne JJ in *Hart's* case:[2]

> "Although it will often be convenient to begin any consideration of the application of the Part by attending to the operation of these elucidating and definitional provisions, approaching a particular case in this way must not be allowed to obscure the way in which the Part as a whole is evidently intended to operate.
>
> Taking Pt IVA as a whole, it is clear that ss 177D ITAA36 [purpose] and 177F(1) ITAA36 [determination] are the two provisions about which the Part pivots ..."

Whichever approach you use, the key points are:

- make the focus of the analysis the question of purpose; and
- don't treat the tax benefit as an exit point from Pt IVA (other than the s 177C(2) ITAA36 exclusion).

2 *FCT v Hart* [2004] HCA 26 at [36]-[37].

Chapter 2

Methodology for a practical approach

¶2-100 Introduction

This chapter sets out the structured methodology that can be used to analyse the application of Pt IVA in a robust but practical way.

¶2-105 Identifying the scheme in practice

The following discussion provides a structured process for identifying the likely scheme to be considered in a Pt IVA analysis.

Overview of the key aspects of the concept of scheme

"Scheme" is one of three key elements in Pt IVA — the others being tax benefit and purpose. The definition of "scheme" is broad and most situations will fall within the definition. The existence of a scheme of some description will rarely be in question.

The Commissioner is entitled to put his case in alternative ways. He can propose multiple schemes or variations in the way that the scheme is to be construed in a particular case.

As a matter of practice, the Commissioner will generally (but not always) identify a broad scheme covering the overall transaction and a narrow scheme focusing on the particular steps that produce the purported tax benefit.

The recent amendments to Pt IVA may require the Commissioner to be more specific about the scope of the scheme that he is relying on. This is because of the way that the concept of scheme is now integrated with the concept of tax benefit in the new s 177CB ITAA36.

The relevant questions will always be whether the tax benefit that is the subject of the Pt IVA determination is a tax benefit obtained in connection with a scheme, and whether the requisite sole or dominant purpose exists in respect of participants in that same scheme.

"Scheme" for the purpose of Pt IVA should be seen as the context within which the analysis of purpose occurs. The broad scheme sets the outer boundary of this context, and the narrow scheme sets the inner boundary. Purpose is assessed objectively, based on the facts and circumstances within this context and by reference to the persons who are involved with all or part of those circumstances.

A practical approach to identifying the scheme

When taking a practical approach to identifying the scheme, the key points to remember are:

- there will almost always be a scheme of some description; and
- you are aiming to identify the key steps that give rise to the particular tax treatment that produces the tax benefit.

The process is as follows:

(1) list in chronological order each step in the transaction/situation under consideration. This is the "overall arrangement";

(2) identify the type of tax benefit(s) that would be considered to be arising from the transaction/situation (don't worry about quantifying it at this stage), including:

   (a) assessable income (ie a reduction in assessable income);
   (b) deduction (ie an additional deduction arising);
   (c) capital loss (ie a capital loss being incurred);
   (d) loss carry-back tax offset (ie an increase in the amount of a loss carry-back tax offset);
   (e) foreign income tax offset (ie an amount of tax being paid overseas for which a credit can be claimed in Australia); and
   (f) withholding tax (ie an amounting ceasing to be subject to withholding tax); and

(3) categorise each step in the overall arrangement based on its relationship to the tax benefit:

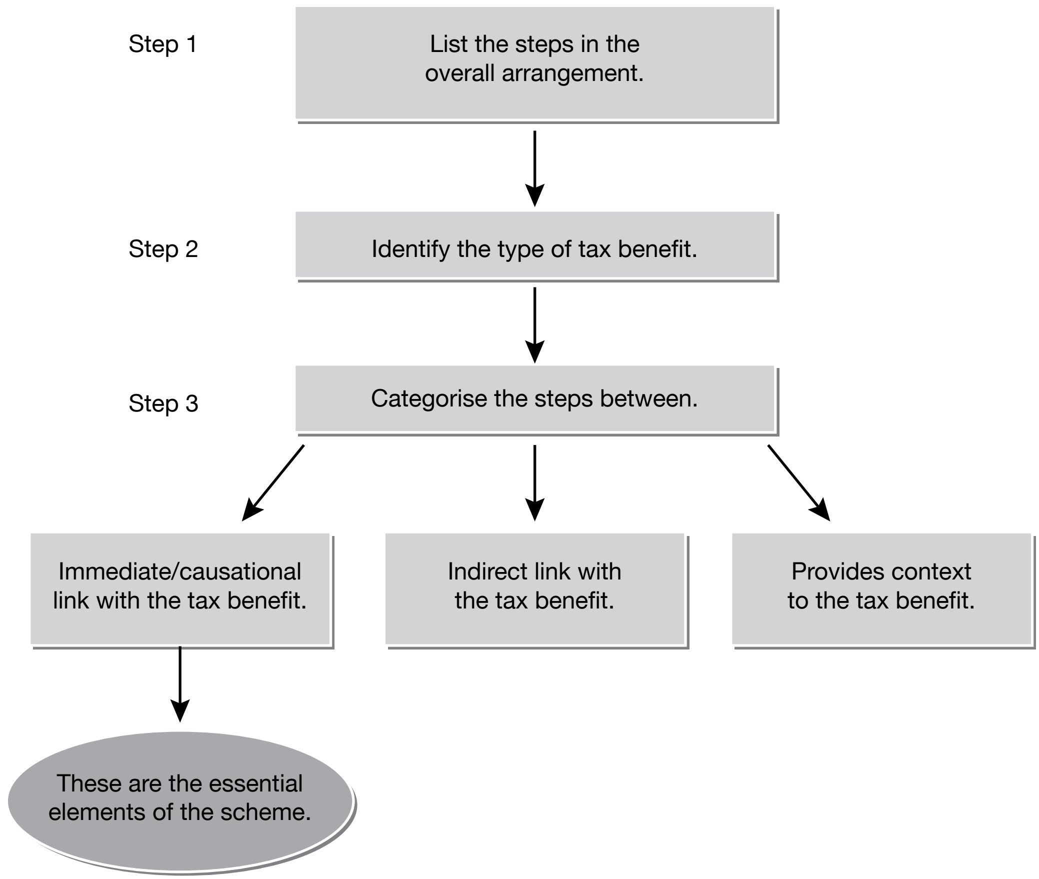
   (a) direct (ie this step has an immediate/causational relationship with the tax benefit);
   (b) indirect (ie this step relates to the tax benefit, but not directly); and
   (c) context (ie this step doesn't cause or indirectly relate to the tax benefit but provides context to the overall arrangement).

The scheme is likely to be those steps which have an immediate/causational relationship with the tax benefit. These are the essential elements of the scheme.

Don't treat the identification of the scheme as an exit point from Pt IVA. View it as providing context within which to assess the relevant dominant purpose and quantify the tax benefit.

The exact parameters of a scheme can be difficult to determine in some cases. Often, the dominant purpose will be the same, regardless of whether a narrowly defined or broadly defined scheme is used.

Focus your analysis on the question of purpose. If you are concerned about the definition of the scheme, repeat the analysis of purpose, once for a narrow scheme and then again for a broader scheme.



The following worksheet will assist you in identifying and documenting the key elements of the Pt IVA scheme, as well as determining the participants in the scheme (which will be relevant when assessing the question of purpose).

Identifying the scheme							
What is the type of tax benefit?	Assessable income Deduction Capital loss Loss carry-back Foreign income tax offset Withholding tax						
List the steps in the overall arrangement	**Allocate the steps between:**			**Identify the active participants in each step:**			
	Immediate/caustional link with the tax benefit	Indirect link with the tax benefit	Provides context to the tax benefit	Taxpayer	Associated party (specify	Adviser (specify)	Other party (specify)
	These steps are the essential elements of the scheme.						

¶2-110 Determining the tax benefit

Key aspects of the concept of tax benefit

Whether a taxpayer has obtained a tax benefit in connection with a scheme is an objective fact rather than a matter of opinion.

When looking at the tax benefit element of a Pt IVA analysis, the initial focus should be an inquiry as to the type of tax benefit that is purported to arise. There are six types of tax benefits that Pt IVA can be applied to:

(1) decreases in assessable income;

(2) increases in allowable deductions;

(3) increases in capital losses;

(4) increases in loss carry-back tax offset;

(5) increases in foreign income tax offsets; and

(6) decreases in withholding tax liabilities.

Using assessable income as an example, a tax benefit can arise when:

- the whole of an amount is not included in assessable income in a particular income year due to the scheme; or
- part of an amount is not included in assessable income in a particular income year due to the scheme.

Note that it can be the whole or part of the amount and the assessment is made in respect of a particular income year. Once the type of tax benefit is determined, the exclusion in s 177C(2) ITAA36 should be considered.

The exclusion from the concept of tax benefit applies where, in broad terms, the impact on the position of the taxpayer (eg the non-inclusion of an amount in assessable income) is attributable to a choice provided for under the tax laws. This is a fairly narrow exclusion and is the principal instance where tax benefit is an "exit point" from Pt IVA.

On the basis that the s 177C(2) exclusion does not apply to the tax benefit, the subsequent Pt IVA analysis will then focus on the quantification of the tax benefit (s 177CB ITAA36). To work out the amount of the tax benefit, the tax position arising for the taxpayer under the scheme is compared with the tax position that would have arisen, or might reasonably be expected to have arisen, if the scheme had not been entered into.

There are two alternative bases for quantifying the tax benefit.

The first approach is based on an alternative postulate that *would have* occurred if the scheme had not been entered into. This is referred to as the annihilation approach. To apply this approach, the steps comprising the scheme are ignored and the tax position is calculated on what remains.

The annihilation approach works most appropriately where the non-tax effects of the scheme are limited (or non-existent) and the taxable income that would otherwise be subject to tax is derived independent of the scheme.

Based on the approach of the courts to date, it is expected that the annihilation approach will have fairly limited application. However, there are indications that the ATO may look to broaden the situations when this approach is sought to be applied, particularly to deduction-type tax benefits.

The second approach is the reconstruction approach. Under this approach, the tax benefit is based on an alternative postulate (counterfactual) that *might reasonably be expected* to have occurred if the scheme had not been entered into. There is a level of prediction involved.

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.

When identifying the reasonable alternative postulate, particular regard must be had to the substance of the scheme and the results and consequences of the scheme (other than tax results) for the taxpayer. If a scheme achieves certain non-tax results for the taxpayer, the presumption is that the alternative postulate should achieve similar non-tax results.

Prior to the recent amendments, an argument raised by taxpayers was that, absent the scheme, they would not have undertaken any transaction and so no tax benefit (as defined) would arise. This was referred to as the "do nothing" counterfactual. The recent amendments (the presumption that the alternative postulate should achieve similar non-tax results) will effectively negate the ability to use a "do nothing" counterfactual in all but a very limited set of circumstances.

When assessing if an alternative postulate is reasonable, the tax consequences are ignored. While this may appear to make the process quite artificial, the intention behind the requirement is clear: a taxpayer cannot argue that an alternative postulate is unreasonable based on the fact that it results in more tax being payable than under the scheme.

A practical approach to determining the tax benefit

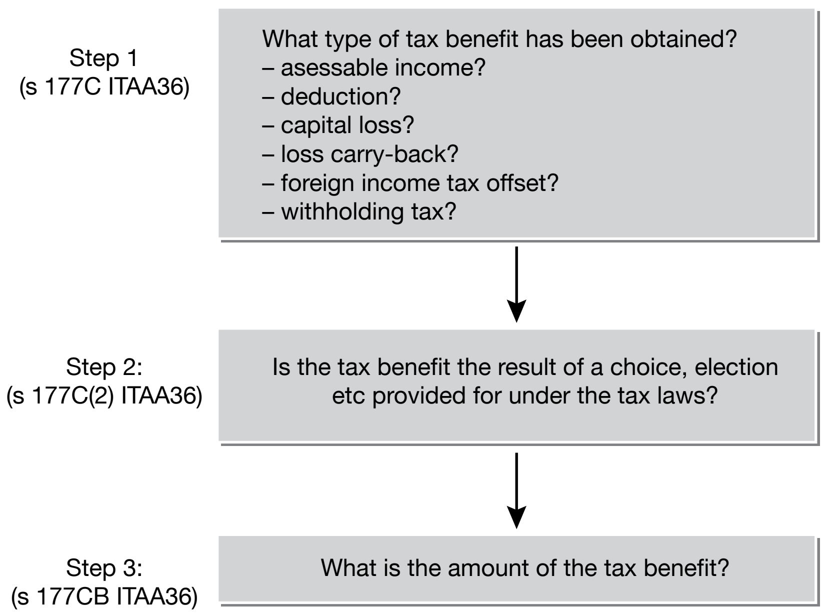
Having identified the scheme, the next step is to determine the tax benefit in question. It is useful to do this before considering the question of purpose (even though the purpose-based approach to Pt IVA may suggest otherwise), as the alternative postulate used to quantify the tax benefit can also be relevant when assessing purpose.

The tax benefit element of Pt IVA can be approached in three steps:

(1) identify the type of tax benefit;

(2) assess whether the s 177C(2) exclusion applies; and

(3) quantify the tax benefit.



Identify the type of tax benefit

This has been undertaken as part of identifying the scheme.

Assess whether the s 177C(2) exclusion applies

Having identified the type of tax benefit, the next question is: does the tax benefit arise due to an election, choice etc specifically provided for under the tax laws?

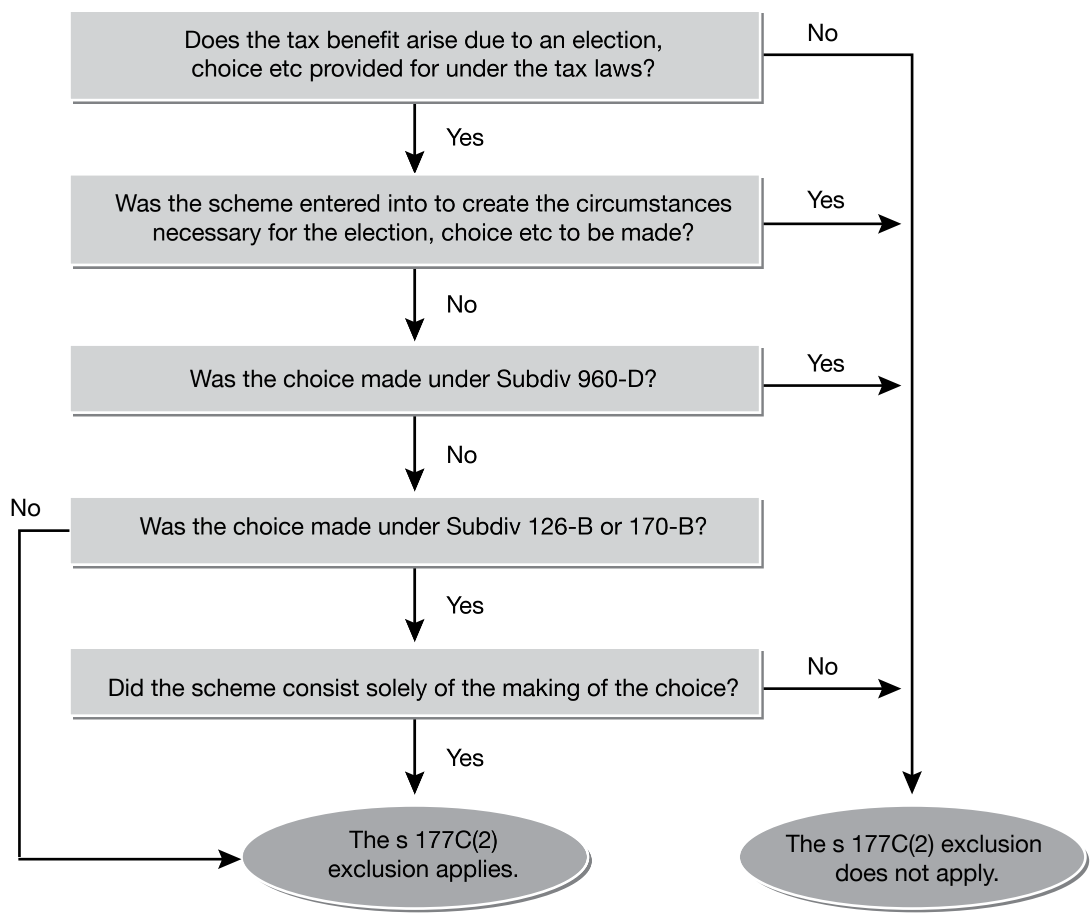
If the answer is "yes", was the scheme entered into or carried out by any person for the purpose of creating any circumstance or state of affairs necessary to enable the choice etc to be made?

If the answer to this second question is "yes", then the s 177C(2) exclusion does not apply and you should proceed to consideration of purpose.

If the answer is "no", then the exclusions to the exclusion need to be considered:

- is the choice etc one made under:
  - Subdiv 126-B ITAA97 (CGT roll-over for companies in the same wholly owned group);
  - Subdiv 170-B ITAA97 (transfer of net capital losses within certain wholly owned groups of companies); or
  - Subdiv 960-D ITAA97 (functional currency); and
- if the tax benefit relates to Subdiv 126-B or Subdiv 170-B, does the scheme consist solely of the making of the agreement or election?

If the choice etc is made under Subdiv 126-B or Subdiv 170-B and the scheme consists solely of the making of the agreement or election, then the exclusion in s 177C(2) ITAA36 applies and no tax benefit arises for Pt IVA purposes. Otherwise, tax benefits arising from choices etc made under these three Subdivisions are not sheltered by the s 177C(2) exclusion.



Quantify the tax benefit

There are two ways that the tax benefit can be quantified:

(1) the annihilation approach (where the scheme is simply ignored in its entirety); and

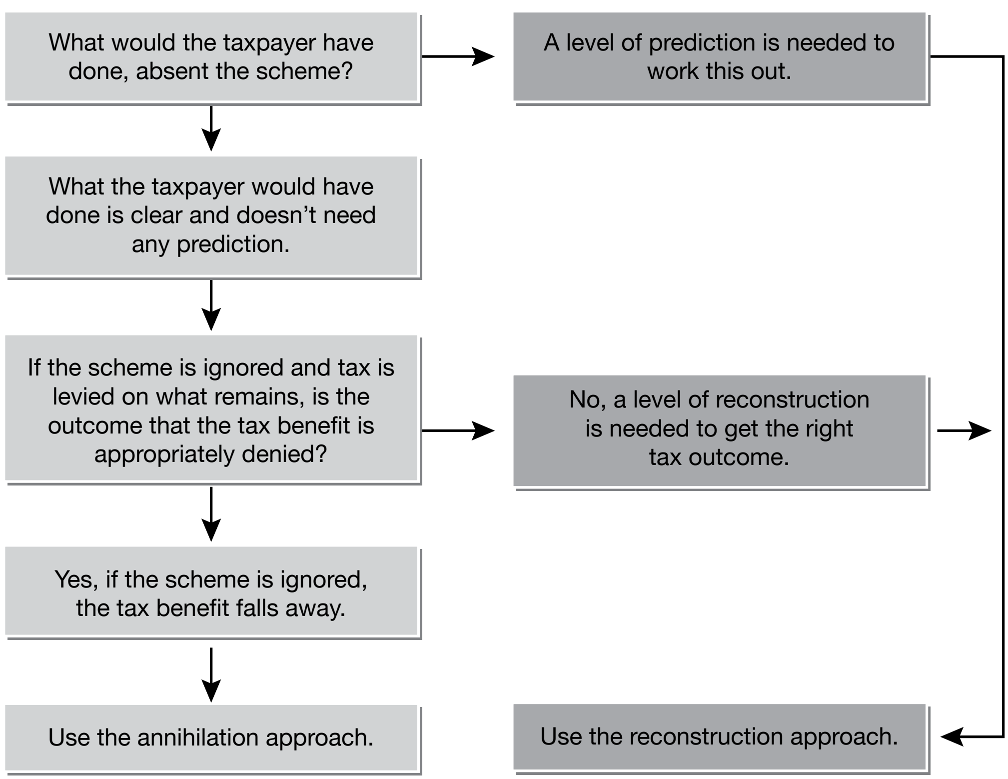
(2) the reconstruction approach (where the tax benefit is based on a reasonable alternative).

The questions to consider when determining which approach to apply are:

- Is it clear what the taxpayer would have done, absent the scheme, or is an element of prediction required to determine what the taxpayer would have done absent the scheme?
- If the scheme is ignored, is the remaining position of the taxpayer sufficient for tax to be imposed such that the tax benefit is denied, or is a level of reconstruction required to achieve this?

If you answer "yes" to both questions, then the annihilation approach is appropriate.

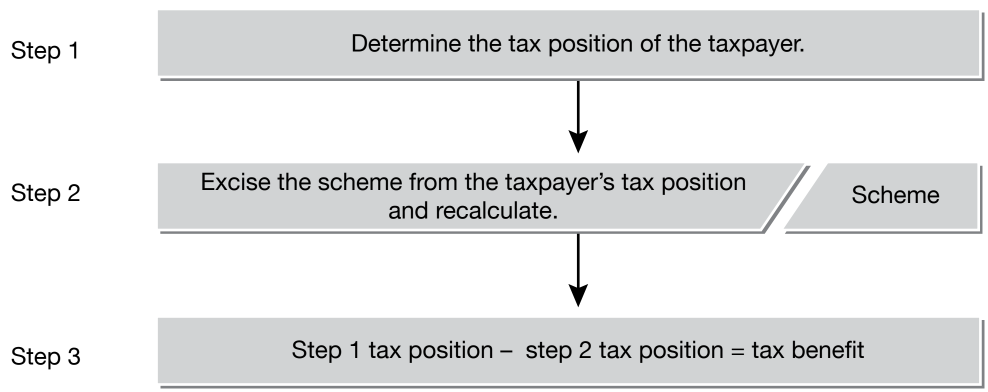
If you answer "no" to either question, then the reconstruction approach is appropriate.



Annihilation

To quantify the tax benefit under the annihilation approach:

- determine the tax position of the taxpayer when the scheme is in place;
- ignore every step that is part of the scheme and recalculate the tax position of the taxpayer on that basis; and
- the difference between the two is the tax benefit.



Reconstruction

The reconstruction approach is the more complicated of the two methods. The first part of this approach is to identify the alternative postulates in the way that is required under s 177CB ITAA36.

Step 1: Determine the parameters. Section 177CB provides that the alternative postulate must be determined having particular regard to certain factors. These are the parameters for the tax benefit quantification process:

- What is the substance of the scheme?
- What are the results and consequences for the taxpayer of the scheme (other than the tax result)?

Step 2: Identify possible alternative postulates. The tax benefit is calculated based on an alternative postulate, ie what it is reasonably expected that the taxpayer would have done absent the scheme. There will almost always be at least one alternative postulate, but usually there will be multiple ones. At this step, you should identify the alternative postulates, regardless of whether they are reasonable or not.

What needs to be identified are other ways that the taxpayer could have started in the same position before carrying out the scheme, and ended in the same or a similar position (apart from the tax result) as they did under the scheme.

Questions to ask that may assist include:

- Is there an alternative transaction that is commercially accepted?
- Is there another way of doing the transaction?
- If the client wanted to be presented with two options to consider for this transaction, what other option would you present?
- Can parts of the transaction be excised from the scheme and the same or similar outcomes still be achieved (other than the tax result)?

Step 3: Determine how comparable the possible alternative postulates are. Alternative postulates need to conform to the statutory parameters set out in s 177CB. Alternative postulates that do not have a moderate to high level of correlation should be reviewed (to see whether a higher level of correlation can be achieved, say, by dropping or modifying a step) or otherwise discarded.

Questions to ask that may assist include:

- What is the substance of the scheme?
- What is the substance of each alternative postulate?
- What are the results and consequences for the taxpayer of the scheme (other than the tax result)?
- What results and consequences for the taxpayer (other than the tax result) are achieved by each alternative postulate?
- How closely does the position for each alternative postulate align with the substance, results and consequences of the scheme?

Step 4: Identify the reasonable alternative postulate. Having identified possible alternative postulates that have a reasonable level of correlation (based on the parameters in s 177CB) to the scheme, the next step is to identify the reasonable alternative postulate.

More than one alternative postulate may be reasonable when considered in isolation. There is some contention as to what should happen in this situation. One view is that you are looking to identify the most reasonable. On the contrary, in the ATO's view, any alternative postulate that can be shown to be reasonable can be used to determine the tax benefit.

The suggested approach is to focus first on identifying the most reasonable alternative postulate. When making this assessment, have particular regard to the substance of the scheme (ie what it actually achieved) and the results and consequences for the taxpayer of the scheme. You should also disregard the tax outcomes of the alternative postulate.

Questions that may assist to identify the reasonable alternative postulate include:

- Do the alternative postulates fail to produce positive outcomes (other than the tax result) that are produced by the scheme?
- Do the alternative postulates produce adverse outcomes (other than the tax result) that are not produced by the scheme?
- Are there commercial or regulatory factors which would prevent or work against an alternative postulate being implemented?
- Are there family or personal factors (that are supported by the evidence) that would prevent or work against an alternative postulate being implemented?

Based on the comparability and reasonableness analysis, rank the alternative postulates based on reasonableness.

Step 5: Quantify the tax benefit. The last step is to calculate the amount of the tax benefit. To do this:

- calculate the tax position under the scheme; and
- calculate the tax position under the most reasonable alternative postulate,

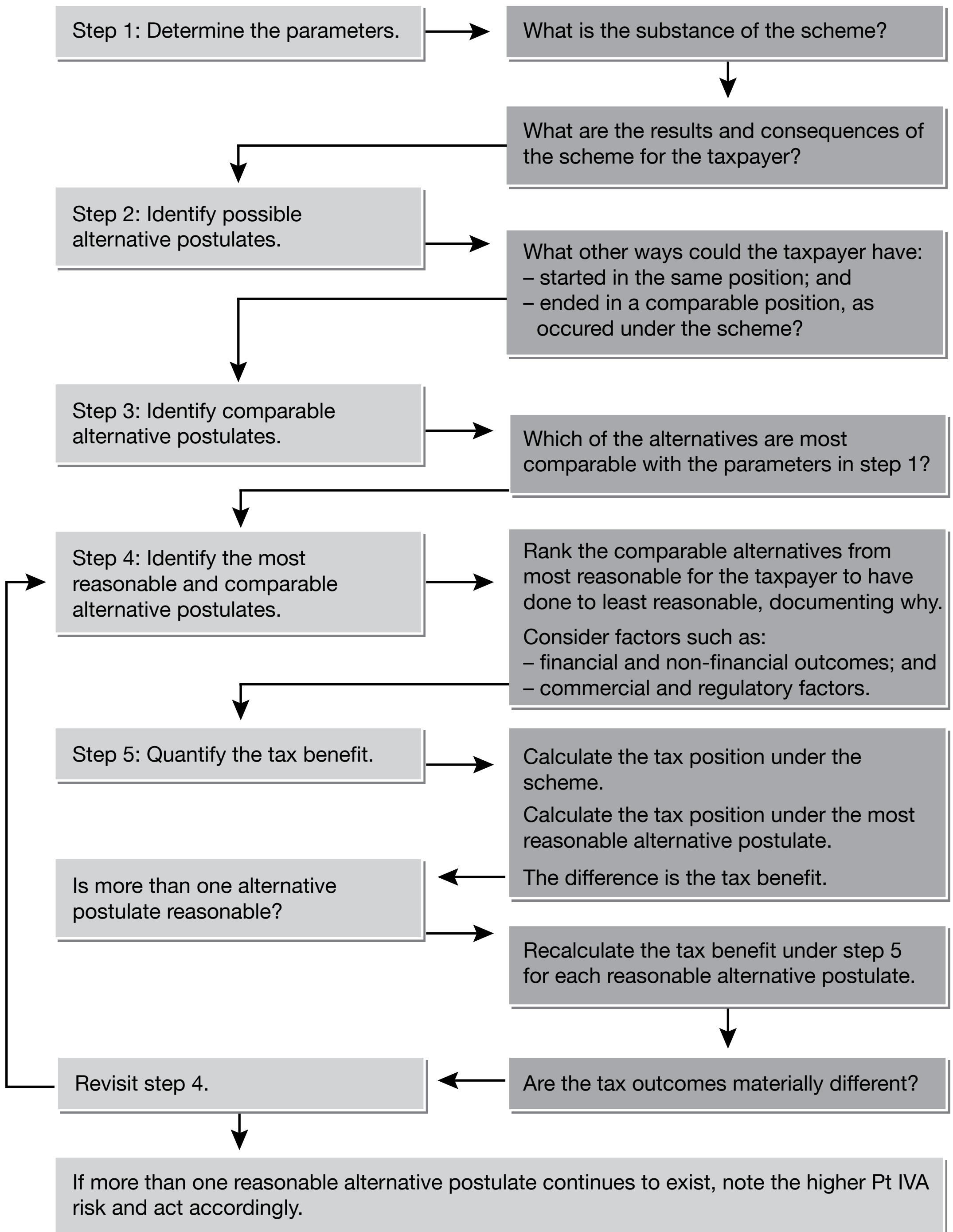
and the tax benefit is the difference.

Where more than one alternative postulate could be a reasonable alternative postulate, a further step is required as a safeguard. In this case, it would be prudent to calculate the tax benefit for any alternative postulate that is reasonably comparable in its outcomes (other than tax) to the scheme but which was not considered the most reasonable alternative postulate according to the analysis in step 4.

If another alternative postulate produces a materially greater tax benefit, revisit step 4 and:

- confirm that each of the “reasonable” alternative postulates that you are assessing are actually reasonable; and
- analyse why one alternative postulate would be selected by a taxpayer (absent the scheme) over another.

If both alternative postulates are still reasonable (so that, in theory, either could be the alternative postulate used to calculate the tax benefit), you have an additional Pt IVA risk factor that will need to be managed.


Step 1: Determine the parameters.
What is the substance of the scheme?
What are the results and consequences of the scheme for the taxpayer?
Step 2: Identify possible alternative postulates.
What other ways could the taxpayer have:
– started in the same position; and
– ended in a comparable position, as occured under the scheme?
Step 3: Identify comparable alternative postulates.
Which of the alternatives are most comparable with the parameters in step 1?
Step 4: Identify the most reasonable and comparable alternative postulates.
Rank the comparable alternatives from most reasonable for the taxpayer to have done to least reasonable, documenting why.
Consider factors such as:
– financial and non-financial outcomes; and
– commercial and regulatory factors.
Step 5: Quantify the tax benefit.
Calculate the tax position under the scheme.
Calculate the tax position under the most reasonable alternative postulate.
The difference is the tax benefit.
Is more than one alternative postulate reasonable?
Recalculate the tax benefit under step 5 for each reasonable alternative postulate.
Are the tax outcomes materially different?
Revisit step 4.
If more than one reasonable alternative postulate continues to exist, note the higher Pt IVA risk and act accordingly.

¶2-115 Determining purpose

Key aspects of the concept of purpose

Purpose is the central concept in Pt IVA. Part IVA only applies where the sole or dominant purpose of a participant in a scheme is to create a tax benefit in the statutory sense of that expression. The dominant purpose is that purpose which was the ruling, prevailing or most influential purpose.

The assessment of the objective purpose is made having regard to the eight factors in s 177D ITAA36 and no other matters. When assessing purpose, the eight factors do not need to be "slavishly ticked off" one by one, but an assessment that does not consider each factor is flawed. As a matter of good practice, it is prudent to work through each factor and then make an overall assessment. Some factors may indicate a tax purpose, some may not. It is the overall assessment which is determinative.

It is the purpose of participants in the scheme that is relevant for Pt IVA. The purpose of the scheme itself is not relevant. The conclusion required to be drawn is not a conclusion about the transaction itself, but the state of mind of a person who participated in the transaction.

Consideration is not limited to the purpose of the taxpayer. A participant is any person who entered into or carried out the scheme or any part of the scheme. Person is used in this context as a reference to a legal person, so it would include a company, for example. It can also include advisers where they play an active role in formulating or implementing the scheme.

Part IVA requires an objective assessment to be made in respect of the purpose(s) of participants in the scheme. It is the conclusion of a reasonable person.

The subjective or actual purposes and motivations of the participants are not relevant. The fact that a taxpayer is aware of a possible tax outcome and wishes to ensure that tax does not arise, or undertakes a transaction to achieve a particular tax outcome, does not of itself mean that the requisite dominant purpose of obtaining a tax benefit required to enliven Pt IVA is present. The taxpayer's intentions are subjective and are not one of the eight factors listed in s 177D. This is particularly relevant in a tax planning context.

Where a particular commercial transaction is chosen from a number of possible alternative courses of action because of tax benefits associated with its adoption, this does not of itself mean that the requisite dominant purpose must be to obtain a tax benefit.

The time for testing dominant purpose must be the time when the scheme was entered into or carried out and by reference to the law as it then stood.

There is no inconsistency between a finding that the purpose of a person lay in the pursuit of commercial gain in the course of carrying on a business and a finding that the dominant purpose was to enable the relevant taxpayer to obtain a tax benefit.

Questions to determine purpose

The questions below are intended to provide you with a structured way to approach an assessment of purpose. This is the most critical step in the Pt IVA analysis.

For each question, record your answer to the question, your reasons for the answer, and what evidence is available to substantiate your answer.

For each factor, make an assessment as to whether:

- it points to a dominant purpose of obtaining a tax benefit;
- it points away from a dominant purpose of obtaining a tax benefit; or
- it is neutral.

You should also focus on identifying any factors which point strongly for or against the purpose of obtaining a tax benefit.

After analysing each factor, you will need to make an overall assessment of the objective dominant purpose.

The questions should be answered from the perspective of a reasonable person, observing all of the parties who participated in the scheme or any part of the scheme.

Manner

(1) Is the manner in which the taxpayer enters into and carries out the scheme reflective of commercially accepted and expected behaviours? If not, why not?

(2) Have commercial negotiations, due diligence and investigation, valuations etc occurred?

(3) Has formal legal documentation been prepared?

(4) Was "pro forma" documentation utilised?

(5) Did the transaction occur at market value?

(6) Are any steps in the scheme directed solely to achieving a tax outcome (ie they don't alter the commercial/non-tax outcomes of the scheme)?

(7) Have unusual or highly complex elements been added to the transaction? What do these steps achieve (tax and non-tax)?

(8) Are any of the steps, or the scheme itself, artificial or contrived?

(9) What non-tax factors are motivating the taxpayer to enter into the transaction?

(10) Is the manner in which the scheme is undertaken the most efficient and effective way to achieve the non-tax outcomes? If not, why was the more efficient and effective alternative not pursued?

(11) Are there external factors which dictate or influence the manner in which the scheme is carried out (eg regulatory requirements)?

Form and substance

(1) What is the "form" of the scheme? What does the scheme purport to do, based on its legal documentation, accounting treatment and other documentation?

(2) What is the "substance" of the scheme? What does it actually achieve?

(3) Do the form and substance align? If not, why not?

(4) Why was this particular form for the transaction chosen over another?

(5) Is the current transaction consistent with the taxpayer's past actions?

Time

(1) Is there a "flurry of activity" around year end?

(2) Is there a commercial factor that drove the scheme to be entered into at a particular time?

(3) Is there another tax event that drove the scheme to be entered into at a particular time (eg the derivation of a capital gain, a pending transaction)?

(4) Is the timing of the transaction important for obtaining the tax outcomes (eg accessing a roll-over)?

(5) Is the tax benefit obtained upfront or over the course of the scheme?

(6) Are the non-tax benefits obtained upfront or over the course of the scheme?

Tax result

(1) How large is the difference between the tax result of the scheme and the tax result of the alternative postulate?

(2) In a relative sense, how significant/large is the tax benefit when compared with the size of the taxpayer and the value of the commercial outcomes of the scheme?

(3) Has tax at the appropriate rate (eg the corporate tax rate if the taxpayer is a company) been levied on the economic gain made by the taxpayer?

(4) Is the tax result/tax benefit of the scheme a timing benefit (ie tax shifted between income years) or a permanent benefit (ie an amount that escapes tax altogether)?

Change in financial position

(1) What are the material changes in the financial position of the taxpayer resulting from the scheme?

(2) What are the material changes in the financial position of other connected parties resulting from the scheme?

(3) On an associate-inclusive basis, how material is the change in financial position of the taxpayer?

(4) Does the change in financial position cause the tax result, or does the tax result cause the change in financial position?

Other changes

(1) What non-financial impacts does the scheme have on connected parties?

(2) Are there commercial benefits for other connected parties?

Nature of connections

(1) Are the participants in the scheme related or unrelated?

(2) Did the participants in the scheme deal at arm's length?

(3) Does the nature of a connection between the participants indicate that they may act not in their own interests as such, but for the purpose of obtaining benefits for the taxpayer (tax or otherwise)?

Overall assessment

(1) Which factors point to the dominant purpose of obtaining a tax benefit?

(2) Which factors are neutral?

(3) Which factors point away from the dominant purpose of obtaining a tax benefit?

(4) Which factors have the most relevance to the scheme being considered?

(5) Considered as a whole, do the eight factors in s 177D point towards or away from the dominant purpose of obtaining a tax benefit?

Next steps

If the dominant purpose is assessed to be to obtain a tax benefit, then:

- reassess the proposed scheme to determine whether it can be modified to achieve the same non-tax outcomes but without the tax issues;
- consider seeking specialist advice to either confirm the Pt IVA assessment or assist with redesigning the scheme; or
- abandon the scheme.

If the dominant purpose is not that of obtaining a tax benefit, then collate the evidence to substantiate the non-tax outcomes and benefits of the scheme.

The following worksheet will assist you with assessing and documenting the eight factors relevant for the question of purpose. Where possible, you should also be collating any evidence that you can obtain that substantiates the comments on the different factors.

Dominant purpose							
Question	Comment	Tax benefit dominant purpose?			Importance in respect of this scheme		
		Points towards	Points away from	Neutral	High	Medium	Low
Manner							
Is the manner in which the taxpayer enters into and carries out the scheme reflective of commercially accepted and expected behaviours? If not, why not?							
Have commercial negotiations, due diligence and investigation, valuations etc occurred?							
Has formal legal documentation been prepared?							
Was "pro forma" documentation utilised?							
Did the transaction occur at market value?							
Are any steps in the scheme directed solely to achieving a tax outcome (ie they don't alter the commercial/non-tax outcomes of the scheme)?							
Have unusual or highly complex elements been added to the transaction? What do these steps achieve (tax and non-tax)?							
Are any of the steps, or the scheme itself, artificial or contrived?							
What non-tax factors are motivating the taxpayer to enter into the transaction?							
Is the manner in which the scheme is undertaken the most efficient and effective way to achieve the non-tax outcomes? If not, why was the more efficient and effective alternative not pursued?							
Are there external factors which dictate or influence the manner in which the scheme is carried out (eg regulatory requirements)?							

cont ...

Dominant purpose							
Question	Comment	Tax benefit dominant purpose?			Importance in respect of this scheme		
		Points towards	Points away from	Neutral	High	Medium	Low
Form and substance							
What is the "form" of the scheme? What does the scheme purport to do, based on its legal documentation, accounting treatment and other documentation?							
What is the "substance" of the scheme? What does it actually achieve?							
Do the form and substance align? If not, why not?							
Why was this particular form for the transaction chosen over another?							
Is the current transaction consistent with the taxpayer's past actions?							
Time							
Is there a "flurry of activity" around year end?							
Is there a commercial factor that drove the scheme to be entered into at the particular time?							
Is there another tax event that drove the scheme to be entered into at the particular time (eg the derivation of a capital gain, a pending transaction)?							
Is the timing of the transaction important for obtaining the tax outcomes (eg accessing a roll-over)?							
Is the tax benefit obtained upfront or over the course of the scheme?							
Are the non-tax benefits obtained upfront or over the course of the scheme?							

Dominant purpose							
Question	Comment	Tax benefit dominant purpose?			Importance in respect of this scheme		
		Points towards	Points away from	Neutral	High	Medium	Low
Tax result							
How large is the difference between the tax result of the scheme and the tax result of the alternative postulate?							
In a relative sense, how significant/large is the tax benefit when compared with the size of the taxpayer and the value of the commercial outcomes of the scheme?							
Has tax at the appropriate rate (eg the corporate tax rate if the taxpayer is a company) been levied on the economic gain made by the taxpayer?							
Is the tax result/tax benefit of the scheme a timing benefit (ie tax shifted between income years) or a permanent benefit (ie an amount that escapes tax altogether)?							
Change in financial and other positions							
What are the material changes in the financial position of the taxpayer resulting from the scheme?							
What are the material changes in the financial position of other connected parties resulting from the scheme?							
On an associate-inclusive basis, how material is the change in financial position of the taxpayer?							
Does the change in financial position cause the tax result, or does the tax result cause the change in financial position?							

cont ...

Dominant purpose							
Question	Comment	Tax benefit dominant purpose?			Importance in respect of this scheme		
		Points towards	Points away from	Neutral	High	Medium	Low
Other changes							
What non-financial impacts does the scheme have on connected parties?							
Are there commercial benefits for other connected parties?							
Nature of connections							
Are the participants in the scheme related or unrelated?							
Did the participants in the scheme deal at arm's length?							
Does the nature of a connection between the participants indicate that they may act not in their own interests as such, but for the purposes of obtaining benefits for the taxpayer (tax or otherwise)?							

¶2-120 Taking a step back

Once you have navigated the detail of Pt IVA, it is worth taking a step back and assessing the proposed transaction in light of the following questions:

- **Is the proposed transaction effective for tax purposes under the tax laws (excluding Pt IVA)?** Part IVA is a provision of last resort. The tax benefit arising under the scheme must be one that is not "knocked out" by other provisions in the tax laws. This includes both general provisions (eg s 8-1 ITAA97) and specific anti-avoidance provisions (eg Div 725 ITAA97).

- **Will the arrangement be implemented as proposed?** Part IVA is dependent on the particular facts and circumstances. If an arrangement is not going to be implemented as proposed, your Pt IVA analysis will be deficient. Worse still, if elements of the proposed arrangement aren't actually implemented at all, the tax outcomes can be quite different to those that were predicted. There are numerous reported cases where taxpayers fail simply because they did not actually implement the transactions that their tax returns claimed had been done.

- **What will the arrangement look like with the benefit of hindsight?** Remember, if the ATO reviews the transaction, it will be a number of years after the arrangement has been implemented.

- **Will the purported non-tax outcomes be achieved?** This goes hand in hand with the benefit of hindsight comment. Whatever the non-tax outcomes targeted by the proposed transaction are, it is going to be critical that they are actually achieved in order to be able to demonstrate a non-tax dominant purpose.

- **Could the proposed transaction be considered as fraudulent or tax evasion?** Part IVA does not apply to cases of fraud or evasion. Part IVA only applies to arrangements that are otherwise effective under the tax laws.

¶2-125 Is there a red flag?

The following points are intended to assist in highlighting situations with a higher Pt IVA risk. These red flags provide another perspective from which to consider the potential application of Pt IVA to an arrangement.

- **A taxpayer alert has been issued on a similar arrangement.** This is clear red flag.

- **There is an established ATO position on a similar issue.** A table of the current ATO public positions on the application of Pt IVA, drawn from rulings and determinations, is included in chapter 3. Also included is a table of the issues considered by the leading cases. If the arrangement under consideration is similar to an arrangement that the ATO has already considered and determined that Pt IVA applies (or is likely to apply) to, then this should be considered a red flag.

■ **One of the steps is only explainable by its tax effect.** This is a common feature in many of the cases (for example, *Spotless*[1]). A red flag would exist where a particular step produces no commercial or non-tax outcome but is an essential element of what produces the tax benefit. Look for steps inserted into an otherwise commercial transaction.

■ **A complex transaction with tax benefits has been used when a simpler, more commercially "standard" transaction would have sufficed.** If there is a simpler, more commercially accepted or more frugal way to achieve the particular non-tax outcomes of a scheme, but a more complex transaction is selected, it is relevant to ask why. Where the complexity produces a tax benefit but doesn't materially alter the non-tax outcomes, then a red flag would exist. Complexity should be assessed in context. Compare the decisions in *McCutcheon*[2] and *News*.[3]

■ **A commercial outcome is only achieved on an after-tax basis.** A transaction should make commercial sense even without the tax benefit. If a transaction relies on the tax benefit to achieve a commercial outcome, then a red flag exists. Consider the comments in *Spotless* and *Citigroup*.[4]

■ **The arrangement is marketed/promoted based on tax attributes.** The tax-effective investment scheme cases provide good commentary on this point. Marketing an arrangement as "tax-effective, tax-effective, tax-effective"[5] is not helpful for an argument that the dominant purpose of the participants was other than obtaining the tax benefit.

■ **The transaction has been reverse-engineered to achieve a particular tax outcome.** In *Clough Engineering*,[6] the interest rate on an intercompany loan was set at a 22% flat rate, as this produced an interest expense that closely approximated the available tax losses. The interest rate was not set with reference to any commercial indicators or parameters. This type of "working backwards" to get the desired tax outcomes should raise a red flag.

■ **The transaction is based on pre-prepared/pro forma documentation.** Marketed arrangements often exhibit this characteristic and it is commented on in the tax-effective investment scheme cases. A standard pre-prepared set of documents for a transaction (often a transaction that is rolled out to numerous taxpayers) would tend to undermine any assertions that the transaction was entered into for commercial purposes that are particular to that taxpayer. The commercial outcomes would appear to be subsidiary to ensuring that the transaction was structured in a way so as to guarantee that tax outcomes are achieved.

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1 *FCT v Spotless Services Ltd* [1996] HCA 34.

2 *McCutcheon v FCT* [2008] FCA 318.

3 *FCT v News Australia Holdings Pty Ltd* [2010] FCAFC 78.

4 *Citigroup Pty Ltd v FCT* [2010] FCA 826.

5 *FCT v Sleight* [2004] FCAFC 94 at [73] per Hill J.

6 *Clough Engineering Ltd v FCT* 97 ATC 2023.

■ **The actual actions are inconsistent with legal relations (substance does not equate with form).** In *Case* X17,[7] the taxpayer purported to enter into a contract with key suppliers in June that was a pre-commitment for the next year's forecast expenditures. The tax objective was to incur the expense in the current tax year so that a deduction could be claimed. While the commercial arrangements were purported to be changed, the timing of payment for the expenses continued as per the previous arrangements. This (and other actions) indicated that the substance of the arrangements between the parties didn't change, despite what the contracts may have said.

Remember that Pt IVA will be assessed by the Commissioner with the benefit of hindsight. If a taxpayer is not going to (or not going to be able to) follow the "form" of the transaction, then this will be a red flag.

■ **The transaction is not recorded in accounting records (or recorded significantly after the fact).** If a transaction is a genuine commercial transaction, then it is reasonable to expect that it will be recorded in the accounting records of a business in the usual course of the preparation of those records. Where accounting records need to be amended, or "fixed up", to record a transaction that produces a tax benefit, this should raise a red flag. At the very least, it may indicate that a transaction is being "back-dated", which can be problematic.

The following comment was made by the court in *Clough Engineering*:[8]

> "As to why the relevant journal entries recording the loan transaction ostensibly resolved by the respective company Directors at their 26 June 1989 meeting were not made at the beginning of the next year of income, Mr Uchanski evidence is that there were some accounting issues to resolve and that the loan balances had not yet been ascertained and would not be until the completion of the year ended 30 June 1989 financial accounts. If the Tribunal were to accept this explanation as reasonable, it merely begs the question of how then did the various parties to the loan transactions know, on 3 July 1989, how much they had recalled and on-lent respectively?"

■ **Uncommercial transactions are instrumental to the tax outcomes.** One of the factors that arose consistently in the tax-effective investment cases was that an uncommercial transaction (or not a usual commercial transaction) was entered into and this transaction was instrumental to the tax outcomes. This should be seen as a red flag.

For example, in *Sleight*,[9] the limited recourse financing arrangements were considered to be an issue. The commercial risks of the arrangements were effectively mitigated by having financing arrangements where recourse was limited to the financial outcomes produced by the arrangements. However, it was these financing arrangements that enabled pre-payment of the management fees and generation of the upfront tax deduction.

Round robin financing arrangements were also highlighted in a number of the cases. While a round robin can be a legally effective way to create real relationships between parties, it must be said that it

7 90 ATC 193.

8 *Clough Engineering Ltd v FCT* 97 ATC 2023 at [59].

9 *FCT v Sleight* [2004] FCAFC 94.

is a feature of many tax avoidance schemes where no real money is involved and it may point to a tax avoidance purpose.

Peabody[10] (with the devaluation of the shares) was another example of this type of uncommercial transaction.

- **The tax benefits are highlighted in other documents.** Putting in a submission to the bank (or another third party) highlighting that a transaction is being entered into for tax purposes is problematic. This was the submission made to the bank in *Case* Y4:[11]

> "Goodwill created by Dr Kildare when operating in own name to be purchased by this company for taxation purposes on suggestion of their accountant which will be utilised in clearance of housing loan with the Perth Building Society in names of Dr Kildare and Mrs Kildare."

¶2-130 Managing your position

Depending on the outcome of your analysis, it may be appropriate for additional steps to be taken to manage the Pt IVA tax risks. There are a range of different ways to manage tax risks, with these approaches often being equally applicable to Pt IVA situations and non-Pt IVA situations.

The right approach will need to be determined based on the particular situation that is being dealt with (complexity, tax risk, value etc) and the nature of the taxpayer (financial sophistication, risk aversion etc).

Specialist tax advice

Obtaining specialist advice is an essential step in ensuring that a taxpayer acts prudently and can establish that they have a reasonably arguable position, both of which help to mitigate penalty exposure.

For transactions which carry a Pt IVA risk, this is particularly the case. At a minimum, written advice should be obtained on the application of the tax laws in any of the more complicated (commercially or tax-wise) aspects of the transactions. Further, the tax adviser should be involved in discussions regarding the tax risks of the proposed course of action, with such risks including the potential application of Pt IVA. This will enable the level of risk to be ascertained and specific actions to mitigate that risk to be identified.

Part IVA advice

Should you obtain written advice on the potential application of Pt IVA to a situation? In most instances, the benefits of obtaining such advice will not justify the exercise.

For advice on Pt IVA to be of benefit, the advice will need to be comprehensive. Unless the advice considers in detail the particular facts and circumstances of the taxpayer, the advice will be superficial (at worst) or deficient in various aspects (at best). In either case, the conclusion on Pt IVA will be

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10 *FCT v Peabody* [1994] HCA 43.

11 91 ATC 114 at [6].

impaired to the extent that relevant facts and circumstances have not been considered. This process equates to significant cost. While favourable advice may provide a taxpayer with a level of comfort, it provides no real protection against actions by the ATO.

In an SME taxpayer context, obtaining specific written advice on the potential application of Pt IVA will rarely be an appropriate course of action.

Applying for a private ruling

Applying for a binding private ruling on the application of the tax laws to a particular situation is an effective way to gain certainty regarding a taxpayer's position. This applies to issues arising under Pt IVA, as it does to any other area of the tax laws. However, Pt IVA does present some unique challenges in a private binding ruling context.

The decision to apply (or not to apply) Pt IVA is dependent on the particular facts and circumstances under consideration. Likewise, a private ruling is only binding on the Commissioner when the facts and circumstances of the actual arrangement that is implemented are consistent with the facts and circumstances on which the ruling is based (which will be set out in the ruling issued by the Commissioner).

It can be very difficult to adequately set out in a ruling application all of the facts and circumstances that will be relevant for assessing the application of Pt IVA. So, while a favourable response may be received for the ruling application, the ruling itself may turn out to be worthless when it is challenged and other facts and circumstances are identified.

A private ruling is based on a static set of facts and circumstances, and there is no mechanism (other than applying for a new ruling) to update the facts and circumstances as they change. This is particularly problematic for transactions which are evolving.

It will take a reasonably long period of time to obtain a private ruling that addresses the application of Pt IVA. This is due to various factors, not the least of which being the additional processes that the ATO is required to undertake to ensure proper consideration of the Pt IVA question. The extended period of time to obtain a ruling is an issue for time-sensitive transactions. The ability to have ruling applications prioritised is limited in an SME taxpayer situation.

Part IVA (specifically, the eight factors in s 177D ITAA36) refers to matters which can only be assessed after the transaction has been entered into or carried out. This in itself can mean that the Commissioner may be unable to rule on the application of Pt IVA, or that any ruling issued is susceptible to challenge and may later be found not to be binding.

It is suggested that there will only be a limited number of situations where seeking a ruling on the application of Pt IVA will be appropriate. A good example would be a non-time-sensitive internal restructure transaction. Given that the "do nothing" alternative postulate may well have been a key defence to the application of Pt IVA to these types of transaction in the past, obtaining a private ruling may warrant greater consideration in the future as a way of managing tax risk on this type of voluntary transaction.

Documenting alternative postulates

Documenting alternative postulates can, in some instances, be a worthwhile exercise. One way of approaching this would be to prepare a file setting out different transactions that could have been undertaken (but weren't) that would be reasonable alternatives to what was undertaken. These alternative transactions would be developed having particular regard to the substance of what was actually done and the results and consequences for the taxpayer.

It is suggested that little would be gained from this approach. The file, without more, is essentially speculation of what might have happened, but didn't, and would have little evidentiary value.

The preferred approach would be to document the commercial considerations leading up to the decision to proceed with a particular course of action, maintaining details of the different options that were considered and why one option was selected over another. This approach will capture contemporaneously information which would be useful at a later time, should the Pt IVA issue proceed to a dispute phase, in identifying the alternative postulates and selecting a reasonable alternative postulate. The information would also assist in evaluating the question of purpose, potentially providing evidence to substantiate what would otherwise be unsupported, subjective purposes. This would particularly be the case where third party documentation exists or expert advice etc was obtained.

Documentation regarding purpose

Often, a taxpayer will have multiple (subjective) purposes when entering into a transaction. Consideration of the eight factors in s 177D (the purpose testing) will highlight what appears to be the dominant purpose.

A relevant matter to consider when assessing the Pt IVA risk is whether a subjective purpose could be sufficiently evidenced to become an objective purpose, or if a non-tax objective purpose could be strengthened by evidence so as to be (or more likely be) the dominant purpose.

For example, asset protection is often cited as a motivation when entering into a particular transaction that may also have tax benefits associated with it. Too often, little will be done to actually evidence the current risk issues and to ensure that the transaction is appropriate for addressing these risks. A taxpayer's position could be improved by:

- documenting the identified risks that the transaction is intended to provide increased protection against (for example, the risk of claims by creditors);
- obtaining specialist advice (from a lawyer or an insolvency specialist) on options that may be available to improve the taxpayer's asset protection position;
- documenting the taxpayer's consideration of the different options that were presented to them;
- implementing the transaction based on legal and/or specialist insolvency practitioner input; and
- obtaining advice after the transaction to confirm the improved asset protection position, or being able to evidence this based on the earlier advice.

A similar set of comments could be made in respect of succession planning (that is, whether a formal succession plan is in place and committed to in writing) and personal financial planning (that is, whether a personal financial plan is in place and being actioned).

Chapter 3

Established positions

¶3-100 Introduction

This chapter lists the taxation rulings (¶3-105) and determinations (¶3-110) which include comments on the ATO's views regarding the application of Pt IVA. In addition, ¶3-115 lists the cases referred to in this guide, with reference to the transaction or issue that was the subject of the Pt IVA aspect of the case.

It is recommended that these tables be reviewed for any arrangement being considered in order to determine whether a similar arrangement has already been addressed by the ATO or the courts.

¶3-105 Taxation rulings

IT series	Subject of ruling
IT 2121, paras 11, 13, 19–20, 27–29 and 36	Income tax: family companies and trusts in relation to income from personal exertion.
IT 2330, paras 17, 19, 30 and 41–42	Income tax: income splitting.
IT 2462, para 19	Income tax: trust stripping — income from family trust distributed to a trust owned by the taxpayer's accountant. Distributed amount returned to the family trust in the form of an interest-free loan repayable on demand.
IT 2466, para 5	Income tax: trust distributions of group interest to non-resident beneficiaries.
IT 2494, paras 6 and 11	Income tax: cars and other fringe benefits supplied to employee/partners of administration entities.
IT 2496, para 7	Income tax: deductibility of the cost of lease receivables.
IT 2501, para 9	Income tax: assignment of partnership interests.
IT 2503, paras 12 and 25	Income tax: incorporation of medical and other professional practices.
IT 2504, para 17	Income tax: deductibility of interest on borrowed funds — life assurance policies.
IT 2512, para 26	Income tax: financing unit trusts.
IT 2519, para 10	Income tax: ownership of plant or fixtures purchased under hire purchase agreements as part of a financing arrangement.
IT 2631, paras 24 and 28	Income tax: lease incentives.
IT 2635, paras 2, 29–33 and 35	Income tax: syndicated research and development arrangements.
TR series	**Subject of ruling**
TR 93/6, para 24	Income tax and FBT: loan account offset arrangements.
TR 96/2, paras 13 and 58–59	Income tax: taxation implications of arrangements known as financial insurance and financial reinsurance.
TR 96/14, paras 4 and 93–95	Income tax: traditional securities.
TR 97/23, para 72	Income tax: deductions for repairs.
TR 98/21, paras 11, 64, 87 and 104–109	Income tax: withholding tax implications of cross-border leasing arrangements.

TR series	Subject of ruling
TR 98/22, paras 1, 15–26, 32–33, 49–71, 78–83, 87 and 97–100	Income tax: the taxation consequences for taxpayers entering into certain linked or split loan facilities.
TR 2000/1, para 7	Income tax: insurance registers.
TR 2000/8, paras 32, 60–64, 66, 110, 132, 181–191, 193–194, 212, 215–229 and 231–233	Income tax: investment schemes.
TR 2001/1, paras 21–22 and 104	Income tax: assessability of amounts from the sale of wheat and grain to AWB (International) Ltd or ABB Grain Ltd.
TR 2001/7, paras 4, 14 and 18	Income tax: the meaning of personal services income
TR 2001/8, paras 2, 25, 32, 102, 249 and 261–267	Income tax: what a personal services business is.
TR 2001/15, paras 21–22 and 104	Income tax: assessability of amounts from the sale of barley, grain or other commodities to ABB Grain Export Ltd or ABB Grain Ltd.
TR 2002/13, paras 31–32 and 87–135	Income tax: Australian films, Div 10B ITAA36 and tax avoidance schemes.
TR 2002/16, paras 3, 25–30, 34–35, 156–168 and 174–175	Income tax: the taxation consequences for taxpayers issuing certain stapled securities.
TR 2002/18, paras 9, 12–16 and 26–47	Income tax: home loan unit trust arrangement.
TR 2002/19, paras 20, 29–31 and 80–119	Income tax: licence arrangements for intellectual property, Div 40 ITAA97 and tax avoidance schemes.
TR 2003/6, paras 10, 41 and 43	Income tax: attribution of personal services income.
TR 2004/5, para 88	Income tax: taxation treatment of volume rebates paid to a retailer association.
TR 2005/6, para 5	Income tax: lease surrender receipts and payments.
TR 2005/14, para 16	Income tax: application of the Australia/New Zealand Double Tax Agreement to New Zealand Resident Trustees of New Zealand Foreign Trusts.
TR 2005/19, paras 18–24 and 79–116	Income tax: scrip-for-scrip roll-over arrangements and application of Subdiv 124-M ITAA97 and Pt IVA ITAA36.
TR 2006/2, paras 16, 35–43 and 46	Income tax: deductibility of service fees paid to associated service entities: Phillips arrangements.
TR 2006/13, paras 33, 37–42, 72 and 84–103	Income tax: sale and lease-back.
TR 2008/1	Income tax: application of Pt IVA to “wash sale” arrangements.
TR 2010/6, paras 16–17, 34–43 and 80–87	Income tax, pay-as-you-go withholding and FBT: tax consequences on the issue, holding and redemption of bonus units as part of an employee benefits trust arrangement.

¶3-110 Taxation determinations

Taxation determination	Subject of determination
TD 92/164, para 3	Income tax: insurance — are amounts paid by an employer on behalf of an employee as premiums on a life insurance policy exempt income of the employee where it is expected that the employee will obtain the amounts paid as premiums shortly after they are paid?
TD 93/187, para 4	Income tax: is a lease acceptable if the lessee or an associate has an option to purchase the shares of, or a controlling interest in, the lessor company?
TD 95/4	Income tax: does the simple disposition of an income-producing asset by a natural person to a wholly owned private company constitute the carrying out of a scheme to which Pt IVA will be applied?
TD 1999/12	Income tax: withholding tax avoidance — do the withholding tax avoidance provisions of Pt IVA and, in particular, s 177CA ITAA36 apply to a decision by a company to establish a program for the issue of debentures in respect of which interest is exempt from interest withholding tax pursuant to the operation of s 128F?
TD 1999/32, paras 4 and 6	Income tax: is a cash collateralisation arrangement acceptable for parties entering into a land transport facilities borrowings agreement?
TD 1999/42, paras 6–9 and 11	Income tax: do the principles set out in TR 98/22 apply to line of credit facilities?
TD 2002/23, paras 15–16	Income tax: is a taxpayer entitled to an income tax deduction for any part of the marketing fee paid in respect of the Internet marketing expenses scheme described in TA 2002/1?
TD 2002/24, paras 10–14 and 17	Income tax: what are the results for income tax purposes of entering into a "partnership" of the type described in TA 2002/4?
TD 2003/3, paras 4–10 and 20	Income tax: can Pt IVA apply to a "CGT reduction arrangement" of the type described in TD 2003/3?
TD 2003/9, paras 15–17	Income tax: is a taxpayer entitled to an income tax deduction for purported partnership losses claimed to have been incurred as a result of entering a prepaid service warrant arrangement as described in TA 2002/5?
TD 2003/32, paras 13–14	Income tax: what are the tax consequences for a taxpayer as a result of entering into a scrip loan and call option arrangement as described in TA 2002/2?
TD 2004/26, paras 5–6	Income tax: does an arrangement under which an employee and his employer lease and lease back the employee's private residence and some of the employee's remuneration is replaced with income from property entitle the employee to a deduction for expenditure in relation to the residence under s 8-1 ITAA97?
TD 2005/29, paras 1–3, 9–12 and 14–15	Income tax: will Pt IVA always apply if a taxpayer who carries on a business (including a personal services business) pays superannuation contributions that do not exceed the age-based limits but are considerably in excess of the value of the services provided by the employer?

Taxation determination	Subject of determination
TD 2005/33, paras 1 and 4–12	Income tax: does expenditure (which is a non-capital cost of ownership of a CGT asset) form part of the cost base of the asset, if it is a tax benefit in connection with a scheme to which the general anti-avoidance rules in Pt IVA apply?
TD 2005/34	Income tax: what are the results for income tax purposes of entering into a profit-washing arrangement as described in TA 2005/1?
TD 2009/17, paras 4–48	Income tax: is interest on a loan fully deductible under s 8-1 ITAA97 when the borrowed moneys are settled by the borrower on trust to benefit the borrower and others?
TD 2010/10	Income tax: can Pt IVA apply to an employee savings plan as described in TA 2008/13?
TD 2010/11	Income tax: can Pt IVA apply to a salary deferral arrangement as described in TA 2008/14?
TD 2010/12	Income tax: can Pt IVA apply to an asymmetric swap scheme?
TD 2010/20	Income tax: treaty shopping — can Pt IVA apply to arrangements designed to alter the intended effect of Australia's international tax agreements network?
TD 2010/22	Income tax: can Pt IVA apply to a scheme designed to convert otherwise assessable interest income into non-assessable non-exempt dividends?
TD 2012/1	Income tax: can Pt IVA apply to deny a deduction for some, or all, of the interest expense incurred in respect of an "investment loan interest payment arrangement" of the type described in TD 2012/1?

¶3-115 Case law

Case	Matter considered
FCT v Peabody [1994] HCA 43	Value shift in respect of shares (transaction explainable by tax, not commercial purposes).
FCT v Spotless Services Ltd [1996] HCA 34	Tax-exempt foreign-sourced income (commercial outcome achieved on an after-tax basis).
FCT v Consolidated Press Holdings Pty Ltd [2001] HCA 32	Interposition of a special purpose entity to hold a foreign investment (transaction explainable by tax, not commercial purposes).
FCT v Hart [2004] HCA 26	Split loan arrangement (particular form of the transaction explainable by tax, not commercial purposes).
Eastern Nitrogen v FCT [2001] FCA 366	Sale and lease-back transaction.
Metal Manufactures v FCT [1999] FCA 1712	Sale and lease-back transaction.
FCT v Zoffanies Pty Ltd [2003] FCAFC 236	R&D syndicate arrangements.
Cumins v FCT [2007] FCAFC 21	Wash sale-style transaction (actual action inconsistent with legal relations).
McCutcheon v FCT [2008] FCA 318	Profits washed through loss trusts (complex transaction with tax benefits chosen over a simpler, more commercially acceptable transaction).
FCT v News Australia Holdings Pty Ltd [2010] FCAFC 78	Internal restructure.
FCT v Trail Bros Steel & Plastics Pty Ltd [2010] FCAFC 94	Employee benefit fund.
Citigroup Pty Ltd v FCT [2010] FCA 826	Foreign tax credit scheme (a commercial outcome is only achieved on an after-tax basis).
FCT v AXA Asia Pacific Holdings Ltd [2010] FCAFC 134	Scrip-for-scrip roll-over.
British American Tobacco Australia Services Ltd v FCT [2010] FCAFC 130	S 177C(2) exclusion and Subdiv 126-B roll-over.
FCT v Ashwick (Qld) No. 127 Pty Ltd [2011] FCAFC 49	Bad debt and loan write-offs.
RCI Pty Ltd v FCT [2011] FCAFC 104	Presale dividend to reduce value and subsequent capital gain.
FCT v Futuris Corporation Ltd [2012] FCAFC 32	Internal restructure, cost base creation and subsequent disposal.
Ryan and FCT [2004] AATA 753	Personal services income and superannuation deductions.
Mochkin v FCT [2002] FCA 675	Personal services income — no alienation.
Egan and FCT [2001] AATA 449	Personal services income — alienation.
Case 3/99, 99 ATC 134	Personal services income — alienation.

Section 2

Part IVA in practice

This section provides a series of discussions and case studies on transactions and issues that affect SME taxpayers.

In some instances, for example, personal services income and wash sale transactions, there is already significant guidance from the courts and/or the ATO about how Pt IVA applies. This existing guidance is used as the basis for the examples and discussions in this section. In other instances, most notably in respect of the CGT small business concessions, there is very limited existing guidance. In these case studies, the examples have been constructed around hypothetical transactions that are reflective of the types of decisions and actions that SME taxpayers need to consider.

The case studies are necessarily generic in nature. The objective of each case study is to highlight a particular point or issue that will then be of assistance when assessing the application of Pt IVA to a real-life example.

> For all case studies, it should be assumed that the arrangements are otherwise effective for tax purposes.

Chapter 4

Personal services income

¶4-100 Part IVA and personal services income cases

The short answer to the question "does Pt IVA still apply to personal services income (PSI) cases?" is "yes". Prior to the introduction of the alienation of PSI provisions in 2001 (Div 84-87 ITAA97), Pt IVA and its predecessor, s 260, were the primary provisions by which income splitting or the alienation of PSI was countered by the ATO. Part IVA continues to apply following the introduction of the PSI provisions.

Personal services income is income that is mainly a reward for the personal efforts and skills of a particular individual. It can be contrasted with income that is derived from a business structure (eg multiple individuals working together), the supply of goods or the use of equipment. Further information on what constitutes PSI is available in IT 2639 and TR 2001/7.

The alienation of PSI provisions have not replaced the role of Pt IVA. They are not an exclusive code for dealing with the alienation of PSI. Rather, these provisions deal with what could be loosely termed the more "clear-cut" cases.

To be brought within the operation of the alienation of PSI provisions, a taxpayer broadly needs to earn PSI (a threshold test), not have a PSB determination, and then not satisfy any of the tests for being classified as a personal services business, that is:

- the results test;
- the unrelated clients test;
- the business premises test; and
- the employee test.

A taxpayer who can satisfy one of the prescribed tests in the alienation of PSI provisions (and so falls into the less clear-cut group) is classified as a personal services business (PSB).

¶4-105 When Pt IVA applies to a personal services business

Part IVA will apply to a PSB where the dominant purpose of obtaining a tax benefit is present.

Divisions 85 and 86 ITAA97 and Div 13 of the *Taxation Administration Act 1953* (Cth) do not apply to a PSB. These provisions deal with the limitation on deductions and taxation of PSI under the alienation of PSI provisions.

A PSB is not a business in the tax or general sense of the expression. The income being derived is still PSI. The concept of a PSB is merely a road sign — do you apply the alienation of PSI provisions or not?

The other provisions in the remainder of the tax law will apply to a PSB. This means that other provisions (as discussed in IT 2121, IT 2330, IT 2503 and IT 2639) may still apply to cases that fall outside of the alienation of PSI measures (ie to PSBs).

TR 2001/8 states:

> "The ATO will seek to [apply Pt IVA] where other factors clearly indicate that the dominant purpose of an arrangement is income splitting."

The basic premise of Pt IVA as it applies to PSI is that such income cannot be alienated and should be included in the taxable income of the person whose efforts and skills enabled the income to be derived in the first instance.

Where personal services or personal exertion income is at risk of being "split" or "alienated", Pt IVA will determine the tax position.

¶4-110 Retaining income in the entity

The general principle is that PSI, net of appropriate expenses, should be taxable to the individual whose personal efforts and skills were responsible for the derivation of that income.

Where PSI is retained in a company and subject to the corporate tax rate, a tax benefit (within the Pt IVA meaning) will arise. It is then a question of whether the objective purpose of the taxpayer (or other participants in the arrangement) was to obtain that tax benefit.

In IT 2330, the ATO states that the retention of profits in the practice company is generally not acceptable. This is subject to the qualification that:

> "… where a bona fide attempt has been made to break even but the practice company returns a relatively small taxable income because of the above or similar difficulties [eg because it is not practicable for the company to ascertain its income and determine its allowable income tax deductions by 30 June], the company should distribute all its taxable income, to the professional person by way of franked dividend, in the following year."

Therefore, in a situation where a small amount of profit is retained in the company after a reasonable effort has been made to distribute the net income to the appropriate individual, Pt IVA should not apply. This could be contrasted with a situation where a significant portion of the current year profits are retained in the company. Often, retention for use as working capital is cited as the purpose of such an action.

It is suggested that the factors which would substantiate a need to retain working capital (that is, to fund payments to creditors, to pay employees and to acquire capital assets) would also support a position that the income is not "personal services" income, which may make this issue redundant. In a true PSI situation, the need for working capital would be limited.

In the absence of genuine non-tax reasons for accumulating PSI in an entity, there is a strong likelihood that Pt IVA would apply. This is certainly the position that the ATO would take.

¶4-115 Remuneration paid to associates

For a taxpayer deriving PSI and not conducting a PSB, the ability to claim a deduction for remuneration paid to an associate is limited by the alienation of PSI provisions. The deduction in this situation is limited to a reasonable amount for the performance of principal work. No deduction can be claimed for remuneration for the performance of administrative and support functions. This same limit does not apply to a PSB, where the general deductibility provision of s 8-1 ITAA97 applies.

A PSB can claim as a deduction a reasonable amount for the remuneration of associates where the work of the associates is sufficiently related to the derivation of the PSI so as to satisfy the general tests for deductibility under s 8-1.

IT 2330 states:

> "[A] taxpayer in business may employ family members in the business — provided the employment is bona fide and the wages reasonable."

The recommended process for substantiating remuneration to associates is:

- define the scope of the role, ie the functions that the associate will perform;
- determine the actual hours of work that will be required to perform these functions (eg one day/eight hours per fortnight);
- identify an appropriate hourly rate for the services, given the functions to be performed. Possible sources of an hourly rate would include temp agencies, contract book-keepers, industry awards etc; and
- keep evidence to substantiate that the work is actually performed by the associate (for example, time sheets, diary records etc).

The objective is to demonstrate that the associate is being paid an arm's length amount for the services performed so that the arrangement does not alienate any of the PSI.

The remuneration to the associate should be assessed on the basis of the salary, benefits and other remuneration that is provided to them, but should exclude superannuation (see ¶4-125).

¶4-120 Remuneration paid to the principal

The level of remuneration paid to the principal is one indicator of the purpose of the arrangement.

Where the remuneration is significantly less than the remuneration that the principal could otherwise obtain by contracting directly with the client, and remuneration is paid to associates or profits are retained in a company etc, this would be an indicator that Pt IVA may apply to the arrangement.

Where the remuneration paid to the principal is commensurate with the level of remuneration that the principal could otherwise obtain by contracting directly with the client, this would be an indicator that Pt IVA should not apply to the arrangement.

However, this raises the prospect that, if a company negotiates a rate with the customer that is higher than the market rate remuneration that the individual would otherwise be able to obtain, the premium may be retained in the company or paid to other related parties. This situation does not appear to have been considered by the courts, perhaps because the situations where this could arise would be limited.

It is suggested that the evidence of the commerciality of the remuneration paid to the principal would be critical to prevent Pt IVA from applying in this situation.

¶4-125 Deducting superannuation contributions

Claiming a deduction for superannuation contributions made for the benefit of the individual whose personal efforts and skills are responsible for the derivation of the PSI would generally not be something that Pt IVA would apply to.

IT 2330 states that:

> "Where incorporation is explicable as an ordinary commercial or business step to take and does not result in any splitting of the income from personal services, and the incorporated business activity is conducted along normal business lines (see paragraph 13 [of IT 2330]), it will be acceptable for income tax purposes. The fact that the company may be able to obtain greater income tax concessions in providing superannuation benefits than would have been the case if the business had not been incorporated would not attract the operation of … Part IVA."

IT 2503 states that:

> "The incorporation of professional practices is accepted for income tax purposes where, inter alia, incorporation does nothing more in relation to income tax than reduce a professional's income by the amount of an appropriate superannuation cover."

The question of a deduction for superannuation contributions made for an associate is a different matter. This issue was considered in *Ryan and FCT*,[1] and is discussed below.

Subsequent to the *Ryan* case, the ATO released TD 2005/29. This determination considers the question of whether Pt IVA will always apply if a taxpayer who carries on a business (including a PSB) pays superannuation contributions that do not exceed the age-based limits but are considerably in excess of the value of the services provided by the employee. The answer given is "no":

> "… the Tax Office accepts that, absent unusual features (and subject to the qualification in paragraph 2 of this Determination), Part IVA of the ITAA 1936 will not apply to a case where a company, trust, partnership or individual conducting a personal services business (as defined in Division 87 of the *Income Tax Assessment Act 1997* (ITAA 1997)) pays superannuation contributions up to the age-based limits (as prescribed in subsection 82AAC(2A) of the ITAA 1936) to a complying superannuation fund in respect of the associate of the main service provider. This is the case even if contributions up to the maximum age-based limits are also provided for the main service provider."

It is noted that the determination relates to the now redundant concept of age-based limits.

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1 [2004] AATA 753.

Under the current law, an employer can claim a tax deduction for contributions made to a complying superannuation fund for the purpose of providing superannuation benefits for another person who is their employee when the contribution is made (s 290-60 ITAA97).

Like s 82AAC ITAA36, s 290-60 specifically provides for a tax deduction for superannuation contributions made for an employee. The limit on deductibility in s 82AAC has been removed and replaced with a limit on the concessional tax treatment of contributions, with this limit being applied at the superannuation fund level.

It is considered that the same principles should apply to superannuation deductions under s 290-60, ie that an entity deriving PSI would not be prevented by Pt IVA from claiming as a deduction superannuation contributions made on behalf of an associate who is an employee.

The ATO has also expressed the view that s 109 ITAA36 would not apply to superannuation contributions made in a situation that is consistent with TD 2005/29.

The qualification

The qualification in TD 2005/29 refers to the provision of personal services through the entity (as opposed to a sole trader) as being "commercially justified". For example, an individual may be required to contract through an entity because the relevant service acquirers will only contract with entities rather than individuals. Alternatively, the asset protection/liability issues may be such that the use of a limited liability entity as the contracting party is a commercially rational decision.

Tupicoff v FCT,[2] *Egan and FCT*[3] and *FCT v Mochkin*[4] are cited in the determination as examples.

If there is no commercial justification for incorporation, this may be an indicator that Pt IVA can be applied.

¶4-130 "Husband and wife" partnerships

If you are in business and you conduct that business with your spouse through a genuine partnership, the ATO will accept this for income tax purposes. As a general observation, the ATO will not usually seek to apply Pt IVA to PSI derived by a husband and wife partnership where the net income of the partnership is split between the partners.

2 84 ATC 4851.

3 [2001] AATA 449.

4 [2002] FCA 675.

¶4-135 Superannuation contributions (Ryan and FCT)

Ryan and FCT[5] deals with the payment of superannuation benefits to an associated individual in a situation where the PSI is being received by an entity, not the individual whose efforts and skills are responsible for the derivation of the income.

Facts

Michael Ryan is an information analyst. He has a PhD in astrophysics. He is married to Maria. She has a BA majoring in science and a DipEd. In 1994, Dr Ryan caused Marjsp Pty Ltd to be incorporated. Dr and Mrs Ryan own 50 shares each of the 100 shares allotted in the company. They are the directors of the company. Marjsp is the trustee of the Marjsp Superannuation Fund. Dr and Mrs Ryan are members of the fund.

Marjsp earned income from fees paid pursuant to contracts to provide information technology services to clients, such as carrying out "data and statistical analysis" and furnishing "reports and projections". Dr Ryan provided the skills and expertise which lay behind the work. Mrs Ryan provided some secretarial assistance.

Table 1 shows the income of Marjsp from the provision of its consulting services, the salary and some director's fees paid by Marjsp to Dr and Mrs Ryan, and the contributions made by Marjsp to an external superannuation fund (in 1995) and to the Marjsp Superannuation Fund (in 1996 and 1997) on behalf of Dr and Mrs Ryan.

Table 1

	Marjsp: income	Dr Ryan: income	Dr Ryan: director's fees	Mrs Ryan: income	Dr Ryan: superannuation	Mrs Ryan: superannuation
1995	$87,897	$54,526	–	$6,300	$5,000	$11,500
1996	$117,695	$37,541	–	$6,000	$20,000	$50,000
1997	$50,532	$26,000	$1,500	$2,500	$12,000	$8,000

Marjsp was incorporated and the agreements were made with Marjsp because Dr Ryan believed that companies such as his clients insisted on dealing with corporations and because he was concerned about reducing his personal exposure to potential negligence claims.

The income paid to Mrs Ryan was commensurate with the value of the services that she provided.

Dr and Mrs Ryan were not paid regular salaries. They drew on the company bank account for what they needed. At the end of the year, the amount of the drawings that they considered reasonable as the income of Mrs Ryan was determined, and the balance of the drawings was treated as Dr Ryan's income.

The amount not distributed as income was treated as superannuation. How it was to be divided was a matter considered at the end of the income tax year. Dr and Mrs Ryan viewed the superannuation as a

5 [2004] AATA 753.

joint asset and were not concerned as to how it was allocated between them. The allocation was made such that the relevant deduction limits were not breached.

Scheme

The scheme included the following steps:

(1) the provision of the taxpayer's services to Marjsp for a salary and superannuation benefits that were substantially less than the costs of the services provided by the applicant to outside companies and other entities; and

(2) the employment of the applicant's wife by Marjsp and the payment of a salary and superannuation benefits on her behalf, the total of such salary and benefits being substantially greater than the value, if any, of those services to Marjsp or the cost of those services if the services had been provided by someone other than the applicant's wife.

Relevantly in this case, the ATO did not challenge the use of the company as the entity to contract with the customers for the provision of Dr Ryan's services.

Tax benefit

The *Ryan* case would be approached on the basis of the reconstruction approach.

On the evidence, it was held that it could not reasonably be expected that the amount paid to the superannuation fund in respect of the taxpayer's wife would otherwise have been paid to Dr Ryan personally. Rather, if the company had not made superannuation contributions in respect of Mrs Ryan, it would have made superannuation contributions in respect of Dr Ryan. As a consequence, no additional income would have been paid directly to either of them.

Purpose

While the question of purpose was redundant (as there was no tax benefit to the taxpayer), it was held that a consideration of the matters listed in s 177D ITAA36 did not reveal a dominant purpose of obtaining a tax benefit. In these circumstances, Pt IVA could not apply. The purposes were providing superannuation for Dr and Mrs Ryan, paying Mrs Ryan for her work, and claiming the necessary deductions. Obtaining a tax benefit was not a purpose.

¶4-140 Superannuation benefits (TD 2005/29)

This example is drawn from TD 2005/29, which sets out the ATO's position following *Ryan and FCT*.

Mary is a computer consultant who provides her professional services through her private company to a number of clients, all of whom refuse to contract with her personally but insist on obtaining her services through a contract with her company.

The company employs Mary to provide programming services to its clients, and employs her husband Derek to provide administrative support. Derek obtains a market value salary for his administrative work for the company, but the company provides superannuation contributions on his behalf to a complying superannuation fund up to his age-based limit of $95,980.

The company provides the remainder of its fee income, net of expenses, to Mary as remuneration for her services. Mary's remuneration consists of salary and a superannuation contribution of $4,500, representing 9% of her salary (the minimum level of superannuation support required under the superannuation guarantee scheme).

Mary's salary is lower than it would have been if the company had not made such a high superannuation contribution on behalf of Derek. However, Derek provides a valuable service to the company for which he is fairly remunerated, the company makes genuine superannuation contributions on his behalf, and there are no unusual features to the arrangement. In the circumstances, Pt IVA does not apply.

The ATO noted in TD 2005/29 that different considerations might arise if, say, Mary was providing her services without administrative support and then took a significant cut in her salary to allow Derek to be employed by the company at his remuneration level to perform tasks that were previously not required.

¶4-145 Use of an incorporated entity (Mochkin v FCT)

Mochkin v FCT[6] is an example of two things. First, it is a case where the use of an incorporated entity to undertake an activity that would otherwise be conducted in the name of an individual was held to be justifiable. Second, it is a case where the income being derived was not considered to be PSI.

Two different income "sources" were considered in *Mochkin*. The summary below considers the income from the ongoing stockbroking business. A second source was a one-off commission for a placement service provided by Mochkin. It was clear that this was income for Mochkin's personal services and was diverted to Daccar (as trustee of a family trust).

The summary is extracted from the Full Federal Court decision. The extracted paragraphs have only been lightly edited. The words of the court provide a good insight as to how this type of matter should be approached.

One point to note is that, if the Commissioner had identified a different, narrower scheme that was focused on the less than market value remuneration paid to Mochkin, the court may have reached a different conclusion on the application of Pt IVA.

Facts

The taxpayer was born in the United States in 1962 and migrated to Australia in 1985. He is an ordained Rabbi and, from 1987, began working as a stockbroker.

6 [2002] FCA 675.

In 1987, the taxpayer, who had not previously worked in the stockbroking industry, entered into a commission-sharing arrangement with a firm of stockbrokers, Bridges Son & Shepherd ("Bridges"). Later that year, Bridges terminated its arrangement with the taxpayer in consequence of a dispute concerning the taxpayer's liability for the default of his clients in completing share transactions, and the taxpayer entered into a similar arrangement with a different firm of stockbrokers, Pembroke Securities Ltd ("Pembroke").

In February 1988, the taxpayer caused Daccar (as trustee of his family trust) to enter into a written commission-sharing agreement with Pembroke in place of the previous agreement between the taxpayer and Pembroke.

At this stage, the litigation between Bridges and the taxpayer was nearing finality. The arrangement ended up being settled for a payment of $150,000 by the taxpayer and the forgoing of $200,000 in commissions.

In June 1989, Ledger was incorporated and constituted as the trustee of a second family trust. In August 1989, the agreement between Pembroke and the taxpayer was terminated and replaced with an agreement between Pembroke and Ledger.

In 1990, Ledger terminated the agreement with Pembroke and entered into a fresh agreement with McDougall & Co ("McDougall"), which was later taken over by BOS Stockbroking. This arrangement stayed in place until 1995, when Ledger again changed the firm that it worked with, this time to Shaw Stockbroking.

In all income years from 1990 to 1997 (except 1991 and 1996), Ledger made substantial distributions from its net income to the first family trust (Daccar). The bulk of the income distributed by Ledger to the first family trust was, in turn, distributed by Daccar either to the L&M Charitable Trust (an associated tax-exempt entity) or, in 1993 and in subsequent income years, to the Tolas Oak Unit Trust (an associated trust with $4,000,000 in accumulated losses).

During the period commencing with the 1989 income year and concluding with the 1997 income year, the taxpayer received a salary from Daccar or Ledger in one year only, namely, a salary of $80,000 from Ledger in the 1990 income year. He did, however, receive a distribution from Daccar in the 1989 income year of $96,703. He also received distributions from Ledger in five income years, as follows: 1993 – $83,000; 1994 – $80,000; 1995 – $105,000; 1996 – $200,000; and 1997 – $1,000,000.

Scheme

According to the Commissioner, the scheme commenced in 1987 and was carried out in the 1988 income year and thereafter. The scheme was said to consist of:

(1) the use of Ledger to receive payments from Pembroke and subsequent firms for the personal services of the taxpayer; and

(2) the use of the trust structure to divert income derived from the personal exertion of the taxpayer to other persons.

Tax benefit

The tax benefit as identified by the Commissioner was the difference between the actual income disclosed by the taxpayer and the income that would have been disclosed had the commission income received by Ledger instead been received directly by the taxpayer. This was determined using the reconstruction approach. The assertion was that it would have been reasonable to expect that, had Ledger not entered into the contracts, the taxpayer would have done so in his individual capacity.

Ultimately, the court did not consider this to be a reasonable expectation. Key in this finding was that the litigation with Bridges meant that the taxpayer was not prepared to contract individually due to the risk of personal liability. The taxpayer's actions were consistent on this point over the course of the scheme — on a number of occasions, he was requested to sign personal guarantees and on each occasion he refused. Technically, this finding meant that no tax benefit arose. However, the court decided in favour of the taxpayer based on the question of purpose, not tax benefit (the court applied a purpose-based approach consistent with the recently amended provisions).

Purpose

The objective facts indicate clearly that, following the settlement of Bridges' claim against him, the taxpayer was not prepared to conduct the stockbroking business on his own account. He had not merely been exposed to possible personal liability in respect of client defaults, but had actually been required to make good defaults by his clients. The taxpayer thereafter resolutely resisted all attempts by the brokers to secure his agreement to provide guarantees or indemnities in support of liabilities incurred by Daccar and Ledger to the brokers. The taxpayer's unwillingness to provide services on his own account after February 1988 was not tax driven, but the product of commercial imperatives.

This was not a case where the taxpayer simply substituted a corporate entity for his own services. Daccar and Ledger accepted that they were liable for the default of their clients. Ledger made good such defaults. The willingness of Daccar and Ledger to indemnify the various brokers against client defaults was essential, from a commercial perspective, to the conduct of the business. In this sense, Daccar and Ledger provided a "service" that, on the objective evidence, the taxpayer was simply not prepared to provide.

In this case, the income received by Daccar and Ledger was not generated simply by the personal exertion of the taxpayer. Undoubtedly, he played an important role in the business. However, Daccar and Ledger each employed or acquired substantial facilities for which they paid. The companies also utilised the services of persons other than the taxpayer.

The taxpayer was the head of what could be regarded as the "Ledger team". The team included:

- Mr Humphrey, the principal of Morgrae Pty Ltd which had a commission-sharing agreement with Ledger and which made Mr Humphrey's services available to Ledger on a full-time basis;
- for part of the relevant period, a part-time book-keeper and a full-time secretary;
- from May 1996, a full-time accountant;

- from July 1995, a full-time employee, Mr Herzog, who took orders from clients and placed them with Bell; and
- from approximately the same time, another person who provided services to clients in return for interest-free loans from Ledger to himself and entities associated with him.

It is undoubtedly true that the discretionary trust structure adopted by the taxpayer had substantial tax advantages when compared with other structures that might have been adopted to achieve the same commercial objectives. The fact that aspects of the scheme are tax-driven does not establish that the “dominant purpose” of the relevant person, objectively assessed, was to obtain a tax benefit.

The manner in which the scheme was entered into or carried out

The scheme was entered into in consequence of commercial imperatives facing the taxpayer. These imperatives were not tax-related. The scheme was carried out in a manner which ensured that the commercial imperatives were satisfied. In particular, Daccar and, subsequently, Ledger provided the indemnities to the brokers that were necessary for the conduct of the business. The business itself was conducted through the “team”, some members of which received substantial remuneration for their services.

The manner in which the scheme was carried out also ensured that distributions of net commission income would be made in a tax-effective manner. Nonetheless, it is incorrect to suggest, as the Commissioner did, that the object of tax minimisation is the only cogent explanation for the creation of Ledger and its role as the contracting party with the various brokers. Daccar had been used as the contracting party with Pembroke for valid commercial reasons. Ledger, in effect, was substituted for Daccar in 1989.

Form and substance of the scheme

There was no disconformity between the form and substance of the scheme. The corporate vehicles were essential to achieve the taxpayer’s commercial objectives of avoiding exposure to personal liability. Daccar and Ledger provided services to brokers (including indemnifying them against any defaults by clients). The services to brokers and clients were not provided exclusively by the taxpayer. Clearly, he played an important role in the conduct of the business, but so did other members of the “team”. The scheme, as a matter of substance, had the effect of permitting the net income derived by Daccar and Ledger to be distributed through the trusts in a tax-effective manner.

Timing

The timing of the scheme is of considerable significance in the present case. The scheme was formulated and implemented under the shadow of the Bridges’ litigation. The timing had little to do with tax planning, but much to do with the legal proceedings instituted by Bridges against the taxpayer. The scheme was carried out over a number of years, although, in the early stages, Ledger was substituted for Daccar. While the scheme was in operation, the business was conducted and the income distributed in the manner described.

Result of the scheme

The result in relation to the operation of the ITAA36 that, apart from Pt IVA, would be achieved by the scheme included the distribution of income generated by Daccar and Ledger to the beneficiaries of the two family trusts. As already noted, it is difficult to see how the result of the scheme, in the sense in which that term is used in s 177D(2)(d), could be said to be tax-neutral. Viewed objectively, the result sought by the scheme, so far as the ITAA36 was concerned, was the opportunity to distribute net commission income derived by Daccar and Ledger in a tax-effective manner. This result nonetheless must be weighed against other aspects of the scheme in order to determine the taxpayer's dominant purpose.

Change in the taxpayer's financial position

The taxpayer achieved the objective of immunising himself from personal liability for the conduct of the stockbroking business. He also received less by way of salary or distributions than his contributions to Ledger, in particular, might have been worth, although he did receive substantial distributions from Ledger from time to time, in one year amounting to $1,000,000. As noted above, the fact that the taxpayer, in effect, forewent remuneration for his services to Ledger would have had more significance in this case had a narrower scheme been identified.

Change in the financial position of other persons

The financial position of beneficiaries under the two family trusts changed, in that they received distributions in consequence of the scheme. The major beneficiaries were the L&M Charitable Trust and the Tolas Oak Unit Trust. The former was set up for charitable public purposes, and the latter received distributions from 1993 onwards which it was able to offset against its substantial accumulated and continuing losses.

There were, without doubt, also changes in the financial position of members of the Ledger "team" and of the brokers in consequence of the carrying out of the scheme. These consequences were commercial in character, reflecting the arm's length arrangements made between Ledger and the brokers on the one hand and Ledger and members of the "team" on the other.

Any other consequence for the taxpayer

There seem to be no other relevant consequences for the taxpayer that bear on the question of dominant purpose.

The nature of the connection between the relevant taxpayer and any person connected with the taxpayer

As the primary judge pointed out, the connection between the taxpayer and his family members and the entities he controlled were such as to lead those family members and entities to expect the exercise of a discretion to make distributions in their favour, to a greater or lesser extent. As the primary judge also pointed out, the connection between the taxpayer on the one hand and the brokers and the Ledger "team" on the other was such as to suggest that business efficacy was the taxpayer's dominant purpose for entering into and carrying out the scheme.

Conclusion

A case such as *Mochkin v FCT* involves the weighing up of the commercial side of a scheme against its tax advantages. The taxpayer entered into and carried out the Ledger scheme because of commercial considerations that were unrelated to tax advantages. It was carried out in a manner that involved Daccar and Ledger providing genuine commercial services to clients and brokers, in return for which commission income was received. The services provided by the companies included indemnifying brokers against client defaults — something the the taxpayer was unwilling to provide on his own account. The business conducted by Daccar and Ledger was substantially more than a one-person operation.

It can readily be concluded that the taxpayer had tax advantages in mind when choosing a discretionary tax structure as the means of carrying out the scheme. Doubtless, there were other ways in which he could have chosen to conduct the stockbroking business and to immunise himself from personal liability.

But the question posed by s 177D(b) is not whether the taxpayer could have chosen a less tax-effective means of achieving his commercial objective of immunising himself from personal liability to the brokers. The question is whether, in view of the matters identified in s 177D(b), it is reasonable to conclude that the taxpayer's ruling, prevailing or most influential purpose in entering into or carrying out the scheme was to obtain the tax benefit identified by the Commissioner.

A reasonable person would conclude that the tax advantages of the scheme were subsidiary to the commercial objectives. A reasonable person would not conclude that the taxpayer entered into or carried out the scheme for the dominant purpose of obtaining a tax benefit in connection therewith.

¶4-150 Less than market value remuneration (Egan and FCT)

Egan and FCT[7] is a classic alienation of PSI case where less than market value remuneration was paid to the principal, with the result that parts of the PSI were subject to tax at a lower rate.

Facts

Mr Egan was an IT professional. He and his wife established Tenth Mounpro Pty Ltd ("TM") in 1987. The company provided IT services to the Australian Wheat Board. In 1988, a contract for services was entered into with the Shell Company of Australia Ltd ("Shell"). After several extensions of the contract, Mr Egan commenced full-time employment with Shell from 1990 to 1993. During this time, TM entered into a contract to develop computer software for a food company.

7 [2001] AATA 449.

Mr Egan met Mr Doubtfire at Shell. In 1993, the two agreed to establish a company, Australian OutSourcing Pty Ltd ("AOS"), to be owned in equal share by TM and a company owned by Mr and Mrs Doubtfire, 81st Patriot Pty Ltd ("81P").

TM and 81P were each entitled to a fixed amount, called a management fee, of $11,000 per month.

The first major assignment of AOS was with Telstra Corporation ("Telstra") to implement a data storage management system. One requirement of the contract was that any contractor intending to work on the project had to sign a confidentiality agreement. The contract provided for an hourly rate fee. Initially, Mr Egan was the only contractor and the only person to sign the confidentiality agreement. Over the five years of the contract, four additional contractors signed the confidentiality agreement and worked on the project.

During the course of the project, Mr Doubtfire continued to seek further work for AOS. In the year ended 30 June 1995, the gross revenue of AOS was $680,114, of which the Telstra project contributed $369,000, with the balance from five other clients and the sale and maintenance of commercial software packages. In the year ended 30 June 1996, the gross revenue was $887,957, with Telstra contributing $493,000, and the balance from four other clients and software packages. For the year ended 30 June 1997, gross revenue of $1,048,995 came from Telstra, and $635,000 came from seven other clients and software packages.

TM held minimal equipment. The only other employee of TM was Mrs Egan who performed limited administrative functions.

In 1998, EMC Corporation ("EMC") acquired a 20% interest in AOS. EMC required some formalisation of the arrangement between TM, 81P and AOS. At the time, no written agreements were in existence. Contracts were entered into between AOS and TM and between AOS and 81P based on the wording of contracts previously used for a subcontractor. These contracts, although clearly not prepared until at least 1998, showed a commencement date of 1 January 1995.

The TM contract named TM as a contractor to perform consultancy services through capable personnel to AOS for a fee of $11,000 per month.

The income of TM was paid to Mrs Egan (as salary), to Mr Egan (as salary), as superannuation contributions on behalf of Mr & Mrs Egan, and part of the income was retained in the company.

Scheme

There was an arrangement and a course of action in which TM was incorporated to be the recipient of fees from services performed by Mr Egan initially to outside clients and, from 1993, to AOS and clients of AOS.

The scheme involved:

- paying Mr Egan a modest salary by TM;
- paying a salary to Mrs Egan;

- making superannuation contributions for both; and
- retaining excess income in the company to be taxed at corporate rates.

Tax benefit

Egan and FCT was approached on the basis of the reconstruction approach.

Mr Egan's salary from TM was significantly less than the fee paid for his services to AOS. The balance of that fee was used to pay a salary to Mrs Egan, to pay superannuation contributions for both Mr and Mrs Egan, and to pay for domestic expenditure which was charged to a loan account in the name of his wife and himself. As a consequence, the whole of the AOS fee was available for the benefit of Mr Egan and his family, with a major part of such fee not being included in his assessable income.

The tax benefit would be the difference between the assessable income of Mr Egan if he had been paid all of the consulting income received by TM and the assessable income actually disclosed by Mr Egan based on the lower amount of income paid to him.

Purpose

There is no evidence that, since the establishment of AOS in 1993, TM purported to provide services to any person other than AOS.

The predominant or sole role of TM was to provide the services of Mr Egan to AOS. The form and substance of the arrangement was to have the earnings from the services of Mr Egan to AOS received by TM.

If it were not for the interposition of TM between AOS and Mr Egan, it would have been reasonable to expect that Mr Egan would have derived assessable income for his services provided to AOS. No objective commercial explanation for the fees paid by AOS to be paid to TM can be identified from the facts other than to enable Mr Egan to spread the earnings between himself, his wife and TM.

The fees paid to TM and 81P were what AOS could afford, that is, they were lower than the amounts which Mr Doubtfire and Mr Egan could earn in the marketplace, and lower than the amounts paid to most other AOS contractors. As such, it is difficult to accept that Mr Egan regarded his salary from TM of $42,744, $22,740 and $50,000, respectively, in each of the three years as appropriate remuneration for his services. It is to be noted that, in the years ended 30 June 1995 and 1996, his salary was only 50% higher than that of Mrs Egan. It represented 27% of the 1995 fees, 17% of the 1996 fees, and 41% of the 1997 fees. As can be seen, it fluctuated significantly over the three years and appeared to have little relation to the services provided.

Consequently, having regard to the matters set out in s 177D, it must be concluded that Mr Egan entered into the arrangement of having the fees paid to TM for the purpose of enabling Mr Egan to obtain a tax benefit.

¶4-155 Use of an incorporated entity (Case 3/99)

Case 3/99[8] is a good contrast to *Mochkin*, as it deals with a situation where PSI is being derived and no objective commercial rationale for the use of an entity (rather than the individual) as the contracting party can be substantiated.

Facts

The taxpayer had been involved in share broking and investment advice since 1960. In 1974, he joined A & Co as an employee. The taxpayer became a member of the Melbourne Stock Exchange in 1981. In 1982, he negotiated with A & Co a changed basis of remuneration from salary to commission on orders introduced by him.

On advice, he decided to use M Pty Ltd (as trustee of a family trust) as the entity to carry on the business of investment adviser. The trust had been inactive from 1977, other than a small volume of share trading in 1982 which produced a minor loss.

The taxpayer and his wife were directors of M Pty Ltd and he was paid a salary. A dealer's licence in the name of the taxpayer was provided by A & Co.

The taxpayer said that oral agreements were entered into between M Pty Ltd, A & Co and himself under which he would be employed by M Pty Ltd and, in that capacity, provide services and take buying and selling orders from clients of M Pty Ltd. Orders would be placed with A & Co by M Pty Ltd which would invoice A & Co on a monthly basis for the commission on such orders. A formal agreement dated 4 June 1996 between B Pty Ltd, which had acquired A & Co in 1984, and M Pty Ltd was produced which recited that it recorded an oral agreement which had existed since 1 July 1982.

In February 1988, the taxpayer's daughter, who had been employed by B Pty Ltd, was retrenched and it was agreed that she would be employed by M Pty Ltd. Under the arrangement, orders taken by the daughter, Mrs S, were to be included in the commission invoiced by M Pty Ltd. A further arrangement was that a fixed monthly amount was paid directly to Mrs S by B Pty Ltd through its payroll system, with further amounts to be paid by M Pty Ltd as salary. A further employee, Miss C, was said to have left B Pty Ltd in January 1994 and commenced employment with M Pty Ltd under similar terms.

No client received any document in the name of M Pty Ltd and, apart from perhaps the top 10 clients from whom buying or selling orders were received, no client was aware of the name M Pty Ltd. The taxpayer carried a business card in the name of B Pty Ltd showing him as an investment adviser, and there was no distinguishing feature on the card which would indicate to a visitor to the offices of B Pty Ltd that some people were employees of M Pty Ltd rather than B Pty Ltd.

Statements prepared monthly by B Pty Ltd entitled "adviser payout statement" made no reference to M Pty Ltd; they only made reference to the taxpayer, Mrs S and, later, Miss C. The monthly invoices from M Pty Ltd agreed with the totals of these adviser payout statements which were identical to statements produced by B Pty Ltd for all investment advisers with that company.

8 99 ATC 134.

The taxpayer maintained that the primary reason for using M Pty Ltd as trustee of the family trust to operate the business was to minimise any personal exposure to liability for bad debts and errors. There was no formal arrangement with A & Co or B Pty Ltd regarding liability for bad debts or errors and, over the years of operation of the arrangement, some small amounts of commission earned had been refunded as a result of client bad debts. The arrangement included the broking firm being liable for professional indemnity insurance premiums covering the investment advisory role.

The net income of the trust was distributed to the taxpayer's wife, a private family company and to the taxpayer.

Scheme

The scheme comprised the following steps:

(1) a change in the status of the taxpayer from an employee of the broking firm to an employee of the company (M Pty Ltd);

(2) the use of the company for supplying the taxpayer's personal services to the broking firm;

(3) the employment of the taxpayer by the company in its capacity as the trustee of a trust;

(4) the arrangement between the broking firm and the company whereby the firm paid the commission, otherwise payable to the taxpayer, to the company and not the taxpayer;

(5) the payment by the company of a salary to the taxpayer which is substantially less than the amount paid by the broking firm for the provision of the taxpayer's services; and

(6) the use of the trust to divert income derived from the personal efforts of the taxpayer to persons other than the taxpayer.

Tax benefit

Case 3/99 would be approached on the basis of the reconstruction approach.

The tax benefit would be the difference between the assessable income of the taxpayer if he had been distributed all of the net income of the trust, or had contracted with B Pty Ltd directly, and the assessable income actually disclosed by the applicant on the lower amount of income distributed to him from the trust.

When assessing the tax benefit, it is necessary to determine whether the income derived by the trust is in the nature of personal services/personal exertion income.

The taxpayer was, prior to the arrangement in 1982, employed by A & Co as an investment adviser. In 1982, he negotiated for his reward for such services to be by way of commission. There was no change in the work performed and no change apparent to any client. His business card continued to be a business card in the name of the broking firm, he continued to work from an office in the firm's premises, and his clients continued to deal with him as a representative of that broking firm. The commission earned from the business introduced by him, at least in the years with which this application is concerned, was the same rate as all other investment advisers representing that broking firm and on a similar basis to that common within the industry. The only difference was that, by agreement, the commission was paid by the firm to M Pty Ltd. The sole role of M Pty Ltd was to issue a monthly handwritten invoice for the commission which was clearly based on the computer-generated commission statement of the broking firm under the names of the relevant individual investment advisers. As such, it is difficult to see that the commission was anything other than personal earnings of the applicant which were assigned after derivation by him to M Pty Ltd.

Purpose

The factor which is at the core of this scheme is the decision to utilise M Pty Ltd in the arrangement. The assessment of purpose should start with consideration of this decision. Relevant factors are:

- the commercial rationale for the use of M Pty Ltd was suggested to be the protection from personal liability. No formal arrangements were put in place, there was no history of significant liability issues, and the broking firm provided professional indemnity insurance cover. The evidence did not support the assertion;
- clients were not generally aware of M Pty Ltd. It served little or no purpose in the relationship with clients;
- the taxpayer's income-producing activities were established well before M Pty Ltd was introduced. The nature of those activities did not change in any material way after the introduction of M Pty Ltd;
- no formal contracts were entered into at the time; and
- M Pty Ltd was prohibited by law from carrying on the business of investment advice.

Considering the factors in s 177D ITAA36 on a holistic basis, the only objective purpose which can be seen for the arrangement was the reduction of personal income and the diversion of income to family members and associates.

Chapter 5

CGT small business concessions

¶5-100 Introduction

Planning around accessing the CGT small business concessions is a key area for SME taxpayers. Such planning has a clear tax motive (a subjective tax purpose), and careful consideration of the application of Pt IVA is warranted.

Timing is critical. Where the planning occurs well before a sale transaction is being pursued, the Pt IVA risk is much lower. Where the planning occurs immediately before the sale transaction, the Pt IVA risk is heightened.

The point was expressed well by the Deputy Chief Tax Counsel of the ATO:[1]

> "If the taxpayer's business structure is not suitable to take advantage of tax planning opportunities and a taxable event is in immediate contemplation, it may not be realistically possible in many ordinary cases to avoid an adverse result under Part IVA by whipping it into shape weeks or a few months before the event. The practical fact is that, in a lot of cases, there will not be other non-tax purposes served by the scheme to which the taxpayer can point.
>
> … Legitimate tax planning should not be crisis management."

The CGT concessions are a key consideration in structuring decisions. The objective is, obviously, to maximise access to the concessions and, in doing so, maximise the after-tax sale proceeds of a future sale.

The situation with the CGT general discount (Div 115 ITAA97) is relatively straightforward. The CGT general discount is only available to individuals and trusts (at the 50% rate) or superannuation funds (at the 33% rate). If the entity making the sale (and hence making the capital gain) is a company, the CGT general discount will not be available. The class of share held is irrelevant.

The situation with the CGT small business concessions is more complex. The eligibility criteria for these concessions are not based on the type of entity making the gain, but, rather, they focus on attributes, such as the size of the entity, ownership structure, and the use of the assets in a business.

The CGT small business concessions in Div 152 ITAA97 enable eligible capital gains to be disregarded, reduced or deferred by applying the various concessions. The four concessions that can potentially be accessed are:

(1) the 15-year exemption which allows a capital gain to be completely disregarded;

(2) the 50% reduction which allows the taxable amount of the gain to be reduced by 50%;

(3) the retirement exemption which allows up to a lifetime limit of $500,000 per person to be disregarded; and

(4) the roll-over which allows all or part of a capital gain to be deferred until a later time.

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1 P Walmsley, "Tax avoidance and succession planning: Pt IVA and ordinary family dealings", (2010) 14(2) *The Tax Specialist* 70.

Eligibility to access the CGT small business concessions is dependent on satisfying a number of basic eligibility criteria, along with additional criteria if accessing the 15-year exemption or the retirement exemption.

¶5-105 Basic eligibility criteria

A number of basic eligibility criteria must be satisfied before being eligible to access the CGT small business concessions. Broadly, the basic conditions are:

- a CGT event must happen in relation to a CGT asset owned by you;
- the event would have otherwise resulted in a gain;
- you are:
  - a small business entity for the income year (the $2m turnover test); or
  - you satisfy the maximum net asset value test (the $6m net asset value test); and
- the CGT asset must satisfy the active asset test.

If the CGT asset is a share in a company or an interest in a trust, one of these additional basic conditions must also be satisfied just before the CGT event:

- you are a CGT concession stakeholder in the object company or trust; or
- CGT concession stakeholders in the company or trust have a small business participation percentage in you (the entity claiming the concessions) of at least 90%.

If the basic eligibility criteria are satisfied, you will be eligible to access the small business 50% reduction. As an individual, you will also be able to access the retirement exemption, subject to making the required payment to a complying superannuation fund if you are under 55 years of age at the relevant time. For companies or trusts to access the retirement exemption, there must be a significant individual in the entity at the time of the CGT event, and the required payments must be made to the CGT concession stakeholders or to a complying superannuation fund (depending on the age of the CGT concession stakeholders).

The 15-year exemption has specific criteria relating to ownership of the entity by a significant individual for at least 15 years and a significant individual being over 55 years of age and retiring.

¶5-110 Satisfying the basic eligibility criteria

The first two basic eligibility criteria require a CGT event to occur in relation to an asset that you own, from which a capital gain would otherwise have resulted. In practice, these first two criteria are generally the easiest to determine whether they have been satisfied. What is more challenging is determining whether the remaining basic conditions have been satisfied.

When determining whether the $2m turnover test or the $6m net asset value test can be satisfied, it is necessary to determine whose turnover or assets need to be included in the calculations. The parties to be included are:

- you;
- the entities connected with you; and
- affiliates of yours.

In a structuring context, it is the connected entities concept which is generally the most relevant consideration.

Determining whether you are connected with another entity requires you to look at whether there is control. Specifically, you will be connected with another entity if:

- you control the other entity;
- the other entity controls you; or
- both you and the other entity are controlled by the same third entity.

You will be taken to control an entity if, between you and your affiliates, you own or have the right to acquire:

- for a company — at least 40% of the voting, capital or dividend rights;
- for a partnership — at least 40% of the income or capital rights; or
- for a non-discretionary trust — at least 40% of the income or capital rights.

Control of a discretionary trust can be established in one of two ways:

(1) an entity controls a discretionary trust if a trustee of the trust acts, or could reasonably be expected to act, in accordance with the directions of the first entity, or the first entity together with its affiliates; or

(2) in any of the four years prior to the year in which the CGT event occurs, you, your affiliates, or you and your affiliates have received distributions of income or capital that were at least 40% of any distributions made for that year.

For the $2m turnover test or the $6m net asset value test, reducing the number of entities connected with the taxpayer who will make the capital gain is beneficial.

A key Pt IVA risk area is any planning that is undertaken to change the entities that are "connected", or to move assets out of the ambit of the $6m net asset value test. Examples of these planning actions are discussed below.

¶5-115 Active asset test

The active asset test is one of the basic eligibility criteria that must be satisfied before being eligible to access the CGT small business concessions. Where the asset being sold is a share in a company or an interest in a trust, special rules apply when determining whether the active asset test has been satisfied.

A CGT asset satisfies the active asset test if:

- you have owned the asset for 15 years or less and the asset was an active asset of yours for a total of at least half of the ownership period; or
- you have owned the asset for more than 15 years and the asset was an active asset of yours for a total of at least 7½ years during the relevant period.

To be considered as an active asset at a particular time, the CGT asset must be used, or held ready for use, in the course of carrying on a business by you, your affiliate or another entity that is connected with you. Alternatively, if the asset is an intangible asset (such as goodwill), it will be an active asset if you own it and it is inherently connected with a business that is carried on by you, your affiliate or another entity that is connected with you.

Planning around the active asset test would generally not be of a nature that would attract the application of Pt IVA, largely because the test is based on the use of an asset in a business over an extended period of time. That said, unusual or artificial arrangements would warrant a more detailed Pt IVA analysis.

¶5-120 CGT concession stakeholder

Where a share in a company or an interest in a trust is disposed of, it is necessary to satisfy the CGT concession stakeholder test. The application of this test varies depending on whether the entity disposing of the shares or trust interests is an individual or not.

To be considered as a CGT concession stakeholder, you must be a significant individual or the spouse of a significant individual who has a small business participation percentage in the entity of greater than zero.

A significant individual is an individual who has a small business participation percentage in the company or trust of at least 20%. The small business participation percentage can be held directly or indirectly (ie by holding an interest in one entity which in turn holds an interest in another entity).

The small business participation percentage in a company is the smaller of:

- the percentage of the voting power in the company held by the individual;
- the percentage of any dividend that the company may pay that the individual would be entitled to receive; or
- the percentage of any distribution of capital that the company may make that the individual would be entitled to receive.

The small business participation percentage in a non-discretionary trust is the smaller of:

- the percentage of any distribution of income to which the individual would be entitled; or
- the percentage of any distribution of capital to which the individual would be entitled.

The small business participation percentage in a discretionary trust is the smaller of:

- if the trustee makes distributions of income during the year — the percentage of distributions to which the individual is entitled; or
- if the trustee makes distributions of capital during the year — the percentage of distributions to which the individual is entitled.

Where the entity disposing of the shares in the company or interest in the trust is an individual, it is necessary to be a CGT concession stakeholder in the company or trust in order to satisfy the CGT concession stakeholder test. However, where the entity disposing of the shares or trust interests is an interposed entity, such as a discretionary trust, the "90% test" must be satisfied.

The 90% test requires CGT concession stakeholders in the company or trust being disposed of to also have a small business participation percentage of at least 90% in the interposed entity.

Planning undertaken to ensure the existence of a CGT concession stakeholder, or multiple CGT concession stakeholders, is a key risk area for the application of Pt IVA. Examples of this planning are discussed below.

In the context of a discretionary trust, the connected entity and controlling individual concepts are ones that can vary year-on-year based on the actual distributions made by the trust. This can provide the benefit of flexibility, but it can also mean that, in the absence of adequate planning in the four years prior to the year when a capital gain is made, the desired connected entity and controlling individual positions are not achieved.

¶5-125 Presale planning to satisfy the net asset value test

The following case study deals with a situation where actions are undertaken to modify the assets and liabilities that are included in the $6m net asset value test. The transactions are legally effective, produce a change in financial positions, and have genuine commercial implications.

Facts

Robert is a successful small business operator. He established a market research consultancy 10 years ago, and he has 30 full-time staff and a turnover of $10m. The business is operated by a company, Pedro Market Research Pty Ltd, which is 100% owned by Robert's trust, the RMT Family Trust. Robert is the sole appointor of the trust and has regularly received distributions from the trust.

The business has been valued at $5m. The cost base in the shares is nominal.

Robert owns a $2m home near a popular surf beach. The debt on the house is $800,000. He also owns various cars and other solely personal-use assets.

Robert is aged 56, as is his wife.

The RMT Family Trust holds investment assets of $1.3m, including shares, a rental property and cash.

Pedro Market Research Pty Ltd also has a loan due to the RMT Family Trust of $500,000. The company does not have sufficient funds to enable this debt to be repaid.

Robert is negotiating to sell the shares in Pedro Market Research Pty Ltd to another industry player. The sale would be for $5m and on the basis that the company would be sold free of debt.

Currently, the family trust's net asset position (including its connected entities) for the purposes of the CGT small business concessions would exceed the $6m threshold as follows:

Pedro Market Research Pty Ltd Business Debt due to RMT Family Trust	 $5,000,000 ($500,000)
RMT Family Trust Loan to Pedro Market Research Pty Ltd Investment portfolio	 $500,000 $1,300,000
Robert Family home	 Excluded
Total	$6,300,000

Robert is proposing that Pedro Market Research Pty Ltd should obtain a short- term loan for $500,000 from a bank on arm's length terms and use these funds to repay the loan due to the RMT Family Trust. The bank is prepared to lend against the assets of the business.

The RMT Family Trust has a significant amount of corpus from funds previously settled on the trust. The trust would use the $500,000 to make a tax-free capital distribution to Robert of $500,000. Robert will use the funds to repay a portion of his home loan. This will modify the net asset position for the purposes of the CGT small business concessions $6m net asset value test as follows:

Pedro Market Research Pty Ltd Business Debt due to bank	 $5,000,000 ($500,000)
RMT Family Trust Investment portfolio	 $1,300,000
Robert Family home	 Excluded
Total	$5,800,000

Robert intends to negotiate with the purchaser for the purchase price to be reduced by the amount of the debt, with the debt being discharged on completion.

As a result of this transaction, the RMT Family Trust can access the CGT small business concessions on the sale of the shares in Pedro Market Research Pty Ltd.

Scheme

The scheme would include:

- obtaining the loan;
- repaying the existing shareholder loan;
- making the capital distribution;
- repaying the home loan; and
- negotiating the sale to occur net of debt.

Tax benefit

The tax benefit would be the reduction in the capital gain included in assessable income that is achieved by accessing the CGT small business concessions.

The tax benefit would be determined using the reconstruction approach. While the scheme could, in theory, be annihilated, an alternative postulate to the scheme necessarily includes an element of prediction, being that the sale could be renegotiated to be net of debt. This aspect affects the transaction that results in the capital gain. As such, the reconstruction approach is more appropriate. In any event, a similar outcome should arise in this case.

The substance of the scheme is that private debt (the home loan) and related party debt (the RMT Family Trust loan) are refinanced. There is no overall change in the financial position of Robert and his associated entities, except for a reduction in the level of debt secured against Robert's home.

The result of the scheme for Robert is a reduction in his home loan, no change in his associate-inclusive overall financial position, and a change in the level of debt secured against his home.

The alternative postulate must be a reasonable alternative to entering into or carrying out the scheme. An alternative postulate could be:

- the refinancing under the scheme does not take place;
- the business is sold net of debt, with the RMT Family Trust loan being repaid on completion;
- the RMT Family Trust makes the capital distribution to Robert; and
- Robert uses the funds to repay the home loan.

The non-tax outcomes of this alternative postulate for Robert are consistent with those of the scheme. There may be other possible alternative postulates (for example, distributions to other parties). When assessing other possible alternative postulates, it would be important to consider the substance of the scheme and the results and consequences for Robert.

The amount of the tax benefit would be the difference between the capital gain in the two instances:

	Scheme	Alternative postulate
Sale consideration (net of debt)	$4,500,000	$4,500,000
Less: cost base (assume nil)	–	–
Capital gain	$4,500,000	$4,500,000
Less: 50% general discount	($2,250,000)	($2,250,000)
Less: 50% reduction	($1,125,000)	
Less: retirement exemption (Robert and his wife)	($1,000,000)	
Net capital gain*	$125,000	$2,250,000
Tax (assuming 46.5% marginal rate)	$58,125	$1,046,250

* This assumes that the small business roll-over is not accessed.

Purpose

The manner in which the scheme was entered into or carried out would include the fact that the bank debt was obtained from a bank on arm's length terms. The loan repaid to the RMT Family Trust was a genuine loan, as was the distribution of capital by the trust. The funds paid by Robert on his loan were a reduction of an actual existing liability. The sale net of debt was negotiated with an arm's length party. This factor is neutral or would point away from a tax purpose.

The substance and form of the transaction may not necessarily be aligned. The form indicates a refinancing. In substance, few changes are made to the overall financial position of the group. This factor would point slightly towards a tax purpose. However, the transaction does produce a reduction in the level of debt secured against Robert's home, which is a benefit that is unrelated to any future sale of the business and accessing CGT concessions.

The timing of the scheme would point to a tax purpose — it occurred in close proximity to the derivation of the capital gain. The length of time that the scheme was carried out would also point to a tax purpose as the funding obtained by the company was short-term.

The change for Robert's financial position is really driven from the tax savings that will be achieved on the capital gain. His net financial position does not change materially under the scheme. A similar statement would apply for Robert's associated entities. This would point to a tax purpose. However, a debt is created with the bank. This brings with it the associated legal and financial obligations. Furthermore, the level of debt secured against Robert's home decreases. This would point away from a tax purpose.

The fact that the refinancing occurred substantially between associated parties would point to a tax purpose. The involvement of the bank and the renegotiation with a third party purchaser would point away from a tax purpose.

There are factors which point to and point away from the requisite dominant purpose of obtaining a tax benefit. The timing of the transaction and the fact that no overall change occurs in the financial position of Robert and his associates point to a tax purpose. The fact that arm's length borrowings are obtained, a contract with a third party is renegotiated, and the level of debt secured against Robert's home decreases would all point away from a tax purpose.

On balance, although there are certainly risks, an argument could be made that Pt IVA should not apply. A stronger commercial rationale for the borrowing would assist in arguing that Pt IVA should not apply, while the absence of any such commercial rationale would increase the likelihood that Pt IVA would apply.

If the transaction occurred before a sale of the shares was imminent, the timing aspects of the s 177D factors and the proximity of the scheme to the derivation of the capital gain would be less indicative of a tax purpose. In this instance, the argument that Pt IVA should not apply would be stronger.

¶5-130 Presale planning to satisfy the net asset value test (no permanent change)

The following case study deals with a situation where actions are undertaken to modify the assets and liabilities that are included in the $6m net asset value test. In this example, the changes are temporary, with the pre-existing position being restored after the CGT event occurs.

Facts

Nicola operates a health spa in the foothills of the mountains. The business is conducted through a company, Spa Nicola Pty Ltd, which is 100% owned by the Nicola Family Trust. The trust also owns the property from which the business is conducted.

Nicola is the sole director of Spa Nicola Pty Ltd and is the trustee and appointor of the trust.

Nicola and her husband Steve also own a rental property, a portfolio of listed company shares, and term deposits of $1m. They operate their own self-managed superannuation fund (SMSF) which holds investments of around $2m. The fund is in pension phase.

Nicola and Steve receive regular distributions from the trust. These are generally split 50/50.

Nicola is aged 62 and Steve 61.

The trust is going to seek expressions of interest for the purchase of the health spa business.

The trust's net asset position for the purposes of the CGT small business concessions is $6.5m. This includes the assets of Nicola and Steve, who are both connected with the trust.

Nicola speaks to a friend of hers who sold a business a few years ago. He tells Nicola of a great strategy that he used to deal with a similar issue. The strategy would require Nicola to break the term deposit and use the funds to make non-concessional contributions to the SMSF. Contributions of up to $450,000 could be made for each of Nicola and Steve. This would reduce the net asset position to below the $6m threshold required for the CGT small business concessions, as the assets of the SMSF are not counted towards this test.

Once the business is sold and the concessions applied, Nicola and Steve will withdraw from the SMSF as a lump sum the non-concessional contributions and place them back in a term deposit in their own names.

Scheme

The scheme would include:

- using the funds currently on deposit to make the non-concessional contributions; and
- withdrawing the funds from the SMSF post-sale and placing the funds back on deposit.

Tax benefit

The tax benefit would be a reduction in the capital gain included in assessable income that is achieved by accessing the CGT small business concessions.

While the reconstruction approach is probably more appropriate, given the confined nature of the scheme, the annihilation approach may be open to the ATO.

The substance of the scheme is an arrangement to temporarily move an asset to an associated entity that is not a connected entity (as defined) just before the CGT event, such that the $6m net asset value test can be satisfied. The non-tax results for the taxpayer are limited — essentially, the temporary depositing of the funds in the SMSF and the utilisation of some or all of their non-concessional contributions caps.

Purpose

The temporary nature of the change in the financial position of Nicola is indicative of a tax purpose.

The manner in which the scheme is entered into would indicate that providing for their retirement through the contribution of funds to the SMSF was not a significant purpose as the funds were withdrawn after a short period of time.

The substance and form of the scheme are not aligned. The form would indicate the making of a superannuation contribution and the withdrawal of funds from an SMSF in pension phase. The substance would indicate that this is an arrangement to temporarily move an asset to an associated entity that is not a connected entity (as defined) just before the CGT event, such that the $6m net asset value test can be satisfied.

The scheme occurs over a short period of time that correlates with the making of the capital gain. The timing of the steps is determined so as to ensure that the $6m net asset value test is satisfied.

The change in financial position of Nicola and her associates from the scheme is minimal and temporary. The major impact on their financial position is from accessing the CGT concessions.

The factors in s 177D ITAA36 would indicate a dominant purpose of obtaining a tax benefit.

Variation 1

Would a different conclusion be reached if the contributions were not subsequently withdrawn from the SMSF? Probably yes. The change in the financial position would then be more permanent and the purpose of the contribution would be more clearly the provision of retirement benefits. The funds would be held in the superannuation environment and subject to the associated regulations. The substance and form of the scheme would also more closely align.

Variation 2

Often, a spouse or closely related family members will not be connected for the purposes of the CGT small business concessions. Using a similar fact pattern as in the example above, would Pt IVA apply if the term deposit was transferred from the taxpayer to their spouse, where their spouse was not connected for the purposes of the CGT small business concessions? The answer is likely to lie in the permanency of the change in financial position (as per the above example and the variation), as well as whether the transaction genuinely results in the taxpayer ceasing to have the benefit or enjoyment of the asset and the income from the asset.

¶5-135 Restructuring ownership of a business to ensure CGT small business concessions are available

The case study below deals with a situation where an out-of-date business structure is modified, with the effect that the CGT small business concessions will become available. The restructuring occurs as part of a succession/exit planning process, but before any specific sale transaction is being contemplated.

Facts

Malcolm and Karin Smith have been operating their appliance repair business for nearly 20 years. A few years ago, they decided to focus on servicing coffee machines, a decision which has paid off handsomely with the recent explosion in sales of home coffee machines.

Malcolm and Karin have both just turned 60 years of age. In conjunction with their advisers, they have undertaken a strategic planning process looking at the next five years for their business. The business has some great opportunities, but both Malcolm and Karin would like to retire in about five years, sell the business and move down the coast.

A discussion was held with their family. Malcolm and Karin's children, Joshua and Matthew, are both aged in their 30s and have successful careers in law and medicine. Neither is particular keen on taking over the business and neither has been involved in the business to any great extent.

The decision is made to prepare the business for a sale in around three years' time, such that the sale process should be able to be completed within the five-year time frame that Malcolm and Karin are targeting.

The business is owned by a company, Pronto Repairs Pty Ltd. The company has multiple classes of shares on issue:

- Malcolm holds 100 A class shares. These carry voting rights, a right to a return of capital on winding-up (but no participation in the distribution of any surplus) and discretionary dividend entitlements;
- Karin holds 100 B class shares. These shares carry voting rights, but only in the event of the death of the A class shareholder. They carry a right to a return of capital on winding-up (but no participation in the distribution of any surplus) and discretionary dividend entitlements;
- the Smith Family Trust holds 100 C class shares. The shares have no voting right, a right to a return of capital on winding-up, participation in the distribution of any surplus, and discretionary dividend entitlements;
- Joshua holds 100 D class shares. The shares have no rights other than discretionary dividend entitlements; and
- Matthew holds 100 E class shares. The shares have no rights other than discretionary dividend entitlements.

Dividends have only ever been paid on the A and B class shares.

In the course of the planning process undertaken with the advisers, it is identified that the current share structure would mean that no CGT concession stakeholder would exist due to the discretionary rights attached to each class of shares.

Malcolm and Karin would satisfy the other eligibility criteria for the CGT small business concessions.

The adviser proposes that:

- a valuation should be obtained on the C, D and E class shares. Given the discretionary dividend entitlements, lack of voting rights and absence of a history of dividends being paid on these shares, she believes that the market value will be quite low;
- Pronto Repairs Pty Ltd will undertake a selective share buy-back to acquire and cancel the C, D and E class shares; and
- the A and B class shares will be converted to ordinary shares. A market valuation will be obtained to ensure that any value-shifting consequences are identified.

Once this restructure occurs, Malcolm and Karin will be CGT concession stakeholders. They intend to access the CGT small business concessions on the future sale of the business or the shares in Pronto Repairs Pty Ltd.

Scheme

The scheme would include:

- conducting the selective share buy-back; and
- converting the A and B class shares to ordinary shares.

Tax benefit

The tax benefit would be determined most appropriately under the reconstruction approach. The tax benefit only arises once the CGT concessions are accessed.

The substance of the scheme is a restructure of the shareholdings in the company. The results for the taxpayers (Malcolm and Karin) are that they move from holding shares with certain discretionary rights to holding shares with rights over all of the voting, capital and dividend entitlements. Individually, Malcolm and Karin will each hold a 50% entitlement.

To cause a tax benefit to arise, the alternative postulate would need to be one where the CGT event still occurs, but the shareholdings are not restructured to put Malcolm and Karin in the position of being CGT concession stakeholders. This would occur if the scheme was ignored (ie no change in the shareholdings), if the conversion to ordinary shares did not occur or, rather than a buy-back, if the C, D and E class shares were transferred to Malcolm and Karin in equal proportions.

This last alternative postulate produces a result that is most closely aligned with the results of the scheme, as it would mean that Malcolm and Karin would, but for Karin's voting rights, each hold 50% of the capital and 50% of the dividend rights.

Assuming that the CGT event is a sale of shares, the amount of the tax benefit is the difference between the capital gains on the sale of the shares where the general discount and the CGT small business concessions are accessed and the capital gain when only the general discount is accessed.

Purpose

The manner in which the scheme is carried out would include that market valuations were undertaken to support the pricing of each transaction. The share buy-back and the conversion of the shares would need to be undertaken in accordance with the corporations law requirements. This factor would point away from a dominant tax purpose. The transactions are legally effective, appropriately documented, and have a real impact on the assets and rights of the different parties.

The form and substance of the scheme are aligned. In form and in substance, there is a restructure of the shareholdings in the company. This factor would point away from a dominant tax purpose.

The timing of the scheme is not indicative of a dominant tax purpose. The scheme would occur in accordance with the corporations law mandated requirements. It is not conducted when a sale of shares or the business is proximate, although it is clearly undertaken in the knowledge that a sale will occur in the foreseeable future. This factor would point away from a dominant tax purpose.

There is genuine change in the financial position of the shareholders. The C, D and E class shareholders cease to hold shares. Malcolm and Karin will each own 50% of the company. The company will operate under the share structure for a number of years before any potential CGT event. This factor would point away from a dominant tax purpose.

The other factors in s 177D ITAA36 are not of material relevance in this case.

While the taxpayers are very much aware of the tax benefit to be obtained from the scheme, the requisite dominant purpose of obtaining a tax benefit is not present.

Were the restructure to occur once a sale was being negotiated, it would be more likely that Pt IVA would apply.

¶5-140 Ownership of a business is restructured to ensure CGT small business concessions are available

The following case study is a variation of the preceding case study. An out-of-date business structure is modified with the effect that the CGT small business concessions will become available. The restructuring occurs as part of a succession/exit planning process, but before any specific sale transaction is being contemplated. The variation is that “side agreements” are entered into with some of the parties to ensure that they continue to receive the same economic benefit after the restructure as they did before.

Facts

The same background applies as in the previous case study, except that Pronto Repairs Pty Ltd has the following classes of shares on issue:

- the Smith Family Trust holds 100 A class shares. These carry voting rights, a right to a return of capital on winding-up, and participation in the distribution of any surplus and discretionary dividend entitlements;
- Karin holds one B class share. This share has no rights other than discretionary dividend entitlements;
- Malcolm holds one C class share. This share has no rights other than discretionary dividend entitlements;
- Joshua holds one D class share. This share has no rights other than discretionary dividend entitlements; and
- Matthew holds one E class share. This share has no rights other than discretionary dividend entitlements.

Malcolm and Karin are the trustees and appointors of the Smith Family Trust. The A class shares have regularly received dividend distributions. The trust has distributed this income to Malcolm and Karin. Dividends have also been paid regularly on each of the D and E class shares.

The adviser proposes that:

- a valuation should be obtained on the B, C, D and E class shares. Given the discretionary dividend entitlements and lack of voting rights, she believes that the market value will be quite low; and
- the Smith Family Trust will acquire the B, C, D and E class shares, such that it holds 100% of the shares on issue.

Once this restructure occurs, Malcolm and Karin will be CGT concession stakeholders if the trust makes appropriate distributions to them. They intend to access the CGT small business concessions on the sale of the business or the shares in Pronto Repairs Pty Ltd. However, Joshua and Matthew are not enthusiastic about this proposal as they believe that they will be losing the dividends that they have been receiving for many years.

To get the deal over the line, Malcolm and Karin as trustees of the trust undertake to make trust distributions to Joshua and Matthew that are equivalent to the dividend distributions that they previously received or, if this is not possible (say, in the year of sale), to gift an equivalent amount to them. This is an understanding between the parties and no formal agreement is entered into.

Scheme

The scheme would include:

- the transfer of the shares to the trust; and
- the undertaking to make distributions to Joshua and Matthew.

Tax benefit

The tax benefit would be the omission of income through the capital gain made on a sale being reduced by the small business concessions that would not have otherwise been available.

The tax benefit would be determined most appropriately under the reconstruction approach, but the annihilation approach may also be effective. The tax benefit only arises once the CGT concessions are accessed.

The substance of the scheme is a restructure of the shareholdings in the company. The result of the scheme is that the trust becomes the 100% shareholder in the company, but Joshua and Matthew continue to have an "entitlement" of sorts to distributions of "profit", albeit ones that continue to be discretionary in nature.

To cause a tax benefit to arise, the alternative postulate would need to be one where the CGT event still occurs but the shareholdings are not restructured to put Malcolm and Karin in the position of being CGT concession stakeholders. This would occur if the scheme was ignored (ie no change in the shareholdings) or the trust only acquired the B and C class shares.

Assuming that the CGT event is a sale of shares, the amount of the tax benefit is the difference between the capital gain on the sale of the shares where the general discount and the CGT small business concessions are accessed and the capital gain where only the general discount is accessed.

Purpose

The manner in which the scheme is undertaken would include the obtaining of market values for the shares and the execution of share transfer documentation. The legal and economic positions of the parties are changed under the scheme. This would point away from a dominant tax purpose. However, the undertaking to continue to pay distributions to the former shareholders would suggest a potential dominant tax purpose as this is an unusual feature to include in a share transfer transaction. It is worth noting that the trustee's discretion cannot be fettered, so enforcing the undertaking may be difficult.

The form and substance of this scheme do not align. The form is suggestive of a restructure of the shareholding. However, in substance, Joshua and Matthew continue to have essentially the same rights — a discretionary right to share in the profits — before and after the scheme, with only the form of the discretionary right changing. This would indicate a dominant tax purpose.

The timing of the scheme is also not indicative of a dominant tax purpose. It is not conducted when a sale of shares or the business is proximate, although it is clearly undertaken in the knowledge that a sale will occur in the foreseeable future. This factor would point away from a dominant tax purpose.

There is no real change in the financial position of the shareholders. Malcolm and Karin now "hold" their interest via a trust that they control. Joshua and Matthew continue to have essentially the same rights — a discretionary right to share in the profits. This would point to a dominant tax purpose.

The other factors in s 177D are not of material relevance in this case.

The undertaking to continue to make distributions to Joshua and Matthew is problematic and distinguishes this case from the previous one. A dominant purpose of obtaining a tax benefit is likely to be the conclusion for this arrangement. The more binding and legally enforceable the undertaking given to Joshua and Matthew, the higher the Pt IVA risk will be. Part IVA will also be assessed with the benefit of hindsight. If the trustee does actually distribute to Joshua and Matthew as agreed, this would be a strong indicator of a dominant purpose of obtaining a tax benefit.

Without this undertaking, or if Joshua and Matthew were paid a lump sum (rather than a nominal amount) for their shares, with the amount being the discounted value of expected future distributions (ignoring the fact that they may be discretionary), then the risk of Pt IVA applying would be lower.

¶5-145 Ownership of a business is restructured using CGT small business concessions

This case study covers a situation where ownership of an entity conducting a business is transferred to an associated family trust. The CGT small business concessions are applied to reduce any associated capital gain to nil.

Facts

Agatha established her business about 10 years ago. At the time, she didn't have the money to get good professional advice, so she just arranged for a company to be incorporated in which she was the sole shareholder and director. The company, Ella Bella Pty Ltd, distributes a range of pet grooming products.

Since establishing her business, Agatha has married David, had one child (Charys) and has another on the way. They've bought a house on the outskirts of town and Agatha is starting to accumulate a few investments in her own name using the profits from the business.

Agatha has just changed accountants. Her new accountant has reviewed her situation and come up with a few observations. He is proposing that she transfer her shares to a new family trust for the following reasons:

- greater flexibility in the distribution of income could be achieved if the shares in the company were held by a family trust. This way, David (who is not working at present) and the children could receive distributions;
- while Agatha can access CGT concessions if the business or shares were sold under the current structure, the same concessions could be accessed if the shares in the company were held by a family trust. In addition, the retirement exemption may also be able to be accessed in respect of David; and
- holding the shares in a family trust would improve Agatha's asset protection position. There are some real potential risks based on the products that the business deals with. While the business has insurance, the accountant is worried that Agatha may have personal liabilities as a director. This would expose her business, the house and her investments. He believes that a family trust may provide a better asset protection outcome.

The shares in Ella Bella Pty Ltd are valued at approximately $750,000. No formal valuation has been prepared. Agatha has a nominal cost base in the shares.

Agatha establishes a family trust with a corporate trustee. Agatha is the sole appointor of the trust, with this role being relinquished if she was to be made bankrupt or on the happening of certain other events.

She enters into an agreement to sell her shares in Ella Bella Pty Ltd to the trust for $750,000. Subsequent to the sale, Agatha also sells her investments to the trust for their market value of $20,000. The investments were only acquired recently and their value has not changed to any great extent since acquisition. The capital gain made on the sale of the investments is minimal.

After these two transactions, the trust has a loan due to Agatha of $770,000. The accountant arranges for her to get some legal advice and, based on this advice, Agatha settles an equivalent amount on the trust which is then set off, by agreement, with the loan.

No changes are made in respect of ownership of the house. There is a substantial mortgage on the home which, in effect, means that the bank is the only creditor that can currently have recourse to it.

Agatha made a capital gain of $750,000 on the sale of the shares in Ella Bella Pty Ltd. Agatha meets the $6m net asset value test, and the shares in Ella Bella Pty Ltd are active assets. She reduces the gain by the discount concession and the 50% reduction to leave a net capital gain of $187,500. Agatha chooses to apply the small business roll-over. Her intent is to try and save enough money over the next two years to make a contribution to superannuation and use the retirement exemption.

Ella Bella Pty Ltd continues to trade profitably and pay dividends to the trust. The dividend income is distributed in a tax-effective manner between Agatha and David.

Can Pt IVA be applied to this transaction?

Scheme

There are probably two main ways in which the scheme could be defined in this situation.

The first would be a scheme that focuses on the transfer of the shares, targeting the accessing of the CGT small business concessions as the driver of the tax benefit.

The other would be a scheme that also includes distributions from the trust, so that the tax benefit would also include the benefit of splitting the dividend income between Agatha and David, rather than being distributed solely to Agatha.

Tax benefit

Is there a tax benefit under s 177C ITAA36 in this situation?

If the scheme is defined to focus on the transfer of shares, the tax benefit must relate to the accessing of the CGT small business concessions on the resultant capital gain. Agatha is already in the position (by virtue of her ownership of the shares, the net asset position and the assets owned by the company) to be eligible for the discount concessions and the CGT small business concessions. The tax benefit therefore arises by virtue of choices (etc) that are made under Div 115 and Div 152 ITAA97.

Has Agatha entered into or carried out the scheme for the purpose of creating any circumstances or state of affairs the existence of which is necessary to enable the choices (etc) to be made? Both Div 115 and Div 152 require the making of a capital gain before the concessions can be applied but, apart from this, the circumstances or state of affairs required for the concessions to be applied existed before the scheme was entered into. This is an example of where the exclusion in s 177C(2) should be applied.

If a broader scheme is identified (one that includes the trust distributions), the exclusion in s 177C(2) would not apply to the tax benefit attributable to the trust distributions. In this situation, the application of Pt IVA would turn on the question of purpose, in particular, the purpose of establishing the trust and the subsequent decisions to make distributions to both David and Agatha.

Purpose

The manner in which the scheme was entered into and carried out is not indicative of a tax purpose. The assets were validly transferred to the trust which was established based on advice from the accountant (and, one would assume, legal assistance). The asset protection risk is valid but contingent. The actions of transferring the investment assets and settling the $770,000 on the trust are consistent with an asset protection strategy. The distributions are then made in accordance with the terms of the trust deed.

The form and substance are aligned. Both are the transfer of assets to a discretionary trust. While Agatha maintains some control over the assets, legal and beneficial ownership of the assets has changed. This would not be indicative of a tax purpose. While a subjective purpose of minimising tax on the trust distributions may have been present, this is not relevant. The distributions are made in accordance with the deed and, in form and substance, result in an entitlement arising for each of David and Agatha.

The tax benefit is not related to the timing of entering into the scheme. The timing is more a factor of a change in accountants and identification of an asset protection issue.

The tax result, being a reduction in the tax on the distributions, does, when considered in isolation, indicate a tax purpose.

The overall financial position of Agatha and her associates is unchanged. They continue to hold the shares and benefit from the profit distributions. Any change in financial position is really attributable to a reduction in the tax on the distribution. However, Agatha's personal financial position has changed as she has disposed of legal and beneficial ownership of the shares to the trust. This factor would be neutral in terms of indicating a tax purpose.

The parties are all related parties, but this has at best a slight inference of a tax benefit in that beneficial ownership of the assets is retained by related parties of Agatha.

Overall, the transaction does not present sufficient indicators of a tax purpose for this to be concluded as the dominant purpose under Pt IVA.

One point to note is the lack of any asset protection-related actions in respect of the house. The assertion is that the house is fully mortgaged, so no creditor other than the bank would be able to have recourse to it. Over time, the bank debt will be paid off and equity will be built up in the house. This equity will be an asset that creditors could have recourse to. Should the ATO review this transaction, it will do so with the benefit of hindsight. A reasonable question would be whether Agatha has actually achieved her asset protection objective if her most valuable asset is not protected from creditor claims. This would increase the risk that Pt IVA may be applied. In respect of real property, the stamp duty cost of transferring ownership of the property to obtain the optimum asset protection position can be prohibitive. This may explain why a decision was made to not change the current ownership of the property.

¶5-150 Gearing used in the restructure of ownership of a business

The following case study covers a situation where ownership of an entity conducting a business is transferred to an associated family trust. The CGT small business concessions are applied to reduce any associated capital gain to nil. It is similar to the previous case study, except that the acquisition by the trust is debt-funded, which has the effect of converting what was personal debt (non-deductible interest) into business/investment-related debt (deductible interest). The asset protection purpose that existed in the previous case study is also absent from this case study.

Facts

Dr Jones operated a thriving medical practice. The practice had been established by him and was operated as a sole proprietorship. The estimated value of the practice was $500,000.

When he went to see his accountant as part of his normal year-end tax planning, it was suggested to Dr Jones by the accountant that there were certain benefits to be obtained by incorporating his practice, including superannuation benefits and tax savings.

Dr Jones and his wife owed the bank $650,000, secured against their home.

Based on the accountant's advice, Dr Jones set up a company, Jones Pty Ltd, for the purposes of having the company acquire his medical practice. Dr Jones was to become an employee of the company, and the sole shareholder and director of the company.

At around this time, Dr Jones approached a different bank on behalf of Jones Pty Ltd for a loan of $500,000. The loan was secured by way of a mortgage over the private residence of Dr Jones and his wife. The loan funds were used to repay in part the existing $650,000 loan owned by Dr Jones and his wife.

Dr Jones and his wife then entered into a loan with that same bank for a personal loan in the sum of $150,000. The loan was also secured by way of a mortgage over the private residence of Dr Jones and his wife. The loan funds were used to discharge the balance of the existing $650,000 loan owned by Dr Jones and his wife.

Jones Pty Ltd acquired the medical practice from Dr Jones for $500,000 (which had been advanced to Dr Jones to enable repayment of the existing loan). Dr Jones applied the general discount, the 50% reduction and the retirement exemption to reduce the taxable capital gain to nil.

Jones Pty Ltd is seeking to claim a tax deduction for the interest incurred on the loan, such interest ordinarily being deductible under s 8-1 ITAA97.

Scheme

The scheme would include the entering into the borrowing arrangements with the new bank in the name of Jones Pty Ltd, with the use of the funds to acquire the business and discharge the existing personal debt.

Tax benefit

The tax benefit is the deduction for interest on the loan.

The tax benefit should be determined using the reconstruction approach. Some level of prediction is required as to what Dr Jones and Jones Pty Ltd would have done to finance the acquisition of the business without the loan arrangement, although, arguably, the annihilation approach could be used to disregard the whole scheme, including the borrowing.

The substance of the scheme and the result of the scheme can be described as the conversion of non-deductible personal debt into deductible debt in the name of the company. Ignoring the tax result, in substance, there is no material change in the financial position of Dr Jones and Jones Pty Ltd, including no change in the level of debt secured against the private residence.

An alternative postulate would be the subscription of shares for $500,000, the sale of the business to the company for $500,000, and the offsetting of the two liabilities thus created.

Purpose

The manner in which the scheme is entered into and carried out would include aspects that point away from a tax purpose (such as the arm's length borrowing arrangements and refinancing entered into with the bank) and aspects that point towards a tax purpose (such as the replacement of one debt secured against the home with two debts, one of which was "tax deductible", also secured against the home).

In form, the company has taken on debt to acquire an income-producing asset. In substance, there has been no material change in the financial position of Dr Jones and his associates. Dr Jones does dispose of the business, but he continues to have beneficial ownership via his shareholding in the company. Dr Jones and his associates continue to have the same level of debt with the same charge over the home. These factors would point towards a tax purpose.

The timing of entering into the scheme and the length of time over which the scheme is carried out would be neutral. The tax benefit — being the interest deduction — arises over the course of the scheme, as do the other obligations under the loan arrangement.

As noted, when considering the substance of the scheme, there is no material change in the financial position of Dr Jones and his associates, but for the benefit of the tax deduction. This would point to a tax purpose.

The transaction also occurs predominantly between associated parties, in a manner that would not occur in an arm's length dealing. When would a vendor provide their property as security for the debt taken on by a purchaser of their business? This aspect of the transaction is critical to obtaining the new finance which is necessary for creating a tax deduction for the interest. This would point strongly to a tax purpose.

The factors in s 177D would indicate the presence of a dominant purpose of obtaining a tax benefit.

For further discussion, see *Re Taxation Appeals.*[2]

¶5-155 Introducing an extra CGT concession stakeholder

In the case study below, the parties enter into a transaction immediately prior to a CGT event that enables an additional CGT concession stakeholder to arise and hence the tax-free amount available under the retirement exemption to be doubled.

Facts

Niamh is the sole shareholder in a company, Sydney Wedding Planners Pty Ltd, holding 100 ordinary shares.

The business commenced as a wedding planning consultancy and was largely dependent on Niamh to provide its services. This side of the business grew to the point where a team of consultants was employed by the company.

Niamh's husband Phillip identified an opportunity to leverage the knowledge and contacts that Niamh had built up in the wedding industry. He worked to develop a website and accompanying app that brides-to-be can utilise to schedule the preparation of their wedding, develop themes, identify potential suppliers, obtain quotes etc. The intellectual property for this offering is owned by Sydney Wedding Planners Pty Ltd.

After successfully building the business in recent years, the decision has been made to sell the online business but retain the consultancy business.

Sydney Wedding Planners Pty Ltd satisfies the conditions for accessing the CGT small business concessions, and neither the company nor Niamh has previously accessed these concessions.

The online business is valued at approximately \$2m. A sale of shares in the company is not feasible, given the existing consultancy business that Niamh intends to maintain.

2 [1991] AATA 1.

A sale of the business assets would yield the following tax position:

Capital gain	$2,000,000
50% reduction (Div 152)	($1,000,000)
Retirement exemption (Div 152)	($500,000)
Taxable gain	$500,000

One day, when Niamh was working with a friend who happened to be a corporate adviser, he made the suggestion that, to fix her tax problem, she could bring Phillip in as a shareholder. The idea is to have Niamh's husband Phillip subscribe for one share in the company at market value. Phillip will then be a CGT concession stakeholder and be eligible to receive $500,000 under the retirement exemption.

Phillip subscribes for the share. Within a couple of months, the online business is sold and the CGT concessions are applied to reduce the resulting capital gain to nil and to distribute $500,000 of the sale proceeds tax-free to each of Phillip and Niamh (both are aged over 55 years).

Does the transaction to introduce Phillip as a shareholder create a Pt IVA issue?

Scheme

The scheme would include the transaction for Phillip to become a shareholder and the distribution of moneys to him by way of the application of the retirement exemption.

Tax benefit

A tax benefit obtained by the choice under Subdiv 152-D ITAA97 to access the retirement concession in respect of an existing shareholder would be covered by the s 177C(2) exclusion. However, where an action is taken to introduce a new shareholder (Phillip) shortly before a sale, the tax benefit obtained by the choice under Subdiv 152-D would fall outside the s 177C(2) exclusion. This is because a scheme has been entered into or carried out for the purpose of creating any circumstance or state of affairs the existence of which is necessary to enable the choice to be made.

The tax benefit is the omission of income from the non-inclusion of a capital gain in assessable income through accessing CGT small business concessions that would otherwise not have been available.

The tax benefit would be determined using the reconstruction approach, because a level of prediction is required as to what the company would have done in respect of the net capital gain absent the scheme.

The substance of the scheme is the distribution of $500,000 of the sale proceeds to Phillip. The result of the scheme, other than the tax result, is that $1,000,000 of the sale proceeds is available to Phillip and Niamh personally and $1,000,000 is retained within the company.

An alternative postulate would be that Phillip does not subscribe for the share and the company does not apply the retirement exemption other than for Niamh. It would have been open to the company to apply the roll-over concession to reduce the gain to nil, but it may be difficult to argue that the alternative postulate should include this aspect as it does not enable the distribution of the sale consideration to Phillip and Niamh for them to use personally.

The more likely alternative postulate is that the company is taxed on the remaining $500,000 capital gain and distributes the proceeds by way of a dividend to Niamh.

Depending on the relevant taxpayer, the tax benefit could be the reduced capital gain (for the company) or reduced dividends (for Niamh).

The ATO would likely need to issue multiple separate determinations under s 177F ITAA36 to address this situation.

Purpose

The manner in which the scheme is entered into may include factors such as that the share was legally acquired and at market value, which would point away from a tax purpose. However, a significant factor would be that a nominal shareholding (less than 1%) was acquired and a distribution of 25% of the capital gain was subsequently received. This would point to a tax purpose.

In form, the transaction is a subscription for a share at market value and then the accessing of CGT concessions on a subsequent sale. In substance, the subscription for the share does little more than enable a tax-free distribution to be made on the sale of the business. This points to a tax purpose.

The timing of the scheme, being in close proximity to a pending sale, points to a tax purpose.

The nominal interest acquired through the share subscription means that there is little change in the financial position of Niamh, Phillip or the company through this transaction. The change in financial position is achieved through the application of the CGT concessions in a manner that would not have been possible but for the share transaction. This points to a tax purpose.

The transactions that produce the tax benefit (the subscription for the share and then the application of the retirement exemption) occur solely between related parties. The price paid to acquire the shares is out of kilter with the value received through the application of the retirement exemption. This factor would indicate a tax purpose.

Considering all of the above, the factors in s 177D would point strongly to a requisite dominant purpose of obtaining a tax benefit.

Variation

Could this transaction be undertaken in a way that does not trigger Pt IVA? Two factors that are quite important in the Pt IVA analysis are:

(1) timing — the transaction occurs when a sale is contemplated, so the connection with obtaining the tax benefit of the concession is strong. If this transaction occurred well before a sale transaction, the Pt IVA risk would be reduced; and

(2) nominal interest — Phillip acquires one share, giving him a less than 1% interest in the company. This has no clear commercial rationale. If Phillip had acquired a more significant shareholding, this may support a conclusion that the requisite dominant purpose of obtaining a tax benefit was not present.

Discretionary trust

An analogous situation is where the distributions from a discretionary trust are managed in the year of sale to ensure that multiple CGT concession stakeholders are created. If the business had been owned in a trust and Phillip had received a distribution sufficient to be a CGT concession stakeholder, would Pt IVA apply? Probably not. Where the distributions are made in accordance with the deed and are genuinely for the benefit of the named beneficiary, the objective purpose should not be concluded to be obtaining a tax benefit (even though this may be the subjective purpose).

The distribution would be made in a manner that is consistent with the deed, and the income or capital distributed would be applied for the benefit of the named beneficiary. Nothing has needed to be created to enable the "scheme" to proceed. The form and substance would align. Both would be that a beneficiary is made entitled to income or capital in accordance with the deed and the amount is distributed for their benefit.

The timing may point to a tax purpose, given that the discretion is exercised in the particular way in the year of sale. But, since the trustee would only be exercising an existing power under the deed, the tax purpose is slight.

The tax result for the taxpayer is consistent with the legislation. The distribution from the trust will be taxable to them. The amount paid under the retirement exemption will be tax-free as provided for under Div 152 ITAA97. Obtaining the tax concession would suggest a possible tax purpose, but the benefit is specifically provided for under the legislation.

There is a change in the financial position of the taxpayer (receipt of the distribution) and the trust (payment of the distribution) that is independent of the tax result of the scheme. While the parties are related, this is to be expected, in view of the nature of the trust arrangement.

In this case, the factors in s 177D would not point strongly to a requisite dominant purpose of obtaining a tax benefit.

¶5-160 Utilising capital losses

In this case study, the parties make two decisions with the specific (subjective) intention of minimising the tax payable on a capital gain. One is to access the small business roll-over when there is no intention to acquire a replacement asset. The second is to choose not to utilise available capital losses. This case study is an example of the s 177C(2) exclusion from the concept of tax benefit.

Facts

The Toddle Family Trust operates a business distributing alpaca fleece and other alpaca-related products. It operates a small retail outlet in a local tourist area, as well as selling fleece in the wholesale market locally and internationally. The wholesale customers tend to be manufacturers of premium fabrics and yarns.

Toddle Pty Ltd is the trustee of the trust. Beth is the sole director and shareholder of the company. She is also the sole appointor of the trust. The trust has generally distributed its net income to Beth.

The Toddle Family Trust previously operated a distribution business specialising in sporting goods. The business was acquired for $200,000. After many successful years of operation, the business suffered a dramatic decline as lower-cost products entered the market. As a consequence, the business traded at a loss for two years before being closed down. The Toddle Family Trust has capital losses of $200,000 from the business goodwill which was written off.

Beth is aged 45.

The Toddle Family Trust has received an offer of $3,000,000, plus the market value of stock, for the sale of its business as a going concern. The business was started by the trust, so there is no cost base in its goodwill. Beth is inclined to accept the offer and has sought advice on the taxation consequences. The capital gain is estimated to be $3,000,000.

Beth is seeking to acquire a $2m property in Queensland and is close to exchanging on the purchase. The sale consideration has been ear-marked by Beth for paying the purchase price of the property. Beth is keen to ensure that the tax on the capital gain is minimised.

Beth and the trust are eligible for the CGT small business concessions. However, there is only one possible CGT concession stakeholder — herself.

Beth is advised to apply the following concessions to the capital gain in the year of the sale:

- apply the 50% general discount (Div 115);
- apply the 50% reduction available (Subdiv 152-C); and
- apply the small business roll-over (Subdiv 152-E).

The trust will not apply its capital losses to reduce the capital gain.

In the year of sale, this will result in the following outcome:

Capital gain	$3,000,000
Less: 50% general discount	($1,500,000)
Less: 50% reduction	($750,000)
Less: small business roll-over	($750,000)
Net capital gain	Nil

The trust proposes to distribute the capital gain to Beth. In advance of the formal distribution, the trust will pay to her the full amount of the sale proceeds.

The trust does not intend to acquire a replacement asset. As a consequence, CGT event J5 will happen in two years' time at the end of the replacement asset period. At this time, the proposal is to utilise the available capital losses of $200,000 to reduce the capital gain to $550,000, and then apply the retirement exemption to reduce the capital gain by a further $500,000 to $50,000.

By not applying the capital losses in the year of sale, a tax savings is achieved. If the capital losses were applied in the year of sale, the following position would arise:

Capital gain	$3,000,000
Less: capital losses	($200,000)
Less: 50% general discount	($1,400,000)
Less: 50% reduction	($700,000)
Less: small business roll-over	($700,000)
Net capital gain	Nil

On the happening of CGT event J5 in two years, a capital gain of $700,000 will arise which would be reduced to $200,000 through accessing the retirement exemption. Under this approach, the taxable capital gain is $150,000 higher.

Scheme

The scheme would include:

- the decision to access the small business roll-over concession, without an intention to actually acquire a replacement asset;
- the decision not to utilise the available capital losses;
- the non-acquisition of a replacement asset; and
- the application of the capital losses against the CGT event J5 capital gain.

Tax benefit

The tax benefit would be determined using the reconstruction approach.

The substance of the scheme is that Beth has available at her disposal 100% of the sale consideration. This is also the result that is achieved by Beth from the scheme. The alternative postulate must be a reasonable alternative to entering into or carrying out the scheme.

One alternative postulate would be that the trust would have accessed the small business retirement exemption (Subdiv 152-E ITAA97), rather than the small business roll-over. This would produce the same tax outcome and therefore no tax benefit would arise. However, as Beth is aged 45, payment would have needed to be made into a complying superannuation fund rather than to Beth. As such, Beth would not have 100% of the sale consideration available to her. This alternative postulate may not be sufficiently aligned with the results for Beth achieved by the scheme.

A second alternative postulate would be that the trust would have utilised the capital losses in the year that the original gain arose. This approach would give Beth access to the funds and, as such, is more aligned with the results achieved by the scheme. The tax benefit is the difference between the $200,000 capital gain under the alternative postulate and the $50,000 capital gain under the scheme.

The relevant question is whether s 177C(2) would apply. An argument based on purpose is unlikely to succeed — why would a decision be made not to utilise available capital losses in this manner other than because better usage (ie a tax benefit) of the losses could be achieved by doing so?

Section 177C(2)(a) provides an exclusion from the definition of a tax benefit for Pt IVA purposes where:

- the non-inclusion of the amount in the assessable income of the taxpayer is attributable to the making of an agreement, choice etc expressly provided for by the tax laws; and
- the scheme was not entered into or carried out by any person for the purpose of creating any circumstance or state of affairs the existence of which is necessary to enable the agreement, choice etc to be made.

Taxpayers have a choice on the amount, if any, of accumulated tax losses that will be utilised to reduce current year assessable income. Subject to meeting the eligibility criteria, a taxpayer can choose to apply the roll-over concessions — an intention to acquire a replacement asset is not part of the eligibility criteria. Therefore, the tax benefit for Beth arises due to choices made under the tax law, and the scheme was not entered into to create the circumstances necessary for the making of those choices. On this basis, the exclusion in s 177C(2) should apply.

¶5-165 Staged sale of shares

In the following case study, the parties renegotiate a sale transaction to address a combination of commercial and tax issues. The changes result in the CGT small business concessions becoming available when otherwise they would not have been able to be accessed.

Facts

Emma and David each hold 50 ordinary shares (equating to a 50% interest) in a company, Eagles Dare Pty Ltd. The company operates an adventure tourism business across Australia. Emma and David founded the business around seven years ago, and have developed it to the point where Eagles Dare Pty Ltd is the leading provider of adventure tourism packages to the premium end of the market.

White Rabbit's Adventures, a Hong Kong-based business, is a similar business but with a focus on the Asian market. White Rabbit's Adventures is looking to expand into the Australian market and sees the Eagles Dare Pty Ltd operation as a natural fit.

Emma and David have held some preliminary discussions with White Rabbit's Adventures about selling the business. White Rabbit's Adventures is prepared to offer as consideration for the acquisition:

- $6.5m upfront, with no adjustments (calculated as four times the net operating profit for the last financial year); or
- an earn-out arrangement whereby the consideration is paid in four instalments, the first on completion (approximately 25% of the expected total consideration) and then on the first, second and third anniversaries of the transactions, with the consideration being a multiple of four times the average net operating profit of the business for the current and prior years.

In either instance, White Rabbit's Adventures would take 100% ownership from the effective date of the sale agreement.

White Rabbit's Adventures is amenable to either an acquisition of the business assets or a share acquisition. Eagles Dare Pty Ltd has no debt or surplus assets and so the shares have the same value as the underlying business.

Emma and David feel that the next three years will be high-growth years for the business and so are inclined towards the earn-out arrangement as this could give them a much greater overall level of consideration from the transaction.

They approach their accountant for advice on the transaction, in particular, the tax implications of the two offers on the table.

The accountant advises Emma and David that they will be eligible for the 50% general discount if they sell their shares in Eagles Dare Pty Ltd, but they will not satisfy the $6m net asset value test and so will not be eligible for the CGT small business concessions. This is because they each are connected with the company (through holding 50% of the shares on issue), and so will each need to include the full value of the company in their $6m net asset value calculation.

Emma and David are not connected with each other for the purposes of the CGT small business concessions. Apart from the $6m net asset value test, they would satisfy the other eligibility criteria for accessing the CGT small business concessions.

The accountant also raises other questions over the earn-out transaction, including:

- the tax legislation relating to the taxation of earn-out arrangements and the application of the CGT concessions is proposed to be changed. The current legislation could actually mean that the tax liability in year one exceeds the cash consideration received. The timing and form of the future legislation is not known; and

- commercially, the notion of transferring 100% ownership and control of the business to White Rabbit's Adventures on day one, but then receiving the consideration over three years, may not be a prudent one. Once they cease to have control over the company, Emma and David will also have reduced control over the way the business is run and be in less of a position to make a decision to maximise the operating profits and hence the earn-out consideration.

The accountant provides Emma and David with a range of commercial points that they can raise with White Rabbit's Adventures during the negotiations. Within reason, White Rabbit's Adventures appears to be open to taking steps to address these issues.

The accountant also suggests an alternative structure for the transaction. Rather than sell 100% of the shares on day one and be paid via the three-year earn-out, the proposal would be to sell the shares in stages, in line with the payment of the consideration. This would correlate to four tranches of approximately 25% each. This alternative structure addresses the two main issues identified with the current offer.

The accountant also highlights a further benefit of this approach. While the capital gain made on the first tranche will only be eligible to be reduced by the 50% general discount, the capital gains made on the subsequent tranches should be eligible to be reduced by both the 50% general discount and (for two of the tranches) the CGT small business concessions (Emma and David's ownership interests in Eagles Dare Pty Ltd will fall below 40% after the first tranche, meaning that only the value of their shares, not the value of the whole entity, will be included in their individual $6m net asset value test).

White Rabbit's Adventures is amenable to the proposal, as long as safeguards are put in place to ensure that each tranche proceeds on the agreed terms (put/call options are intended to be used) and that the overall financial implications of the transaction for them do not change (a restriction on dividend payments will be put in place). Would Pt IVA apply to this transaction?

Scheme

The scheme would include:

- the earn-out offer tabled by White Rabbit's Adventures;
- the formulation of the alternative four-tranche proposal;
- negotiation of this alternative with White Rabbit's Adventures; and
- implementing additional elements to the transaction, such as the put/call options and the dividend restrictions.

Tax benefit

The tax benefit would be the omission of income through the reduced capital gain that is included in assessable income. The quantum of the tax benefit will depend on the alternative postulate. Depending on the alternative postulate, the timing and amount of the potential capital gain, and therefore omitted income, will vary and the Commissioner may need to issue alternative Pt IVA determinations and assessments to cover those contingencies.

The tax benefit in this situation would need to be determined using the reconstruction approach.

When formulating the alternative postulate, the substance of the scheme and the non-tax results for the taxpayers (Emma and David individually) need to be considered. The tax results of the alternative postulates are to be disregarded.

The scheme results in the sale of 100% of Emma and David's shareholding in Eagles Dare Pty Ltd, with the consideration being received in four instalments over three years.

The possible alternative postulates would include:

- the sale of 100% of the shares for the $6.5m offer;
- the sale of 100% of the shares under the earn-out arrangement; or
- the sale of 100% of the shares under a modified version of the earn-out.

Which alternative postulate is reasonable also needs to be determined:

- the $6.5m sale doesn't provide for participation in the future growth of the business;
- the earn-out arrangement has the identified issues with the timing of the tax payments and the uncertainty of the tax position; and
- the third alternative is dependent on being negotiated with White Rabbit's Adventures, although it has proved quite reasonable in its negotiation on other points.

The third alternative may be one where a higher amount of the consideration is paid upfront and the earn-out component is reduced (although the overall consideration may remain unchanged).

The tax consequences of the original earn-out arrangement are not a basis for asserting that this is not a reasonable alternative postulate. Potentially, however, the resulting cash flow issues (if the tax outflow was to exceed the consideration received) may provide a basis for asserting that this approach was not reasonable. The amended Pt IVA legislation requires the tax effects of an alternative postulate to be ignored when assessing whether it is a reasonable alternative postulate. Depending on how this requirement comes to be interpreted by the courts, the resultant cash flow issue in this case study may be a valid consideration for assessing the reasonableness of the alternative postulate.

A fourth alternative could be that, if Emma and David could not get the four-tranche proposal negotiated, they would not have proceeded with the sale transaction, ie a "do nothing counterfactual". Under the amended Pt IVA provisions, the do nothing counterfactual is all but removed as a viable option. To argue a do nothing counterfactual, it will be necessary that no other reasonable alternative way of achieving the substance of the scheme and its outcomes is able to be identified. Given the different ways that this transaction could be structured, such an argument is unlikely to be valid in this case.

The s 177C(2) argument, ie that any tax benefit is attributable to a choice made under the tax laws, is not valid in this situation as part of the scheme is for Emma and David to each partially sell down their current shareholding so that they are able to then access the CGT small business concessions on the subsequent CGT events.

Regardless of which alternative postulate is selected, if the reasonable alternative postulate alters the timing of the tax payments (relative to the scheme) or the access to the CGT concessions, then a tax benefit will arise.

Purpose

Ultimately, a situation like this will come down to an assessment of purpose.

The manner in which the scheme is carried out would include consideration of factors such as that: the taxpayer sought advice on the tax, legal and financial elements of the transaction; the transaction was negotiated with an arm's length party; and appropriate legal documentation will be put in place. These factors would point away from the dominant purpose being to obtain a tax benefit. The amended transaction deals with commercial issues as well as tax issues. On its face, this would also point away from the dominant purpose being to obtain a tax benefit, but perhaps an assessment of whether the commercial issues could have been managed in an alternative way (say, the third of the alternative postulates) may reveal much about the question of dominant purpose. Are the commercial issues a cover for modifying the transaction to achieve a lower tax impost on the transaction?

The form and substance of the scheme are aligned. Both involve the sale of shares in the company, with the consideration being paid contemporaneously with when the shares are transferred. On the basis that the put/call options are genuine options, this factor would point away from the dominant purpose being to obtain a tax benefit. The question of the form of the transaction itself is relevant — why was this particular structure chosen? This is a similar question as was posed above in respect of manner. Does this form of the transaction better enable the commercial issues to be dealt with, or does the real purpose lie in enabling the tax benefits to be obtained?

The time of entering into the scheme correlates with the negotiations to sell the business/shares, which is only to be expected. This factor would be neutral.

The tax result produced by the scheme for the taxpayers has a number of elements. First, tax is aligned when the economic gain arises. Second, any uncertainty over the tax outcome of the transaction is removed. Third, the quantum of tax payable is reduced through access to the CGT small business concessions. It is a question of the relevant importance (dominance) of these elements. Accessing the concessions has probably the most significant impact on the taxpayers and would seem to be something that could only be achieved under the scheme. This would point towards a dominant purpose of obtaining a tax benefit, although the other elements would moderate this somewhat.

The change in financial position of the taxpayers (Emma and David individually) is due in large part to accessing CGT small business concessions which reduces the overall level of tax liability arising on the transaction. The overall consideration (pre-tax) does not change. The scheme does remove some of the potential cash flow issues associated with the original earn-out proposal, but this is a timing benefit; the benefit of the CGT small business concessions is permanent. This factor would point to the dominant purpose of being able to obtain a tax benefit.

The scheme does have an impact on White Rabbit's Adventures, in that its ownership of the shares arises over the duration of the scheme, not 100% upfront. This is consistent with the form and substance of the scheme. This factor would be neutral.

The main parties involved in the scheme are Emma and David (with input from their accountant) on the one hand, and White Rabbit's Adventures on the other. White Rabbit's Adventures agrees to changes in a proposed transaction that have limited impact on it, but materially alter the tax outcomes for Emma and David. The parties are arm's length, but are they dealing at arm's length? There are useful comments in *AXA*[3] on this exact point. The fact that one party to a negotiation proposes or agrees to something which benefits the other party does not necessarily indicate a non-arm's length dealing. In this case, while agreeing to the change, White Rabbit's Adventures also sought measures to protect its position. This would suggest an arm's length dealing and would support a conclusion that the dominant purpose was not the obtaining of a tax benefit.

This situation is far from clear-cut in a Pt IVA sense, as factors point to and away from the requisite tax purpose. In this case, if the evidence can support a position that the scheme provided commercial benefits or dealt with commercial issues in a more effective manner than alternatives, then the more appropriate conclusion should be that Pt IVA does not apply. If, however, there are multiple alternatives that could each adequately address the commercial issues, it would be reasonably likely that Pt IVA would be applied on the basis that the dominant purpose in choosing this particular way of undertaking the transaction was to obtain the tax benefit of access to the CGT concessions that were otherwise unavailable.

Variation

A simpler form of this type of planning is where a greater than 40% shareholder sells in multiple tranches (the first tranche would take their interest just below 40% and the subsequent tranche(s) would result in the sale of the remaining interest) with the purpose that the subsequent tranches would be eligible for the CGT small business concessions.

Being able to demonstrate the commercial/non-tax purposes of structuring the transaction in this way will be important for ensuring that Pt IVA is not applied.

3 *FCT v AXA Asia Pacific Holdings Ltd* [2010] FCAFC 134.

Chapter 6

Trusts

¶6-100 Introduction

Ordinarily, the establishment of a discretionary trust, or the genuine transfer of assets to a discretionary trust, would not be an arrangement to which Pt IVA would be applied. The Pt IVA risk is increased when other tax consequences flow from the arrangement, for example, the alienation of income (see the discussion on personal services income in chapter 4) or the generation of a loss (see ¶8-125 and ¶8-130).

¶6-105 Transfer to a discretionary trust

The following case study is based on an example in TR 2008/1 and deals with the transfer of assets to a discretionary trust to crystallise a capital loss.

Facts

Liam Lewis holds a number of investments, including rental properties and shares in listed public companies. His investment activities do not constitute the carrying on of a business. Liam is also the trustee and appointer of the Lewis Maintenance Trust (the trust), under which Liam has the discretion to hold and apply the assets and income of the trust for the maintenance and education of his children, according to their needs and requirements. The beneficiaries of the trust are his four school-aged children. Liam is the default beneficiary. As trustee, Liam holds shares and interests in managed investment funds.

On 17 August 2006, Liam derives a $20,000 capital gain from the sale of some of his shares. On 15 June 2007, Liam meets with his financial adviser to review the current income tax and financial position of himself and the trust.

While reviewing his share portfolio, Liam and his adviser examine his interests in Orion Metals Ltd ("Orion"), a listed public company. Liam holds 14,000 shares in Orion and its current share price is $3.75. Liam's cost base and reduced cost base in Orion is $4.55. Liam is advised that, notwithstanding the current poor performance of Orion's share price, Orion has recently undertaken a strategic review of its operations and will be expanding its operations in anticipation of growing demand for the commodities it produces, which should lead to a higher share price in the medium to long term, and that the shares should be retained. However, as the trust requires further capital to meet his children's education needs, Liam is advised that he should gift the shares to the trust as a source of further investment capital and to reduce his income tax liability.

Liam acts on the advice and transfers the shares for no consideration to the trust on 15 June 2007. The documentation associated with the transfer is prepared by Liam's solicitor. CGT event E2 happens on the transfer of the shares to the trust. After taking into account the market value substitution rules, Liam makes a capital loss of $11,200 on the transfer that reduces his $20,000 capital gain, resulting in a net capital gain of $8,800 which is included in his assessable income for the year ended 30 June 2007.

The Orion shares pay high-yielding and reliable franked dividends. Prior to the transfer, these dividends were received and applied by Liam against the living expenses of himself and his family. After the transfer, the dividends are distributed to Liam's four children or accumulated as necessary to provide for the children's education. Liam, as trustee for the trust, sells the Orion shares for a substantial profit in January 2009 and distributes the net capital gain to one of his children, who has recently turned 18 and requires money for university.

The scheme

The scheme would include:

- all of the steps leading to, the entering into, and the implementation of the arrangement to gift the Orion shares to the trust;
- the realisation of the capital loss of $11,200; and
- the offsetting of the capital loss against part of the $20,000 capital gain in Liam's income tax return for the year ended 30 June 2007.

The scheme would not include the subsequent disposal of the shares in January 2009, as it is not connected with the transfer of the shares to the trust that occurred on 15 June 2007.

Tax benefit

The substance and results of the scheme are that the shares are transferred from Liam to a trust that Liam has control over and under which his family can benefit.

Liam remains the registered owner of the shares (although now in his capacity as trustee), continues to control who benefits from the shares subject to the equitable obligations imposed under the terms of the trust, and is a default beneficiary of the trust.

The scheme had no effect or outcome on Liam's legal title, and he retains an economic exposure to the asset as an object of the trust.

The tax benefit would be determined using the annihilation approach, such that the share transfer would not have occurred and Liam would have retained beneficial ownership of the shares.

The tax benefit obtained by Liam is the capital loss of $11,200 incurred during the 2006-07 income year.

Purpose

The manner in which the scheme is entered into is consistent with an ordinary family dealing. Liam has divested himself of the Orion shares in order to provide for the education and maintenance of his four children, but maintains control to ensure against dissipation of the fund. The fact that the shares were disposed of for no consideration is consistent with this purpose, and this aspect tends against the conclusion as to the dominant purpose being to obtain a tax benefit. However, the act of transferring the particular Orion shares, which were in loss, to the trust as opposed to Liam's other more profitable assets may impact on this conclusion. In this regard, Liam transferred the Orion shares on the advice of his financial adviser. It could be argued that this was done to reduce his income tax liability. However, the trust required further capital, and the advice was to the effect that the Orion shares would become a profitable investment in the years to come.

The form and substance are consistent in that the shares are transferred to the trust to be dealt with in accordance with the terms of the deed. Although Liam remains the legal owner of the shares, is a default beneficiary and has sole control over how the capital or income of the shares is distributed, the obligation under the trust deed that they be applied for the maintenance and education of his children is substantive and real. His discretion to distribute income has always been exercised in favour of his children. The income produced by the shares is now applied or accumulated for the benefit of his four children. Thus, Liam's four children substantively benefit from the arrangement. However, it is also noted that, prior to the transfer, Liam's four children could be said to have economically benefited from the Orion shares as they are financially dependent on Liam. This factor would point marginally away from the dominant purpose being to obtain a tax benefit.

The timing suggests the requisite dominant purpose of obtaining a tax benefit. The scheme lasted only a few days, with the disposal of the loss-making shares occurring close to year end.

The tax result achieved (but for Pt IVA) is the realisation of the $11,200 capital loss that was partially applied against the $20,000 capital gain, thus reducing Liam's liability for CGT. This was the only financial benefit obtained by Liam under the scheme and is indicative of a dominant purpose of obtaining a tax benefit.

There has been a material change in Liam's financial position (amounting to parting with $52,500 which is the current value of the shares) as a result of the scheme, that is, he now holds the Orion shares subject to the equitable obligation under the trust deed that they be applied towards the maintenance and education of his children, and the income has been applied in the past for that purpose. However, this change in Liam's financial position is offset by the improved financial position of his four children. This factor is accordingly neutral as to the required purpose.

The financial position of Liam's four children has been improved as they now benefit from the Orion shares. However, this factor is neutral as to purpose as it is offset by the inverse financial change of Liam. Although Liam is a default beneficiary, the manner in which the trust is used suggests that, substantively, he no longer benefits from the dividends or any capital appreciation in the shares. This factor points away from the required purpose.

Liam is the trustee of the trust and father of the beneficiaries of the trust. Thus, the familial connection explains why the transfer occurred and no consideration was received for it, and points away from the dominant purpose.

On weighing up the eight matters, it would be concluded that none of the parties to the scheme had the dominant purpose of obtaining a tax benefit in the form of a capital loss. The purpose of Liam entering into and carrying out the scheme was to provide for the maintenance and education of his children without fear of dissipation. In particular, the manner, form and substance, financial consequences and nature of the connection between the parties would support this conclusion. Accordingly, Pt IVA does not apply.

Important comments

Some of the factors which are important in reaching this conclusion (that Pt IVA does not apply) and which would need to be considered carefully before applying these principals to a similar factual situation include:

- the trust was not an ordinary discretionary trust but, rather, a trust established specifically for the maintenance of the children. If Liam had previously been a significant beneficiary of distributions from the trust, a different outcome may have occurred; and
- the trust was administered consistent with its purposes, ie the funds were used to support the education of the four children. While an assessment of a Pt IVA risk may be taken at the time the decision to enter into a transaction is made, the ATO will generally be reviewing the transaction with the benefit of hindsight.

¶6-110 Distributions from a discretionary trust to a low-tax/loss entity

This case study considers the tax benefit that could arise if a trust distribution is washed through an associated loss entity.

Facts

Joanne established a discretionary trust a number of years ago. The trust was settled by her accountant for a nominal sum, with Joanne subsequently settling additional moneys on the trust. Joanne is the trustee of the trust and the appointor.

The beneficiaries of the trust include Joanne, her husband, their extended family, any entities that a potential beneficiary holds an interest in, and any trust that a potential beneficiary could also benefit under.

The trust has accumulated significant property investments which are leased to various unrelated parties. In the current year, as well as the net rental income of $350,000, the trust has received a lease termination payment of $800,000.

Joanne's brother Andrew owns 100% of the shares in Old Business Pty Ltd. Andrew previously operated a retail business through this company. The business ceased around three years ago due to ever-increasing operating losses. The company has accumulated tax losses of $650,000 which are being carried forward on the basis that the continuity of ownership test is satisfied.

Andrew has proposed to Joanne that she distribute a portion of the income to Old Business Pty Ltd and utilise the accumulated losses. Old Business Pty Ltd has a loan due to Andrew of an equivalent amount (he funded the business and its operating losses) which otherwise would not be repaid. Old Business

Pty Ltd will use the trust distribution to repay Andrew, and Andrew will give the money to Joanne. Rather than flow the funds between the entities, the intent is to record the transactions as book entries, with the only payment being from the trust to Joanne.

The trust has not distributed to Andrew or Old Business Pty Ltd previously. The trust normally distributes its income to Joanne and her husband. In the current year, the balance of the income will be distributed to Joanne and her husband.

Among other issues, there is a concern that Pt IVA may apply to the transaction.

Scheme

The scheme would constitute the decision to distribute a portion of the income to Old Business Pty Ltd and may extend to include the arrangements to return the financial benefits to Joanne.

Tax benefit

A level of prediction would be required to determine what would, or might reasonably be, expected to have occurred absent the scheme. As such, the reconstruction approach would be the appropriate basis to determine the tax benefit.

In substance, while the distribution may be made to the company in the first instance, the financial benefits ultimately accrue to Joanne. The results and consequences would include this, but also that the loan in Old Business Pty Ltd is able to be discharged. As the loan was essentially unrecoverable, this factor is unlikely to have a persuasive impact on the formulation of the alternative postulate.

A likely alternative postulate would be that all of the income would be distributed to Joanne and her husband, as it has been in previous years.

The tax benefit is the income that these individuals would have included in their assessable income but didn't due to the loss, ie the income distributed to Old Business Pty Ltd.

Purpose

The question of purpose in this particular case is almost a proxy for the question of whether a discretionary trust is able to select the most tax-effective beneficiaries for it to distribute income to within the terms of the deed, or whether its discretion as to the distribution of income is somehow fettered.

The fact that the trustee may be aware that a more tax-effective outcome can be achieved through a distribution to a particular beneficiary is a subjective factor that would not of itself support the application of Pt IVA.

In terms of the manner in which the scheme is entered into and carried out, the decision to distribute to Old Business Pty Ltd is consistent with the terms of the existing trust deed, with this company being within the class of the potential beneficiaries. The application of the funds received by the company to repay an existing debt does not indicate a tax purpose. It is perhaps only the gifting of the funds from Andrew to Joanne that may indicate the presence of a tax purpose — it would be questionable whether such a large gift could be considered an ordinary family dealing.

Undertaking aspects of the transactions as book entries rather than cash transactions may be suggestive of a tax purpose (it may be akin to a round robin of cheques scenario). However, where genuine legal rights and obligations exist and the parties agree to set these off, the transaction is legal and valid and should not be considered indicative of a tax (or other untoward) motivation. In this case, it does however imply a pre-existing agreement that Andrew would gift the funds back to Joanne.

In form, a distribution is made to Old Business Pty Ltd. In substance, the benefit of the distribution accrues to Joanne. In between are the repayment of the debt and the gifting of the funds by Andrew. The disparity between form and substance may be indicative of a tax purpose.

The timing factor points to and away from the parties to the scheme having the dominant purpose of obtaining a tax benefit. The decision to distribute to Old Business Pty Ltd this year as opposed to any previous year is made with the tax benefits in mind and is critical to achieving these. The series of transactions also occurs within a short period of time, indicating that they are interrelated and potential preordained. However, it is usual for a trustee to assess the position of the trust on an annual basis and determine at this time which beneficiaries distributions will be made to.

The tax outcomes are that tax losses are recouped and a distribution that would otherwise be taxable to Joanne (if made direct) is received by her in a tax-free form. This would indicate a tax purpose.

The financial and other outcomes would include that the debt owed by Old Business Pty Ltd is repaid. Other than this, the major financial outcome is the tax savings on the distribution. This would be indicative of a tax purpose.

The parties are associated, but that would also be expected in a family trust situation. This factor is probably neutral, but does go to explaining why a transaction of this nature may occur.

Can reliance be placed on the trustee merely acting in accordance with its powers under the deed as a basis for concluding that Pt IVA does not apply in this case? Probably yes. The distribution is a genuine distribution made in accordance with the deed. The distribution is set off against losses that arose in the course of a business — "real" losses, so to speak. The debt repaid to Andrew is also a genuine, existing debt. The gifting from Andrew, while not really explainable as an ordinary family dealing, is clearly attributable to the close family relationship that exists. This in itself should not be enough to enliven Pt IVA.

Variation

Would the same Pt IVA conclusion be reached if Old Business Pty Ltd was not currently a potential beneficiary of the trust, but rather the trustee needed to exercise a power in the deed to nominate Old Business Pty Ltd as a beneficiary? This is likely to increase the Pt IVA risk (the trustee would be taking additional actions to enable it to distribute to the lower tax beneficiary), but may not be sufficient for Pt IVA to apply.

If the power to nominate additional beneficiaries was provided for by the deed, the argument against Pt IVA applying would continue to be that the trustee is merely acting in accordance with its powers under the deed. However, the more that the trustee needs to do to enable a distribution to be made to a particular beneficiary, the more a dominant tax purpose would appear to be present.

¶6-115 Streaming of distributions

In the following case study, the distributions from a discretionary trust are managed so as to ensure that a deemed capital gain is distributed to a tax-exempt entity and not to the beneficiaries who received the economic benefit that triggered the deemed gain.

Facts

Kenneth is a wealthy individual. He is the trustee and appointor of a discretionary trust. The beneficiaries of the trust include Kenneth, his wife, their extended family, any entities that a potential beneficiary holds an interest in, and any trust that a potential beneficiary could also benefit under.

One asset of the trust is a holiday house. The house was acquired in 1990 for $150,000 when the area was a sleepy fishing village. It's now one of the prime holiday locations on the coast and the value of the property has increased to around $1m.

Kenneth is also a stockbroker and share trader, and he operates his business through the trust. The economic downturn taught him a valuable lesson — losses on trades, bad debts from clients and similar events create liability issues. Kenneth has settled a number of significant but manageable claims made against the trust. He is concerned that a large claim could be made which would impact on the other assets of the trust.

Kenneth's proposal is to transfer the property to a new trust for nominal consideration (he is aware of the bankruptcy issues of a transfer for less than market consideration). For CGT purposes, market value substitution will apply. The gain on the sale, after allowing for various costs, will be around $800,000.

For the current year, the trust has $250,000 of income, $1,500 of capital gains on the sale of shares, and an $800,000 deemed capital gain from the property transfer.

Kenneth is proposing to distribute the income of the trust to himself and his wife, but to distribute the capital gain to a tax-exempt entity that he is associated with. He will pay the $1,500 in realised capital gains to the tax-exempt entity.

He believes that s 100AB ITAA36 will be satisfied. Can Pt IVA apply to the transaction?

Scheme

The scheme could be defined broadly to include the steps from the transfer of the property through to the decision to distribute the capital gain to the tax-exempt entity. A more narrowly defined scheme, focusing on the decision to distribute the capital gain to the tax-exempt entity, would also be valid.

Tax benefit

For the broader scheme, a level of prediction would be required to determine what would or might reasonably be expected to have occurred absent the scheme. As such, the reconstruction approach would be the appropriate basis to determine the tax benefit.

If the narrower scheme was used, the reconstruction approach would still be the appropriate approach. If the scheme (being the decision to distribute the capital gain to the tax-exempt entity) was ignored, the taxable income (including the deemed capital gain) would be assessable to the other beneficiaries to whom the income of the trust was appointed, but a level of prediction would be required as to how the trustee would have dealt with the income under the terms of the deed.

In substance, Kenneth and his wife receive substantially all of the "financial benefits" distributed by the trust. The results and consequences of the scheme, ignoring the tax outcomes, are principally that Kenneth and his wife continue to get the economic benefits from the property and achieve a level of improved asset protection. A reasonable alternative postulate is therefore likely to be one where the distribution to the tax-exempt entity is not made, but the financial benefits distributed by the trust still flow wholly or substantially to Kenneth and his wife.

Depending on the alternative postulate, the tax benefit will be based on the trust distribution comprising the capital gain that Kenneth and his wife would have otherwise included in assessable income.

Purpose

The manner in which the scheme is entered into and carried out points to and away from the parties to the scheme having the dominant purpose of obtaining a tax benefit. The selection of the tax-exempt entity as the beneficiary for the capital gain was clearly made with the tax benefits in mind. However, the discretionary trust that made the gain has been established for many years and the tax-exempt entity was within the class of potential beneficiaries. The trustee has merely acted in accordance with its powers and obligations under the trust deed.

In form, a small capital gain is distributed (and paid) to a tax-exempt entity. In substance, this action also has the effect of meaning that the other beneficiaries are not taxed on a large deemed capital gain. This indicates a likely tax purpose.

The timing factor also points to and away from the parties to the scheme having the dominant purpose of obtaining a tax benefit. The decision to distribute to the tax-exempt entity this year as opposed to any previous year is consistent with the findings in respect of manner — it was clearly made with the tax benefits in mind and is critical to achieving these. However, it is usual for a trustee to assess the position of the trust on an annual basis and determine at this time which beneficiaries distributions will be made to. In that respect, the timing factor is more neutral.

The tax outcome is that no tax is ultimately paid on the deemed capital gain. This would point to a tax purpose.

The financial and other changes of the narrow scheme would include that $1,500 is paid to the tax-exempt entity but, more relevantly, that the tax liability on the deemed capital gain is avoided. The broader scheme has other implications, including the asset protection advantages obtained by separating the property from the business entity. Clearly, in respect of this factor, the narrower scheme is more indicative of a tax purpose than the broader scheme.

The parties are associated, but that would also be expected in a family trust situation. This factor is probably neutral.

Overall, if the broader scheme is considered, the asset protection benefits provide a basis for concluding that the dominant purpose is not tax-related; however, this is not beyond question. The conclusion is even less clear when the narrower scheme is considered. In this case, reliance would need to be placed on the argument that the trustee has merely acted in accordance with its powers and obligations under the trust deed, the discretionary trust has been established for many years, and the tax-exempt entity was within the class of potential beneficiaries. This is the same argument that is applied when the most tax-effective combination of beneficiaries is selected for "regular" distributions made by a trust (as opposed to the deemed gains in this case). The contrivance in this case may distinguish it from the "regular" trust distribution cases and mean that Pt IVA could be applied.

Alternative

The case for the application of Pt IVA would be stronger if actions were taken by the trustee to put itself in the position to make this distribution. For example:

- if the definition of income was amended or clauses to allow streaming were inserted into the deed so that this particular distribution could occur in this manner; and/or
- if the class of potential beneficiaries was amended (either by altering the definition of the class of beneficiaries or by nominating the tax-exempt entity as a potential beneficiary) to allow for the tax-exempt entity to receive the distribution.

Reliance on the argument that the trustee has merely acted in accordance with its powers and obligations under the trust deed (and so Pt IVA should not apply) is strongest where the deed has not been amended to allow for the scheme to occur.

Chapter 7

Tax planning

¶7-100 Losses and the continuity of ownership

This case study considers the situation where the form of a share sale transaction is modified to enable the continuity of ownership test to be satisfied.

Facts

Thomas and Percy have been in business together for many years. The two friends are shareholders in a company, Sodor Freight Handling Pty Ltd, each holding 50% of the ordinary shares in the company.

Until recently, Sodor Freight Handling Pty Ltd has been the dominant freight company in the region, specialising in rail freight. Over the past couple of years, increases in costs, competition from road transport providers, and investment in developing a largely unsuccessful passenger service have meant that the company has accumulated significant losses.

Thomas and Percy have decided that, in the interest of maintaining their friendship, it is time for them to each separate their business interests.

Percy wants to concentrate on the existing rail freight business. He believes that ceasing the passenger service and making some changes to the way the rail freight business is conducted will enable the business to return to profit. Thomas is more interested in developing a passenger service as he sees this as a way to tap into the growing tourism market in the region.

It is agreed that Thomas will set up a new company and focus on providing passenger services. He will buy some assets from Sodor Freight Handling Pty Ltd, but the business will essentially be a start-up.

Thomas and Percy agree that Percy should take 100% ownership of Sodor Freight Handling Pty Ltd. They arrange for the business to be valued and agree in principle that Thomas will transfer his shares to Percy at market value under a vendor-financed arrangement. Thomas will be paid his consideration in future years as the business returns to profit.

Emily is Thomas and Percy's accountant. She advises them that the transfer of Thomas' 50% shareholding in Sodor Freight Handling Pty Ltd to Percy will cause the continuity of ownership test to be failed, and mean that the same business test will need to be satisfied in order for the losses to be utilised. Percy is worried that the changes he wants to make to the business will mean that the same business test will be failed.

To resolve this situation, Thomas and Percy agree that Thomas will continue to hold a 1% interest in Sodor Freight Handling Pty Ltd and transfer his other 49% interest to Percy. This will ensure that the continuity of ownership test is satisfied. While no formal agreements are put in place, the two friends agree that Thomas will transfer the remaining shares to Percy once the losses are recouped.

Thomas resigns as a director and ceases to have any involvement with the business. The sale consideration to be paid to Thomas is based on the market valuation and calculated in respect of the 49% interest that is sold.

Sodor Freight Handling Pty Ltd does indeed begin to generate profits once again, and is looking to utilise the carried-forward tax losses in the current year.

Scheme

The scheme would include the transfer of the 49% interest to Percy and the retention of the 1% shareholding by Thomas.

Tax benefit

The tax benefit would be determined under the reconstruction approach. The tax benefit would be the omission of income arising in a future year when the tax losses are recouped.

Quite often, "deduction"-type tax benefits can be dealt with effectively under the annihilation approach. In this case, it is not the creation of the carry-forward tax losses that the scheme gives rise to but the preservation of an entitlement to deduct those losses. If the only relevant act that happens is the transfer of 49% of the shares and that is the scheme that the Commissioner identified, the annihilation approach would leave the entitlement to claim the losses in place. Application of the reconstruction approach is required to provide an alternative postulate under which the losses are not available and the tax benefit is addressed.

The substance of the scheme is that Percy becomes, for all intents and purposes, the sole owner and controller of Sodor Freight Handling Pty Ltd. The results and consequences of the scheme for the taxpayer (Sodor Freight Handling Pty Ltd) are limited (when the tax benefit is excluded), as the transaction is essentially one between the shareholders, albeit with an impact on the company.

A reasonable alternative postulate would appear to be that the full 50% shareholding is transferred from Thomas to Percy.

Purpose

The manner in which the scheme is entered into and carried out is indicative of a tax purpose. Thomas ceases to have any role in a business that he was formally an active "partner" in and he has established his own new business. Thomas disposes of essentially all of his ownership interest in the company, apart from an economically insignificant shareholding.

The shares are said to be sold at market value but the consideration is not able to be paid immediately. The commerciality of this arrangement may be a relevant factor.

In form, Thomas retains a 1% shareholding in the company. In substance, he ceases to have any involvement in the operation of the company, having disposed of 49% of the shares, resigned as a director, and established his own new business. This factor would be indicative of a tax purpose.

It would be hard to include the agreement to transfer the 1% shareholding (post-recoupment of the losses) into consideration of this factor without any formal agreement being in place. However, where this factor is being considered in hindsight (after the 1% is transferred), that may be different. This subsequent action would be strongly indicative of a tax purpose.

The timing is probably neutral or indicative of a non-tax purpose, at least if the 1% transfer is excluded. The timing of the transaction is being determined by the decision to split the business interests of Thomas and Percy. It is only the decision to retain (and, in the future, to transfer) the 1% shareholding that is indicative of a tax purpose.

The scheme enables the company to claim tax losses that it would otherwise not be entitled to claim. This is indicative of a tax purpose.

The financial implications for the company and the shareholders are the same under the 49% transfer scheme and the 50% transfer alternative postulate, other than that, under the scheme, a tax savings is achieved through the ability to carry forward and utilise tax losses. Under both scenarios, there are no other financial implications for the taxpayer (the company), and Percy is only required to pay Thomas once the business returns to profit, so the timing of payment to Thomas is likely to be the same in both situations. There are no other material implications for the parties. This factor would at best be neutral, but more probably inclines towards indicating a tax purpose.

The parties are associated through friendship (although not family) and business connections. This may be relevant in concluding that an agreement (if not a formal one) or understanding existed in respect of the 1% shareholding. This factor would at best be neutral, but more probably inclines towards indicating a tax purpose.

On balance, the absence of any objective commercial rationale for the retention of the 1% shareholding and the clear connection with the generation of a tax benefit from doing so would support a conclusion that the dominant purpose of Thomas and Percy in entering into the scheme was to obtain a tax benefit for Sodor Freight Handling Pty Ltd.

Alternative

Would the same conclusion be reached if Thomas retained an economically significant interest? For example, instead of selling 49% and retaining 1%, what if Thomas sold 30% (giving Percy effective control over the company) and retained 20% (a more economically significant investment than 1%)?

The more genuine (in form and in substance) the residual shareholding held by Thomas, the lower the Pt IVA risk.

As a further alternative, would the same conclusion on the application of Pt IVA be reached if Thomas and Percy structured the share transfers as a put/call option-style arrangement (subject to the requirements of Div 165 ITAA97) where exercise of the options was contingent on the company achieving certain profit-related targets?

In both instances, the same tax outcome would be achieved, ie satisfaction of the continuity of ownership test. However, the artificiality of retaining a 1% interest is removed. The alternatives are more indicative (when compared with the original facts) of a staged exit from the business on commercial terms, rather than an arrangement designed to ensure that the tax losses remain available. Retention of the 1% interest is explainable only by reference to the tax outcome that it achieves. The alternative arrangements, on their face, would be indicative of a broader set of purposes. This may allow for a different conclusion to be reached on the application of Pt IVA.

¶7-105 Debt/equity

The classification of an interest as debt or equity for tax purposes is important for determining its tax implications. This case study considers whether Pt IVA can apply when actions are taken to achieve the preferred debt or equity classification.

Facts

Jamie operates a security business through a private company, Red Wall Pty Ltd. While he is good at providing security services, his skills at running a business are limited. He has been seeking to identify a potential partner who could look after the business administration, provide funding to allow Jamie to grow the business, and give him an avenue for exit from the business.

Steve runs a business specialising in the supply and installation of security hardware. He is interested in the Red Wall Pty Ltd business. He thinks Jamie is a good operator and, in the longer term, sees strong synergies between the two businesses.

Steve, through his holding company, Central Defence Pty Ltd, negotiates to buy a 40% interest in Red Wall Pty Ltd at market value, which is agreed to be $3m.

Central Defence Pty Ltd also agrees to provide debt funding of an additional $2m. Interest at a commercial rate will be charged on the debt funding. A formal loan agreement will be put in place, for which Steve will speak to his lawyers to arrange.

After speaking with his lawyers, it is identified that the debt funding will be classified as an "equity interest" under Div 974 ITAA97, as no fixed term for repayment has been agreed on. This is problematic for both parties from a tax perspective.

Steve expects that the debt funding will be repaid; he just doesn't have a fixed time period in mind.

The lawyers suggest, and the parties agree, to modify the arrangements such that the conversion or repayment must occur within nine years and 10 months from the date of the initial advance. This is specifically set so as to be less than 10 years and to ensure that the funding will be a debt instrument.

Does Pt IVA apply to the arrangement?

Scheme

The scheme could be viewed quiet narrowly as the selection of the nine year and 10 month term for the agreement. A broader scheme would include the overall debt investment, but defining the scheme this broadly is not necessary to capture the elements which drive the tax benefit.

Tax benefit

Potentially, the tax benefit could be determined using the annihilation approach, but a similar outcome would be achieved under a reconstruction approach.

In substance, Red Wall Pty Ltd has received an advance from Central Defence Pty Ltd of funds at interest for an extended period. The results and consequences for Red Wall Pty Ltd from the scheme, excluding tax, are consistent with the substance of the scheme but would include that an obligation for repayment at a predetermined time would be in place.

The alternative postulate would be that the parties would have entered into the same arrangement but without the fixed loan term (ie the loan as originally agreed between the parties). Red Wall Pty Ltd would have received the funding, but the instrument would be classified as an equity interest so that the interest expense would not be deductible. The tax benefit is determined based on the quantum of the deduction.

Purpose

The manner in which the scheme is entered into or carried out is indicative of a dominant purpose of obtaining a tax benefit, as the change enables a tax deduction to be claimed for the "interest" payments. Absent the scheme, the interest payments would have been treated as non-deductible dividend payments.

However, the introduction of the fixed term has brought the tax classification in line with the commercial intentions of the parties. Central Defence Pty Ltd made two investments, one clearly of equity and one (ignoring Div 974) of debt. Absent the scheme, both investments would have been treated as equity. With the scheme, the second investment is treated as debt for tax purposes.

The form and substance are consistent. The form is that of a fixed-term loan. In substance, this is also the case. The fixed term is included in a formal loan agreement that is binding on both parties.

The timing of entering into the scheme is aligned with entering into the commercial arrangements, which is to be expected.

The tax result for the taxpayer is the deductibility of the interest payments. This tax outcome is consistent with any loan-style arrangement. Under the alternative postulate, the interest would not be deductible, but the fact that a deduction is obtained for what, in commercial terms, is interest on a loan would not of itself be indicative (or strongly indicative) of a tax-related purpose.

The financial and other outcomes for the parties of the narrowly defined scheme are that a fixed obligation to make a capital repayment or convert the loan to equity is in place. This is within the broader context that finance is provided and received, and an obligation to make interest repayments is created. This is a genuine legal obligation, with implications that extend well beyond the tax impact. This factor is not indicative of a tax purpose.

The parties are related by way of a business relationship but not otherwise. They are arm's length parties that have negotiated a commercial deal. It would be presumed that they would be acting in their own interests. This factor is not indicative of a tax purpose.

The subjective purpose of putting that particular term into the loan agreement is clearly to achieve a desired tax outcome. That of itself does not answer the question with respect to Pt IVA. Viewed objectively, the insertion of that clause ensures alignment of the tax outcomes with the commercial arrangement. It creates legally binding obligations that extend well beyond the tax impact. The narrow scheme should be viewed in the context of the broader investment and financing arrangement which has been negotiated on commercial terms between arm's length parties. These factors would support a conclusion that the dominant purpose of the parties to the scheme was not to obtain a tax benefit.

Alternative

What assists in the conclusion in this case is that the tax and commercial outcomes are aligned. A different outcome may result from a situation where an instrument, which would be viewed as an equity-style investment in a commercial sense, uses particular terms in the agreement so as to cause the instrument to be classified as a debt interest.

¶7-110 Double roll-over

This case study considers the published guidance on "double roll-overs" and its potential broader application.

The s 177C(2) ITAA36 exclusion often arises in the context of a "double roll-over" arrangement. This is an arrangement whereby a taxpayer obtains a tax benefit through the application of the roll-over, but has undertaken a previous roll-over in order to put themselves in a position to access the second roll-over.

An example would be rolling over from a discretionary trust to a company (Subdiv 122-A ITAA97), and then accessing the scrip-for-scrip roll-over (Subdiv 124-M ITAA97) on disposal of the shares in the company.

ID 2003/203 considers a double roll-over situation and concludes that Pt IVA does not apply. The transaction discussed in this interpretive decision is similar to that used in the intergenerational transfer of primary production businesses. It should not be automatically assumed that the same conclusion would be reached in other double roll-over situations. However, the interpretive decision does provide guidance on the ATO's approach:

> "**Facts**
>
> The taxpayer proposes to undergo a corporate restructure and simplification process. The outcome will be that one company holds all the assets.

> The restructure will involve the transfer of trading stock from the taxpayer to a partnership.
>
> The partnership will comprise of the taxpayer and a subsidiary company. Each partner will hold a 50% interest in the partnership.
>
> The transfer of assets will involve a 2-stage process, in which the trading stock will be transferred to the partnership, followed by the partnership transferring the trading stock to the subsidiary company.
>
> The subsidiary company will ultimately own 100% of the trading stock.
>
> An election will be made under subsection 70-100(4) of the ITAA 1997 to treat the assets having been disposed of for what would have been their value as trading stock of the transferor on hand at the date of transfer.
>
> **Reasons for Decision**
>
> Part IVA of the ITAA 1936 contains general anti-avoidance provisions designed to prevent the avoidance of tax.
>
> Part IVA of the ITAA 1936 will only apply where a scheme has been entered into or carried out to obtain a tax benefit and it can be concluded the dominant purpose of entering the scheme was to obtain a tax benefit. In such situations, the Commissioner can apply the provisions to deny the tax benefit obtained.
>
> Paragraph 177C(2)(a) of the ITAA 1936 provides for an exclusion to obtaining a tax benefit where it relates to the non-inclusion of an amount in assessable income where it is attributable to an election being made as provided for under the ITAA 1936 or ITAA 1997. The exclusion will only apply where the scheme was not entered into or carried out for the purpose of creating any circumstance or state of affairs to enable such an election being made (see also Case Decision Summary CDS 10334).
>
> Taxation Determination TD 96/3 clearly enables an election to be made where there is a transfer of trading stock from a sole trader to a partnership and from the partnership to a trustee of a discretionary trust, on the basis that at least a 25% ownership interest in the assets is maintained and where all parties sign an agreement. Therefore, TD 96/3 allows the interposition of a partnership as part of a 2-stage transfer and a subsequent election being made, without a determination ultimately being made that Part IVA of the ITAA 1936 applies to the transaction.
>
> However, TD 96/3 does not consider the potential application of Part IVA of the ITAA 1936 to this, directly comparable, arrangement. It is reasonable to conclude, therefore, that the Commissioner does not consider that Part IVA of the ITAA 1936 should apply to this arrangement, on the basis that the creation of the 2-stage transfer, with elections, did not prevent the application of the exclusion provided for by paragraph 177C(2)(a) of the ITAA 1936.
>
> The interposition of the partnership to enable the election to be made will not prevent the operation of the exclusion in paragraph 177C(2)(a) of the ITAA 1936. As there is no 'tax benefit', Part IVA of the ITAA 1936 will not apply."

The reasoning in ID 2003/203 could be read as limiting this interpretation (that s 177C(2) applies) to the same facts as those in the example below and in TD 93/3. Other situations where two roll-overs are claimed, such as the Subdiv 122-A/Subdiv 124-M example referred to above, may not receive the same treatment.

Scheme

In this arrangement, the two-stage process for transferring the stock from the current ownership to the partnership and then to the new partner solely (the subsidiary company) could be considered as a scheme. Individual elements of this broader arrangement would also constitute a scheme, for example, the initial transfer to the partnership.

Tax benefit

The tax benefit would need to be determined under the reconstruction approach, as the gain on disposal of the trading stock would not arise if the scheme was ignored under the annihilation approach.

The tax benefit is the omission of income from the disposal of trading stock.

Putting aside the s 177C(2) exclusion, by accessing the roll-overs, the stock is able to be transferred to new owners at cost rather than at market value.

The substance of the scheme is the transfer of ownership of the stock to new owners (the subsidiary company). The results and consequences for the taxpayer (the original owner) are similar to this, being principally that the stock was disposed of.

A reasonable alternative postulate would be that the stock was sold from the original owner to the new owner. This transfer would be at market value (or otherwise be deemed to be at market value for tax purposes). However, if other consequences for the taxpayer can be identified, a different alternative postulate may be able to be substantiated as reasonable. These factors are also likely to be relevant for the assessment of purpose.

ID 2003/203 and the taxation determination that it refers to do not include any detailed analysis of why the initial action of creating the partnership is not a scheme entered into for the purpose of creating the state of affairs necessary for the trading stock election to be made (and thereby excluding the operation of s 177C(2) to prevent a tax benefit from arising). It is difficult to see why this position was not pursued by the Commissioner. In the absence of authoritative or binding guidance, reliance on this interpretive decision as the sole basis for asserting that Pt IVA does not apply would be risky.

Purpose

The question of purpose is more than likely going to be the critical element of the Pt IVA analysis in a "double roll-over" situation. As always, the conclusions will be highly dependent on the facts of the particular case.

Consider two scenarios in respect of the above example.

In the first scenario, assume that the partnership exists for a "moment in time". In this case, the partnership would serve no (or limited) commercial purposes, with its sole (or predominant) role being to facilitate accessing the trading stock roll-over. In this scenario, the manner in which the scheme was entered into and the form and substance of the scheme would point strongly towards the sole or dominant purposes of one or more of the parties to the scheme being to obtain the tax benefit associated with the roll-over.

Contrast this with a situation where the partnership holds the stock for a more extended period and actively conducts a business during this period. In the context of an intergenerational transfer of a primary production business, this may be for a period when both generations of the family are actively working in the business.

In this second scenario, the partnership has substance and consequences beyond those associated with the trading stock roll-over. It facilitates the introduction of the new "partner" into the business, allows for a period of joint operation, and then facilitates the exit of the old "partner".

The manner in which the scheme is entered into and carried out is consistent with the introduction of the next generation into the business. The form and substance are essentially aligned and again point towards the purpose being that of an intergenerational transfer. Rather than pointing towards a tax purpose (as is the case when the partnership exists only for a moment in time), these factors point towards a non-tax purpose. In this scenario, where the transaction occurs between related parties, the non-tax purpose would also be supported.

These same factors may also mean that an alternative postulate that does not include the initial transfer to the partnership may not be reasonable or appropriate under s 177CB(4) ITAA36.

¶7-115 Issue of dividend access shares

The following example is drawn from TD 2013/D5. That determination focuses on the dividend-stripping aspects of Pt IVA. Equally relevant is whether the general anti-avoidance provisions could be enlivened.

Facts

TD 2013/D5 deals with a form of the arrangement described in TA 2012/4, which displays all or most of the following features:

(1) a private company (the "target company") has accumulated significant profits which have been subject to income tax at the company tax rate;

(2) the target company's ordinary shares are held by an individual (the "original shareholder") who is also the director of the target company;

(3) the target company's constitution is amended to allow for the creation of a new class of shares (the "Z class shares") which have the following characteristics:

  (a) a right to receive a dividend distribution at the discretion of the target company's director(s);

  (b) no voting rights or rights to participate in the surplus assets of the target company on its winding-up; and

  (c) a right by the target company to redeem the Z class shares within four years of the share's issue date. If the Z class shares are not redeemed, they will cease to exist at the expiration of four years from their issue;

(4) the original shareholder may incorporate new companies and establish new discretionary trusts or employ existing companies and trusts to implement the remaining steps of the arrangement. The interposed companies and trusts will typically be controlled by the original shareholder and the beneficiaries of the trusts will likely comprise the original shareholder and his associates;

(5) the target company issues Z class shares for nominal consideration to the company controlled by the original shareholder or to a company acting as trustee of a discretionary trust;

(6) the target company declares and pays a fully franked dividend on the Z class shares of an amount approximately equal to the accumulated profits in the target company. The dividend payment is satisfied by way of a promissory note issued by the target company; and

(7) a series of transactions are then carried out to effectively deliver the economic benefit of the target company's profits to the original shareholder and his or her associates in a tax-free or substantially tax-free form. Examples of this include:

    (a) where the Z class shares are issued to a company, the company need not pay tax on the fully franked dividend as it gets enough franking credits to offset any tax liability. In many of these arrangements, the company is wholly owned by a discretionary trust. This allows the original shareholder to direct any subsequent dividend distributions by the company to tax-preferred entities, such as non-resident associates of the original shareholder, other related individuals exposed to a lower marginal tax rate or entities with carried-forward tax losses; and

    (b) where the Z class shares are issued to the trustee of a discretionary trust, the trustee appoints the net income of the trust to a second trust without immediately paying out that entitlement. This amount will represent an unpaid present entitlement (UPE) of the second trust. The trustee of the second trust then appoints its net income to a private company beneficiary without immediately paying out that entitlement. This amount represents a UPE of the private company beneficiary. Absent any consequences under Div 7A ITAA36, the UPE will remain an asset of the private company beneficiary indefinitely. In many of these arrangements, the assets represented by the fully franked dividend on the Z class shares are lent by the trustee of the trust to the original shareholder and/or his or her family for their personal use under an interest-free loan repayable only on demand by the trustee company, which is controlled by the original shareholder.

Scheme

The scheme could simply have all of the above features. The issue of the new class of shares would need to form part of the scheme. The payment of the dividend and the application of those funds by the new shareholder would also likely need to constitute a part of the scheme as these steps would appear to be critical to the tax outcomes.

Tax benefit

The reconstruction approach would be the appropriate way to determine the tax benefit.

The substance of the arrangement is that funds currently held within the corporate structure are extracted from this structure either to a new structure (say, a trust) and/or made available to the shareholder or their associates for their personal use. The results and consequences of the scheme would be similar to this.

The alternative postulate would likely need to achieve similar financial outcomes for the shareholder and their associates, being that funds within the company are made available for alternative use outside the company.

This is the first point where evidence will be critical. The Commissioner's default alternative postulate would involve the payment of a dividend to the existing shareholder. If the taxpayer can demonstrate that various other alternative courses of action were considered, perhaps one of those alternatives may be able to be demonstrated to constitute the reasonable alternative postulate.

For example, a Subdiv 122-A or 124-G ITAA97 roll-over would enable the interposition of a new holding company above the existing company. A fully franked dividend paid to this company would not attract a tax liability. If the funds distributed under the scheme are held in the recipient entity and invested, the new holding company scenario may produce a result that is consistent with the substance, results and consequences of the scheme. If the funds distributed under the scheme are released to the shareholder or their associates for personal use, the reasonable alternative postulate may be more along the line of a dividend to existing shareholders.

For Pt IVA to apply, the alternative postulate would need to be one where income is omitted from the assessable income of a taxpayer (probably the shareholder). For example, the alternative postulate could be that a dividend was paid to the existing shareholder.

Purpose

When assessing the question of purpose, it is useful in this instance to start with considering what could be the subjective intentions of the parties when entering into this type of arrangement, and then, how successful the scheme is in achieving these outcomes.

Asset protection is commonly put forward as the purpose for entering into this type of transaction. Relevant questions to validate this subjective purpose would include:

- What are the asset protection risks that action is being taken to address (business/company risks, shareholders risks, other risks)?
- Are the risks theoretical or real?
- Has advice been sought on the asset protection implications of what was proposed to be undertaken?
- Does the asset protection position change after the arrangement? Essentially, have the quantum of assets exposed to the asset protection risks been reduced?

An assertion of asset protection is insufficient; the objective facts must support the assertion. Remember that the Commissioner will be able to review the transaction with the benefit of hindsight, so actually attaining the improved asset protection position will be important.

Succession planning has been suggested as a purpose for entering into this type of transaction. Relevant questions to validate this subjective purpose would include:

- Is a structured succession plan in place?
- How is the succession plan furthered by the issue of a share with such limited rights?
- Have the funds distributed under the scheme been applied in a way that is consistent with a succession planning purpose? Releasing the funds to the existing shareholder or their associates would appear inconsistent with this purpose.
- Could the same outcomes be achieved in a simpler way?
- How does the transaction assist with transitioning ownership to the next generation/new owners?

An example that may be more in line with a succession planning purpose compared with the facts outlined in TD 2013/D5 would be:

- the Z class share is issued to a company owned by the existing shareholder;
- a dividend equal to the accumulated profits is declared on the Z class shares but is not paid;
- the dividend has the effect of reducing the value of the ordinary shares in the original company;
- the ordinary shares in the original company are then transferred/issued to the incoming shareholders under the succession plan using the reduced value; and
- arrangements are put in place to pay the Z class dividend over time.

Another factor which may support a succession planning purpose is if the Z class shares have greater rights, even if these rights accrue (vest) over time. Similar arrangements have been utilised when offering shares in private companies to employees.

In the absence of being able to demonstrate financial and other consequences of the scheme that are sufficient to substantiate a non-tax purpose for the parties when entering into the scheme, the factors in s 177D are likely to point strongly towards a tax-related purpose.

Further examples

The examples in TD 2013/D5, in particular the second example, are useful to consider:

> "Example 1
>
> Jack and Dianne are the sole shareholders and directors of Aust Co, an Australian private company which has accumulated profits of $5m.
>
> Jack and Dianne wish to liberate the accumulated profits of Aust Co for reasons that are said to include 'asset protection', because they believe Aust Co operates in an industry which exposes it to legal risks. If Aust Co were to pay a dividend of $5m to Jack and Dianne, it would create a

potential tax liability in Jack and Dianne's hands at the highest marginal tax rate net the benefit of franking credits.

On 10 June 2009, Jack and Dianne approve a resolution to issue a new class of shares, 'Z' class shares, in Aust Co. The new class of shares carries no right to vote however does carry the right to receive a dividend from Aust Co. The new shares must be redeemed by Aust Co within 4 years.

5 new 'Z' class shares are issued and are acquired for nominal consideration of $1 per share by the Jack and Dianne Trust, a discretionary trust established on 10 June 2009, to which Jack, Dianne and their immediate family members are beneficiaries.

On 10 June 2009, Jack and Dianne resolve to declare a fully franked dividend of $1m per 'Z' class share in Aust Co to the Jack and Dianne Trust. On 10 June 2009, the Trustee of the Jack and Dianne Trust makes a trust distribution of $5m to Jack and Dianne's son Tommy, a non-resident. Tommy is not subject to further Australian tax on the $5m. Tommy lends the amount of $5m back to Aust Co on 11 June 2009.

Jack and Dianne have little objective evidence to support their claims of asset protection. In any case, they are unable to explain why the asset protection in question could not have been achieved more simply by having Aust Co declare a dividend to them as ordinary shareholders. Jack and Dianne have entered into a scheme 'by way of or in the nature of dividend stripping' within the meaning of section 177E of Part IVA. (emphasis added)

Example 2

Ian is the sole shareholder and director of XYZ Co, an Australian private company which has accumulated profits of $5m. Ian and Tracey are in divorce proceedings. As part of a Family Court settlement, XYZ Co issues 5 new 'Z' class shares to a newly established company, New Co for consideration of $1 per share. The new class of shares carries no right to vote however does carry the right to receive a dividend from XYZ Co. The new shares must be redeemed by XYZ Co within 4 years. Ian is the sole shareholder of New Co.

A fully franked dividend of $1 million per share is paid on those shares and New Co is liable to tax on these dividends, but also entitled to imputation credits on them. As part of the family court settlement Ian's shareholding in New Co is transferred to Tracey. New Co later pays Tracey a fully franked dividend of $5 million. Tracey includes this income in her income tax return in the year in which she receives it.

This arrangement objectively appears to be an ordinary family dealing, rather than a scheme for the purpose of avoiding tax on dividends. The relevant facts include that:

- Tracey is liable for income tax on the fully franked dividend she receives on her shareholding in New Co, but is also entitled to imputation credits on it. She is subject to tax at her marginal rate and, overall, no tax is avoided.
- The particular manner of the arrangement is explicable by the terms of the Family Court settlement."

¶7-120 Intercompany loan write-offs

The following case study considers the decision to write off related party loans to trigger a capital loss in the same year when a capital gain is being derived, with the intent that the two be offset.

Facts

Michael and his associated entities operate a number of businesses, hold various properties, and have a substantial investment portfolio. The different entities do not form part of a tax consolidated group.

With recent economic conditions, business has been difficult. A number of the companies carrying on businesses have been trading at a loss. Some of Michael's other companies have made loans to the loss-making companies to fund their operations.

One of the companies was operating Michael's retail business. Given the ongoing losses, Michael has decided to shut down this business. All of the external creditors will be paid. However, the company will be left with debts due to associated companies of nearly $1m. The debts are unsecured.

The banks have tired of Michael and the trials and tribulations of his businesses. They are requiring that a commercial property be sold and the net proceeds be used to discharge the bank debt. This will substantially reduce the bank's exposure to Michael and his businesses. The property is owned by a discretionary trust.

Michael's concern is that he will generate a capital gain of nearly $1m on the sale of the property. He doesn't have the funds available to pay the tax that would arise on this gain as the businesses have no excess cash and all of the funds from the sale of the property will be applied by the bank to reduce debt.

To deal with this situation, Michael is proposing to write off the loans due from his retail business to the associated companies. Formal legal documentation will be entered into. Michael has confirmed that this will trigger capital losses of $1m (after assessment of market-value substitution and cost-base issues). The family trust will then distribute the gain on the sale of the property to these associated companies to be offset against the losses. The companies are potential beneficiaries under the trust deed and have previously received distributions.

Scheme

The scheme would include the decision to write off the loans and crystallise the capital losses. This in itself can constitute a tax benefit.

Tax benefit

Potentially, the tax benefit could be determined under the annihilation approach by simply ignoring the actions to crystallise the capital loss. This would have the result that the companies would be assessed on the capital gain distributed to them by the trust.

Would use of the reconstruction approach produce a different result? The substance of the scheme is the realisation of a loss on a related party debt. The results and consequences for the taxpayer are that an unsecured debt that they previously held but could not collect is brought to an end such that they no longer hold the asset. In financial terms, the loss in value of the asset would have already occurred so that the taxpayer would already have an unrealised loss for the amount of the debt. The scheme converts this to a realised loss, but there is no real change in financial position.

A different alternative postulate is that the taxpayer would not have taken steps to realise the loss on the debt until a later time (say, when the creditor company was wound up). This could be seen as being consistent with the substance and results of the scheme as it places the taxpayer in the same financial position. It would also produce the same tax benefit outcome as the annihilation approach.

The resolution to this case will be found in the assessment of purpose, rather than an argument around tax benefit.

Purpose

The manner in which the scheme is entered into and carried out would include elements such as:

- the debt arose from intercompany funding of a business on a basis that is relatively commonplace in privately owned groups;
- the debt became "bad" due to commercial factors arising from the operation of the business, rather than from actions of the taxpayer or their associates in, say, stripping assets or value from the creditor company;
- the business of the creditor company is being wound up and all external creditors discharged; and
- formal legal documentation is being entered into to implement the debt write-off.

This factor (the manner) would not indicate a dominant tax purpose.

The form of the scheme is the write-off of a related party debt. The substance is similar, in that the debt is released. However, the debt is already essentially worthless and uncollectable. There is nothing in the way in which the transaction is structured that would be indicative of a tax purpose. This factor would not seem to indicate a dominant tax purpose.

Timing is important. On the one hand, the debt write-off is occurring contemporaneously with the winding-up of the business, which would not be indicative of a tax purpose. However, the debt was already uncollectable and the action of writing it off produces no real change in the overall financial position of the taxpayer and their associates. The action of writing off the debt is prompted by the generation of a capital gain on the sale of the property. This factor would indicate that the timing of the decision to write off the debt was for the purpose of obtaining a tax benefit.

The tax result of the scheme is enabling the sheltering of a capital gain against the capital loss arising from the write-off of the debt. It is a material permanent benefit and indicative of the requisite tax purpose.

The financial position of the taxpayer and their associates does not change materially under the scheme, but for the savings in tax. The action of writing off the debt does position the creditor company to be more readily wound up. This factor is at best neutral, but more probably is slightly indicative of a tax purpose.

The parties to the transaction are related. This explains why the loan was originally entered into. The reasons for the loan becoming uncollectable are unrelated to any connection between the parties. This factor would be neutral.

Overall, the manner, form and substance would probably be sufficient to conclude that the dominant purpose of the participants in the scheme was not to obtain a tax benefit. While subjectively this may have been the intent of the parties and explains the timing of the decision, the way in which the loan arose and became bad, as well the fact that the write-off occurs contemporaneously with the winding-up of the creditor company, would support an objective conclusion that the requisite tax purpose was not present.

¶7-125 Year-end tax planning

The potential application of Pt IVA to traditional tax planning is an area of concern for many practitioners. The following case study looks at that issue.

Facts

Josh and David own a company, Medigear Pty Ltd, which specialises in importing and distributing niche medical consumables and small equipment.

The business has been built on the back of quality service, competitive prices and having products available for immediate delivery. To achieve this, Josh and David order bulk quantities of products and hold these in stock pending orders from their customers. With their years of industry experience, Josh and David are skilled at forecasting which products will be in high demand and which new products will be best accepted into the market.

In June each year, Josh and David meet with the company's tax adviser, who is also their personal tax adviser, to undertake some year-end tax planning. This year, the business has been very successful and has generated a significant profit. In an effort to reduce/defer the tax payable by the company, the following actions are being considered:

- an aged stock listing is being reviewed to identify any stock lines where no sales have been made in the previous six months, or where the particular product is close to its expiry date and so is unlikely to be able to be sold (particularly for consumables, customers expect a minimum shelf life on the product). The items will be written down or written off, as deemed appropriate. The stock will be retained in the warehouse and in the inventory system in case it can actually be sold;

- two old problematic debtors are identified. The company has done what it can to chase the debts, but has not been able to recover them. There is no intention of formally releasing the debts, but it is proposed to write them off for tax purposes;
- the company normally pays discretionary bonuses to staff. This year, it is considering notifying the staff in writing pre-30 June of their bonus entitlement so that the company is committed to the payment and can claim the tax deduction. The bonuses won't be paid until August or September;
- Josh and David haven't been drawing a salary. It is proposed that they will be paid $80,000 each (to get them to approximately a 30% tax rate), plus $25,000 in superannuation contributions; and
- employee superannuation is normally paid in the first week of each month. For June, the plan is to bring forward the payment so that it is made pre-30 June and a deduction can be claimed.

Are these the types of arrangements that Pt IVA could apply to?

Scheme

There are multiple schemes here, with each course of action, as well as the overall planning process, being a scheme.

Tax benefits

There are also multiple potential tax benefits here. Mostly, these are timing benefits (for example, a deduction being available in the current year as opposed to the following year).

The s 177C(2) ITAA36 exclusion may be applicable. For example, the stock valuation is based on elections contained in Div 70 ITAA97.

Purpose

The answer to the Pt IVA question is to be found in the assessment of purpose. The subjective intent of the parties is clearly to achieve a better tax outcome for the company and its owners. That is why the tax planning process is being undertaken. However, this does not necessarily mean that Pt IVA will apply. The relevant question is whether a reasonable purpose, having regard to the eight factors in s 177D, would conclude that the sole or dominant purpose of the participants in parts or all of the tax planning process was to obtain a tax benefit for a particular taxpayer.

As a general observation (but one qualified by noting that Pt IVA is not limited in this way), where the tax planning accords with sound commercial practice, for example, writing down the value of obsolete stock, the Pt IVA risk is low. Where the tax planning has clear commercial implications, for example, bringing forward the payment of superannuation, the Pt IVA risk is low. Part IVA is more likely to apply where there is an element of artificiality or contrivance to the arrangement.

Relevant questions for assessing the Pt IVA risk of the above actions include the following.

Trading stock

The valuation of trading stock may well be covered by the s 177C(2) exclusion. Assuming for the moment that it is not, then consider:

- Is the adjustment for the value of specific lines of stock, rather than a general provision?
- Has the same valuation methodology been used for accounting purposes?
- Is the valuation methodology consistently applied between income years?
- Is the rationale for identifying obsolete stock commercially justifiable?

Bad debts

- Is the debt with an unrelated party?
- Is the debt genuinely bad, rather than the debtor just a slow payer?
- Have the requirements of s 25-35ITAA97 and TR 92/18 been met?
- Has the debt been written off for accounting purposes (a bad debt expense), rather than merely being provided for (a provision for bad debts)?

Bonuses

- Are the recipients of the bonuses unrelated parties?
- Will the bonus be (or was it) paid within a reasonable period after year end?

Salaries

- Were the salaries paid before year end?
- Were appropriate on-costs paid or accrued, and was PAYG withholding remitted?
- Is the salary assessable to the shareholder/associate in the same period as the deduction is being claimed?

Superannuation

This would be the least contentious of the tax planning actions, given the specific rules governing the tax deductibility of superannuation contributions. The relevant question (which is also applicable as to whether the deduction is available in the first instance) is whether the amounts were actually paid to superannuation funds.

VT88/562 and FCT

VT88/562 and FCT[1] provides an interesting illustration of tax planning that may attract Pt IVA. In broad terms, a business had well-established commercial relationships with key suppliers (in this case, a supplier of raw materials and a supplier of advertising services).

1 [1990] AATA 333.

As part of a tax planning arrangement, the taxpayer purported to enter into variations in the contractual arrangements with the suppliers that had the effect of the taxpayer incurring an expense in the current year for which it would claim a tax deduction. The actual acquisitions being made did not alter materially; rather, it was the contractual terms as to the commitment to procure the services that changed. The agreement was purporting to bind the taxpayer to a liability for payment for future services.

A key factor that caused Pt IVA to be applied in this case was that the apparent significant change in the commercial arrangements of the taxpayer was not reflected in a change in the behaviour of the taxpayer, in particular regarding payment. The AAT stated:[2]

> "… the substantially significant matters are the major change in the relevant commercial practices whereby the Applicant made forward commitments such as it had not previously made; and, secondly, the circumstance that it proceeded to actually defray such liabilities as it had assumed in accordance with that former practice and not in accordance with the obligations assumed by the documented contract. In order to complete the analysis, I express the view that, had payment been made in accordance with the agreements upon the execution of them, there would probably have been no scope for the application of Part IVA of the Act …"

In this case, the tax position (incurred in the current year) was inconsistent with the commercial reality and the arrangement demonstrated a level of artificiality. It is this type of attribute that will bring with it a higher risk of the application of Pt IVA.

¶7-130 Employee incentive arrangement

The following case study looks at the potential application of Pt IVA to the design and implementation of a tax-effective employee incentive arrangement.

Facts

Murray has been in the market research industry for many years. He realises that the competition for talented people is tough, and without the best people, the business will falter. Economic conditions have also been placing additional financial pressures on the industry, with most major customers cutting back on their market research spend.

Murray, through his family trust, is the sole shareholder in Left Field Research Pty Ltd, which operates a strategic market research and brand insights business. For many years, the company has paid its key employees sizable performance-related bonuses. Essentially, if the business exceeds its budgeted result for the year, a portion of the excess is allocated to a bonus pool and paid equally to each of the key employees. If an employee leaves before the bonus is paid, they forfeit their right to the bonus.

At one of the regular advisory board meetings for Left Field Research Pty Ltd, the issue of the bonus arrangement is raised. An idea is floated about issuing the employees with a class of share that carries limited rights, and using this as the mechanism for making the "bonus" payments. The thought is that

2 [1990] AATA 333 at [60].

a dividend distribution may be more tax-effective for the employees and so the company could pay a lower amount, but with the employees achieving the same or a higher after-tax outcome. Accessing the significant accumulated franking credits may also assist in lowering the cost of the arrangement to the company.

The dividend payments should also not attract the employee-related on-costs, such as payroll tax, workers compensation insurance and compulsory superannuation.

The shares would carry a discretionary right to a dividend, no capital rights and no voting rights. The shares would be forfeited if the employee ceased employment with the company. The shares would need to be held by the employee or their family company or trust.

Detailed tax and legal advice is obtained which confirms the effectiveness (aside from Pt IVA) of the arrangement. A market valuation is obtained which values the shares at a nominal amount.

Would Pt IVA apply to this arrangement?

Scheme

The scheme would be the issue of the new class of shares to the employees (or their nominees) in substitution for the existing bonus arrangements and the subsequent payment of dividends in lieu of bonuses.

Tax benefit

The tax benefit would be determined using the reconstruction approach. It is relatively clear, but a level of prediction would still be required, as to what the company would have done if this new employee incentive arrangement had not been put in place.

The substance of the arrangement is that the employees and the company have entered into a profit-sharing-type arrangement. The taxpayers in a Pt IVA sense are the employees, for it is the employees who will receive the tax benefit. The results and consequences of the scheme for the taxpayers are that a profit share/bonus payment is received and their after-tax position is maintained or improved.

Given the importance that the company places on providing incentives to its key employees, a reasonable alternative postulate (in any event, but certainly given s 177CB(4) ITAA36) would be one where some form of incentive arrangement is in place. In the absence of evidence as to other courses of action that the company considered, a reasonable alternative postulate would be one where the existing bonus arrangement was maintained.

In this case, the tax benefit is the omission from assessable income of a bonus payment. The fact that an equivalent amount of income (in the form of a dividend) may be included in assessable income does not prevent a tax benefit from arising (see IT 2456).

Purpose

In respect of the manner in which the scheme is entered into and carried out, on the positive side are factors such as that the arrangement was considered by the advisory board, tax, legal and valuation advice was obtained, and the arrangements create genuine legal relationships and obligations between the parties. On the other hand, the arrangements allow for what was previously a profit share received by the individual employees to now be received by their nominee.

The form and substance of the scheme do not necessarily align. In form, the employees (or their nominees) become shareholders in the company and receive dividends. In substance, they are participants in a profit share arrangement. However, when the alternative postulate (ie the original arrangement) is considered, a similar point could be made. In substance, it's a profit share arrangement where a portion of the annual profits of the business is paid to a group of individuals. The form that the payment takes is a bonus. Should a distribution of profits among a group be characterised as a dividend or a bonus?

There is nothing in the facts to suggest that timing is an important factor, other than that the arrangement is being considered now due to increased pressures on the business.

The tax result of the scheme is that the employee or their nominee will receive and be taxed on a dividend distribution. As the dividend will be fully franked, the tax payable by the recipient would be lower compared with payment in the form of a bonus. Payment to a nominee may also enable a lower tax rate to be applied. The "or nominee" element would suggest the presence of a tax purpose.

The changes in financial and other positions for the parties would include:

- the creation of the shareholder arrangement;
- the payment of non-deductible dividends, rather than deductible bonuses by the company;
- the cost savings achieved by the company; and
- the employees or their nominees being in the same or a better after-tax position.

On the company side, clear non-tax benefit-related outcomes are achieved, including the cost savings. On the taxpayer side (the employee or their nominee), any benefit is attributable to the different tax treatment.

The parties are connected by way of a business relationship. This factor is neutral.

Looking at the arrangement on a holistic basis, clear commercial benefits are achieved by the company that are independent of the tax benefits to the employees. However, what indicates that Pt IVA may be enlivened would include:

- that an existing arrangement is being modified;
- that the cost savings to the company are partly attributable to the ability to pay a lower distribution because the employee can achieve a tax saving through the differential tax treatment applied to a dividend distribution as compared to a bonus; and

- that what was formally a bonus received by the individual employee can now be received by their nominee.

If the company was paying the same distribution (adjusted for the fact that a dividend is paid after the company has paid tax on the profits being distributed) and the payment was made to individual employees, the case for Pt IVA not applying would be stronger. The employees will pay a lower amount of tax on a dividend as compared to a bonus but, when the additional tax payable by the company is taken into account, the overall tax paid on the distribution is unchanged. The employees would be neutral as to whether the payment was made as a bonus or a dividend. The benefit of the arrangement is really the saving of employee-related on-costs.

Once the amount of the bonus payment is adjusted to factor in the tax savings achieved by the employees, or when the employees can substitute a family company or trust to hold the shares and receive the dividend, the situation changes. Here, the tax benefit assumes greater importance.

The specific facts of the case will be important, but so will the way that the scheme is defined. If the scheme is limited to the decision by an employee to nominate a family company or trust to hold the shares, rather than them personally, it may be easier for the Commissioner to rely on Pt IVA to disallow the tax benefits compared to a scheme which is defined as the overall share arrangement.

Note that, as the scheme involves the payment of franked dividends, consideration of s 177EA ITAA36 would also be required.

¶7-135 Purported alienation of income through discretionary trust partners

The ATO has issued a taxpayer alert (TA 2013/3) which describes arrangements where an individual purports to make the trustee of a discretionary trust a partner in a firm of accountants, lawyers or other professionals, but fails to give legal effect to that structure or fails to account for its tax consequences.

TA 2013/3 describes the arrangement as follows:

> "This alert applies to arrangements with features substantially equivalent, but not limited to, those described below. All factors should be weighed up in assessing whether any tax risks are posed by a particular arrangement.
>
> 1. An individual causes transactions to occur which purport to make the trustee of a discretionary trust (trustee) a partner in a professional firm. The trustee may be the individual acting in their capacity as trustee or another entity. The beneficiaries of the trust include the individual or their associates.
> 2. The individual purports to assign their existing interest in the partnership to the trustee. In such a case the individual may not report any capital gain associated with the assignment in their tax return, or report an understated capital gain.

3. Alternatively, the individual may not have had an existing interest in the partnership, but transactions occur which purport to provide the trustee with a new partnership interest.

4. The arrangement has some or all of the following features:

a. the trustee does not actively engage in the conduct of the firm's practice and may not hold professional qualifications,
b. the practice is carried on in much the same way as it had been before the trustee purported to become a partner, or would have been if the trustee had not purported to become a partner; specifically:
    i. the individual renders substantial personal services to clients of the firm, the value of which cannot be attributed solely to the efforts of employees or income producing assets,
    ii. the individual has the same or similar roles, responsibilities and obligations as they had before the trustee purported to become a partner, or would have had if the trustee had not purported to become a partner,
    iii. no advice of the trustee arrangement is given to clients of the firm or other third parties,
    iv. the trustee arrangement does not result in any limitation of liability for the individual, or the individual is exposed to substantially the same level of business risk they were exposed to as a partner, or would have been exposed to, if they had been a partner,
    v. the trustee arrangement does not assist in the provision of professional services by the individual.
a. the amount of salary or other remuneration payable to the individual is considerably lower than the income which they formerly derived from the practice, or would have derived if they had been a partner,
b. the individual has the ability to remove the trustee, revoke or alter the trust arrangement, or otherwise control the trustee's interest in the partnership.

5. In addition, or in the alternative, the arrangement may have some or all of the following features:

a. inconsistencies in the documentation that make it unclear whether the individual or the trustee is a partner in the firm,
b. the individual contracts with clients or other third parties on the basis that the individual is a partner,
c. the firm or the individual represents to the public that the individual is a partner,
d. there is no employment or other contractual relationship between the trustee and the individual,
e. the documentation purports to provide corporate trustees with entitlements (eg leave) which can only be enjoyed by a natural person,
f. the trustee does not have any employees (whether in its capacity as partner or otherwise),
g. the trustee does not hold any significant assets (whether in its capacity as partner or otherwise),
h. the trustee does not contribute any capital to the partnership,
i. the individual purports to make drawings from partnership equity for their personal use.

6. In each financial year:

a. the firm directs distributions of net profits of the firm to the trustee as partner of the firm. This distribution may correspond to the amount the individual could reasonably be expected to have received if they had not entered into the arrangement.

b. the trustee resolves to distribute most or all of the income to lower taxed beneficiaries of the trust.

7. The individual does not report any income from the professional firm in their tax return, except to the extent (if any) that such income is part of their entitlement as a beneficiary of the trust.

8. The arrangements described above may alternatively be implemented using a unit trust, units in which are held by lower taxed beneficiaries."

What are the ATO's concerns?

The ATO has three sets of concerns with this arrangement:

(1) whether the arrangement is legally effective. If not, the assessable income from the partnership may actually still be income for the individual partners. This is not a PSI issue as the income is business income. It is more a question of whether the restructure has been implemented in a legally effective manner;

(2) whether the CGT implications of the restructure have been appropriately determined; and

(3) whether Pt IVA may apply to the arrangement.

Assuming that the arrangement is otherwise effective for tax purposes, could Pt IVA be invoked by the Commissioner?

Scheme

The scheme would include most or all of the above steps.

Tax benefit

The tax benefit is a reduction in assessable income for the individual. The appropriate approach (annihilation or reconstruction) for determining the tax benefit is debatable.

Under the annihilation approach, the restructure transactions would be ignored and the original pre-restructure position restored. Part IVA is only an issue if the restructure is legally effective. A legally effective restructure would have other results and consequences for the taxpayer which may then necessitate using the reconstruction approach. Determining a reasonable alternative postulate based on the scheme outlined in TA 2013/3 is difficult. Limited particulars are given, the facts are somewhat artificial, and the description of the arrangement implies that the restructure is not legally effective.

The answer to the Pt IVA issue lies not in the determination of the tax benefit question, but in the question of purpose.

Purpose

Manner

Whether the transaction occurred at market value would be relevant, including whether advice was obtained on determining the market value.

The legal documentation prepared will be important. Comprehensive formal legal documentation would obviously be preferable to an undocumented or partly documented arrangement or a situation where pro forma documentation was used.

A move to remunerating the partner on a clearly uncommercial basis may be an indicator of a tax purpose.

It is worth noting that the structure (non-individual partners in a firm, with the individual practitioners working in the firm but not being partners in the partnership) is permissible under the laws governing the ownership and operations of many of the professions.

Form and substance

In form, the transaction involves a transfer of an interest in a partnership. In substance, it may be considered that the trustee is a partner in name only and that the individual continues as a partner for all intents and purposes. The individual continues to perform the same role and carry the same liability exposure. The more that, in substance, the individual continues to act and be treated as a partner, the greater the indicator of a tax purpose.

In many instances, over time the trust as a partner will build up a "current account" with the partnership to fund working capital, will become party to the firm's banking arrangements, and will do other things which are consistent with its role as a partner in the partnership. This will give greater alignment to the form and substance of the arrangement.

Time

Time does not appear to be a critical factor in this arrangement.

Tax result

The arrangement has the effect of reducing the income of the individual and increasing the income of an associated trust which can then manage its income tax position through the discretionary distribution powers. This would be indicative of a tax purpose. However, this should also create a capital gain for the individual from the disposal of the partnership interest. Depending on the tax treatment of the gain (is it sheltered by the various CGT concessions or does a taxable gain arise?), this may point away from a tax purpose.

Change in financial position

On an associate-inclusive basis, the financial position of the individual (and their associates) does not materially change under the arrangement other than for tax savings that may be achieved and for the transaction costs of the arrangement.

The use of gearing in the trust to acquire the partnership interest may be a further issue.

Other changes

Another critical change would be in the individual's asset protection position. If this is genuinely improved, then that would point away from a tax purpose. Based on the description of the arrangement in TA 2013/3, the individual continues to have a liability exposure in respect of the partnership which would suggest that the asset protection benefits are limited. Similar transactions could be part of an effective asset protection strategy.

Nature of the connections

The trust and the individual are associated, which may explain in part why the transaction was entered into. The relevance of this factor is correlated to the "manner" and "form and substance" — if these indicate an uncommercial transaction, the fact that the parties are associates would point towards a tax purpose.

Overall

It would be difficult to apply Pt IVA to this arrangement if:

(1) it is legally effective;

(2) it is undertaken at market value; and

(3) it improves the level of asset protection.

However, if little is achieved from the arrangement other than the tax savings through use of the trust to receive income, there is a real risk that Pt IVA may be applied.

What will also be important is the extent to which, in substance, the individual continues to act and be treated as a partner. A partnership structure may be problematic in that regard as, to the outside world, the individual will still appear to be a partner. An alternative may be to restructure into a corporate model, with discretionary trusts as the shareholders. This would produce a much more distinct change in the role of the individual. It may also have other implications which are beneficial from a Pt IVA perspective, such as improved asset protection outcomes.

Everett assignments

How does the Commissioner's position on Everett assignments reconcile with TA 2013/3?

Under an Everett assignment, a partner assigns to an associated party the right to distributions of income relating to their partnership interest. The individual continues to be a partner in the partnership and acts accordingly. The associate does not become a partner in the partnership.

It was ruled by the Federal Court[3] that the rights created under an Everett assignment were not rights separate from the interest in the partnership itself. Rather, under an Everett assignment, the partnership interest commences to be held for the benefit of the assignee. This conclusion is accepted by the Commissioner in IT 2540, where he states (para 24):

> "For the purposes of Part IIIA, it is considered that the effect of an Everett assignment is that the partner disposes of part of his or her partnership interest, notwithstanding that the assignee only has an equitable interest in the assignor's partnership interest and that legal title to the partnership assets continues to vest in the partners to the exclusion of the assignee (see Everett's case at p. 448). In line with the discussion earlier in this Ruling, the assignment of part of the partnership interest will be treated as a part disposal of the partner's interests in the partnership assets."

In IT 2501 (para 9), the Commissioner states that:

> "Valid assignments on all fours with the Everett or Galland decisions will be accepted for tax purposes and will not be regarded as caught by section 260 or Part IVA."

An Everett assignment is:

- legally effective and creates and alters genuine legal relationships; and
- undertaken at market value (or market value consideration is deemed to have been paid for tax purposes).

These are factors that, in the TA 2013/3 context, would support Pt IVA not applying. In addition, in an Everett assignment, the individual continues as a partner, so the issue of the individual being a partner in substance but not in form is removed.

The concept underlying the arrangement in TA 2013/3 (the transfer of income-producing property to an associated party) is generally an acceptable transaction, even if it brings with it certain tax advantages. However, where the restructure is not implemented well (legally and practically) and where the non-tax outcomes achieved are limited, Pt IVA may have potential application.

3 *FCT v Galland* [1984] FCA 402; *FCT v Everett* [1978] FCA 39.

Chapter 8

Wash sale-type transactions

¶8-100 Introduction

While the term "wash sale" does not have any precise meaning, it is well understood what the term refers to. It is a transaction whereby the same, or substantially the same, asset is bought and sold within a short period of time. The net effect is that there is effectively no change in the economic position of the party as a result of the two transactions.

One use of a wash sale-style transaction is to crystallise an unrealised loss on an asset. The loss is crystallised through the sale of the asset; however, the same (or substantially the same) asset is then repurchased. There is no change in the economic position of the owner of the asset, but for crystallising the loss.

Where the same taxpayer has generated, or expects to generate, a taxable gain and the loss crystallised under the wash sale is used to offset the gain, a Pt IVA risk arises.

The ATO has published TR 2008/1 which sets out its views on the application of Pt IVA to wash sales. The types of wash sale transaction identified in the ruling are:

- disposing and reacquiring the same or a similar asset;
- acquiring an asset and then disposing of the same or a similar asset;
- disposing of an asset with an arrangement to acquire the same or a similar asset for a similar price and subsequently acting on that arrangement;
- disposing of an asset but using derivatives or financial instruments that substantially provide continued exposure to the risks and opportunities of the asset;
- disposing of an asset but entering into an agreement providing an entitlement to future income produced by the asset and/or any capital appreciation in the asset;
- disposing of an asset to a controlled or an associated trust or company;
- disposing of an asset to a controlled or an associated trust or company and the subsequent on-sale of the asset back to the original owner;
- transferring the asset from one wholly owned company to another;
- transferring the asset between two trusts with the same trustee and class of beneficiaries or objects; and
- disposing of an asset to a family member with an arrangement or understanding that it will be reacquired or otherwise held for their ongoing benefit.

The form of a wash sale is not as important as the outcome. The outcome is the crystallisation of a loss without a corresponding change in the economic position of the taxpayer.

The examples in this chapter are drawn from TR 2008/1.

¶8-105 Application of Pt IVA

The scheme under s 177A ITAA36 would consist of the steps taken to affect the wash sale. The scheme would broadly consist of: those steps taken to dispose of, or deal with, the asset so that a capital loss or allowable deduction is incurred; those steps taken to continue the taxpayer's economic exposure to, or interest in, the asset, or substantially the same asset; and the application of that capital loss or allowable deduction against a capital gain or assessable income, whether in that income year or a following income year.

The tax benefit would generally be based on an alternative postulate that the taxpayer would not have disposed of or otherwise dealt with the asset but would, or could, be expected to have continued to beneficially own, or have an interest in, the asset during that income year. Under this alternative postulate, the crystallised loss does not arise.

In TR 2008/1, the ATO has made the following comments in relation to the eight factors in s 177D.

1. Manner in which the scheme was entered into or carried out. The manner in which the scheme is carried out is not ordinary, is complicated or artificial, or is explicable only by reference to the tax benefit obtained, when compared to the manner in which a disposal of an asset to a third party is usually effected or to what would have been expected had the counterfactual occurred.

Under the relevant counterfactual, the taxpayer continues to beneficially own or have an interest in the asset, and is not required to do anything to the asset in order to ensure their continuing beneficial ownership or interest.

In contrast, under the scheme, the taxpayer enters into transactions which effectively cancel each other, or otherwise provide the taxpayer with continued economic exposure to the asset, in order to achieve the same result as the counterfactual but produce no benefit other than the tax benefit.

2. Form and substance of the scheme. The form of the scheme is the disposal, or otherwise ending, of the taxpayer's beneficial ownership of, or interest in, the asset. The substance of the scheme is that the taxpayer continues to economically own or benefit from the same or substantially the same asset, while creating a capital loss or allowable deduction for tax purposes. The substance of the scheme is that the taxpayer is left in materially the same economic position with respect to the asset as they were in prior to the scheme.

3. The time at which the scheme was entered into and the length of the period during which the scheme was carried out. The period during which the scheme is carried out is short, and the time at which the scheme was entered into is proximate to the derivation of a capital gain or assessable income, or the end of the income year. Further, the timing of the scheme is not proximate to any events that explain the disposal as being for ordinary business or family reasons.

4. The result in relation to the operation of the ITAA36 that, but for Pt IVA, would be achieved by the scheme. The result achieved by the scheme is the incurrence of a capital loss, and thus a reduction in income tax payable on any capital gains made by the taxpayer, or the incurrence of an allowable deduction and, thus, a reduction in the income tax payable by the taxpayer, whether in that income year or a subsequent income year.

5. The change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result from the scheme. With the exception of transaction costs associated with the scheme and the increase in the taxpayer's financial resources by reason of not having to pay tax, the taxpayer's financial position remains essentially unchanged, or if it does change, it is offset by an inverse financial change of an associate.

6. The change in the financial position of any person ("connected persons") 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. If the asset is disposed of to an associate, the financial position of the associate remains essentially unchanged, or if it does change, is offset by an inverse financial change of the taxpayer.

7. Any other consequence for the relevant taxpayer, or for any connected person, of the scheme having being entered into or carried out. The taxpayer does not forego further increases in the value of the asset disposed of, or any income produced by it, or continues to otherwise enjoy the financial benefits of the asset such that the person to whom it is disposed of does not benefit in substance from their ownership of, or interest in, the asset.

8. The nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any connected person. The persons to whom the taxpayer disposes of the asset, or with whom the taxpayer deals with in implementing the scheme, are controlled or influenced by the taxpayer or have a family connection to the taxpayer.

On an overall basis, a taxpayer enters into a transaction to crystallise a capital loss, but at the same time preserves their ongoing economic interest in the asset (or a similar, equivalent asset), often through transactions with an associate. This is done at a time when the taxpayer has derived a capital gain and can therefore utilise the capital loss.

Are all sales to associates caught?

Not all sales to associates are caught. If an asset is sold to an associate under a genuine transaction where the associate benefits in substance from the asset, the transaction should not be considered as a wash sale because the economic position of the taxpayer has changed, as has the economic position of the associate.

What if the asset is worthless?

If the asset being transferred is worthless, this could be problematic. The ATO considers that, if the asset is worthless or near worthless, the associate is unlikely to financially benefit from it by virtue of its worthlessness. This would suggest, subject to the other factors, that the dominant purpose of the scheme was to enable the taxpayer to incur a capital loss or allowable deduction.

However, just because an asset is transferred at a depressed market value or has lost substantial value since it was acquired, doesn't mean that a transfer of that asset to an associate is a transaction that Pt IVA will apply to. What could be persuasive in this situation is evidence as to why the asset is expected to increase in value or produce income that will accrue to the benefit of the associate as the new owner.

See the example at ¶8-130 for a discussion on this point.

¶8-110 Rebalancing a portfolio

Financial planners and investment advisers will periodically rebalance a portfolio of investments. This transaction can be undertaken in a number of different ways, but often it will involve disposing of underperforming assets, crystallising any losses on those assets. Where a broader investment portfolio is held, those losses can be utilised to offset gains made on the remainder of the portfolio.

While not strictly a wash sale (as the asset may be genuinely disposed of), would this type of transaction be considered one that Pt IVA would be applied to? Is the decision to crystallise losses so that they can be utilised to offset existing or pending gains a decision that could attract the application of Pt IVA?

In TR 2008/1, the ATO makes some comments in respect of the manner in which the scheme is entered into or carried out that are useful in this analysis.

Evidence as to the investment strategies followed by the taxpayer, or evidence that the taxpayer entered into the scheme on the basis of financial or tax advice and the nature of that advice, would be relevant. Examples of advice that is relevant would include the circumstance of obtaining expert opinion regarding market conditions, or expectations as to movements in the price of an asset. Presumably, where the financial planner is providing the advice in the context of a well-developed financial strategy, the rebalancing should be viewed as part of that investment strategy rather than for the dominant purpose of obtaining a tax benefit.

Conversely, if the nature of the advice is inconsistent with such strategies, or is otherwise suggestive of a tax purpose, this factor will point towards the requisite purpose. For example, a once-off rebalancing at year end that is only undertaken after the quantum of the realised (and taxable) gains has been determined may be one that is more suggestive of a dominant purpose of obtaining a tax benefit.

Past conduct can be relevant. For instance, if the taxpayer has entered into this type of transaction at year end (or other times) in prior years or if the transaction forms part of a regular reassessment of the portfolio of investments held, these actions would point away from the dominant purpose being to obtain a tax benefit.

¶8-115 Concurrent disposal and acquisition

This case study involves a concurrent and contingent sell and buy transaction on the same stock in a manner that triggers a capital loss.

Facts

Catherine owns a large share portfolio and land as a consequence of being named a beneficiary of her grandfather's estate in the year ended 30 June 2001. Acting on professional financial advice from Simon, Catherine sells the land on 18 May 2007 and makes a capital gain of $50,000 in the year ended 30 June 2007. That same day, Catherine discusses with Simon her impending income tax liability.

Simon reviews Catherine's share portfolio and notes that she holds 100,000 shares in Beta Communications Ltd (Beta), a listed public company. Beta is currently trading at 51 cents per share. Catherine's reduced cost base for her Beta shares is $1.00 per share. Simon advises Catherine that she is currently holding unrealised losses of $49,000 in Beta, and proposes a strategy to realise those losses while allowing her to maintain her interest in Beta.

Catherine acts on this advice. On 20 May 2007, Simon, on Catherine's behalf, instructs an arm's length stockbroker to undertake concurrent and contingent sell and buy contracts (that is, to sell all of Catherine's existing Beta shares prior to purchasing any new ones) on the Beta stock. Under this arrangement, on the same day, Catherine sells 100,000 Beta shares for 51 cents each and then buys 100,000 shares in Beta at a price of 51 cents each. The sale and purchase are not referable to any contemporaneous change in the performance of Beta or any other matters that might cause a reasonable investor to change their view regarding the stock.

Simon charges Catherine $1,000 for transaction costs associated with the concurrent and contingent sell and buy arrangement. CGT event A1 happens on the sale of the shares. Catherine's capital proceeds from the transaction are $51,000, and her reduced cost base is $101,000 (including the $1,000 transaction costs), giving her a capital loss of $50,000. Catherine offsets the capital loss against the $50,000 capital gain when preparing her income tax return for the year ended 30 June 2007.

Scheme

The scheme includes all of the steps leading to, the entering into and the implementation of the sell and buy transactions, the incurrence of the capital loss, and the offsetting of the $50,000 capital loss against the $50,000 capital gain by Catherine.

Tax benefit

As the scheme had no effect or outcome on Catherine's economic exposure to the stock, it is reasonable to conclude that nothing would have happened if the scheme had not been entered into or carried out.

The tax benefit is calculated using the annihilation approach.

The tax benefit obtained by Catherine is the capital loss of $50,000 incurred during the 2006-07 income year.

Purpose

Ordinarily, an investor would not sell shares in a company and immediately apply the proceeds of sale to acquire the same number of shares in the same company. The manner in which the scheme was entered into is indicative of a dominant purpose of obtaining a tax benefit.

In form, Catherine disposed of her beneficial ownership of the shares, but the effect of the concurrent and contingent sale and purchase is such that, in substance, Catherine's position with respect to the shares has not materially changed. Catherine suffered no economic loss under the scheme. This is indicative of a dominant purpose of obtaining a tax benefit.

The scheme lasted a day, with the sale and purchase occurring concurrently on 20 May 2007, which is proximate to the derivation of the $50,000 capital gain from the sale of land on 18 May 2007 and is not referable to any contemporaneous change in market sentiment or performance of the company. This is indicative of a dominant purpose of obtaining a tax benefit.

The tax result achieved (but for Pt IVA) is the incurrence of the $50,000 capital loss that reduces the separate $50,000 capital gain and the amount of tax payable by Catherine for the 2006-07 income year. This was the only benefit obtained by Catherine under the scheme, as the sale proceeds were substantially used to purchase the same amount of shares in the company. This is indicative of a dominant purpose of obtaining a tax benefit.

There has been no material change in Catherine's financial position as a result of the scheme, other than an increase in her financial resources from not having to pay tax on the capital gain derived on the sale of the land. This is indicative of a dominant purpose of obtaining a tax benefit.

The analysis of the eight factors would indicate that the dominant purpose was that of obtaining a tax benefit.

¶8-120 24 hours between disposal and acquisition

As an alternative to the previous case study, the example below considers how a delay between the disposal and acquisition transactions affects the application of Pt IVA.

Facts

Assume the same facts as the example in ¶8-115 except, as an alternative transaction, Catherine places a sell order for the 100,000 shares with her broker and the next day instructs her broker to buy 100,000 Beta shares. She does this after having sought advice from the broker on the potential for price movements in the stock and being advised that the likelihood of a material change in price was low. The price of the stock has moved up by 1 cent during that interval.

Scheme

The scheme is essentially unchanged from the example in ¶8-115, except that the sell and buy transaction occur over two days rather than concurrently.

Tax benefit

The tax benefit is unchanged from the example in ¶8-115.

Purpose

An analysis of purpose would proceed on a similar basis as in the example in ¶8-115. However, the change in the scheme does warrant revision of some elements of the previous Pt IVA analysis.

In terms of manner, and to a degree, timing, the short period of time between the disposal and acquisition, coupled with the obtaining of advice to confirm suitable market conditions, may objectively be taken to indicate that Catherine sold her shares without any real intention of ceasing to hold an economic exposure to Beta. These factors would continue to point to the obtaining of a tax benefit as the dominant purpose.

In form, Catherine has disposed of her beneficial ownership of the shares. However, the overall result of the scheme is that, in substance, Catherine's position with respect to the shares has not materially changed. Although Catherine was at risk of an adverse economic outcome from a change in price of the Beta shares, and this is consistent with her having disposed of those shares, the market conditions and the short period of time out of the market limited her exposure to that risk.

These factors would indicate that the dominant purpose was that of obtaining a tax benefit.

The longer the period between the sell transaction and the buy transaction, the less likely that this would be a factor that would point to a dominant purpose of obtaining a tax benefit.

¶8-125 Transfer between two trusts

This case study considers a transfer between two trusts that triggers a capital loss but also enables ongoing exposure to the economic benefits of the shares.

Facts

Oscar is the sole trustee and a general beneficiary, together with his family, of a discretionary trust (Trust 1). Trust 1 was settled in March 1992. As trustee, during the 2003-04 income year, Oscar purchased 1,000,000 shares in the publicly listed ABC Ltd (ABC) at $1 per share. The purchase was financed by an interest-only loan from a third party, secured on other assets of the trust under which market rates of interest are payable. On 11 June 2007, Oscar, as trustee of Trust 1, sold shares held in another company, XYZ Ltd, and generated a capital gain of $255,000.

On 12 June 2007, a second discretionary trust (Trust 2) was settled, with Oscar as the sole trustee. The terms of Trust 1 and Trust 2 are very similar, but not the same. Both trusts are under the sole control of Oscar, and their objects are the same. On that same day, Oscar, as trustee for Trust 1, transferred 500,000 shares in ABC to himself, as trustee of Trust 2, for a consideration of $250,000. Oscar signed and executed a share sale agreement in his capacities as trustee of Trust 1 and trustee of Trust 2. The purchase price was paid by Trust 1 providing an interest-only loan to Trust 2 on an unsecured basis, with interest payable based on the same rates as the original loan from the third party. There was no loan agreement.

CGT event E2 happens on the transfer of the ABC shares to Trust 2. Trust 1 incurred a capital loss of $250,000. The capital loss was calculated on a reduced cost base of $1.00 per share and capital proceeds of 50 cents, the closing market price of the shares on 12 June 2007. The capital loss of $250,000 incurred by Trust 1 was applied against the capital gain of $255,000, resulting in a net capital gain of $5,000. The net capital gain of $5,000 was distributed to Oscar and included in his assessable income for the year ended 30 June 2007.

Scheme

The scheme consists of all of the steps leading to, the entering into and the implementation of the transfer of the shares to Trust 2, including:

- the creation of Trust 2 on 12 June 2007;
- the transfer of 500,000 ABC shares by Trust 1 to Trust 2 on 12 June 2007;
- the incurrence by Trust 1 of a capital loss of $250,000 from the transfer;
- the offsetting of the $250,000 capital loss against Trust 1's capital gains for the year ended 30 June 2007; and
- the distribution by Oscar, as trustee of Trust 1, to himself, as a beneficiary of Trust 1, of the net capital gain of Trust 1 for the income year ended 30 June 2007.

Tax benefit

The substance of the scheme is that Oscar continues to have the control of, and benefit from, the shares as the terms of the two trusts are very similar, they have the same objects, and they are under the sole control of Oscar. The scheme had no effect or outcome on Oscar's legal title, or the economic exposure to the asset of the potential beneficiaries of the trust.

The annihilation approach would be appropriate for determining the tax benefit. It is reasonable to conclude that nothing would have happened if the scheme had not been entered into or carried out. The tax benefit obtained by Oscar as trustee of Trust 1 is the capital loss of $250,000 incurred during the 2006-07 income year.

Purpose

The manner in which the scheme was entered into or carried out is not straightforward. It involved the settling of a trust, the transfer of shares and a loan all occurring on the same day. The terms of the trusts are very similar and the vendor and purchaser were the same person, acting in different capacities. The manner of the scheme points to the conclusion that the scheme was entered into or carried out for the dominant purpose of incurring the capital loss.

There is a discrepancy between the form and substance of the scheme. In form, there is a sale from Trust 1 to Trust 2 but, in substance, the beneficial ownership of the shares remained under the sole and complete control of Oscar, subject to the equitable obligation imposed under the terms of Trust 2 that was very similar to the previous obligation imposed under Trust 1. There was no change in the economic interests in the ABC shares of the potential beneficiaries, as the objects under Trust 2 were the same as the objects under Trust 1. Thus, no economic loss was suffered as a result of the scheme. This factor points to the dominant purpose being to obtain a tax benefit.

The scheme lasted only one day. Trust 2 was established on 12 June 2007 and the transfer of ABC shares took place on that day. The transfer was proximate to the capital gain derived the day before and to the end of the financial year. The timing of the scheme also suggests the requisite purpose of obtaining a tax benefit.

The tax result achieved (but for Pt IVA) is the making of the capital loss of $250,000 that was applied against the capital gain of $255,000 in the year ended 30 June 2007, reducing the trustee's net capital gain for that year, and thus the tax payable on that gain that was distributed to Oscar in his personal capacity. This factor points to the dominant purpose being to obtain a tax benefit.

There has been no material change in Oscar's financial position or, when considered on a holistic basis, the financial position of other parties under the scheme other than the increase in financial resources from not having to pay tax. As a beneficiary of Trust 1, Oscar benefited from the capital loss which reduced his trust distribution from a net capital gain of $255,000 to $5,000. As trustee of Trust 2, he remains the registered owner and he controls, in his discretion, who may benefit from the ABC shares. Thus, these factors point towards the requisite dominant purpose.

For both the trustee and objects, Trust 2 substantially replicates their legal and economic positions with respect to the shares. No substantive family or business advantages have been secured by entering into the scheme. This factor points to the dominant purpose being to obtain a tax benefit.

The connection between the parties is one of associates, in respect of which Oscar has sole control of both trusts, allowing him to cause Trust 1 to incur a capital loss while retaining legal title and the ability to benefit from control of the shares. This points towards the dominant purpose being to obtain a tax benefit.

On weighing up the eight matters, it would be concluded that the dominant purpose of Oscar as trustee of Trust 1 in entering into and carrying out the scheme was to obtain a tax benefit in the form of a capital loss.[1]

¶8-130 Transfer to a discretionary trust of worthless shares

This case study involves the sale of shares in a company that are essentially worthless, and considers whether Pt IVA can apply to deny the resultant capital loss.

Facts

Stephen Bartlet holds a number of investments, including rental properties and shares in listed public companies. Stephen derives regular rents and dividends from most of these investments. His investment activities do not constitute the carrying on of a business. Stephen is also the trustee and appointer of the Bartlet Family Trust, under which Stephen has a wide range of discretionary powers. The discretionary objects of the trust include Stephen, his spouse and dependent children. As trustee, Stephen holds shares and interests in managed investment funds.

On 5 February 2007, Stephen derives a $40,000 capital gain from the sale of shares. Stephen does not want to pay tax on the $40,000 capital gain. On 15 June 2007, he meets with his financial adviser who recommends that they review his share portfolio and determine whether he has any unrealised capital losses that could be crystallised and set off against the capital gain.

Stephen's adviser notes that he holds 4,000 shares in Davros Industries Ltd (Davros), a listed public company. The last time that Davros was traded on the stock exchange was over six months ago at $0.05. Stephen's reduced cost base in Davros is $10.55. Davros has experienced a number of spectacular corporate misadventures over the last two years which has seen its profits turn into significant losses and its stock price plummet from a high of $20.00 per share. Stephen is advised that it is highly unlikely that Davros' share price will ever improve. Furthermore, he is advised that, if he wishes to crystallise a capital loss, he should gift the shares to the trust, as it is highly unlikely that he will be able to sell the shares on the market.

Acting on the advice, Stephen transfers the shares for no consideration to the trust on 15 June 2007. The documentation associated with the transfer is prepared by Stephen's solicitor, at a cost of $500. CGT event E2 happens on the transfer of the shares to the trust. After taking into account the market value substitution rules, Stephen incurs a capital loss of $42,500 that he applies to reduce his $40,000 capital gain, giving him a net capital loss of $2,500 for the year ended 30 June 2007.

Prior to the problems that beset Davros, its shares paid high-yielding and reliable franked dividends. In previous years, these dividends were received and applied by Stephen to provide for his and his family's everyday expenses. The Davros shares have not paid dividends for almost two years.

1 This example was based on *Cumins v FCT* [2007] FCAFC 21.

Stephen continued to hold the shares in his capacity as trustee for the trust until Davros was wound up in insolvency during 2008. None of the ordinary shareholders of Davros, including Stephen, received a return on winding-up. Davros was dissolved and the shares cancelled in October 2008.

Scheme

The scheme includes:

- all of the steps leading to, the entering into, and the implementation of the arrangement to gift the Davros shares to the trust;
- the incurrence of the capital loss of $42,500; and
- the application of the capital loss against the $40,000 capital gain so that it was reduced to zero, resulting in a net capital loss of $2,500 to Stephen for the year ended 30 June 2007.

Tax benefit

The substance of the scheme is that Stephen remains the registered owner of the shares (although now in his capacity as trustee), has control over who benefits from the shares as trustee in his unfettered discretion and, thus, also has the ability as an object to still benefit from, or otherwise reinstate his beneficial ownership of, the shares.

The scheme had no effect or outcome on Stephen's legal title, and he retains an economic exposure to the asset as an object of the trust.

The tax benefit should be determined under the annihilation approach.

The tax benefit obtained by Stephen is the capital loss of $42,500 incurred during the 2006-07 income year.

Purpose

The manner in which Stephen entered into the scheme would include that it was undertaken on the advice of his financial adviser as a strategy to reduce his tax liability. Although the shares were disposed of for no consideration and this aspect is consistent with a dealing of a familial nature, the decision to transfer the Davros shares (which carry little prospect of producing financial benefits for the beneficiaries of the trust over Stephen's other more profitable assets) points towards the required dominant purpose of obtaining a tax benefit. The beneficiaries are unlikely to benefit in substance from the arrangement — an outcome that is contradictory to the notion of a gift to, or otherwise providing for, one's family. The manner of entering into the scheme may not initially point to a dominant purpose of obtaining a tax benefit, but the absence of any prospect of financial gain for the trust does suggest such a purpose.

There is a discrepancy between the form and substance of the scheme. In form, the scheme is a gift of an asset to Stephen's family. The substance of the scheme is that the shares have been transferred to the trust to crystallise a loss. Although Stephen's family in form may potentially benefit from the Davros shares, the circumstances and prospects of the Davros shares suggest that this is unlikely to occur and that the trust is being used simply to hold worthless shares. Further, Stephen remains the legal owner of the shares as trustee, is an object of the trust, and has sole control over how the capital or income of the trust is applied. Stephen could retransfer the shares to himself at any time (this is the statement in the ruling — it is suggested that any such power is subject to the terms of the trust deed), or distribute to himself any financial benefits produced by the shares, in the unlikely event that Davros' position improved. This factor would point to the dominant purpose being to obtain a tax benefit.

The timing of the scheme suggests the requisite dominant purpose of obtaining a tax benefit. The scheme lasted only a few days, with the disposal of the loss-making shares occurring close to year end. Stephen realised a capital gain earlier in that income year and consideration was only given to disposing of the Davros shares when it became apparent that Stephen would be assessable on this capital gain.

The tax result achieved (but for Pt IVA) is the incurrence of a $42,500 capital loss that entirely reduced the tax that Stephen would otherwise have had to pay on the $40,000 capital gain that he derived earlier in the year. This was the only financial benefit obtained by Stephen under the scheme. There has been a change in Stephen's financial position as a result of the scheme as he now holds the Davros shares subject to the equitable obligations of the trust. However, this change in position is offset by an inverse change of an associate, by reason of a corresponding change in the financial positions of Stephen in his capacity as trustee of the trust and of Stephen's family as potential beneficiaries under the trust. The relationship between these parties must be taken into account. These factors either favour, or are neutral to, the required dominant purpose.

Stephen, in his capacity as trustee, has acquired an asset, and his family has the opportunity to benefit from that asset. However, Stephen's family will only be capable of benefiting from the transfer if the shares recover in value. There has been no real change in Stephen's or his family's positions as there is no value in the shares, nor is there any likelihood of an improvement in the value of the shares having regard to the information at the time.

Stephen is the trustee of the trust, father and spouse of the beneficiaries of the trust, and a beneficiary himself. Notwithstanding this familial connection to explain the transfer for no consideration, given the nature and prospects of the Davros shares, the transfer could not be regarded as a substantive gift. The large and immediate financial benefit obtained by Stephen through saving tax on the otherwise taxable $40,000 capital gain outweighs any uncertain and unlikely chance of a recovery in Davros' fortunes.

On weighing up the eight matters, it would be concluded that the dominant purpose of Stephen in entering into and carrying out the scheme was to obtain a tax benefit in the form of a capital loss.

Variation

Would the same conclusion be reached if the shares had value and were expected to produce income in the future, albeit that the transaction crystallised a capital loss? Potentially yes. This transaction would produce a more material change in financial position of the parties, independent of the tax savings.

The gifting of a valuable asset to a family trust is more reflective of a family dealing than the gifting of a worthless asset.

The timing would still be indicative of a tax purpose and the parties to the transaction would still be associates. However, the absence of any value to the family trust was a decisive factor in the example from TR 2008/1. A transaction that is otherwise consistent with the example, but where the shares have genuine value, would be much less likely to attract the application of Pt IVA.

An even stronger position could be achieved if the advice from the financial planner was not a single sale to crystallise a loss, but a broader rebalancing of the portfolio which included shifting some assets into the family trust and disposing of others.

¶8-135 Share trader: period of time between disposal and acquisition

This case study considers a wash sale-type transaction but where a more sound commercial rationale exists for each transaction.

Facts

David, a plumber by trade, has a keen interest in the share market and maintains an online trading account. David holds a diversified portfolio in a number of large publicly listed companies but, on occasion, David likes to gamble on certain speculative stocks that attract his attention. His investment activities do not constitute the carrying on of a business.

One such speculative stock is the listed, widely traded and highly volatile technology-based stock, IT Ltd (IT). Following a recent rally, IT goes into "free fall" in September 2006. Over the last weekend of September 2006, David reviews his portfolio, researches the company's financial position and the views held by commentators, and follows the discussion in various share market chat rooms. Following his research, David decides that he should sell his stake in IT, which has a reduced cost base of $2.88, in order to minimise further losses.

On 2 October 2006, David sells his entire holding in IT, being 30,000 shares at a price of $1.50 per share. CGT event A1 happens on the sale of the shares and David incurs a capital loss of $41,400.
On 2 and 3 October 2006, David actively investigates potential companies to invest the proceeds that he received from the sale of IT. During the course of those investigations, he notices that the sentiment of certain investors towards IT has changed, that there has been a relative increase in the volume of IT shares traded, and that the IT share price is climbing again. David continues to monitor IT while trying to decide what company he should invest the surplus funds in. As he is unable to decide on a suitable investment, and IT's price has continued to climb, David decides to purchase shares in IT.
On 5 October 2006, David purchases 27,000 shares at the prevailing market rate of $1.67 per share.
On 6 April 2007, David sells some other shares and makes a capital gain of $35,000. The $41,400 capital loss is applied against this capital gain, giving David a net capital loss of $6,400 for the 2006-07 income year.

Scheme

The scheme includes:

- all of the steps leading to (including the objective research undertaken by David), the entering into and the implementation of the sale and the subsequent purchase of IT shares; and
- the making of the $41,400 capital loss and the application of the capital loss against the $35,000 capital gain so that it was reduced to zero, resulting in a net capital loss of $6,400 to David for the year ended 30 June 2007.

Tax benefit

The step which causes the tax benefit is the sale of the IT shares, as it is this step which crystallises the capital loss. The main step which brings Pt IVA into consideration is the reacquisition of the IT shares a number of days later.

While there are commercial factors behind each of these steps, that is not really the question at this point. What needs to be done is to identify a tax benefit that is connected with the scheme. An assessment of purpose can then be applied in respect of that tax benefit and that scheme.

The scheme necessarily includes both the sale and the reacquisition of the shares, as it is these steps which create the "wash". The alternative postulate will need to exclude both of these steps in order to produce a tax benefit.

This example should be approached in a similar manner to the earlier wash sale examples in this chapter. The premise for the alternative postulate needs to be that the scheme had no material effect or outcome on David's economic exposure to the asset and so it is reasonable to conclude that nothing would have happened if the scheme had not been entered into or carried out.

Alternatively, the length of time between the sale and purchase, which coincides with changes in the market performance of IT, may suggest that the sale and purchase are not part of the same scheme, and that David would have disposed of the IT shares, regardless of the scheme. If this is the case, David may not have obtained a tax benefit. It is suggested that the same end point in terms of the application of Pt IVA should be achieved with either approach. Given that the ATO is looking for "purpose" to be the key test in Pt IVA and for "tax benefit" not to be an exit point, an approach which identifies a potential tax benefit and then proceeds to an assessment of purpose should be the preferred way to approach a Pt IVA analysis.

Purpose

The manner in which the scheme was entered into or carried out, in particular the short period of time between the disposal and acquisition, may objectively be taken to indicate that David sold the shares without any intention of ceasing to hold an economic exposure to IT. However, the fact that the disposal and acquisition are explicable by reference to market changes (for instance, the improvement in share price and demand for the stock) may also be regarded as consistent with the way in which taxpayers usually hold and realise investments. The coincidence with market changes may lead a reasonable person to infer that the sale and purchase of the IT shares within a short time was the result of independent investment decisions to sell and buy for commercial reasons, but evidence supporting this would be critical to show the predominance of a non-tax benefit purpose. Overall, this factor points away from the conclusion as to the dominant purpose being to obtain a tax benefit.

There is no discrepancy between the form and substance of the scheme. In form, David has changed his beneficial ownership of the shares. The fact that David was at risk of (having regard to the widely held, actively traded and volatile nature of the IT shares), and suffered, an adverse economic outcome from the change in the market value of the IT shares is consistent with David in substance disposing of his IT holding. The risk is material having regard to the market conditions of the time. This factor would point away from the dominant purpose being to obtain a tax benefit.

The timing of the scheme, in particular of the purchase, being referable to a change in investor sentiment and market activity tends against the dominant purpose of obtaining a tax benefit. The loss was incurred prior to the capital gain against which it was applied. However, there is nothing in the facts and circumstances to suggest that this gain was predictable or expected.

The tax result achieved (but for Pt IVA) is the incurrence of the $41,400 capital loss that entirely reduced the tax that David would otherwise have had to pay on the $35,000 capital gain that he derived later in the year. This was the only material benefit obtained, as the sale proceeds he received were used to purchase shares in IT on 5 October 2006. This factor points, at least to some degree, to the dominant purpose being to obtain a tax benefit.

There has been no material change in David's financial position as a result of the scheme. Other than the increase in his financial resources from not having to pay tax on the capital gain, David acquired materially the same value of shares as he disposed of, just a smaller number. This factor points, at least to some degree, to the dominant purpose being to obtain a tax benefit.

There has been no change in the financial position of any parties associated with David, but this is because no such parties were involved in the scheme. This factor is neutral.

David missed out on the increase in the market value of the IT shares while not holding them. Furthermore, David had to pay more to acquire each IT share than he received on disposal and, thus, could only purchase a smaller number of IT shares. Therefore, David has suffered an economic loss in comparison to what would have been the case if he had not entered into the scheme. This factor tends against the conclusion as to the dominant purpose being to obtain a tax benefit.

On weighing up the eight matters, it would be concluded that the dominant purpose of David in entering into and carrying out the scheme was not to obtain a tax benefit in the form of a capital loss.

Section 3

The key legislative concepts

Chapter 9

Importance of the legislation

¶9-100 Introduction

The correct way to apply Pt IVA is based on the words of the legislation itself. As tempting as it is to substitute another test, for example, does an arrangement pass a "smell test" or "bare the stamp of tax avoidance", ignoring the actual words of Pt IVA risks reaching the wrong conclusion.

Shorthand ways of expressing the general anti-avoidance rule have their place, but the better the words of the legislation are understood, the better the shorthand/practical ways of approaching Pt IVA work.

This section of the guide is focused on providing an analysis of the key provisions of Pt IVA — essentially, building your base knowledge of Pt IVA so that you are better equipped to make an informed and accurate assessment of the application of Pt IVA to particular circumstances.

¶9-105 The legislation

The legislation in Pt IVA can be divided into three main areas (see Table 1):

- the key concepts of scheme, tax benefit and purpose (see chapters 10, 11 and 12, respectively);
- the provisions which are administrative in nature and allow for the operation of Pt IVA (see chapter 18); and
- the specific anti-avoidance provisions included within Pt IVA.

Table 1

Key concept
Scheme: s 177A ITAA36
Tax benefit: ss 177C and 177CB ITAA36
Purpose: s 177D ITAA36 (dominant purpose is provided for in s 177A)
Administrative issue
Operational provisions: s 177B ITAA36
Part IVA determinations: s 177F ITAA36
Amendment periods: s 177G ITAA36
Specific avoidance provision
Dividend stripping: s 177E ITAA36
Imputation schemes: s 177EA ITAA36
Imputation schemes and consolidated groups: s 177EB ITAA36

The focus of this guide is on the general anti-avoidance provision in Pt IVA, rather than the various specific anti-avoidance provisions contained in Pt IVA and elsewhere in the tax law.

¶9-110 Relevance of extrinsic materials

When John Howard, then the Treasurer, introduced into parliament the Bill containing Pt IVA, he made the following (now famous, at least in tax circles) speech about what the new general anti-avoidance rule was intended to achieve:

> "We are acutely aware that 'tax avoidance' means different things to different people. Reasonable men and women are bound to differ on this crucial question and on the subsidiary matter of the appropriate tests for determining what behaviour a general anti-avoidance provision ought to proscribe.
>
> 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."

Few would argue with the policy that Mr Howard indicated Pt IVA was intended to implement. However, these are not the words that the draftsmen used when Pt IVA was written.

The question, which was considered a number of times in the early Pt IVA-related court cases, was whether Pt IVA needed to be read in the context of the policy intent of parliament as set out in Mr Howard's speech. The conclusion reached by the courts was that extrinsic materials could not be used in that way.

The use of extrinsic materials for interpretation of tax laws is dealt with in s 15AB of the *Acts Interpretation Act 1901* (Cth):

> "(1) Subject to subsection (3), in the interpretation of a provision of an Act, if any material not forming part of the Act is capable of assisting in the ascertainment of the meaning of the provision, consideration may be given to that material:
>
> (a) to confirm that the meaning of the provision is the ordinary meaning conveyed by the text of the provision taking into account its context in the Act and the purpose or object underlying the Act; or
>
> (b) to determine the meaning of the provision when:
>
> (i) the provision is ambiguous or obscure; or
>
> (ii) the ordinary meaning conveyed by the text of the provision taking into account its context in the Act and the purpose or object underlying the Act leads to a result that is manifestly absurd or is unreasonable."

Such an argument was raised before O'Loughlin J in the Federal Court during the *Peabody* case:[1]

> "Counsel for the taxpayer submitted that I should have regard to the Treasurer's second reading speech and the explanatory memorandum relating to the Bill that introduced Part IVA into the Act. He submitted that reference to this extrinsic material was necessary because it was, in the terms of s. 15AB of the Acts Interpretation Act 1901 (Cth) 'capable of assisting in the ascertainment of the meaning of the provision of the Act ...' Such a submission inappropriately assumes that there is, or might be, some difficulty in ascertaining the meaning of the relevant

1 *Peabody v FCT* [1992] FCA 463 at [34]-[35].

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.'

His Honour was also comforted by his conclusion that in any event his perusal of the extrinsic material confirmed:

> '... that the meaning of the provisions in question is the ordinary meaning conveyed by the text of the provision taking into account its context in the Act and the purpose or object underlying the Act.'

Although it was not necessary for Hartigan J. to take this extra step in light of his earlier finding that the 'words of the statute are plain', I respectfully agree with his Honour's conclusion; I decline therefore to examine the extrinsic material."

As tempting as it may be to look to the second reading speech as a basis for imposing limits on Pt IVA, it is clear that, historically, the courts have not seen this as appropriate.

This question will arise again in the context of the recent amendments to Pt IVA. The courts will need to determine whether the "words of the [amended] statute are plain" or whether the extrinsic materials are "capable of assisting in the ascertainment of the meaning of the provisions of the Act". Until this occurs (which will not be for quite a few years), the ATO is likely to administer the law in a manner that is consistent with the policy outlined in the explanatory memorandum.

¶9-115 The operation of Pt IVA

Section 177B ITAA36 sets out the operation of Pt IVA:

"(1) Nothing in the following limit the operation of this Part:

(a) the provisions of this Act (other than this Part);

(b) the *International Tax Agreements Act 1953*;

(c) the *Petroleum (Timor Sea Treaty) Act 2003*.

(2) This Part does not affect the operation of Division 393 of the *Income Tax Assessment Act 1997* (Farm management deposits).

(3) Where a provision of this Act other than this Part is expressed to have effect where a deduction would be allowable to a taxpayer but for or apart from a provision or provisions of this Act, the reference to that provision or to those provisions, as the case may be, shall be read as including a reference to subsection 177F(1).

(4) Where a provision of this Act other than this Part is expressed to have effect where a deduction would otherwise be allowable to a taxpayer, that provision shall be deemed to be expressed to have effect where a deduction would, but for subsection 177F(1), be otherwise allowable to the taxpayer."

Part IVA operates with paramount force

The operation of Pt IVA is not limited by any provision in the ITAA36 or the ITAA97. In addition, the provisions of the *International Tax Agreements Act 1953* (and the associated tax treaties) do not limit the application of Pt IVA.

Various arguments have been raised over time, most recently in *FCT v Macquarie Bank Ltd*,[2] that the operation of Pt IVA should be limited by particular aspects of the tax law (in this case, the consolidation regime). The courts have consistently rejected such arguments. This position is also clearly consistent with the explanatory memorandum accompanying the Bill that introduced Pt IVA:

> "... sub-section (1) of section 177B will mean that the anti-avoidance operation of Part IVA is not to be limited by anything else in the general income tax law ..."

The only exclusions to this are in s 177(2) and the special rules for farm management deposits.

Provision of last resort

While Pt IVA is not limited by the other provisions in the tax law, the other provisions in the tax law apply in priority to Pt IVA. In this way, Pt IVA is a provision of "last resort".

Where another provision applies, and in particular where a specific anti-avoidance provision applies, that provision will apply in priority to Pt IVA. For example, if a private company with accumulated profits makes a series of payments to associates of shareholders, rather than paying dividends to the shareholders, Div 7A will apply to this arrangement, not Pt IVA.

Likewise, if a company has two classes of shares on issue and resolves to vary the rights attaching to one class of shares (say, by removing its right to dividends), the issue will be considered under the value-shifting provisions, not Pt IVA. However, if the outcome produced through the application of the other provisions in the tax law is not adequate, the Commissioner can look to Pt IVA to deny the tax benefit.

So, following the above examples, if Div 7A or the value-shifting provisions did not negate the tax benefit to the taxpayers of the particular arrangements that were entered into, say, because the arrangement was structured in a particular way so as to technically fall outside these provisions or to limit their application, Pt IVA can be called on by the Commissioner to address the perceived deficiencies.

Reading s 177(1) (Pt IVA has paramount force) and s 177(3) (Pt IVA is a provision of last resort) together, the application of a specific anti-avoidance provision to a scheme does not then preclude the application of Pt IVA to the same scheme.

2 [2013] FCAFC 13.

The argument that Pt IVA can be limited by a specific anti-avoidance provision was rejected by the Federal Court in *Futuris*.[3] This case concerned the value-shifting provisions in Div 19A ITAA36. The judge referred to the clear statement of legislative intent in s 177B(1).

¶9-120 Fraud or evasion

Part IVA does not apply to cases of fraud or evasion. Part IVA only applies to arrangements that are otherwise effective under the tax law.

Fraud

In a tax context, fraud refers to situations where a taxpayer makes a statement or representation to the Commissioner which is false, and the taxpayer either knows that it is false or the taxpayer is recklessly careless in ascertaining that the statement is true or false.

The common law of fraud was described by Lord Hershell in *Derry v Peek*:[4]

> "First, in order to sustain an action of deceit, there must be proof of fraud, and nothing short of that will suffice. Secondly, fraud is proved when it is shown that a false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false. Although I have treated the second and third as distinct cases, I think the third is but an instance of the second, for one who makes a statement under such circumstances can have no real belief in the truth of what he states."

The High Court in *Krakowski v Eurolynx Properties Ltd* stated:[5]

> "In order to succeed in fraud, a representee must prove, inter alia, that the representor had no honest belief in the truth of the representation in the sense in which the representor intended it to be understood."

In *Masterman v FCT; MacFarlane v FCT*,[6] incorrect tax returns were lodged claiming tax deductions in respect of employees who did not exist. The Supreme Court concluded that the statements made in the returns "can only be described as frauds on the Commissioner of Taxation".

Tax schemes which rely on making false statements to the Commissioner will often constitute fraud and so will fall outside the ambit of Pt IVA.

3 *FCT v Futuris Corporation Ltd* [2012] FCAFC 32.

4 (1889) 14 App Cas 337 at 373.

5 (1995) 183 CLR 563 at 578.

6 85 ATC 4015.

Evasion

The leading case on evasion is *Denver Chemical Manufacturing Co v FCT*,[7] which was decided by the Full High Court. The case required the interpretation of evasion in the context of state income tax legislation. The High Court agreed with the judgment of Dixon J:[8]

> "I think it is unwise to attempt to define the word 'evasion'. The context of s. 210(2) shows that it means more than avoid and also more than a mere withholding of information or the mere furnishing of misleading information. It is probably safe to say that some blameworthy act or omission on the part of the taxpayer or those for whom he is responsible is contemplated. An intention to withhold information lest the Commissioner should concede the taxpayer liable to a greater extent than the taxpayer is prepared to concede, is conduct which if the result is to avoid tax would justify finding evasion."

Evasion would generally require intent on behalf of the taxpayer, and knowledge that the action will impact on their tax position. In some instances, an objective assessment of the taxpayer's intent and knowledge would be appropriate.

Arrangements that require an intentional non-disclosure of information to the Commissioner in order to be "effective" would often fall into the category of evasion and so will fall outside the ambit of Pt IVA.

¶9-125 Amendment of assessments

Section 177G ITAA36 is the relevant provision regarding the amendment of assessments:

> "Nothing in section 170 prevents the amendment of an assessment at any time if the amendment is for the purpose of giving effect to subsection 177F(3)."

There are two elements to the amendment periods for Pt IVA:

- **Applying Pt IVA.** An assessment can be amended to apply Pt IVA (ie to give effect to a determination under s 177F) for a period of four years from the date of assessment or deemed assessment. The amendment period is provided for in s 170 ITAA36.
- **Compensating adjustments.** Section 177F(3) allows the Commissioner, having made a Pt IVA determination, to make compensating adjustments where it would be fair and reasonable to do so. Section 177G provides an unlimited period of time to make amendments to give effect to these compensating adjustments.

7 [1949] HCA 25.

8 [1949] HCA 25 at [19]

Chapter 10

Scheme

¶10-100 The legislation

> "This definition is very broad. It encompasses not only a series of steps which together can be said to constitute a 'scheme' or a 'plan' but also … the taking of but one step. The very breadth of the definition of 'scheme' is consistent with the objective nature of the inquiries that are to be made under Pt IVA."[1]

Section 177A ITAA36 provides definitions and parameters for a number of concepts which are important for applying the other provisions in Pt IVA, the foremost among these being the definition of a "scheme":

> "(1) In this Part, unless the contrary intention appears:
>
> …
>
> 'scheme' means:
>
> (a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and
>
> (b) any scheme, plan, proposal, action, course of action or course of conduct.
>
> …
>
> (3) The reference in the definition of ***scheme*** in subsection (1) to a scheme, plan, proposal, action, course of action or course of conduct shall be read as including a reference to a unilateral scheme, plan, proposal, action, course of action or course of conduct, as the case may be.
>
> (4) A reference in this Part to the carrying out of a scheme by a person shall be read as including a reference to the carrying out of a scheme by a person together with another person or other persons."

¶10-105 Overview

Scheme is one of three key elements in Pt IVA — the others being tax benefit and purpose. The definition of "scheme" is broad, and most situations will fall within the definition.

The existence of a scheme of some description will rarely be in question.

The Commissioner is entitled to put his case in alternative ways. He can propose multiple schemes or variations in the way that the scheme is to be construed in a particular case.

As a matter of practice, the Commissioner will generally (but not always) identify a broad scheme covering the overall transaction and a narrow scheme focusing on the particular steps that produce the purported tax benefit.

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1 *FCT v Hart* [2004] HCA 26 at [43] per Glesson CJ and McHugh J.

The recent amendments to Pt IVA may necessitate the Commissioner being more specific about the scope of the scheme that he is relying on. This is because of the way the concept of scheme is now integrated with the concept of tax benefit in the new s 177CB ITAA36.

The relevant questions will always be whether the tax benefit that is the subject of the Pt IVA determination is a tax benefit obtained in connection with a scheme, and whether the requisite sole or dominant purpose exists in respect of participants in that same scheme.

"Scheme" for the purposes of Pt IVA should be seen as the context within which the analysis of purpose occurs. The broad scheme sets the outer boundary of this context, with the narrow scheme setting the inner boundary. Purpose is assessed objectively, based on the facts and circumstances within this context and by reference to the persons who are involved with all or part of those circumstances.

¶10-110 Very wide definition

The definition of a scheme in Pt IVA was recognised in *Peabody*[2] as being a "very wide definition". For the purposes of Pt IVA, scheme means:

> "(a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and
>
> (b) any scheme, plan, proposal, action, course of action or course of conduct."

It may be possible to conceive of a circumstance that did not constitute a scheme, but such circumstances would be very limited.

The breadth of the definition of "scheme" is consistent with the objective nature of the inquiries that are to be made under Pt IVA.

The actual existence of a scheme for Pt IVA purposes would rarely be a matter for dispute. However, what can be a matter for dispute is the precise identification of the scheme. The High Court stated in *Hart*[3] that scheme is defined in terms that may not always permit the precise identification of what are said to be all of the integers of a particular "scheme". This may prove problematic with the new way that a tax benefit is to be determined under s 177CB.

¶10-115 What is the role of "scheme" in Pt IVA?

A scheme, along with a tax benefit and purpose, is one of three key requirements for Pt IVA to be applied.

2 *FCT v Peabody* [1994] HCA 43 at [28].

3 *FCT v Hart* [2004] HCA 26 at [43].

Part IVA only applies to a scheme where it would be objectively concluded, having regard to the eight factors in s 177D ITAA36, that the sole or dominant purpose of a person who entered into or carried out any part of the scheme was to enable the taxpayer to obtain a tax benefit.

The tax benefit that Pt IVA seeks to cancel must be a tax benefit connected with the scheme. This point is discussed in more detail in chapter 11. Suffice to say, in any given case, a wider scheme or a narrower scheme can usually be identified, but the approach to identifying the scheme cannot be an approach which divorces the scheme from the tax benefit. If a step is an indispensable part of what produces the tax benefit, it should be included in the scheme as defined for the Pt IVA analysis.

As Hill J stated in the Full Federal Court decision in *Hart*:[4]

> "The definition of the scheme is very important. Any tax benefit which is identified must have a relationship to the defined scheme and not some other scheme. The conclusion of dominant purpose must be made by reference to the defined scheme, not some other scheme. Any determination made by the Commissioner must, likewise, be made by reference to the defined scheme and not some other scheme."

¶10-120 Do the recent amendments change the role of a scheme?

The recent amendments to Pt IVA have not altered the definition of "scheme", but may result in a change to the role of scheme in Pt IVA. There is a strong likelihood that "scheme" will assume a much more important role.

Application of the annihilation approach to quantifying a tax benefit is based only on the events or circumstances that actually happened or existed, other than those that form part of the scheme. This would require a precise identification of the steps that comprise the scheme.

Likewise, application of the reconstruction approach to quantifying a tax benefit sees the scheme as playing a central role. The limitations on the assessment of the reasonableness of an alternative postulate must have particular regard to the substance of the scheme and the results (other than tax) for the taxpayer that are achieved by the scheme.

These changes are likely to mean that the Commissioner will need to identify the scope of the scheme with greater precision, because it is only once the scope of the scheme is clear that the tax benefit analysis can proceed. This may see a move away from the broad scheme/narrow scheme approach that has been common practice to date.

¶10-125 Can a unilateral action be a scheme?

Section 177A(3) ITAA36 specifically includes a unilateral action within the concept of scheme. This is to remove any doubt that the definition of scheme may require the participation of two parties (for example, a consensual agreement) for a scheme to exist.

4 *Hart v FCT* [2002] FCAFC 222 at [41].

Section 177A(3) overcomes an argument made in various cases, including *Howland-Rose*,[5] that sought to limit the concept of scheme to situations where two or more parties were involved. In that case, the taxpayers referred to a decision of the New Zealand Court of Appeal (*BNZ Investments*) in which the need to establish the existence of consensual conduct was emphasised:[6]

> "In short, an arrangement involves a consensus, a meeting of minds between parties involving an expectation on the part of each that the other will act in a particular way. The descending order of the terms 'contract, agreement, plan or understanding' suggests that there are descending degrees of enforceability, so that a contract is ordinarily but not necessarily legally enforceable, as is perhaps an agreement, while a plan or understanding may often not be legally enforceable. The essential thread is mutuality as to content. The meeting of minds embodies an expectation as to future conduct. There is a consensus as to what is to be done.
>
> It is a fundamental pre-requisite to the use of section 99 against the taxpayer that there be a contract, agreement, plan or understanding (the words the legislature chose to use in s 99(1) in defining 'arrangement') in which the taxpayer is a participant. This state of affairs cannot exist for the taxpayer unless there has been formally or informally — even if unenforceably — a consensus between the taxpayer and another or others as to what, in general terms, will occur pursuant to the arrangement. The taxpayer does not have to know all the detail or be able to discern exactly how the arrangement will avoid tax by producing the illegitimate tax advantage, by which I mean an advantage which the legislature cannot have contemplated as flowing from the legislation. But the taxpayer must at least have a broad appreciation of the character of what is occurring."

However, as the court noted, the operation of the New Zealand legislation is controlled by a statutory definition of "arrangement", which reads as follows:

> "'Arrangement' means any contract, agreement, plan or understanding (whether enforceable or unenforceable) including all steps and transactions by which it is carried into effect."

Two points were made clear by the court in *Howland-Rose*:

(1) the definition of scheme in Pt IVA, including the aspects relating to unilateral actions, means that the argument made in *BNZ Investments* will be ineffective in an Australian context. It is clear that the independent actions of one party can themselves constitute a scheme; and

(2) the taxpayer does not need to be a participant in the scheme. Therefore, the unilateral action can be that of someone other than the actual taxpayer. The participant could be related to the taxpayer (for example, a controlled entity) or they could be unrelated. This was the situation in *Howland-Rose* (a "Budplan" case), where the unilateral actions of the promoter of the "tax-effective arrangement" were themselves sufficient to constitute a scheme for the purposes of Pt IVA.

The concept of unilateral scheme may limit the person or persons who enter into or carry out the scheme or any part of the scheme to that one individual, which in turn impacts on the assessment of the sole or dominant purpose, but it will not mean that a scheme doesn't exist.

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5 *Howland-Rose v FCT* [2002] FCA 246.

6 *Commissioner of Inland Revenue v BNZ Investments Ltd* [2001] NZCA 184 at [134].

¶10-130 Are there circumstances that do not constitute a scheme?

The court in *Peabody* indicated that it was possible "to conceive of a set of circumstances which constitutes only part of a scheme and not a scheme in itself". However, it does not give any examples, other than saying "that will occur where the circumstances are incapable of standing on their own without being 'robbed of all practical meaning'". These comments started a line of thought that perhaps situations could fall outside the very wide definition of scheme. Given that a unilateral action can constitute a scheme, there will probably be limited circumstances where something constitutes only part of a scheme and not a scheme in itself.

Does "robbed of all practical meaning" have any ongoing relevance? The High Court in *Hart*[7] (Gummow and Hayne JJ) addressed this specific point indicating that "[t]his statement must be understood as having been directed to the issues of procedural fairness which underlay the issue presented in that case". The line of thought that a part of a scheme may not be a scheme itself because it was robbed of all practical meaning potentially took that expression out of context.

The words "robbed of all practical meaning" were taken from *Inland Revenue Commissioners v Brebner*.[8] In that case, the words were used in a very different context and with a clearly intended meaning. Referring to *Brebner*, the High Court stated in *Hart*:[9]

> "The legislation in question in *Brebner* required comparison with what the statute called 'bona fide commercial reasons'. Part IVA, of course, contains no equivalent expression. What Lord Pearce said would be 'robbed of all practical meaning', if one part of an arrangement were to be isolated from other parts, was the sub-section, not the arrangement."

¶10-135 What are "broad" and "narrow" schemes?

The way that the concept of scheme tends to be applied is through the identification of a broad scheme (ie the whole series of events undertaken by the taxpayer) and then a narrow scheme within the broader scheme (ie only those steps that are directly related to the tax benefit).

Taxpayers have generally favoured the use of a broader scheme. The thinking is that a broader scheme encompasses more of the commercial elements of what was undertaken, and these commercial elements will support a finding that the sole or dominant purpose was not to produce a tax benefit.

The Commissioner (at least, it is perceived) has favoured the use of a narrower scheme. The thinking is that, if the scheme is limited to the particular steps that give rise to the tax benefit, it is more likely that the requisite sole or dominant purpose of obtaining a tax benefit will be found.

7 *FCT v Hart* [2004] HCA 26 at [46].

8 *Inland Revenue Commissioners v Brebner* [1967] 2 AC 18.

9 *FCT v Hart* [2004] HCA 26 at [47].

In the words of Hely J in the Full Federal Court decision in *Hart*:[10]

> "The more the scheme can be confined to the essential elements by which the tax benefit is obtained, the more likely it will be that the conclusion will be drawn that the dominant purpose for a person entering into a scheme so defined was to obtain the tax benefit."

Whether this proposition is always correct (as the High Court subsequently questioned) is open for discussion, but ultimately it is the consideration of the eight factors in s 177D ITAA36 that will be most relevant.

The High Court decisions in *Hart* and *Consolidated Press*[11] indicate that these cases would *not* have been decided differently if the scheme had been defined more broadly or more narrowly. The reasoning is found in the way that the "purpose" and "scheme" interact in Pt IVA, and was perhaps best articulated by Justice Hill:[12]

> "The conclusion in a case like Hart which has to be drawn by reference to the eight factors is a conclusion which has to be drawn by reference to the *way* the borrowing is structured and not a conclusion as to the borrowing itself. It is a conclusion not as to why the borrowing itself is entered into but why a borrowing on the particular terms and conditions is entered into."

In both *Hart* and *Consolidated Press*, the same non-tax outcomes could be achieved (or largely achieved) without the wealth optimiser or interposed entity (respectively) elements to the transactions. The Pt IVA inquiry is really one as to why those elements were included in the transaction — the assessment of purpose.

The eight factors in s 177D ITAA36 deal with the way in which the scheme is carried out, the effects and consequences of the scheme, and the nature of any connections between the parties to the scheme. The eight factors cover fairly comprehensively the points that you would want to consider when evaluating the objective purpose for a particular scheme. Even if the scheme is defined very narrowly, these eight factors provide a basis for evaluating the scheme in context and with reference to other facts which surround the particular scheme.

In theory, the precise definition of the scheme should not matter. In practice, it is useful to consider both a narrower and a broader version of the scheme and to see whether the same conclusions as to purpose are achieved. If so, you can have a reasonable level of comfort that the conclusions are robust. If not, a deeper consideration of the factors that drive the different conclusions as to purpose is warranted.

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10 *Hart v FCT* [2002] FCAFC 222 at [85].

11 *FCT v Consolidated Press Holdings* [2001] HCA 32.

12 DG Hill, *The incremental expansion of Part IVA*, South Australian Division, The Tax Institute, 7 May 2005.

¶10-140 Does a scheme for the purposes of Pt IVA need to have a commercial purpose?

Expressed another way, does the scope of the scheme need to be broad enough so that the scheme itself represents a commercially possible or meaningful transaction? For example, in *Consolidated Press*, could the scheme be limited to the interposition of the special purpose entity (a transaction which, viewed on its own, has no commercial meaning), or must the scheme include the borrowing and subsequent investment acquisition so as to represent a commercially meaningful transaction? The answer to this question is "no".

According to Gummow and Hayne JJ in *Hart's* case:[13]

> "[T]here is no basis to be found in the words used in Pt IVA for the introduction of some criterion additional to those identified in the Act itself. There is no reference to a scheme having some commercial or other coherence."

Edmonds J (with whom Bennett and Middleton JJ agreed) in *Ashwick*[14] made a similar statement. He went on to note that, while a lack of commercial or other coherence may not impede a conclusion as to the existence of a scheme, it may impede the drawing of a conclusion as to the dominant purpose of a party to a scheme that is sufficient to enable the Commissioner to make a Pt IVA determination. The issue is one of purpose (s 177D), not the existence of a scheme (s 177A).

¶10-145 How directly must the scheme be connected to the tax benefit?

For a tax benefit to be denied through the application of Pt IVA, the tax benefit must arise in connection with a scheme to which Pt IVA can be applied, ie a scheme where the requisite dominant purpose of obtaining a tax benefit has been established. But does the scheme need to include the specific steps that create the tax benefit that the Commissioner is seeking to deny through the application of Pt IVA?

The connection between the tax benefit and the scheme was the only real major point of disagreement between the various judges who considered *Hart's* case (originally in the Federal Court, then on appeal in the Full Federal Court and High Court).

The original decision accepted a narrowly defined scheme which consisted of the steps to implement the splitting of a loan, but not the taking out of the loan itself.[15] The Full Federal Court felt that the borrowing itself needed to be included in the scheme:[16]

> "... it is clear that the definition of a scheme which did not include the loan itself and the incurring of interest under it could not stand on its own feet. It is the loan and the application of funds

13 *FCT v Hart* [2004] HCA 26 at [47].

14 *FCT v Ashwick (Qld) No. 127 Pty Ltd* [2011] FCAFC 49 at [138].

15 *Hart v FCT* [2001] FCA 1547.

16 *Hart v FCT* [2002] FCAFC 222 at [44].

> under it which gives rise to the deduction for interest, even if it is the way the loan is structured that is fastened upon by the Commissioner as indicating the tax avoidance conclusion."

The discernible purpose from taking out the borrowing (ie financing the two properties) is central to the Full Federal Court's conclusion that the requisite dominant purpose was not present. Relevantly, when considering just the "wealth optimiser" aspect of the scheme, the Full Federal Court indicated that the manner in which this was entered into was explicable only by taxation consequences.

Gleeson CJ and Mason J in their joint judgment agreed with the Full Federal Court that the scheme should include the borrowing itself; however, they came to a different conclusion as to the dominant purpose.

Gummow and Hayne JJ were less concerned with the inclusion or exclusion of the borrowing from the scheme, noting that the way scheme is defined means that it may not always permit the precise identification of what are said to be all of the integers of a particular scheme. In their view, the narrow scheme — being just the split loan features and not the borrowing itself — fell within the definition of scheme. Their preferred route for resolving any apparent difficulty between the narrowly defined scheme and the identified tax benefit was to focus on the question of dominant purpose. This is what the recent amendments to Pt IVA also seek to achieve.

The varying positions are partially reconciled by a comment in the judgment of Callinan J:[17]

> "Nor is there any doubt that the respondents obtained a tax benefit under s 177C '*in connection with a scheme*'. The use of the word 'connection' is significant. It is a word of wider import than, for example, 'result'. The benefit is obvious: a deduction from each respondent's taxable income of the whole of the interest payable in respect of a loan to finance not just the acquisition or holding of an investment property but of both it and a residence, the interest on the financing of which is not tax deductible."

This issue was also raised in *RCI*:[18]

> "RCI pointed out that the narrower scheme did not include the transfer of the JHH(O) shares by RCI and it is only the transfer of those shares that could give rise to the tax benefit contended by the Commissioner to have been obtained by RCI in connection with the scheme. This submission was not pressed orally on the hearing of the appeal, correctly in my view. What the primary judge said at [75] of her reasons is a complete answer:
>
>> 'Attractive as that submission may seem initially, it makes an unwarranted assumption. Section 177D(a) provides that a scheme to which Part IVA applies is, relevantly, one where "a taxpayer ... has obtained, or would but for section 177F obtain, a tax benefit *in connection with* the scheme"; [emphasis added]. There is nothing in the provision which says that the tax benefit has to be generated by a step in the scheme.'"

A similar issue arose in *Consolidated Press* when considering whether a narrowly defined scheme that focused on the interposition of the entity and excluded the financing and the acquisition elements of

17 *FCT v Hart* [2004] HCA 26 at [91].

18 *RCI Pty Ltd v FCT* [2011] FCAFC 104 at [14].

the transaction was an acceptable way for "scheme" to be defined. The same conclusion as was later expressed in *RCI* was reached.

So, while a tax benefit must be connected with a scheme, the scheme does not need to include everything to enable the tax benefit to be calculated.

When identifying the narrow scheme, the objective is to find the steps which impact on the tax position so as to produce the difference in the tax outcomes that gives rise to the tax benefit.

¶10-150 What if the dominant purpose exists only in respect of part of a scheme?

For Pt IVA to apply to cancel a tax benefit, the tax benefit must arise in connection with the scheme. Section 177D ITAA36 provides that:

> "(1) This Part applies to a scheme if it would be concluded (having regard to the matters in subsection (2)) that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of:
>
> (a) enabling a taxpayer (a ***relevant taxpayer***) to obtain a tax benefit in connection with the scheme …"

The tax benefit needs to be connected with the scheme (the whole of the scheme), not just a part of the scheme. The dominant purpose is assessed having regard to the whole of the scheme. It is only the participants in the scheme who are identified by reference to the whole or a part of the scheme.

If a participant in the whole or a part of the scheme has, objectively, the purpose of obtaining a tax benefit for the taxpayer in respect of a specific step or steps within the scheme, but the requisite dominant purpose is not present when the whole of the scheme is considered, Pt IVA cannot be applied based on a part of the scheme. In this situation, the relevant question is really whether the part of the scheme could itself constitute a scheme to which Pt IVA applies.

As was noted by Hill J in *Consolidated Press*,[19] it does not matter if the scheme identified by the Commissioner is itself but a part of a larger scheme, so long as it brings about a tax benefit and thus is susceptible to cancellation under s 177F ITAA36.

¶10-155 Can the Commissioner change the scheme that he is relying on?

The Full Federal Court in *Peabody*[20] (in deciding for the taxpayer) had stated that the Commissioner needed to identify a scheme and, once that scheme was identified, it was the only relevant scheme and the decision on Pt IVA applying needed to be made in respect of that scheme and that scheme alone.

19 *CPH Property Pty Ltd v FCT* [1998] FCA 1276.

20 *Peabody v FCT* [1992] FCA 463 at [60].

The High Court disagreed. While the Commissioner needed to supply details of the scheme being relied on, "the Commissioner is entitled to put his case in alternative ways".[21] What this means in practice is that the Commissioner can propose a range of different schemes and see whether any one of them fulfils the requirements of Pt IVA.

It is yet to be seen whether the recent amendments to Pt IVA will change this practice. It is expected that the Commissioner will find it necessary to be more specific in the way that he defines the scheme so as to enable the tax benefit analysis to occur in a meaningful way.

21 *FCT v Peabody* [1994] HCA 43 at [25].

Chapter 11

Tax benefit

¶11-100 The role of tax benefit in Pt IVA

> "… the identification of a tax benefit is an ingredient, and indeed an essential ingredient, in the application of Part IVA to a particular scheme …"[1]
>
> "Part IVA is engaged only where a tax benefit has been obtained …"[2]

"Tax benefit" is one of the key elements required for Pt IVA to be applied. In recent case law (notably from around 2009 to 2012), tax benefit was central to the decision of the courts, with some decisions being made on the basis that there was no tax benefit and so the question of purpose did not need to be addressed.

The Full Federal Court in *Trail Bros*[3] stated that the starting point in any consideration of a tax benefit must actually be the whole of Pt IVA, as no one provision can be viewed in isolation. Although, without a tax benefit, Pt IVA has no application.

The recent amendments to Pt IVA, at their core, "split" the previous concept of "tax benefit" into two components:

(1) the existing s 177C ITAA36, which sets out the types of tax benefits; and

(2) the new s 177CB ITAA36, which sets out how to quantify a tax benefit through either an "annihilation" method or the construction of an "alternative postulate".

Section 177C ITAA36 is not modified by the recent amendments; it is the quantification exercise now provided for in the new s 177CB which is the contentious element.

Section 177C(2) provides for an exclusion from what would otherwise constitute a tax benefit, for an amount arising under certain elections etc that are provided for under the tax law. This too is unaffected by the recent amendments.

¶11-105 How an analysis of tax benefit should be approached

Whether a taxpayer has obtained a tax benefit in connection with a scheme is an objective fact rather than a matter of opinion. When looking at the tax benefit element of a Pt IVA analysis, the initial focus should be an inquiry as to the type of tax benefit that is purported to arise.

Once the type of tax benefit is determined, the exclusion in s 177C(2) should be considered. This is a fairly narrow exclusion and is the principal instance where tax benefit is an "exit point" from Pt IVA.

On the basis that the s 177C(2) exclusion does not apply to the tax benefit, the subsequent Pt IVA analysis will then focus on the quantification of the tax benefit (s 177CB).

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1 *CPH Property Pty Ltd v FCT* [1998] FCA 1276 per Hill J.

2 *FCT v Hart* [2004] HCA 26 at [33] per Gummow and Hayne JJ.

3 *FCT v Trail Bros Steel & Plastics Pty Ltd* [2010] FCAFC 94 at [21].

The following discussion on tax benefit follows these same three steps:

- Step 1: Identifying the type of tax benefit.
- Step 2: Assessing the s 177C(2) exclusion.
- Step 3: Quantifying the tax benefit under s 177CB.

¶11-110 The legislation

Section 177C ITAA36 sets out the types of tax benefits to which Pt IVA can be applied:

> "(1) Subject to this section, a reference in this Part to the obtaining by a taxpayer of a tax benefit in connection with a scheme shall be read as a reference to:
>
> (a) an amount not being included in the assessable income of the taxpayer of a year of income where that amount would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out; or
>
> (b) a deduction being allowable to the taxpayer in relation to a year of income where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out; or
>
> (ba) a capital loss being incurred by the taxpayer during a year of income where the whole or a part of that capital loss would not have been, or might reasonably be expected not to have been, incurred by the taxpayer during the year of income if the scheme had not been entered into or carried out; or
>
> (baa) a loss carry back tax offset being allowable to the taxpayer where the whole or a part of that loss carry back tax offset would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer if the scheme had not been entered into or carried out; or
>
> (bb) a foreign income tax offset being allowable to the taxpayer where the whole or a part of that foreign income tax offset would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer if the scheme had not been entered into or carried out; or
>
> (bc) the taxpayer not being liable to pay withholding tax on an amount where the taxpayer either would have, or might reasonably be expected to have, been liable to pay withholding tax on the amount if the scheme had not been entered into or carried out;
>
> and, for the purposes of this Part, the amount of the tax benefit shall be taken to be:
>
> (c) in a case to which paragraph (a) applies — the amount referred to in that paragraph; and
>
> (d) in a case to which paragraph (b) applies — the amount of the whole of the deduction or of the part of the deduction, as the case may be, referred to in that paragraph; and
>
> (e) in a case to which paragraph (ba) applies — the amount of the whole of the capital loss or of the part of the capital loss, as the case may be, referred to in that paragraph; and

(ea) in a case where paragraph (baa) applies — the amount of the whole of the loss carry back tax offset or of the part of the loss carry back tax offset, as the case may be, referred to in that paragraph; and

(f) in a case where paragraph (bb) applies — the amount of the whole of the foreign income tax offset or of the part of the foreign income tax offset, as the case may be, referred to in that paragraph; and

(g) in a case to which paragraph (bc) applies — the amount referred to in that paragraph...

(4) To avoid doubt, paragraph (1)(a) applies to a scheme if:

(a) an amount of income is not included in the assessable income of the taxpayer of a year of income; and

(b) an amount would have been included, or might reasonably be expected to have been included, in the assessable income if the scheme had not been entered into or carried out; and

(c) instead, the taxpayer or any other taxpayer makes a discount capital gain (within the meaning of the *Income Tax Assessment Act 1997*) for that or any other year of income.

(5) Subsection (4) does not limit the generality of any other provision of this Part."

¶11-115 The types of tax benefits caught by Pt IVA

There are six types of tax benefits that Pt IVA can be applied to:

(1) decreases in assessable income — s 177C(1)(a);

(2) increases in allowable deductions — s 177C(1)(b);

(3) increases in capital losses — s 177C(1)(ba);

(4) increases in loss carry-back tax offset — s 177C(1)(baa);

(5) increases in foreign income tax offsets — s 177C(1)(bb); and

(6) decreases in withholding tax liabilities — s 177C(1)(bc).

Using assessable income as an example, a tax benefit can arise when:

- the whole of an amount is not included in assessable income in a particular income year due to the scheme; or
- part of an amount is not included in assessable income in a particular income year due to the scheme.

Under s 177C(4), a scheme to recharacterise an amount of assessable income as a discount capital gain will be regarded as a tax benefit under s 177(1)(a) (a reduction in assessable income).

A similar position exists for deductions, capital losses and foreign income tax offsets. The tax benefit can be the *whole* of the deduction, capital loss, loss carry-back or foreign income tax offset, ie the scheme creates a deduction, capital loss or foreign income tax offset.

The tax benefit can also be a *part* of the deduction, capital loss, loss carry-back or foreign income tax offset, ie the scheme increases a deduction, capital loss or foreign income tax offset that would otherwise arise.

In respect of capital losses, the tax benefit arises when the capital loss is incurred and is not dependent on the subsequent utilisation of the capital loss.

The tax benefit can also be:

- a permanent benefit, ie the amount will not be included in any other year of income; or
- a timing benefit, ie the amount will be included in a different year of income.

In respect of withholding tax, the tax benefit arises where withholding tax that would otherwise (but for the scheme) be payable is not payable.

Other types of tax benefits

Where the tax benefit relates to something other than these six types, Pt IVA would not apply. However, other anti-avoidance provisions (such as those in the FBT or GST legislation) may apply.

Where charges such as the Medicare levy (and other levies and surcharges) are based on taxable income, the disallowance of a tax benefit can have an impact both on the income tax payable and on the levies and surcharges payable.

¶11-120 Amount of the tax benefit

Using the deduction element of s 177C as an example:

> "(1) Subject to this section, a reference in this Part to the obtaining by a taxpayer of a tax benefit in connection with a scheme shall be read as a reference to:
>
> …
>
> (b) a deduction being allowable to the taxpayer in relation to a year of income where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out; or
>
> …
>
> and, for the purposes of this Part, the amount of the tax benefit shall be taken to be:
>
> …
>
> (d) in a case to which paragraph (b) applies — the amount of the whole of the deduction or of the part of the deduction, as the case may be, referred to in that paragraph; and" (emphasis added)

A question raised before the courts is whether the deduction under the alternative postulate needs to be of the "same kind" as the deduction under the scheme so as to come within the expression "that deduction" used in s 177C.

The Full Federal Court in *Trail Bros* rejected this interpretation of s 177C:[4]

> "Imposing the notion that to determine the amount of the tax benefit, a comparison must be made between deductions of the same kind or class assumes, wrongly, that tax benefits follow only in cases where, but for the scheme, a taxpayer would have sought to engage the same provisions of the Act in ordering its affairs. There is no warrant for making that assumption."

The focus of s 177C was considered to be the identification of an activity (the alternative postulate) — the predicted events that would have, or might have, taken place in the absence of the scheme. Having identified the activity, the next task is to determine the allowable deduction as a result of that activity.

This was addressed in *Lenzo*.[5] In this case, the court described s 177C(1)(b) as presenting what might be described, "perhaps loosely, as a question of characterisation". In respect of a deduction case, the concept of tax benefit is based around a deduction that is allowable to a taxpayer in relation to a year of income in circumstances where the whole or part of "that deduction" would or might not have been allowable in the absence of the scheme.

The question was considered as to what the expression "that deduction" means. The court held that a narrow view of "that deduction", meaning exactly the same deduction, was inappropriate and inconsistent with the intent and wording of the provision. Such an approach would essentially make the inquiry redundant as rarely, if ever, would exactly the same deduction be available absent the scheme. Rather, a broader interpretation was appropriate: "that deduction" means that "kind" of deduction, or a deduction of the same character.

The Federal Court had rejected a submission that no tax benefit arose because, had Mr Lenzo not invested in the plantation project, he would have obtained a similar tax benefit by putting money into his self-managed superannuation fund. The Full Federal Court concurred with this finding on the basis that a superannuation contribution was not a deduction of the same kind as a deduction for prepaid maintenance fees, rent and indemnity fees in respect of an investment in a sandalwood plantation.

The above discussion refers to deduction cases (s 177C(1)(b)). Given the similarity in the wording and structure of s 177C(1)(a), it is likely that the same interpretation would apply to income cases, although this specific point has not been considered by the courts.

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4 *FCT v Trail Bros Steel & Plastics Pty Ltd* [2010] FCAFC 94 at [48].

5 *FCT v Lenzo* [2008] FCAFC 50 at [123].

¶11-125 Is the overall amount of assessable income relevant?

Although a scheme may not result in a reduction of the overall amount of assessable income for a taxpayer, and perhaps assessable income may even be greater under the scheme, a tax benefit for the purposes of Pt IVA can still arise.

The fact that the scheme might result in the inclusion of an amount in assessable income is also not decisive when determining whether a tax benefit arises. This type of issue would tend to arise where the tax payable by the taxpayer decreases, even though assessable income may increase or stay the same. This could occur where income of a different character is included in assessable income and that results in a different amount of tax being payable.

An example might be where a franked dividend is received in lieu of income for the provision of services, with the tax payable being reduced by the franking credits.

Section 177C(1)(a) refers to an amount not being included in assessable income. It does not refer to the overall amount of assessable income. Therefore, the fact that a scheme might result in some other amount of income being included in assessable income will not preclude Pt IVA from applying where the scheme also means that a particular amount is not included in assessable income.

¶11-130 Year of income

The tax benefit is determined in respect of a particular year of income. In a practical sense, this is mainly a quantification issue in that the amount of the tax adjustment being proposed by the Commissioner must be allocated to a year of income so that it can be reflected in a notice of assessment.

At a litigation phase, this criterion can become more important. If the Commissioner has issued assessments in respect of a particular year of income but the tax benefit relates to a different year of income, the assessments issued by the Commissioner could be demonstrated to be excessive on this basis.

The difficulty faced by the Commissioner in *Peabody* was not in establishing that a tax benefit was obtained by reason of the conversion of the Kleinschmidt shares to "Z" class preference shares, but in establishing that the tax benefit was obtained by Mrs Peabody in the relevant year of income. The gain arose for a company which was owned by the trust in which Mrs Peabody was a beneficiary. Until the company declared a dividend and the trust resolved to distribute that income to Mrs Peabody, no tax benefit arose for Mrs Peabody.

The ultimate success of this argument is obviously dependent on those other years of income being outside the amendment periods. This is less likely to be the case when considering Pt IVA at a planning or an audit stage. However, it may be the case at an objection or a litigation stage. The Commissioner will also often issue multiple determinations to cover, for example, both the trust and the beneficiaries of the trust in respect of the same tax adjustment (although, ultimately, he will only seek to enforce one).

¶11-200 Assessing the s 177C(2) exclusion

Section 177C contains an important exclusion from the concept of tax benefit. The exclusion is contained in s 177(2) and (3).

The exclusion from the concept of tax benefit applies where, in broad terms, the impact on the position of the taxpayer (for example, the non-inclusion of an amount in assessable income) is attributable to a choice provided for under the tax laws.

Section 177C(2) ITAA36 sets out the exclusion from the concept of tax benefit:

> "(2) A reference in this Part to the obtaining by a taxpayer of a tax benefit in connection with a scheme shall be read as not including a reference to:
>
> (a) the assessable income of the taxpayer of a year of income not including an amount that would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out where:
>
> (i) the non-inclusion of the amount in the assessable income of the taxpayer is attributable to the making of an agreement, choice, declaration, election or selection, the giving of a notice or the exercise of an option (expressly provided for by this Act or the *Income Tax Assessment Act 1997*) by any person, except one under Subdivision 126-B, 170-B or 960-D of the *Income Tax Assessment Act 1997*; and
>
> (ii) the scheme was not entered into or carried out by any person for the purpose of creating any circumstance or state of affairs the existence of which is necessary to enable the declaration, agreement, election, selection, choice, notice or option to be made, given or exercised, as the case may be; or
>
> (b) a deduction being allowable to the taxpayer in relation to a year of income the whole or a part of which would not have been, or might reasonably be expected not to have been, allowable to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out where:
>
> (i) the allowance of the deduction to the taxpayer is attributable to the making of a declaration, agreement, election, selection or choice, the giving of a notice or the exercise of an option by any person, being a declaration, agreement, election, selection, choice, notice or option expressly provided for by this Act or the *Income Tax Assessment Act 1997*, except one under Subdivision 960-D of the *Income Tax Assessment Act 1997*; and
>
> (ii) the scheme was not entered into or carried out by any person for the purpose of creating any circumstance or state of affairs the existence of which is necessary to

enable the declaration, agreement, election, selection, choice, notice or option to be made, given or exercised, as the case may be; or

(c) a capital loss being incurred by the taxpayer during a year of income the whole or part of which would not have been, or might reasonably be expected not to have been, incurred by the taxpayer during the year of income if the scheme had not been entered into or carried out where:

(i) the incurring of the capital loss by the taxpayer is attributable to the making of a declaration, agreement, choice, election or selection, the giving of a notice or the exercise of an option (expressly provided for by this Act or the *Income Tax Assessment Act 1997*) by any person, except one under Subdivision 126-B, 170-B or 960-D of the *Income Tax Assessment Act 1997*; and

(ii) the scheme was not entered into or carried out by any person for the purpose of creating any circumstance or state of affairs the existence of which is necessary to enable the declaration, agreement, election, selection, notice or option to be made, given or exercised, as the case may be; or

(ca) a loss carry back tax offset being allowable to the taxpayer the whole or a part of which would not have been, or might reasonably be expected not to have been, allowable to the taxpayer if the scheme had not been entered into or carried out, where:

(i) the allowance of the loss carry back tax offset to the taxpayer is attributable to the making of a declaration, agreement, election, selection or choice, the giving of a notice or the exercise of an option by any person, being a declaration, agreement, election, selection, choice, notice or option expressly provided for by this Act; and

(ii) the scheme was not entered into or carried out by any person for the purpose of creating any circumstance or state of affairs the existence of which is necessary to enable the declaration, agreement, election, selection, choice, notice or option to be made, given or exercised, as the case may be; or

(d) a foreign income tax offset being allowable to the taxpayer the whole or a part of which would not have been, or might reasonably be expected not to have been, allowable to the taxpayer if the scheme had not been entered into or carried out, where:

(i) the allowance of the foreign income tax offset to the taxpayer is attributable to the making of a declaration, agreement, election, selection or choice, the giving of a notice or the exercise of an option by any person, being a declaration, agreement, election, selection, choice, notice or option expressly provided for by this Act; and

(ii) the scheme was not entered into or carried out by any person for the purpose of creating any circumstance or state of affairs the existence of which is necessary to enable the declaration, agreement, election, selection, choice, notice or option to be made, given or exercised, as the case may be.

(2A) A reference in this Part to the obtaining by a taxpayer of a tax benefit in connection with a scheme is to be read as not including a reference to:

(a) the assessable income of the taxpayer of a year of income not including an amount that would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out where:

(i) the non-inclusion of the amount in the assessable income of the taxpayer is attributable to the making of a choice under Subdivision 126-B of the *Income Tax Assessment Act 1997* or an agreement under Subdivision 170-B of that Act; and

(ii) the scheme consisted solely of the making of the agreement or election; or

(b) a capital loss being incurred by the taxpayer during a year of income the whole or part of which would not have been, or might reasonably be expected not to have been, incurred by the taxpayer during the year of income if the scheme had not been entered into or carried out where:

(i) the incurring of the capital loss by the taxpayer is attributable to the making of a choice under Subdivision 126-B of the *Income Tax Assessment Act 1997* or an agreement under Subdivision 170-B of that Act; and

(ii) the scheme consisted solely of the making of the agreement or election.

(3) For the purposes of subparagraph (2)(a)(i), (b)(i), (c)(i) or (d)(i) or (2A)(a)(i) or (b)(i):

(a) the non-inclusion of an amount in the assessable income of a taxpayer; or

(b) the allowance of a deduction to a taxpayer; or

(c) the incurring of a capital loss by a taxpayer; or

(caa) the allowance of a loss carry back tax offset to a taxpayer; or

(ca) the allowance of a foreign income tax offset to a taxpayer;

is taken to be attributable to the making of a declaration, election, agreement or selection, the giving of a notice or the exercise of an option where, if the declaration, election, agreement, selection, notice or option had not been made, given or exercised, as the case may be:

(d) the amount would have been included in that assessable income; or

(e) the deduction would not have been allowable; or

(f) the capital loss would not have been incurred; or

(fa) the loss carry back tax offset would not have been allowable; or

(g) the foreign income tax offset would not have been allowable."

¶11-205 What choices etc give rise to the exclusion?

The tax outcome must be attributable to the making of an agreement, a choice, a declaration, an election or a selection, the giving of a notice or the exercise of an option expressly provided for by the ITAA36 or the ITAA97.

Agreements, choices etc or the exercise of an option that are not expressly provided for by the ITAA36 or the ITAA97 cannot benefit from this exclusion. For example, the exercise of an option to acquire shares will not be the exercise of an option expressly provided for by the ITAA36 or the ITAA97.

Each of these terms (agreement, choice, declaration, election or selection, the giving of a notice or the exercise of an option) is used in various other parts of the tax laws. For example, under s 152-220 ITAA97, you can choose not to apply the CGT small business 50% reduction. Under s 70-45 ITAA97, you can elect to value each item of trading stock on hand at year end based on one of three methods.

Commercial choices etc that are not provided for under the tax laws do not fall within this exclusion. For example, a choice between two commercial transactions or a choice between two types of entities for use in a business structure are not choices covered by s 177C(2) ITAA36.

¶11-210 Why are certain sections excluded?

Choices etc made under specific parts of the ITAA97 are "excluded from the exclusion" in s 177C(2). These parts are:

(1) Subdiv 126-B (CGT roll-over for companies in the same wholly owned group);

(2) Subdiv 170-B (transfer of net capital losses within certain wholly owned groups of companies); or

(3) Subdiv 960-D (functional currency).

Subdivision 126-B is the subject of a separate exclusion in s 177C(2A), which provides that a tax benefit (reduction in assessable income or increase in capital losses) attributable to the making of a choice under Subdiv 126-B is not a tax benefit to which Pt IVA will apply if the scheme consisted solely of the making of the agreement or election.

Likewise, Subdiv 170-B is the subject of a separate exclusion in s 177C(2A), which provides that a tax benefit (increase in capital losses) attributable to the making of a choice under Subdiv 170-B is not a tax benefit to which Pt IVA will apply if the scheme consisted solely of the making of the agreement or election.

Section 177C(2A) is directed at preserving the benefit of the Subdiv 126-B roll-over and the Subdiv 170-B loss transfer provisions, but at the same time ensuring that these provisions are not misused through forming part of a broader scheme for obtaining a tax benefit.

No similar separate exclusion exists for Subdiv 960-D, meaning that any tax benefit obtained by the making of choices or elections under this Subdivision is subject to cancellation under Pt IVA if the requisite dominant purpose is present.

¶11-215 What limits apply to this exclusion?

The exclusion does not apply (there is another exclusion to the exclusion) where the scheme was entered into or carried out by any person for the purpose of creating any circumstance or state of affairs necessary to enable the choice etc to be made. This is interpreted quite strictly. The requirement is to look at the factual circumstances of the taxpayer before the scheme is entered into and determine, if nothing else was done, whether they would they meet the conditions etc for the making of the choice, election, or the like.

The CGT small business concessions provide a useful example. A corporate taxpayer can choose, under s 152-305 ITAA97, to access the small business retirement exemption if the basic conditions in Subdiv 152-A are satisfied and the entity satisfies the significant individual test.

Assume that a company has multiple classes of shares on issue, such that it cannot satisfy the significant individual test. Immediately before deriving a capital gain, the company undertakes a restructure of its shares so that it can meet the significant individual test and satisfy the requirements of s 152-305.

In this situation, the scheme would likely include this restructure which would be a transaction entered into or carried out for the purpose of creating any circumstance or state of affairs the existence of which is necessary to enable the choice to be made. Section 177C(2) would not provide protection from the application of Pt IVA in this instance.

This could be contrasted to a similar situation, except the restructure occurs many years before a capital gain arises or a sale is contemplated. It would be much less likely that the restructure would form part of the scheme and much more likely that the s 177C(2) exclusion would apply.

This exclusion is considered in more detail in the case studies discussed below and the *British American Tobacco* case.[6]

¶11-300 Quantifying the tax benefit — the legislation

Section 177CB sets out the bases for identifying tax benefits:

> "(1) This section applies to deciding, under section 177C, whether any of the following (tax effects) would have occurred, or might reasonably be expected to have occurred, if a scheme had not been entered into or carried out:
>
> (a) an amount being included in the assessable income of the taxpayer;
>
> (b) the whole or a part of a deduction not being allowable to the taxpayer;
>
> (c) the whole or a part of a capital loss not being incurred by the taxpayer;
>
> (ca) the whole or a part of a loss carry back tax offset not being allowable to the taxpayer;
>
> (d) the whole or a part of a foreign income tax offset not being allowable to the taxpayer;
>
> (e) the taxpayer being liable to pay withholding tax on an amount.

6 *British American Tobacco Australia Services Ltd v FCT* [2010] FCAFC 130.

(2) A decision that a tax effect would have occurred if the scheme had not been entered into or carried out must be based on a postulate that comprises only the events or circumstances that actually happened or existed (other than those that form part of the scheme).

(3) A decision that a tax effect might reasonably be expected to have occurred if the scheme had not been entered into or carried out must be based on a postulate that is a reasonable alternative to entering into or carrying out the scheme.

(4) In determining for the purposes of subsection (3) whether a postulate is such a reasonable alternative:

(a) have particular regard to:

(i) the substance of the scheme; and

(ii) any result or consequence for the taxpayer that is or would be achieved by the scheme (other– than a result in relation to the operation of this Act); but

(b) disregard any result in relation to the operation of this Act that would be achieved by the postulate for any person (whether or not a party to the scheme)."

¶11-305 What are the bases for identifying the tax benefit?

To work out the amount of the tax benefit, the tax position arising for the taxpayer under the scheme is compared with the tax position that would have arisen, or might reasonably be expected to have arisen, if the scheme had not been entered into. That is provided for by s 177C and reiterated in s 177CB(1).

There are two alternative bases provided for in s 177CB for quantifying the tax benefit.

The first approach is based on an alternative postulate that *would have* occurred if the scheme had not been entered into. This is referred to as the annihilation approach. To apply this approach, the steps comprising the scheme are ignored and the tax position is calculated on what remains. This approach is provided for in s 177CB(2). It is expected that the annihilation approach will have fairly limited application. The annihilation approach is discussed at ¶11-350.

The second approach is the reconstruction approach. Under this approach, the tax benefit is based on an alternative postulate (counterfactual) that *might reasonably be expected* to have occurred if the scheme had not been entered into. There is a level of prediction involved. The reconstruction approach is provided for in s 177CB(3), with limitations set under s 177CB(4). The reconstruction approach is discussed at ¶11-400, in addition to a discussion on the existing judicial guidance which is expected to continue to be relevant following the recent amendments.

The way in which a tax benefit is determined, and particularly how a reasonable alternative postulate is identified, was altered significantly under the recent amendments. Understanding the context of these amendments is therefore important when determining whether a tax benefit is present. The context of the recent amendments is discussed at ¶11-310.

¶11-310 Why was s 177CB introduced?

Section 177CB was introduced in 2013 (with effect from 16 November 2012) in response to perceived issues with regard to how Pt IVA was being applied by the courts.

First, it was perceived that the second limb of s 177C(1) (identifying the alternative postulate) had been interpreted as permitting a broad-ranging inquiry into what might reasonably be expected to have happened absent the scheme.

The inquiry was unconstrained by the factors that needed to be considered when testing purpose (ie the eight factors in s 177D) or the limits of what it is that the scheme has achieved. It was viewed as an open-ended inquiry into what, if anything, the taxpayer might reasonably have done if it had not participated in the scheme.

The government considered that, from a policy perspective, the operation of Pt IVA as a general anti-avoidance provision would be better served if the inquiry focused on whether or not there were other ways in which the taxpayer might reasonably have achieved the substance and effect (tax implications aside) that it achieved from the scheme. That inquiry would assist in exposing the purposes of the participants in a scheme, and prevent taxpayers who achieve substantive non-tax effects from a scheme avoiding the normal tax consequences of what they have actually done by arguing that they would have done something completely different, or done nothing at all.

Second, an alternative course of action could be held to be unreasonable on the basis that the tax costs involved in undertaking that action would have caused the parties to do nothing, including deferring or abandoning a wider transaction of which the scheme was a part.

Again, from a policy perspective, having identified a postulate that is in other respects functionally substitutable for the scheme, it was thought to be undesirable to consider the tax consequences of that postulate to be a basis for disregarding it as unreasonable. To do so would be to allow the normal tax consequences of what it is that the taxpayer has achieved to function as a shield against the operation of Pt IVA.

It will be some years before these amendments are tested in the courts. Debate may continue on the need for these amendments and whether the amendments actually implement the policy objectives in an appropriate way, but focus will increasingly need to turn to applying the amended legislation to real transactions.

¶11-350 When will the annihilation approach apply?

The annihilation approach quantifies the tax benefit by reference to what would have happened if the scheme had not been entered into. To do this, the steps comprising the scheme are simply ignored.

The annihilation approach works most appropriately where the non-tax effects of the scheme are limited (or non-existent) and the taxable income that would otherwise be subject to tax is derived independent of the scheme.

In cases dealing with an increase in tax deductions created by a scheme, the annihilation approach could often be the appropriate method for applying Pt IVA to that scheme.

The annihilation approach existed under the legislation before the recent amendments were made.

Section 177C(1) contains two bases on which the existence of a tax benefit can be demonstrated. The first is that, absent the scheme, a relevant tax outcome "would have been" the case. The second is that, absent the scheme, a relevant tax outcome "might reasonably be expected to have been" the case.

The first limb is the annihilation approach. It requires a comparison of the tax consequences of the scheme with the tax consequences that "would have" resulted if the scheme had not occurred.

One approach to the first limb has been to view it as satisfied in cases where a relevant tax advantage is exposed by applying the tax law to the facts remaining once the statutory postulate has done its work in deleting the scheme. This is what s 177CB(2) now embodies in the legislation.

Puzey[7] and *Sleight*[8] are cited in the explanatory memorandum[9] as examples of where the annihilation approach has been applied. Both of these cases involve "tax-effective investment schemes". The scheme to which Pt IVA applied was the structuring of an investment to generate higher deductions through the prepayment of management fees using limited recourse loan arrangements. The deductions achieved by these features of the investment were disallowed, and tax was applied to the position that remained after disallowance of the deductions.

The explanatory memorandum implies (in particular, through the examples provided) that the annihilation approach would be appropriate to apply to schemes, like tax-effective investment schemes, that purport to generate a deduction that can be utilised to offset income derived independent of the scheme. However, the legislation is not limited in this way.

The legislation provides that:

> "A decision that a tax effect would have occurred if the scheme had not been entered into or carried out must be based on a postulate that comprises only the events or circumstances that actually happened or existed (other than those that form part of the scheme)."

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7 *Puzey v FCT* [2003] FCAFC 197.

8 *FCT v Sleight* [2004] FCAFC 94.

9 Tax Laws Amemdment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013.

"Would" is an absolute expression — there is no question as to what "would" have been the case had the scheme not been entered into. There is no element of prediction. This terminology is likely to place a real limit on the scope of arrangements that the annihilation approach will apply to. In addition, given the history of how the determination of the "tax benefit" under s 177C has been approached by the courts (in the vast majority of cases, a reconstruction approach has been used), it would appear that the situations in which the annihilation approach would be applied are limited. However, the annihilation approach may be given greater application in time, for example, where a scheme can be identified:

- which it is broad enough to enliven Pt IVA, ie it supports a conclusion as to dominant purpose and the tax benefit arises in connection with the scheme;
- which it is narrow enough so that no material non-tax outcomes arise, in particular for the taxpayer; and
- the income position sought to be taxed continues to exist if the scheme is "deleted", ie the income arises independent of the scheme.

It is particularly risky where a discrete step is inserted into an existing arrangement or a course of action that the parties have already, for all practical purposes, agreed to.

It is worth noting that the High Court used the reconstruction approach in *Hart*[10] (when only the wealth optimiser features needed to be deleted) and *Consolidated Press*[11] (when only the interposed entity needed to be deleted). They did not use the annihilation approach.

Examples from the explanatory memorandum include the following:

> "Example 1.1
>
> Sandy enters into a scheme from which he secures a large, up front, tax deduction. The scheme is structured so as to provide him with a highly contingent right to income payable some years in the future. The potential investment returns are speculative and clearly subordinate to the tax deduction.
>
> When postulating what the tax effects would have been without the scheme, the events and circumstances comprising the scheme must be assumed not to have happened, and it is impermissible to speculate about events or circumstances that did not exist (for example, that Sandy would have done something else that would have also secured a tax deduction).
>
> If the scheme is assumed not to have happened, Sandy would not have obtained a tax deduction. Sandy has therefore obtained a tax benefit in connection with the scheme that is equal to the amount of the tax deduction that he secured by entering into the scheme.
>
> Example 1.2
>
> Deborah, a foreign resident, enters into an arrangement under which assessable income that would otherwise be derived by her from Australian sources is instead derived by her from foreign sources with the result that it is not assessable in Australia.

10 *FCT v Hart* [1996] HCA 34.

11 *FCT v Consolidated Press Holdings Pty Ltd* [2001] HCA 32.

> If the scheme had not been entered into, the income would have been included in Deborah's assessable income because the only operation of the scheme was to change the source of the income for taxation purposes. The tax benefit is the reduction in Deborah's assessable income.
>
> No speculation is necessary or permitted in deciding what else might have happened if Deborah had not entered into the scheme."

Although this approach involves an alternative postulate, that postulate consists solely of deleting the scheme.

Interestingly, there is no requirement that the alternative postulate produced under the annihilation approach is a reasonable alternative postulate. Perhaps the reasonableness test is built into the "would" test — a taxpayer "would" not have undertaken a course of action, absent the scheme, if that course of action was not reasonable.

The statutory limitations on an assessment of "reasonable" contained in s 177CB(4) do not apply to the annihilation case. This means that the tax effect of the alternative postulate may be a basis for asserting that it cannot be shown that a taxpayer would have undertaken a course of action. If this argument was successful, the practical outcome may simply be that the ATO moves from using the annihilation approach to using the reconstruction approach where the tax effects are ignored when assessing whether the alternative postulate is reasonable.

¶11-400 The reconstruction approach

The reconstruction approach is one of the key aspects of Pt IVA. The ability to reconstruct a transaction, rather than merely annihilate it, was seen as overcoming a fundamental limitation of the previous anti-avoidance provision, s 260 ITAA36.

The modified way in which the reconstruction approach is to be applied is probably the most significant aspect of the recent amendments to Pt IVA. These changes will cause a major revision in the way that the "alternative postulate" or "counterfactual" is determined.

The reconstruction approach quantifies the tax benefit by reference to what might reasonably be expected to have happened if the scheme had not been entered into.

"Reasonably be expected" is a broad concept which involves a level of prediction. Therefore, whenever a level of speculation as to the actions of the taxpayer is required, it will be the reconstruction approach that will need to be used to determine the tax benefit.

The reconstruction approach is set out in s 177CB(3), with significant limitations being contained in s 177CB(4). Section 177CB(3) provides that:

> "A decision that a tax effect might reasonably be expected to have occurred if the scheme had not been entered into or carried out must be based on a postulate that is a reasonable alternative to entering into or carrying out the scheme."

This is how the reconstruction approach has been applied by the courts over many years. It requires the identification of a postulate (a course of actions and events) that is an alternative to the scheme that was actually carried out, and that alternative postulate must be a reasonable alternative to the scheme.

¶11-410 The modifications under the recent amendments

The modifications to the way in which the reconstruction approach is to be applied are contained in s 177CB(4). The first part of the modifications is to provide direction as to how the alternative postulate should be formulated:

> "In determining for the purposes of subsection (3) whether a postulate is such a reasonable alternative:
>
> (a) have particular regard to:
>
> (i) the substance of the scheme; and
>
> (ii) any result or consequence for the taxpayer that is or would be achieved by the scheme (other than a result in relation to the operation of this Act);"

The intent of this change, as stated in the explanatory memorandum, is that the tax consequences of the scheme should be compared with the tax consequences of an alternative that is reasonably capable of achieving for the taxpayer substantially the same non-tax results and consequences as those achieved by the scheme.

The requirement of s 177CB(3)(a) is that particular regard is had to the two points listed in that section. This means that the two points are not an exclusive list of factors that should be considered; however, development of an alternative postulate without having due regard to these factors would be a flawed approach.

The two points (the substance of the scheme and the results of the scheme for the taxpayer) are factors that are provided for in s 177D as factors to be considered when assessing purpose. The two points are also, in many ways, interrelated.

Substance

Section 177D(2)(b) requires that, when assessing purpose, regard must be had to the form and substance of the scheme. The "substance" is what the scheme actually achieves. It is the commercial and economic implications of the actions that are undertaken. The modification to the reconstruction approach would indicate that, in most instances, the substance of the alternative postulate would correlate with the substance of the scheme.

Results and consequences

Section 177D(2)(e) requires that, when assessing purpose, regard must be had to 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.

Section 177D(2)(g) requires that regard must be had to any other consequence for the relevant taxpayer of the scheme having been entered into or carried out.

Results and consequences are about outcomes, ie what does the scheme actually produce for the taxpayer?

The modification to the reconstruction approach would indicate that, in most instances, the non-tax outcomes of the alternative postulate should correlate with the non-tax outcomes of the scheme. Non-tax outcomes could include:

- the acquisition or disposal of assets;
- an increase or decrease in income-earning capacity;
- a change in level of debt or the provision of assets as security for debt;
- improvements in asset-protection position;
- the financial impact of transaction costs, such as fees, stamp duties, payroll taxes;
- commercial advantages;
- the effect that the scheme has on personal or family relationships; and
- satisfaction of regulatory requirements, such as directors' duties, workplace health or safety requirements and environmental standards.

A good example of constructing an alternative postulate based on substance, results and circumstance is provided in *Spotless*,[12] although discussed, in part, in a different context (part of the original argument was about an "amount" not being included in assessable income and the identity of that amount; this argument was dismissed by the court).

The Federal Court had held that, if the scheme had not been entered into or carried out, an amount of income from the use of the sum on deposit would have been, or could reasonably be expected to have been, included in the assessable income of the taxpayers for the year of income.

The taxpayer submitted that there is no possible way of knowing whether the amount actually derived from the investment, or any other particular amount, would have been included in the assessable income of the taxpayers had they chosen not to make the investment that they did.

The court considered that the taxpayers were determined to place the $40m in short-term investment for the balance of the then current financial year. The reasonable expectation is that, in the absence of any other acceptable alternative proposal for "off-shore" investment at interest, the taxpayers would have invested the funds, for the balance of the financial year, in Australia. The amount derived from that investment would have been included in the assessable income of the taxpayers.

The reasonable alternative postulate should be based on the short-term investment of the funds, not on some other completely unrelated application of the moneys, such as investment into the business as working capital or to fund capital acquisitions. The tax benefit was calculated in this way.

12 *FCT v Spotless Services Ltd* [1996] HCA 34.

¶11-420 How the tax effects are treated under the amendments

A tax effect is first and foremost any result in relation to the operation of the ITAA97 or the ITAA36 (collectively, "this Act"). Commonly, it will simply be the tax liability that arises.

The contentious amendment, and one where judicial guidance will be critical, is the qualification provided for in s 177CB(4)(b) that tax effects will be ignored:

> "(4) In determining for the purposes of subsection (3) whether a postulate is such a reasonable alternative:
>
> …
>
> (b) disregard any result in relation to the operation of this Act that would be achieved by the postulate for any person (whether or not a party to the scheme)."

This modification means that potential tax liabilities are not to be taken into account when assessing the likelihood or reasonableness of any alternative postulate.

According to the explanatory memorandum, this amendment is intended to make it clear that alternative postulates should not be rejected as unreasonable postulates on the grounds that the tax effects involved in undertaking those postulates would have caused the parties to either abandon or indefinitely defer the schemes and/or the wider transactions of which they were a part.

According to the Full Federal Court in *Trail Bros*:[13]

> "It is contrary to the express words of s 177C (including s 177C(2)), its context and its purpose to exclude particular integers from a prediction about what would happen or might reasonably be expected to happen. Put another way, without particular integers, the enquiry would not be an objective enquiry as required by s 177C but a prediction of what would happen or might happen having regard to only a sub-set of the integers available to a taxpayer. That is not the object of Pt IVA."

Even though a limitation (such as that contained in s 177CB(4)(b) in respect of tax costs) on formulation of the alternative postulate may be contrary to the context and purpose of the Pt IVA inquiry, this limitation is now embodied in the statute, and the way in which the determination of a tax benefit based on an alternative postulate is approached will need to change to take this into account.

An unresolved question is the ambit of what should be disregarded under s 177CB(4)(b). Clearly, the tax liability itself should be disregarded, but what about things that are achieved under the scheme — the results and consequences — that would not be achieved if the higher tax liability imposed under the proposed alternative postulate arose? For example:

> Joe owns an asset worth $1,000. The asset is fully geared, with the debt being secured against the asset. Joe enters in a transaction to sell the asset without triggering a tax liability. This results in him having $1,000 in after-tax funds which can be applied to discharge the debt and release the security over the asset. Without repaying the debt in this way, the actual sale could not have occurred.
>
> The proposed alternative postulate would result in Joe disposing of the asset for $1,000 but incurring $300 in tax. This would not leave Joe with sufficient funds to discharge the debt and

13 *FCT v Trail Bros Steel & Plastics Pty Ltd* [2010] FCAFC 94 at [31].

> have the security removed. For the transaction to proceed, he would need to provide alternative security for the remaining debt or obtain additional funds from another source.
>
> Is the inability to use the $300 to discharge the debt and have the security removed a "result" that should be disregarded under s 177CB(4)(b)?

It is suggested that, while these "flow-on effects" may not always provide a basis for demonstrating that an alternative postulate is unreasonable, they may provide support for the dominant purpose being other than the obtaining of a tax benefit.

The fact that a tax effect itself is prohibitive will not be a valid ground for concluding that the alternative postulate is not reasonable. Similarly, the "no tax, no tax risk" position put forward in the *News* case[14] would not be a valid ground for concluding that the alternative postulate is not reasonable. However, where the tax cost is part of a broader set of circumstances (in *News*, other risks were being mitigated, for example, exchange rate exposures), the broader circumstance may provide a valid ground for concluding that the alternative postulate is not reasonable.

When framing an argument based on tax implications, the comments in *Spotless* should be borne in mind:[15]

> "... it was this collateral tax advantage which provided the key to the whole transaction and gave it its particular commercial attraction.
>
> ... it was the obtaining of the tax benefit which directed the taxpayers in taking steps they otherwise would not have taken by entering into the scheme."

¶11-430 Identifying the alternative postulate

The alternative postulate is identified by inquiring what the taxpayer might reasonably be expected to have done if the scheme had not been entered into.

The Full Federal Court in *Consolidated Press*[16] expressed the view that there would be a large range of factual circumstances that may require consideration when hypothesising what the alternative postulate may be. The introduction of s 177CB(4) is directed at limiting this inquiry to some degree, or at least formalising some parameters within which the inquiry should occur.

The alternative postulate needs to be developed on the assumption that the scheme had not been entered into or carried out. Sections 177C and 177CB, unlike, for example, s 177D, do not refer to "any part of the scheme". Thus, the question must be approached by assuming that the entire scheme was not entered into or carried out (*Lenzo,*[17] *Peabody*[18]).

14 *FCT v News Australia Holdings Pty Ltd* [2010] FCAFC 78.

15 *FCT v Spotless Services Ltd* [1996] HCA 34.

16 *FCT v Consolidated Press Holdings Pty Ltd* [1999] FCA 1199 at [87].

17 *FCT v Lenzo* [2008] FCAFC 50.

18 *FCT v Peabody* [1994] HCA 43.

It is not open to the taxpayer to point to what might reasonably be expected to have been done if only part of the scheme had not been entered into or carried out. For example, in *Lenzo*, it was not open to Mr Lenzo to point to what could reasonably be expected to occur if the loan deed is ignored but the remainder of the scheme is assumed to have continued intact.

That said, particular steps that form part of the scheme can also form part of the alternative postulate. It cannot be the same complete set of events giving rise to the scheme — that would be the scheme. But, at the same time, the identification of the activity or the events forming the alternative postulate does not necessarily preclude the inclusion of any element of the scheme (*Trail Bros*[19]).

Where the scheme is a severable component of a larger series of transactions which have been arranged or executed, the fact that they were arranged or executed can offer support for the hypothesis that they would or might reasonably be expected to have stood absent the scheme.

Where the remaining transactions are not commercially or legally possible, the hypothesis as to what would, or might reasonably be expected to, have happened will likely have to cope with a wider range of possibilities (*Spotless*[20]).

The alternative postulate is based on a reasonable expectation that a particular alternative course of action would have taken place. The concept of reasonableness of an alternative postulate is discussed in more detail below.

¶11-440 Timing of the inquiry

The court in *AXA*[21] considered that the alternative postulate needed to be formulated at a similar time as to when the scheme was actually entered into. This meant that the facts and circumstances that existed at the time would need to be taken into account when assessing whether an alternative postulate is reasonable. In this case, this approach meant that the various agreements would be in place and could not be ignored when formulating and evaluating the alternative postulate.

¶11-450 Is the Commissioner required to set out the alternative postulate?

The Commissioner is not required to set out the alternative postulate. That said, in many instances, it is apparent from the quantum of the tax benefit identified by the Commissioner as to what he considers to be the alternative postulate. In *Futuris*, Mansfield J commented that:[22]

> "It would be nonsensical for the Commissioner to 'suggest' a possible series of transactions that the applicant might have undertaken which might have led to the relevant amount being

19 *FCT v Trail Bros Steel & Plastics Pty Ltd* [2009] FCA 1210.

20 *FCT v Spotless Services Ltd* [1996] HCA 34.

21 *FCT v AXA Asia Pacific Holdings Ltd* [2010] FCAFC 134.

22 *FCT v Futuris Corporation Ltd* [2012] FCAFC 32 at [35].

> included in the assessable income, because such suggestion could only be a matter of conjecture and, if disproved, would leave the Court no better informed and having come no further to answer the question of whether Part IVA of the ITAA 1936 applies. It is for the applicant, who bears the onus, to establish the series of transactions or arrangements which, it contends, would have or might reasonably be expected to have been entered into or carried out and which would have or might reasonably be expected to have resulted in the relevant amount being obtained as a tax benefit regardless of the scheme."

This situation may change. Identification of the alternative postulate is now more integral to the determination of the tax benefit, ie without setting out an alternative postulate, it is not apparent how the Commissioner could quantify the tax benefit that would be subject to a Pt IVA determination.

¶11-460 Who carries the onus of proof?

The taxpayer bears the onus of proving that an assessment is excessive.

Discharging the onus of proof is not a matter of establishing that the Commissioner's alternative postulate is unreasonable. Whether the alternative postulate is reasonable or unreasonable is a question that is to be determined objectively having regarding to the facts and evidence.

What the taxpayer must prove is that they did not obtain a tax benefit in connection with a scheme or that the tax benefit obtained was less than that determined by the Commissioner (in which case, Pt IVA can apply to this lesser amount). This is not a matter of showing that the Commissioner's alternative postulate is unreasonable. Rather, it is a case of showing what alternative postulate would be reasonable to expect to have occurred.

¶11-470 Reasonable expectation

The tax benefit is calculated under s 177C and s 177CB, based on a situation that, from the available evidence, "might reasonably be expected" to have occurred absent the scheme.

There is considerable judicial guidance on the notion of reasonable expectation. While the new s 177CB may place some boundaries around an assessment of what is reasonable to expect, by and large, the existing judicial guidance is expected to remain relevant and authoritative.

The concept was first discussed in *Peabody*.[23] In this case, an interposed entity (Loftway) was used by the Peabody Family Trust to acquire shares in the target company. This action was taken as it enabled a cheaper form of finance to be obtained to fund the acquisition. A direct acquisition by the trust would not have permitted this lower cost finance to be obtained.

The Commissioner's alternative postulate relied on a direct acquisition by the trust (this meant that the gain would accrue to the trust and so be distributed to the taxpayer). The court stated that:[24]

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23 *FCT v Peabody* [1994] HCA 43.

24 *FCT v Peabody* [1994] HCA 43 at [31].

> "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."

Accessing the lower-cost financing was an important element of the commercial transaction entered into by the taxpayer. It was reasonable to expect that this feature would be included in any alternative postulate.

The High Court in *Spotless* when dealing with an issue raised with regard to s 177C(1)(a) (relating to determining the "amount" of the tax benefit) said:[25]

> "In our view, the amount to which par (a) refers as not being included in the assessable income of the taxpayer is identified more generally than the taxpayers would have it. The paragraph speaks of the amount produced from a particular source or activity. In the present case, this was the investment of $40 million and its employment to generate a return to the taxpayers. It is sufficient that at least the amount in question might reasonably have been included in the assessable income had the scheme not been entered into or carried out."

In *Spotless*, the court considered that the taxpayer was determined to place the $40m in short-term investment for the balance of the current financial year. The reasonable expectation was that, in the absence of any other acceptable alternative for an offshore investment at interest (these alternatives having been evaluated and rejected by the taxpayer), the taxpayer would have invested the funds in Australia under one of the other options open to them and so derived Australian-sourced interest income.

The Full Federal Court in *Consolidated Press* commented that the language used by the High Court in *Spotless* suggested less of a predictive and more of a reasonable hypothesis approach than the quote from *Peabody*. The court referred to a paragraph in the Full Court decision in *Peabody*:[26]

> "The word 'expectation' requires that the hypothesis be one which proceeds beyond the level of a mere possibility to become that which is the expected outcome. If it were necessary to substitute one ordinary English phrase for another, it might be said that it requires consideration of the question whether the hypothesised outcome is a reasonable probability ..."

In *Consolidated Press*,[27] the court considered that it was reasonable to expect that, had the scheme as defined not been entered into, ACP would have proceeded with funding the acquisition either by subscribing for shares in the United Kingdom company or making a loan to that company. It was considered more likely than not that the investment would have been by way of subscription for shares, since that was the way the actual investment (via the interposed entity) was structured.

The Full Federal Court in *RCI* stated that:[28]

> "… the issue is not whether the Commissioner puts forward a reasonable counterfactual or not; it is a question of the Court determining objectively, and on all of the evidence, including

25 *FCT v Spotless Services Ltd* [1996] HCA 34.

26 *FCT v Consolidated Press Holdings Ltd* [1999] FCA 1199 at [86].

27 *FCT v Consolidated Press Holdings Pty Ltd* [2001] HCA 32.

28 *RCI Pty Ltd v FCT* [2011] FCAFC 104 at [130].

> inferences open on the evidence, as well as the apparent logic of events, what would have or might reasonably be expected to have occurred if the scheme had not been entered into.
>
> That [the statement made by the trial judge] is at worst erroneous and at best unhelpful, can also be illustrated from the other side of the coin, because it implies that if the Commissioner's counterfactual is reasonable that is the end of the matter; even if the Court were to conclude, on all the evidence, inferences and logic referred to, that if the scheme had not been entered into the taxpayer would have or might reasonably be expected to have done something which did not give rise to a tax benefit, or which gave rise to a tax benefit less than that thrown up by the Commissioner's counterfactual.
>
> In our view, that cannot be correct."

"An objective enquiry and determination amongst alternative possibilities as to which is the most reliable prediction" was how the court expressed the exercise that needed to be undertaken to determine what a taxpayer might reasonably be expected to have done if they hadn't entered into the scheme.

The Full Federal Court emphasised that the taxpayer carried the onus of demonstrating what it would be reasonable to expect the parties to have done, absent the scheme.

In the decision impact statement on this case, the Commissioner stated that the case was authority for the propositions made in relation to the determination of the alternative postulate.

With the recent amendments, the question has again been raised as to whether the alternative postulate needs to be the most reasonable, or just one of a number of potential alternative postulates that are each reasonable. The ATO's view is that the alternative postulate needs to be reasonable, but it is not necessary to identify the most reasonable alternative postulate.

It is questionable whether this approach to interpreting the amended Pt IVA provisions is the correct approach or one that is appropriate. This is where the concerns about the Commissioner applying Pt IVA based on the highest taxed alternative stem from.

The comments in *RCI* were made in respect of s 177C. This section has not been amended.

The explanatory memorandum identifies a number of issues with the Pt IVA provisions (prior to the amendments) which the amendments where intended to address. Making the alternative postulate a reasonable alternative, but not necessarily the most reasonable alternative, is not specifically identified in the explanatory memorandum as a change brought about by the amendments.

Further, it would be questionable if there could be a range of alternative postulates that it "might reasonably be expected" the taxpayer would have entered into. If one of the alternative postulates produces a more optimum outcome (after allowing for the requirements of s 177CB), then wouldn't this mean that this is the course of action that the taxpayer "might reasonably be expected to take"? Why would it be reasonable to expect that a taxpayer would select a less optimum alternative?

This issue is likely to be a point of contention under the amended Pt IVA provisions.

¶11-490 Demonstrating whether a proposed alternative postulate is reasonable

A taxpayer can choose how they discharge their onus of demonstrating what would constitute a reasonable alternative postulate.

A taxpayer can lead evidence on the activity or course of action that they would have adopted if the scheme did not occur. If a taxpayer has given evidence about what he or she would have done but for entering the scheme, that evidence will be relevant and useful to the extent to which it reveals facts or matters that bear on the objective determination of the alternative postulate.[29]

It is also conceivable that a taxpayer may not lead positive evidence of an alternative postulate because, for example, the result of any objective enquiry of the alternative postulate is inevitable. The evidence must support an objective conclusion having regard to:

- the context;
- the underlying facts; and
- the logic of the alternative postulate, having regard to the commercial or financial aspirations and limitations of the parties.

In *Trail Bros*, the trial judge identified the following failings in respect of the case put by the taxpayer:[30]

> "1. the Taxpayer did not identify any particular arrangement that might actually have been in contemplation or might reasonably have been adopted in the absence of the scheme;
>
> 2. the Taxpayer called no evidence providing a foundation for an objective assessment, on all the evidence, that the Taxpayer would or might reasonably have been expected to take a particular course of action that would or might reasonably be expected to have given rise to an allowable deduction under the scheme;
>
> 3. no likely variation to the contracts was put in evidence nor the likely central terms of any potential variation;
>
> 4. none of the other directors of the Taxpayer were called to give evidence of the Taxpayer's likely course of conduct had the scheme not been entered into having regard to the potential frustration of the employment contracts by the legislative changes; and
>
> 5. no other director of the Taxpayer gave evidence that a common assumption upon which the contractual obligations rested had failed and, in consequence, in order to adjust the terms of the employment relationship, the Taxpayer would have been likely to undertake particular steps for a particular reason giving rise to particular payments that would or might reasonably be expected to have given rise to an allowable deduction."

In *Futuris*,[31] the evidence lead was the report of an expert witness. Properly instructed (for example, to consider the requirements in s 177CB(4)), this can be a basis for demonstrating what would constitute a reasonable alternative postulate.

29 *FCT v Trail Bros Steel & Plastics Pty Ltd* [2010] FCAFC 94 at [36].

30 *FCT v Trail Bros Steel & Plastics Pty Ltd* [2010] FCAFC 94 at [33].

31 *FCT* v *Futuris Corporation Ltd* [2012] FCAFC 32.

On appeal, the Commissioner argued that the expert's "opinion was mere speculation as to what Futuris 'might' have done unsupported by evidence which would have transformed it into a reasonable expectation." The Full Federal Court rejected this assertion, stating:[32]

> "There was, of course an element of speculation involved in Mr Duivenvoorde's analysis. But it was not mere speculation. It was a prediction based on given facts, established market values, calculations based on unchallenged financial data, a stated goal and the application of Mr Duivenvoorde's expertise in corporate finance and his experience as a chartered accountant. The definition of 'tax benefit' in s 177C(1)(a) requires that there be a prediction as to what 'might reasonably be expected to have been included in the assessable income of the taxpayer'. That prediction necessarily involves an opinion as to events and transactions that have not taken place. It must be not just a possibility but 'sufficiently reliable for it to be regarded as reasonable': *Peabody* at 385.
>
> The reliability of a prediction might be established by direct evidence of contemporaneous consideration of the alternative postulate; or by evidence from company officers as to established commercial parameters for sale and whether the alternative postulate met those parameters; or evidence from those who were involved in the transactions challenged under Pt IVA. But that is not the only way to establish reliability. To the extent that the Commissioner submits that it is only by such direct evidence that a reliable prediction can be made, we reject that submission. This much was recognised by the Full Federal Court in *Trail*."

Although a taxpayer can state what they would have done but for the scheme, the statement needs to be supported by evidence and foundation facts. In *McCutcheon's* case,[33] the taxpayer did not put forward anything other than the history of distributions and his desire to make the most tax-effective distributions possible to support his assertion, which was considered inadequate to support his case.

¶11-510 The "do nothing" approach

Under the concept of tax benefit as it stood prior to the recent amendments, the "do nothing" approach was a valid basis for determining that a tax benefit did not arise. This approach was used in particular when considering the Pt IVA implications of a voluntary transaction, for example, an internal restructure.

The argument was that, if a significant tax cost arose from the transaction, the taxpayer would have deferred or abandoned their planned course of action. Often, the transaction did not produce an economic gain to the taxpayer and its associated entities, so a leakage of tax at a material level was prohibitive to the financial effectiveness of the planned course of action. This was exactly what was held by the court to be in the case in *RCI*. The court noted that:[34]

> "… the matters or reasons … that activates a decision to sell an asset to a party external to the group of companies of which the vendor forms part, will always be very different from the matters or reasons which activate the transfer of an asset to another company in the same group as part of an internal reorganisation of the group. The former will be dictated by matters

32 *FCT v Futuris Corporation Ltd* [2012] FCAFC 32 at [79]-[80].

33 *McCutcheon v FCT* [2008] FCA 318.

34 *RCI Pty Ltd v FCT* [2011] FCAFC 104 at [143]-[144].

> of price, gain, evaluation of the asset in terms of its ongoing group contribution and temporal considerations going to the timing of the sale; the latter by reference to an evaluation of the net economic benefit to the group reorganisation that the transfer brings — on the one hand, the transfer's contribution to that benefit and on the other hand, the economic cost of that benefit.
>
> What is said ... above, is not to introduce subjective considerations to the determination of the issue as to what might reasonably be expected to have been done if the scheme as identified had not been entered into or carried out, but they do inform the determination of that issue, put as they are without reference to the facts of this particular case."

The comment can be read as indicating that the "do nothing" position accepted by the court in *RCI* is one that is likely to be limited to internal-type transactions, rather than external transactions.

The introduction of s 177CB(4) is intended to remove the ability to argue a "do nothing" position, regardless of the transaction. While not explicitly prohibited, it is effectively removed by requiring the alternative postulate to be determined having regard to the substance of the scheme and the results and consequences of the scheme for the taxpayer.

To successfully argue a "do nothing" position, it would need to be the case that there was no other reasonable way to achieve similar results and consequences for the taxpayer as were achieved by undertaking the scheme. There will be a fairly limited set of circumstances where this would be a valid argument (probably a limited subset of the internal-type transactions).

Non-tax factors which may prohibit or make unreasonable various alternative postulates, such as regulatory requirements, would likely also provide a basis for determining that the dominant purpose was not to obtain a tax benefit. See, for example, the decision in *Citigroup*[35] where the structure of the transaction was dictated by Hong Kong regulatory requirements (noting that other factors in this case led to the decision against the taxpayer). It would be prudent to assess the dominant purpose as well, rather than relying solely on a "do nothing" position.

¶11-530 Does the alternative postulate need to be reasonable?

One implication of the recent amendments is that an alternative postulate that is completely unreasonable due to the tax cost involved (for example, that the same economic gain is taxed twice) could nonetheless be a reasonable alternative postulate under s 177CB because that tax effect must be disregarded when assessing whether the alternative is reasonable in a statutory sense.

How the courts eventually reconcile s 177CB(3) (which requires an alternative postulate to be reasonable) and s 177CB(4)(b) (which places a limit on the assessment of reasonableness) will be an interesting and important development. Until then, unless a taxpayer is looking to litigate a Pt IVA matter, another basis for demonstrating that a particular alternative postulate is not reasonable will need to be identified.

35 *Citigroup Pty Ltd v FCT* [2010] FCA 826.

Another approach will be to accept the "high tax" alternative postulate and focus on the question of purpose. Making "purpose" central to the Pt IVA analysis is a key objective of the recent amendments. The fact that a way of undertaking a transaction that would produce a higher tax liability exists and a lower-taxed alternative is chosen does not, of itself, mean that the dominant purpose of obtaining a tax benefit is present. That question must be answered based on the s 177D requirements alone.

¶11-550 How the "offending" cases would be decided under the amended law

Futuris

In *Futuris*,[36] the taxpayer's corporate group decided to dispose of its Building Products Division and to do so by a public float of its wholly owned subsidiary, Walshville, but only after an internal restructure was undertaken to transfer parts of the Building Products Division that were held by other companies in the Futuris group to Walshville.

If s 177CB(4)(b) was applied in this case, the tax cost would not be a valid ground for concluding that the alternative postulate was unreasonable. This is so, even though there "would be a doubling up of capital gains in respect of essentially the same assets".[37]

One of the other factors identified as relevant for demonstrating that the alternative postulate was not reasonable was that accessing the roll-over relief would have resulted in Futuris attempting to float a company with a large contingent tax liability that would be triggered as soon as the float proceeded. Is this a "result in relation to the operation of this Act"? The tax liability is. However, is the non-commerciality of floating an entity with a contingent liability of this magnitude a result that must be disregarded?

The Commissioner's argument in *Futuris* also failed because Futuris was able to demonstrate that the alternative postulate that it was reasonable to expect would have occurred in the absence of the scheme was the use of an alternative company (Bristile) as the vehicle for floating the Building Products Division. The gain on disposal of these shares would actually accrue to a different taxpayer (Vockbay, a subsidiary of Futuris).

Would this be an acceptable alternative postulate under the new s 177CB(4)? The substance of the scheme was that Futuris disposed of its direct and indirect ownership interests in the Building Products Division. The results and consequences for Futuris were that it obtained the capital proceeds from the disposal of shares in a subsidiary in the course of the float.

The alternative postulate whereby Bristile is the float vehicle is consistent with the substance of the scheme in that Futuris disposed of its direct and indirect ownership interests in the Building Products Division. The variance occurs in respect of the results and consequences. Futuris would not receive

36 *FCT v Futuris Corporation Ltd* [2012] FCAFC 32.

37 *FCT v Futuris Corporation Ltd* [2012] FCAFC 32 at [42].

the capital proceeds from the float, these would be received by a subsidiary company, although, in substance, Futuris still receives the economic benefit from the capital proceeds from the float.

Given that the s 177CB(4) conditions are provided as a guide to, rather than an exhaustive list of, the matters to have regard to, the alternative postulate demonstrated by Futuris in this case would still appear to be open to them under the amended provisions.

RCI

RCI Pty Ltd was a member of the James Hardie group. RCI was involved in two sets of transactions: a revaluation/dividend transaction and a corporate restructure.

The market value of the United States subsidiary had been reduced by the earlier dividend and therefore the capital gain made on this corporate restructure was reduced.

Based on the evidence, the court determined that it was not reasonable to expect that RCI would have entered into the alternative postulate proposed by the Commissioner due to the costs involved. Similarly, other alternative ways of undertaking the corporate restructure were also prohibitive on a cost basis.

The court determined that, if the scheme had not been entered into, the reasonable expectation was that the parties would have either abandoned the proposal, indefinitely deferred it, altered it so that it did not involve the transfer by RCI of the shares or pursued an alternative, but they would not have proceeded with the corporate restructure in its current form.

The *RCI* case[38] would appear to be more problematic under the amended provisions. The additional costs of the scheme were attributable to the tax liability on the alternative postulate. This tax cost would be disregarded under s 177CB(4)(b).

In addition, an alternative postulate based on deferral or abandonment of the scheme may be difficult to substantiate. Using the s 177CB(4)(a) factors, the alternative postulate for RCI would likely include transactions that result in the disposal of the US subsidiary to an offshore entity (not necessarily Malta). Retaining the US subsidiary would be inconsistent with the results and consequences of the scheme.

38 *RCI Pty Ltd v FCT* [2011] FCAFC 104.

Chapter 12

Purpose

¶12-100 The legislation

> "[The question of purpose] was intended to be the fulcrum upon which most Pt IVA cases will turn ..."[1]

Section 177D contains the core provisions for determining whether there is a purpose of obtaining a tax benefit cancellable under Pt IVA:

> "Scheme for purpose of obtaining a tax benefit
>
> (1) This Part applies to a scheme if it would be concluded (having regard to the matters in subsection (2)) that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of:
>
> (a) enabling a taxpayer (a relevant taxpayer) to obtain a tax benefit in connection with the scheme; or
>
> (b) enabling the relevant taxpayer and another taxpayer (or other taxpayers) each to obtain a tax benefit in connection with the scheme;
>
> whether or not that person who entered into or carried out the scheme or any part of the scheme is the relevant taxpayer or is the other taxpayer or one of the other taxpayers.
>
> Have regard to certain matters
>
> (2) For the purpose of subsection (1), have regard to the following matters:
>
> (a) the manner in which the scheme was entered into or carried out;
>
> (b) the form and substance of the scheme;
>
> (c) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;
>
> (d) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;
>
> (e) 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;
>
> (f) 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;
>
> (g) any other consequence for the relevant taxpayer, or for any person referred to in paragraph (f), of the scheme having been entered into or carried out;
>
> (h) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in paragraph (f).
>
> Note: Section 960-255 of the *Income Tax Assessment Act 1997* may be relevant to determining family relationships for the purposes of paragraphs (f) and (h).

1 *FCT v Hart* [2004] HCA 26 at [92] per Callinan J.

Tax benefit

(3) Despite subsection (1), this Part applies to the scheme only if the relevant taxpayer has obtained, or would but for section 177F obtain, a tax benefit in connection with the scheme.

When schemes entered into etc.

(4) Despite subsection (1), this Part applies to the scheme only if:

(a) the scheme has been or is entered into after 27 May 1981; or

(b) the scheme has been or is carried out or commenced to be carried out after that day (and is not a scheme that was entered into on or before that day).

Schemes outside Australia

(5) This section applies whether or not the scheme has been or is entered into or carried out in Australia or outside Australia or partly in Australia and partly outside Australia."

Section 177A(5) provides for the concept of dominant purpose:

> "(5) A reference in this Part to a scheme or a part of a scheme being entered into or carried out by a person for a particular purpose shall be read as including a reference to the scheme or the part of the scheme being entered into or carried out by the person for 2 or more purposes of which that particular purpose is the dominant purpose."

¶12-105 Role of purpose

Purpose is the central concept in Pt IVA. Section 177D ITAA36 states that Pt IVA will apply only if, after considering the eight factors (discussed below):

> "... it would be concluded ... that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of ... enabling a taxpayer ... to obtain a tax benefit in connection with the scheme ..."

The court in *Spotless* expressed the test this way:[2]

> "... whether, having regard, as objective facts, to the matters answering the description in [s 177D], a reasonable person would conclude that the taxpayers [or other participants in the scheme] entered into or carried out the scheme for the dominant purpose of enabling the taxpayers to obtain a tax benefit in connection with the scheme."

Hart's case emphasised the central role of "purpose" when applying Pt IVA. These comments are even more relevant now, after the recent amendments:[3]

> "Although it will often be convenient to begin any consideration of the application of the Part by attending to the operation of these elucidating and definitional provisions, approaching a particular case in this way must not be allowed to obscure the way in which the Part as a whole is evidently intended to operate.

2 *FCT v Spotless* [1996] HCA 34.

3 *FCT v Hart* [2004] HCA 26 at [36]-[37] per Gummow and Hayne JJ.

> Taking Pt IVA as a whole, it is clear that ss 177D and 177F(1) are the two provisions about which the Part pivots."

And:[4]

> "The next question, which is of purpose, is whether under s 177D the scheme is one to which Pt IVA applies. This will, in my view, in most cases be the critical question. The answer to it, both as a matter of statutory interpretation and as the Explanatory Memorandum indicates, was intended to be the fulcrum upon which most Pt IVA cases will turn, because the definition of a scheme, being as wide as it is, will relatively easily be satisfied, and the presence or absence of a tax advantage will also usually be readily apparent."

As has been noted elsewhere in this guide, it can be difficult to determine with precision the boundaries of concepts such as "scheme" and "tax benefit". Paraphrasing Gummow and Hayne JJ in *Hart's* case, if there is a difficulty, its solution must be found in the construction and operation of Pt IVA and, most particularly, in the analysis of purpose under s 177D. In a way, this is what the recent amendments are also aimed at achieving.

¶12-110 Whose purpose is relevant?

It is the purpose of the participants in the scheme that is relevant for Pt IVA. The purpose of the scheme itself is not relevant. According to Hill J in *Zoffanies*,[5] the conclusion required to be drawn is not a conclusion about the transaction itself, but the state of mind of a person (who participated in the transaction).

Consideration is not limited to the purpose of the taxpayer themselves. A participant is any person who entered into or carried out the scheme or any part of the scheme. Person is used in this context as a reference to a legal person, so it would include a company for example.

The conclusion as to dominant purpose may be reached not only with respect to the dominant purpose of the taxpayer, but also by reference to the dominant purpose of any other person or persons, so long as they are persons who entered into or carried out the scheme or any part of it.[6]

The person needs to play an active role in some part of the scheme. The fact that the person is only involved in carrying out part of the scheme, even if it is only one step in a much broader scheme, would not preclude them from being a participant. However, you would generally expect that the person would be involved in carrying out the step or steps in the scheme that are key to the tax benefit arising.

Using the facts in *Hart's* case as an example, the overall scheme may include the obtaining of loan finance to refinance two properties with existing debt, but the step which caused the tax benefit to arise was the inclusion in the loan agreement of the terms relating to the "split loan" feature. It would be the persons who are involved in introducing the split loan feature to the refinancing transaction who would

4 *FCT v Hart* [2004] HCA 26 at [92] per Callinan J.

5 *FCT v Zoffanies Pty Ltd* [2003] FCAFC 236 at [54] per Hill J.

6 *FCT v Spotless* [1996] HCA 34.

be most relevant in the Pt IVA analysis. A person who was involved in, say, the original loan application (which excluded the split loan feature) would be less relevant.

¶12-115 When the purposes of advisers are relevant

In a number of cases,[7] the purpose of the advisers was considered relevant (and determinative in the case of *Consolidated Press*) when assessing the question of dominant purpose. This approach is permissible, as the relevant dominant purpose is assessed not just in respect of the taxpayer, but also in respect of any person who entered into or carried out the scheme or any part of the scheme.

A qualification noted by the court in *RCI*[8] is that the adviser would need to be “a party to the scheme”. This would necessitate the adviser taking an instrumental or active role in the design and/or implementation of the scheme.

Extending the group of relevant persons beyond the taxpayer, and specifically including advisers, is intended to overcome any suggestion that a lack of awareness on the part of the taxpayer could be a defence against the application of Pt IVA. If a taxpayer does not understand or is not aware of the implications of a scheme or a step within a scheme, and instead chooses to rely on a third party, then the objective purpose of that third party is relevant for the question of dominant purpose.

This aspect of Pt IVA (the adviser purpose) is often misconstrued as meaning that providing tax-focused advice (as would be done by any tax adviser) necessarily indicates a dominant purpose on the part of the adviser to obtain a tax benefit for their client. This is not the case. The actual purpose of the adviser is irrelevant. It is the objective purpose, determined having regard to the eight factors in s 177D, that is relevant.

The following quotes (taken from cases where the adviser’s purpose was considered) provide a useful basis for understanding the role of the adviser’s purpose.

Consolidated Press[9]

> “But as the Commissioner contended the scheme was entered into on the basis of advice received from Arthur Young. Mr Bourke gave evidence that on matters of this kind he relied on the advice of his tax advisers. The Commissioner submitted that in these circumstances the purpose or purposes of Arthur Young in recommending the scheme are to be attributed to those who entered into and carried it out on the basis of their advice. His Honour’s reference to those who advised the group at Arthur Young is to be read in that light. There would be few such arrangements which do not involve the obtaining of prior professional advice and the objective purposes associated with the implementation of that advice can properly be attributed to those who implement it. In the circumstances the relevant purpose has been found, albeit by reference to the purpose of the advisers to the Group.”

7 For example, *FCT v Consolidated Press Holdings* [2001] HCA 32 and *RCI Pty Ltd v FCT* [2011] FCAFC 104.

8 *RCI Pty Ltd v FCT* [2011] FCAFC 104 at [156].

9 *FCT v Consolidated Press Holdings Ltd* [1999] FCA 1199 at [99].

Consolidated Press[10]

"The plan was said to have been conceived by the tax advisors, Arthur Young, and adopted by ACP and MLG ...

The finding made by Hill J, set out above, was criticised both in the Full Court and in this Court on the ground that, as the case was particularised by the Commissioner, the persons who entered into or carried out the scheme were CPIL(UK), MLG and ACP. They were the persons referred to in s 177D; not some unidentified advisors. There is no point in making a finding about what would be concluded concerning the purpose of an advisor unless that purpose is then attributed to a relevant person. It is reasonably clear that, albeit in a slightly elliptical fashion, Hill J was doing that. He was justified in doing so. As was mentioned above, it is to be expected that those who participate in a complex, international, commercial transaction will be concerned about its tax implications, and will seek expert advice. Attributing the purpose of a professional advisor to one or more of the corporate parties in the present case is both possible and appropriate. In some cases, the actual parties to a scheme subjectively may not have any purpose, independent of that of a professional advisor, in relation to the scheme or part of the scheme, but that does not defeat the operation of s 177D. If, in the present case, there had been evidence which showed that no director or employee of any member of the Group had ever heard of s 79D, that would not conclude the matter in favour of the taxpayer. One of the reasons for making s 177D turn upon the objective matters listed in the section, it may be inferred, was to avoid the consequence that the operation of Pt IVA depends upon the fiscal awareness of a taxpayer."

Sleight[11]

"It is arguable whether his Honour did fail to consider the promoter (or the promoter's companies) in this context. But it is unnecessary to decide whether this was so. With respect to the submission of counsel for the Commissioner it is difficult to see why, having regard to the relevant eight factors, the conclusion would be drawn that the promoter entered into or carried out the scheme for the dominant purpose of providing to Mr Sleight a tax deduction. The promoter no doubt was motivated by the profit which the promoter and his or her entities would make. That profit was no doubt dependent upon Mr Sleight and others entering into the scheme. That in turn no doubt depended upon Mr Sleigh forming the view that a tax benefit was available to him. However, I do not think that it would be concluded that the promoter or associated entities entered into or carried out the scheme for the dominant purpose of Mr Sleight obtaining tax deductions."

¶12-120 Dominant purpose

Part IVA only applies where the sole or dominant purpose of a participant in a scheme is to create a tax benefit in the statutory sense of that expression.

10 *FCT v Consolidated Press Holdings* [2001] HCA 32 at [52] and [95].

11 *FCT v Sleight* [2004] FCAFC 94 at [96] per Hill J.

It is s 177A(5) ITAA36 that introduces the dominant purpose concept. The other provisions in Pt IVA refer only to "the purpose":

> "(5) A reference in this Part to a scheme or a part of a scheme being entered into or carried out by a person for a particular purpose shall be read as including a reference to the scheme or the part of the scheme being entered into or carried out by the person for 2 or more purposes of which that particular purpose is the dominant purpose."

Where two or more purposes are present, s 177A(5) provides that any reference to purpose is a reference to the dominant purpose.

As the High Court noted in *Spotless*:[12]

> "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."

The purpose or purposes of participants in a scheme are determined objectively having regard to the eight factors in s 177D. The dominant purpose is likewise determined objectively as part of this analysis.

¶12-125 What is meant by "objective assessment"

Part IVA requires an objective assessment to be made in respect of the purpose(s) of the participants in the scheme. It is the conclusion of a reasonable person:[13]

> "The eight categories set out in [s 177D] as matters to which regard is to be had 'are posited as objective facts'. The construction is supported by the employment in s 177D of the phrase 'it would be concluded that …'. This phrase indicates that the conclusion reached, having regard to the matters in [s 177D], 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."

The subjective or actual purposes and motivations of the participants are not relevant. Whether or not a party to the scheme had as their actual purpose the obtaining of a particular tax outcome would not be relevant for the s 177D analysis. That said, where the evidence is consistent with the subjective or actual purpose of the participants, the objective purpose will often correlate with the subjective/actual purpose:[14]

> "It follows that while the conclusion required to be drawn is one that requires consideration of the purpose or dominant purpose of a person, including the taxpayer, that conclusion can not take into account evidence of the actual purpose of a taxpayer or other person, save and except so far as that could be forensically relevant to any one of the matters specifically referred to in s 177D(b) for example, the manner in which the scheme was entered into. None of the eight

12 *FCT v Spotless* [1996] HCA 34.

13 *FCT v Spotless* [1996] HCA 34.

14 *FCT v Zoffanies Pty Ltd* [2003] FCAFC 236 at [53] and [91] per Hill J.

> matters refer to the actual purpose of any person. It also follows that generally, at least, evidence of what may be referred to as the actual or subjective purpose of the taxpayer is irrelevant ...
>
> The difference between the actual purpose of a taxpayer, on the one hand, and the purpose which is to be imputed to the taxpayer based upon an exclusive set of criteria, on the other hand, is not without subtlety and has been misunderstood before."

What the courts (and the ATO) will do is make an assessment based on the facts as supported by the evidence. It's not enough to just state a purpose; you need to be able to prove it. This is why "building a file" at the time of the transaction can be a beneficial exercise.

¶12-130 Tax planning and tax-driven transactions

The fact that a taxpayer is aware of a possible tax outcome and wishes to ensure that tax does not arise, or undertakes a transaction to achieve a particular tax outcome, does not of itself mean that the requisite dominant purpose of obtaining a tax benefit required to enliven Pt IVA is present. The taxpayer's intentions are subjective and are not one of the eight factors listed in s 177D. This is particularly relevant in a tax planning context.

Where a particular commercial transaction is chosen from a number of possible alternative courses of action because of tax benefits associated with its adoption, it does not of itself mean that the requisite dominant purpose must be to obtain a tax benefit (per Gleeson and McHugh JJ in *Hart*[15]).

Eastern Nitrogen is an example where the tax effectiveness of the transaction was key for the taxpayer but was not something which enabled Pt IVA to be enlivened:[16]

> "His Honour attached some importance to the fact that the change in the method by which the appellant obtained finance for use in its business, arose out of a proposal initiated and put to the appellant by Macquarie Bank Ltd ('MBL') and was not a step taken by the appellant after it had decided for itself that there was a need to change those arrangements.
>
> In my opinion, that was a circumstance of neutral consequence. MBL carried on business, inter alia, of arranging financial facilities for operating businesses. MBL did not carry on business as the promoter of schemes in which a taxpayer may participate in order to reduce a liability to pay income tax. Indeed, so much was accepted by his Honour as is set out in par 77 of his reasons. Having regard to the foregoing it was not significant, in the terms of s 177D, that the appellant responded to, rather than initiated, the finance proposal outlined by MBL. The need to have, or to obtain, access to working capital on the best available terms was a constant requirement of the business of the appellant. The proposal put forward by MBL was directed to meeting the needs of the business conducted by the appellant and was accepted as such by the appellant ...
>
> On the facts found by his Honour the 'after-tax cost' of finance was always of importance to the appellant in the conduct of its business, whatever line of finance was under consideration. Due and proper management of the business required assessment to be made of the net cost of finance after taking into account the extent to which any outgoings associated with that cost were allowable deductions from assessable income. In the circumstances of this case, to say

15 *FCT v Hart* [2004] HCA 26.

16 *Eastern Nitrogen Ltd v FCT* [2001] FCA 366 per Lee J.

> that the appellant was attracted by a proposal that provided finance at a lower after-tax cost than another means of obtaining funds for the business would not, without more, support an objective conclusion that the appellant obtained finance for the dominant purpose of obtaining the tax benefit constituted by the deductibility from assessable income of the outgoings incurred in connection with the obtaining of that finance.
>
> To show that a business which depends upon financiers to provide the recirculating capital needed for the operation of the business, has obtained that finance at a net cost, after taking into account provisions of the Act, that is less than the net cost of obtaining finance by another method, will not, in itself, show that the dominant, ruling or supervening purpose of the operator of the business is to obtain the tax benefit constituted by the extent to which deductible outgoings incurred in respect of that borrowing will be greater than the deductible outgoings that would have been incurred under another method of obtaining finance. That is to say, something more must be shown than that the business has obtained finance at best available net cost after-tax before it can be said that a tax benefit has arisen to which s 177C(1)(b) applies."

The court in *Mochkin* considered the choice of a taxpayer to use a discretionary trust as his operating structure. Again, the taxpayer's actual motivation for making this choice was considered irrelevant:[17]

> "It can readily be concluded that the Taxpayer had tax advantages in mind in choosing a discretionary tax structure as the means of carrying out the scheme. Doubtless, there were other ways in which he could have chosen to conduct the stockbroking business and to immunise himself from personal liability. But the question posed by s 177D(b) is not whether the Taxpayer could have chosen a less tax effective means of achieving his commercial objective of immunising himself from personal liability to the brokers. The question is whether, in view of the matters identified in s 177D(b) it is reasonable to conclude that the Taxpayer's ruling, prevailing or most influential purpose in entering into or carrying out the scheme was to obtain the tax benefit identified by the Commissioner. In my respectful opinion, the primary Judge was correct in finding that a reasonable person would conclude that the tax advantages of the scheme were subsidiary to the commercial objectives. The Taxpayer has therefore established that a reasonable person would not conclude that he entered into or carried out the scheme for the dominant purpose of obtaining a tax benefit in connection therewith."

¶12-135 When is the purpose assessed?

The time for testing dominant purpose must be the time when the scheme was entered into or carried out and by reference to the law as it then stood.[18]

The application of Pt IVA can only be tested with respect to the obtaining of a tax benefit in accordance with the law as applicable to the time when the scheme was entered into and by reference to the law as it stood at that time. It cannot be tested retroactively after the scheme has been entered into merely because, in the meantime, the law has changed.

17 *FCT v Mochkin* [2003] FCAFC 15 at [98] per Sackville J.

18 *CPH Property Pty Ltd & Ors v FCT* [1998] FCA 1276 per Hill J.

¶12-140 Can a commercial transaction be subject to Pt IVA?

There is no inconsistency between a finding that the purpose of a person lay in the pursuit of commercial gain in the course of carrying on a business and a finding that the dominant purpose was to enable the relevant taxpayer to obtain a tax benefit.[19]

In *Spotless*,[20] the references on the one hand to a "rational commercial decision" and on the other to the obtaining of a tax benefit as "the dominant purpose of the taxpayers in making the investment" suggested the acceptance of a false dichotomy.

As was stated by Sackville J in *Lenzo*,[21] the commercial viability of the arrangement provides no guarantee that, after taking into account all of the matters identified in s 177D, it would not be concluded that the relevant person entered into or carried out the scheme for the dominant purpose of obtaining a tax benefit.

A person may enter into a scheme for the dominant person of obtaining a tax benefit where that dominant purpose is consistent with the pursuit of commercial gain in the course of carrying on a business.[22]

In all instances, the question is what a reasonable person would conclude as the dominant purpose of participants in the scheme. A clearly commercial transaction that has not been designed in whole or in part to achieve particular advantageous tax outcomes would be expected to have a low risk of attracting the application of Pt IVA. However, where the commerciality of the scheme is driven by or dependent on the tax outcomes to achieve its commercial purpose, the Pt IVA risk is more significant. This was the case in *Spotless*, where the court made the following observation:[23]

> "The Cook Islands levied withholding tax at the rate of 5 per cent of the amount of interest. The interest rate payable to the depositors was approximately 4 per cent below the Australian bank bill buying rate. However, what might be seen as the commercially unattractive aspects of the deposit with EPBCL would be more than offset if the interest were exempt from income tax in Australia. As will appear, it was this collateral tax advantage which provided the key to the whole transaction and gave it its particular commercial attraction.
>
> ... it was the obtaining of the tax benefit which directed the taxpayers in taking steps they otherwise would not have taken by entering into the scheme."

The High Court in *Spotless* referred to a judgment in *Commissioner of Internal Revenue v Brown*, where Harlan J said:[24]

19 *FCT v Consolidated Press Holdings Ltd* [2001] HCA 32.

20 *FCT v Spotless* [1996] HCA 34.

21 *FCT v Lenzo* [2008] FCAFC 50 at [146] per Sackville J.

22 *FCT v Spotless* [1996] HCA 34.

23 *FCT v Spotless* [1996] HCA 34.

24 [1965] USSC 82.

> "[T]he tax laws exist as an economic reality in the businessman's world, much like the existence of a competitor. Businessmen plan their affairs around both, and a tax dollar is just as real as one derived from any other source."

The court went on to state:[25]

> "... Pt IVA does not authorise the Commissioner to make a determination under par (a) of s 177F(1) merely because a taxpayer has arranged its business or investments in a way that derives a tax benefit."

¶12-145 What if the taxpayer is unaware of the tax benefit?

It is irrelevant if the taxpayer is unaware of the tax benefit. The broad formulation of the factors in s 177D (particularly paras (i) and (ii)) clearly encompasses matters of which a taxpayer may be quite unaware.

A taxpayer may execute agreements without reading them. That does not mean that the taxpayer is taken to be unaware of them and that the contents of the agreements are to be disregarded when assessing purpose under s 177D. The absence of such inquiry and the lack of awareness of transactions and their implications do not mean that those factors are to be disregarded in the objective assessment of purpose under s 177D.

The tax-effective investment scheme cases are good examples of this principle. In a number of these cases, the taxpayer was unaware of the detail of the transactions that occurred (for example, the related party financing arrangements between entities associated with the promoter). In all instances, the court disregarded the taxpayer's lack of awareness.

¶12-200 What are the "eight factors"?

The assessment of the objective purpose is made having regard to the eight factors in s 177D:

> "(a) the manner in which the scheme was entered into or carried out;
>
> (b) the form and substance of the scheme;
>
> (c) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;
>
> (d) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;
>
> (e) 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;
>
> (f) 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;

25 *FCT v Spotless* [1996] HCA 34.

(g) 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

(h) 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);"

Different factors could point to the requisite tax purpose, suggest the absence of the requisite tax purpose or be neutral.

Each of the eight factors needs to be considered, but not each of them needs to point to the dominant purpose being the obtaining of a tax benefit. Some of the matters may point in one direction and others may point in another direction. It is the evaluation of these matters, alone or in combination, some for, some against, that s 177D requires in order to reach the conclusion to which s 177D refers.[26]

¶12-210 Can other factors be taken into account?

According to Hill J in *Zoffanies*,[27] it is clear from the terms of s 177D itself that that conclusion is one that must be reached having regard to the eight matters stipulated in s 177D and no other matters. This same statement was made by Hill J in the Full Federal Court decision in *Peabody*:[28]

> "It will be seen that the determination of what schemes fall within s 177D requires an objective conclusion to be drawn, having regard to the matters referred to in paragraph [(2)] of the section, by no other matters. It is notable that the actual subjective purpose of any relevant purpose is not a matter to which regard may be had in drawing the conclusion."

¶12-220 Do you need to consider each factor individually?

When assessing purpose, the eight factors do not need to be "slavishly ticked off" one by one. It is possible to arrive at the conclusion as to purpose by making a global assessment of the facts, so long as it is clear that the relevant eight factors in s 177D(b) are taken into account.[29]

¶12-230 How does dominant purpose interact with scheme?

Scheme, tax benefit and purpose are the three core interrelated concepts on which Pt IVA is constructed.

The scheme sets the context for the analysis. The tax benefit must be connected with the scheme. The persons who are the relevant persons when assessing the question of dominant purpose are those who enter into or carry out the scheme or part of the scheme.

26 *Peabody v FCT* [1993] FCA 74 at [46] per Hill J.

27 *FCT v Zoffanies Pty Ltd* [2003] FCAFC 236 at [53] per Hill J.

28 *Peabody v FCT* [1993] FCA 74 at [42] per Hill J.

29 *FCT v Consolidated Press Holdings Ltd* [1999] FCA 1199 at [93].

Scheme therefore sets who the relevant persons are for the dominant purpose inquiry and provides context for making that inquiry. While the inquiry as to dominant purpose is based on the scheme, it is not strictly limited by the scheme.

The identification of purpose based on an identified scheme, in particular a narrowly defined scheme, may be undertaken in the context of its surrounding transactions. Identification of a scheme is based on the wording in s 177A ITAA36. The scheme does not need to extend to include all of the related transactions and circumstances. However, once the scheme is identified, these related transactions and circumstances may be relevant for the assessment of purpose.

The High Court in *Consolidated Press*, commenting on aspects of the judgment of Hill J in the first instance, said:[30]

> "Objection was also taken to what was said to be the artificiality of the selection of part of the overall transaction as the scheme. This, it was said, was not warranted by *Peabody* or *Spotless*. The artificiality was said to result from the fact that the overall transaction was for the clearly commercial purpose of financing the Group's participation in the takeover bid for BAT. However, as was held in *Spotless*, a person may enter into or carry out a scheme, within the meaning of Pt 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. The fact that the overall transaction was aimed at a profit making does not make it artificial and inappropriate to observe that part of the structure of the transaction is to be explained by reference to a s 177D purpose. Nor is there any inconsistency involved, as was submitted, in looking to the wider transaction in order to understand and explain the scheme, and the eight matters listed in s 177D."

¶12-300 Manner

The first of the eight factors in s 177D is "the manner in which the scheme was entered into or carried out". This has tended to be one of the most influential of the eight factors. Consideration of the "manner" will often cross over with consideration of the "form and substance", also one of the most influential of the eight factors.

"Manner" is described in *Spotless*[31] as "consideration of the way in which and method or procedure by which the particular scheme in question was established".

The commerciality of the behaviour of the taxpayer will be an important consideration. The manner in which the taxpayer enters into and carries out the scheme should be reflective of commercially accepted and expected behaviours. For example, evidence of negotiation, due diligence and investigation, valuations, consideration at a board level, obtaining advice and legal documentation would all contribute to supporting a purpose other than obtaining a tax benefit.

30 *FCT v Consolidated Press Holdings* [2001] HCA 32 at [96].

31 *FCT v Spotless* [1996] HCA 34.

On the other hand, a transaction entered into other than at market value and the absence of legal documentation to support a transaction would undermine a position that the purpose was not the obtaining of a tax benefit.

The use of "pro forma" legal documentation can be an issue where it shows that transactions are preconceived or highly structured so as to ensure that a particular tax outcome is achieved. For example, see the comments in *McCutcheon*[32] and *Lenzo*.[33]

While a taxpayer may be aware of the tax implications of a transaction and actively seek to minimise the tax impact (and maximise their after-tax position), this is not a relevant factor when assessing purpose under Pt IVA (this is not among the eight factors and, in any event, is a subjective purpose). However, undertaking steps in a scheme that are directed solely at achieving a tax outcome would be relevant.

Where there is a commercially accepted way of undertaking a transaction and it is adopted in the scheme under consideration, this would add support to a purpose other than obtaining a tax benefit. Where unusual or highly complex elements are added to a transaction, this may indicate the purpose of obtaining a tax benefit.

In *Consolidated Press*,[34] the scheme was the interposition of transactions (using the interposed special purpose entity to make an overseas investment) into an overall commercially focused transaction. The taxpayer argued that the manner in which the transaction was entered into was consistent with the dominant purpose of financing an acquisition that would produce dividend income, and that the scheme made perfect commercial sense. However, the court considered that, when viewed in context, the scheme was explicable principally, or solely, by reference to a desire to protect the deductibility of interest payments.

The factors that motivate a taxpayer to enter into a transaction may be relevant. For example, in *Mochkin* (the liability issue)[35] and *Eastern Nitrogen* (reliance on short-term finance facilities),[36] evidence of these commercial imperatives was taken into account when considering the manner of entering into the scheme. However, in *Spotless* (tax exemption for offshore interest income)[37] and *Calder* (tax-effective investment scheme),[38] while commercial objectives were proposed to exist for each scheme, it was the obtaining of the tax benefit, through the manner in which the scheme was entered into and carried out, that allowed the transaction to produce a commercial outcome or return.

32 *McCutcheon and FCT* [2006] AATA 535.

33 *FCT v Lenzo* [2008] FCAFC 50.

34 *FCT v Consolidated Press Holdings Ltd* [2001] HCA 32.

35 *FCT v Mochkin* [2003] FCAFC 15.

36 *Eastern Nitrogen Ltd v FCT* [2001] FCA 366.

37 *FCT v Spotless* [1996] HCA 34.

38 *Calder v FCT* [2005] FCAFC 254.

The extracts below are from leading cases where the manner in which the scheme was entered into or carried out was considered.

Hart[39]

> "In these matters, demonstrating that there was another way in which the money might have been borrowed was very easy. Austral (the lender's agent) went to great lengths to give to the respondents (and presumably anyone else interested in similar proposals to borrow money for two purposes) material that identified the advantages that would be obtained by taking a split loan instead of other forms of loan. Much of this material was tendered in evidence at trial. It included elaborately worked examples illustrating how quickly the home loan could be paid off and how large were the tax benefits which could be obtained. As one of the brochures published by Austral, and given to the respondents, put it (by reference to a 'working example,'):
>
> 'By structuring your loan using Wealth Optimiser you obtain these potential benefits:
>
> - Your home loan portion is paid off in 4 years, 6 months ... This is approximately 20 years less than the old way, and
> - You obtain increased deductible interest on your investment loan portion ...
>
> All by paying *exactly the same monthly amount as you would have normally*.'
>
> There could be no doubt in these matters that the terms on which the loan was made available were explicable only by the taxation consequences for the respondents."

Eastern Nitrogen[40]

> "... there was a lengthy process of deliberation, on the part of the appellant's Finance Managers and Board before the Instalment Purchase Agreement and the Agreement for Lease were entered into. The proposal was exhaustively researched and the benefits, costs and risks involved were examined at length. Advice was taken on legal, accounting, taxation and financial implications ...
>
> The agreements were not shams. They reflected real transactions which the parties had agreed upon. The parties carried out the scheme by honouring the respective obligations which the agreements imposed."

Eastern Nitrogen[41]

> "Where the scheme, as in this case, involves a transaction which, it is conceded, creates legally enforceable rights and obligations, an objective assessment of the purpose of the transaction must have due regard to the effect of those rights and obligations. If there are 'elements of artificiality' in the context surrounding the transaction, that fact may have relevance to the purpose for which the transaction was entered into but it does not determine the purpose and nor does it remove the requirement to consider the effect of the transaction and the rights, obligations and duties arising thereunder. In the instant case regard had to be given also to

39 *FCT v Hart* [2004] HCA 26 at [67]-[68] per Gummow and Hayne JJ.

40 *Eastern Nitrogen Ltd v FCT* [2001] FCA 366 per Carr J.

41 *Eastern Nitrogen Ltd v FCT* [2001] FCA 366 per Lee J.

the fact that the scheme was a commercial transaction, made between parties acting at arm's length, concerned to protect their respective interests in the terms of their agreements. The latter characteristic will not, in itself, prevent the formation of an objective conclusion that the transaction was entered into with the dominant purpose by a party to the transaction to obtain a tax benefit for a taxpayer, but it is a matter to be duly considered."

Hart[42]

"The inescapable purpose of the Wealth Optimiser was, as will appear, to facilitate the repayment of a loan to be used not exclusively for the derivation of income but so as to derive the maximum tax benefits possible.

The accurate description by the broker of the arrangements and terms of a Wealth Optimiser in this way, which it provided in its promotional material, almost alone establishes this:

> '"*Lets you better manage your after tax dollars*" ...'"

Spotless[43]

"The elaborate nature of the scheme and its attendant circumstances lead inevitably to the conclusion that the scheme was not merely tax driven but that its [participants in the scheme's] dominant purpose was to enable the taxpayer to obtain a tax benefit by participating in the scheme.

It was the obtaining of the tax benefit which directed the taxpayers in taking steps they otherwise would not have taken by entering into the scheme."

Mochkin[44]

"The scheme was entered into in consequence of commercial imperatives facing the Taxpayer. These imperatives were not tax related. The scheme was carried out in a manner which ensured that the commercial imperatives were satisfied ...

The manner in which the scheme was carried out also ensured that distributions of net commission income would be made in a tax effective manner. Nonetheless, it is incorrect to suggest, as the Commissioner did, that the object of tax minimisation is the only cogent explanation for the creation of Ledger and its role as the contracting party with the various brokers. Daccar had been used as the contracting party with Pembroke for valid commercial reasons. Ledger, in effect, was substituted for Daccar in 1989 ...

[I]t is clear that the commercial arrangements described by the Taxpayer were carried into effect."

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42 *FCT v Hart* [2004] HCA 26 at [76]-[77] per Callinan J.

43 *FCT v Spotless* [1996] HCA 34 per McHugh J.

44 *FCT v Mochkin* [2003] FCAFC 15 at [86]-[88] per Sackville J.

Sleight

The way in which an arrangement is marketed, or presented to taxpayers, can be influential:[45]

> "The document [supplying basic information to interested persons before the prospectus was registered], in describing the features of the project, referred to one as 'Tax effective, tax effective, tax effective.' The emphasis is telling. A table in that document showing the tax consequences (there is a similar table in the prospectus) revealed that an investor on the top rate of tax, after taking into account the tax deductions thought to be available, actually was ahead on cash flow, other than for the investment in shares in the Land Company. On the other hand, as the Primary Judge observed, the information brochure promoted eight advantages of investment. Tax was but one of these. Other advantages promoted were ownership, asset building, income production, capital gain, strong forecasted returns, established marketing infrastructure, environmental aspects and early investor advantage."

A similar comment was made by Nicholson J in *Calder*,[46] in that the prospectus did not over-emphasise the tax-effectiveness of the project. It emphasised the commercial aspects of the project above any other aspects.

Hill J also made comments about how the scheme was entered into. The fact that some of the documents were signed by the taxpayer but they then appointed an attorney (related to the scheme promoter) to execute the balance of the documentation was noted.

Payment via a round robin of cheques was another factor that consistently arose in the "tax-effective investment case":[47]

> "While a round robin is perfectly legally effective to create real relationships between parties, it must be said that it is a feature of many tax avoidance schemes where no real money is involved and may point to a tax avoidance purpose ...
>
> But the question is not whether the transactions are genuine, but what, if anything, they tell concerning the purpose of the taxpayer."

The arrangement in *Sleight* used a loan agreement with prepaid interest to "gear up" an investment and increase the amount of the tax deductions available without a corresponding increase in the cash outlay of the investors or the cash made available to the investment. This was considered a marker of tax avoidance schemes:[48]

> "... the financial structure that the management agreement, loan agreement and indemnity agreement created was not necessary to the success of a tea tree project. Presumably the promoters, for example, could have still received the same amount of return by limiting the first year management fee to the actual cash outlay of the investor, and then adjusting the management fee in subsequent years to achieve this result. Arguably, an investor would thus have a legitimate, albeit significantly reduced, tax deduction for his cash outlay because it

45 *FCT v Sleight* [2004] FCAFC 94 at [73] per Hill J.

46 *Calder v FCT* [2005] FCA 911.

47 *FCT v Sleight* [2004] FCAFC 94 at [77]-[78] per Hill J.

48 *FCT v Sleight* [2004] FCAFC 94 at [80] per Hill J.

was actually a necessary cost of the project. This fact points towards a dominant tax incentive purpose because it could be objectively determined or concluded that an investor, who had a dominant commercial purpose, would prefer the project with a normal structure, rather than one which was so structured that it maximised the deductions available by the use of a somewhat artificial structure."

Sleight[49]

"The 'internal loans' provided no funds for the establishment or operation of the plantation scheme. By prepayment of the Management Fee ($21,000) the respondent became entitled to a tax refund which substantially funded those payments required to be made by him actually in cash in the early months of his participation in the Project."

Calder[50]

"His Honour found that the scheme was so structured as to significantly self-fund the financial obligation of Mr Calder to the Project. He regarded it as of significance that the scheme provided an immediate tax deduction and later deductions sufficient to generate tax savings which would cover the cash required from Mr Calder without risk to his own funds. His Honour accepted the Commissioner's submission that the manner in which the scheme was structured favoured an objective conclusion that Mr Calder as a taxpayer had entered into it for the purpose of enabling him to obtain a tax benefit. The structure therefore supported a finding of a tax benefit purpose ...

> '*... Mr Langridge's evidence was that the Project relied upon the tax deductibility and effect of the initial payments and the gearing up provided by the loan to show any rate of return. In those circumstances it cannot be objectively found that the dominant purpose of the applicant's entry into the scheme was to enable the applicant to make a commercial investment: the tax benefit was the key to the commerciality of the investment.*'

... It is no doubt possible in any given case to imagine schemes or structures or ways of doing things which might have given rise to greater tax benefits than those actually secured. Such imaginings have little bearing on the question whether in the case at hand it could have been concluded that the dominant purpose of entering into a scheme was to secure a tax benefit."

McCutcheon[51]

"The Tribunal accepts that the Applicants entered into the scheme transactions in order to provide funding to purchase new businesses following the sale of wholesale and retail petroleum businesses they had conducted. Mr McCutcheon was aware and stated in cross-examination that but for the scheme transactions, he would have had a tax liability and it was this prospect which led him to consult his taxation advisers and lawyers. The scheme has, however, several artificial steps or layers designed to avoid the application of section 100A (trust stripping). Several payments took the form of bearer promissory notes which were transferred for no consideration between different entities who were participants to the scheme. The scheme was said to be legitimated or justified in terms of its legality by an Opinion from an eminent Queen's

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49 *FCT v Sleight* [2004] FCAFC 94 at [212] per Carr J.

50 *Calder v FCT* [2005] FCAFC 254 at [68], [74] and [99].

51 *McCutcheon and FCT* [2006] AATA 535 at [150].

> Counsel practising in Queensland. The text of this Opinion was not in evidence before the Tribunal."

News

The complexity in the manner in which the transaction is entered into and carried out needs to be assessed in context:[52]

> "The apparent 'complexity' of the arrangements is hardly surprising, given the size and global reach of the News Group and the ambitious nature of the reincorporation exercise. The taking of numerous steps and the need for significant legal documentation were unavoidable. The Commissioner's suggestion that the alternative postulate could have been undertaken in three or four straightforward steps is an extreme over-simplification. On any measure this was a major undertaking, no matter how it was to be put into effect."

A further point made in *News* is that the manner may be explained by a need to obtain certainty on the outcomes of the arrangement. One form of transaction may be selected over another because it would enable the management of a key variable (eg exchange rate fluctuations) or enable the obtaining of a private binding ruling (so as to provide a level of certainty as to the tax outcomes) which may be commercially desirable.

Citigroup[53]

> "There is no doubt that the structure of the schemes was dictated by the [Hong Kong] Guidelines ... But the identity of the participants in the structure, at least on the BPP/BPQ side, were not dictated by the Guidelines; they were dictated by the need for the participants, in particular the principal partner in the BPP/BPQ, to be entitled to some form of relief in a jurisdiction outside Hong Kong to offset the post-tax loss in Hong Kong ... In my view, the choice of CPL as the principal partner in the BPP/BPQ is explicable solely on the basis of the foreign tax credit regime in Australia embodied, in the relevant years, in Div 18 of Pt III of the 1936 Act."

British American Tobacco[54]

> "Thus, the Taxpayer says, the scheme was an ordinary transaction entered into or carried out for the dominant purpose of successfully completing the merger without intervention from the Commission and therefore does not satisfy Part IVA.
>
> However, that analysis ignores the essential concept of the scheme identified by the Commissioner. As I have said, the essential element is to be found in the disposal of the 9 Wills Brands by the Taxpayer to Rothmans and the subsequent disposal by Rothmans to the Imperial Group of the 9 Wills brands, together with the Rothmans Brands. The desired objective of the disposition of all of the relevant brands, both the 9 Wills brands and the Rothmans Brands, to the Imperial subsidiaries could have been achieved by a transfer direct from the Taxpayer to the Imperial subsidiaries of the 9 Wills Brands and a transfer direct from Rothmans to the Imperial subsidiaries of the Rothmans Brands. The requirements of the Commission would

52 *News Australia Holdings Pty Ltd and FCT* [2009] AATA 750 at [87].

53 *Citigroup Pty Ltd v FCT* [2010] FCA 826 at [132] per Edmonds J.

54 *British American Tobacco Australia Services Ltd v FCT* [2009] FCA 1550 at [88]-[89] per Emmett J.

> have been satisfied and the intended object of the merger would have been achieved. There was no commercial or legal reason why the disposition to the Imperial subsidiaries of both the 9 Wills Brands and the Rothmans Brands should have been effected from a single vendor, transferor or disposer rather than a disposition from separate vendors, transferors or disposers. Precisely the same commercial and legal object could have been achieved without the transfer, sale or disposal by the Taxpayer to Rothmans followed by transfer, sale or disposal by Rothmans to the Imperial subsidiaries."

¶12-310 Form and substance

The second factor in s 177D is "the form and substance of the scheme". The "form" is what the scheme purports to do based on its legal documentation, accounting treatment, and other documentation. The "substance" is what the scheme actually achieves. It is the commercial and economic implications of the actions that are undertaken.

If form and substance don't align, this is an indicator of a Pt IVA risk. Indeed, this particular one of the eight factors in s 177D has commonly been viewed as a question of whether the form and substance of the scheme are aligned. However:[55]

> "... there is nothing in the statutory context to limit the consideration of this factor to merely a comparison between the form and substance of the scheme. Both have to be considered separately and together, so far as may be relevant."

Form, when considered separately, can be a question of why a particular form of transaction was chosen over another. Does the evidence show a commercial motivation for choosing that particular form of transaction, or does the evidence show that the only difference to an alternative form is the tax outcomes produced?

A taxpayer may have a particular objective or requirement which is to be met or pursued by a transaction. The "shape" of that transaction need not necessarily take only one form. The adoption of one particular form over another may be influenced by revenue considerations, and this is only to be expected. Tax laws affect the shape of nearly every business transaction and this reality cannot be ignored. A transaction can be both "tax-driven" and bear the character of a rational commercial decision.[56]

Evidence of past behaviour can be relevant. For example, in *Consolidated Press*,[57] direct investments in overseas entities had previously been the approach adopted by the taxpayer. In *Peabody*,[58] the family trust, not a subsidiary company, had been the preferred entity for holding the share investment in the company conducting the business. In both instances, the court thought it relevant to consider why the taxpayer chose an alternative form for the current transaction.

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55 *Eastern Nitrogen Ltd v FCT* [2001] FCA 366 per Carr J.

56 *FCT v Spotless* [1996] HCA 34.

57 *FCT v Consolidated Press Holdings Ltd* [2001] HCA 32.

58 *Peabody v FCT* [1993] FCA 74.

Substance, when considered separately, can perhaps be viewed as an evaluation of the "gist", "crux" or "heart" of the scheme, that is, what does it really achieve?

The extracts below are from leading cases where the form and substance of the scheme were considered.

Hart[59]

> "The benefit was not the whole of the interest on loan account 2 (the investment part of the borrowing); it was that part of the interest which resulted from the special, or non-standard, features of the arrangements between the lender and the borrowers. Those were the features to which the respondents were invited to pay attention in deciding whether to enter into the *particular* transaction. Those features, which defined the 'wealth optimiser structure' and distinguished it from 'standard financing arrangements', were definitive of the scheme in connection with which the tax benefit, identified by all four members of the Federal Court, was obtained ...
>
> It was the wealth optimiser aspect of the structure, not divorced from the borrowing, but giving the borrowing its distinctive character, that constituted the scheme."

Hart[60]

> "There could be no doubt in these matters that the terms on which the loan was made available were explicable *only* by the taxation consequences for the respondents. If the scheme was identified as 'all the steps leading to, and the entering into, and the implementation of the loan arrangements' the manner in which *that* scheme was entered into strongly suggested that the respondents (each a relevant taxpayer) entered into that scheme for the dominant purpose of obtaining a tax benefit."

Hart[61]

> "It may be that the respondents did wish to make an investment and to change their residence. These were entirely irreproachable and proper objectives. But the means adopted to achieve these results could readily, and should be objectively concluded to be a scheme for the [dominant] purpose of enabling the respondents to obtain a tax benefit, and that is so no matter which of the alternative definitions as to the width of the schemes, within which what occurred here falls, is preferred."

Hart[62]

> "... the form and substance of the scheme (s 177D(b)(ii)) also point to the purpose of a relevant person obtaining a tax advantage. What was one advance, to be repaid by 300 instalments, was treated as if it were two separate loans. The only persons obtaining any advantage from the treatment were the respondents. And the only advantages which they obtained depended upon

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59 *FCT v Hart* [2004] HCA 26 at [6] and [12] per Gleeson CJ and McHugh J.

60 *FCT v Hart* [2004] HCA 26 at [68] per Gummow and Hayne JJ.

61 *FCT v Hart* [2004] HCA 26 at [96] per Callinan J.

62 *FCT v Hart* [2004] HCA 26 at [71] per Gummow and Hayne JJ.

the taxation treatment resulting from the application of payments and accumulation of interest for which the scheme (however identified) provided."

Hart[63]

"An aspect of the question to which s 177D(b)(ii) gives rise, is whether the substance of the transaction (tax implications apart) could more conveniently, or commercially, or frugally have been achieved by a different transaction or form of transaction."

Eastern Nitrogen[64]

"The transaction was not dressed up as something which it was not."

Eastern Nitrogen[65]

"... there is nothing in the statutory context to limit the consideration of this factor to merely a comparison between the form and substance of the scheme. Both have to be considered separately and together, so far as may be relevant."

Sleight[66]

"The form, involving pre-payment of management fee and interest is, it may be concluded readily, designed to increase the taxation deductions available to an investor. The substance is, however, quite different. As Senior Counsel for the Commissioner put it, in substance the investor is a mere passive investor in what, once the tax features are removed, is a managed fund where no deduction would be available, or perhaps an alternative characterisation of the substance of the scheme is an investment in shares in the Land Company which at the expiration of 15 years is to own the tea tree plantation.

... the particular shape the investment took was clearly fashioned in a way that would maximise the tax deductions. They were geared up by the loan agreement with up front interest payments. But for the tax deductions the form the investment might be expected to take would clearly relate more to the substance of what happened."

McCutcheon[67]

"The form of the scheme comprised the making of three successive distributions of the income derived from the sale of the Townsville business, two gifts, and a subscription for units in a trust, a vesting of four trusts and the making of loans. The scheme was determined by the requirements of s 100A of the Act, by the need to introduce an entity with which to carry forward tax losses to derive the trust income, and by the need to direct that trust income back to the Applicants in non-taxable form. The substance of the scheme is that the ultimate use and enjoyment of the income derived by the P & A Trust remained with the Applicants."

63 *FCT v Hart* [2004] HCA 26 at [94] per Callinan J.

64 *Eastern Nitrogen Ltd v FCT* [2001] FCA 366 per Carr J.

65 *Eastern Nitrogen Ltd v FCT* [2001] FCA 366 per Carr J.

66 *FCT v Sleight* [2004] FCAFC 94 at [81] and [82] per Hill J.

67 *McCutcheon and FCT* [2006] AATA 535 at [89].

¶12-320 Time

The third of the s 177D factors is "... the time at which the scheme was entered into and the length of the period during which the scheme was carried out". There are two different considerations in this factor. One is the time when the scheme was entered into, and the other is the length of time over which the scheme was carried out.

A classic indicator of a dominant purpose of obtaining a tax benefit is a "flurry of activity" around year end. This was an attribute of many of the tax-effective investment schemes.

The following extracts are from leading cases in which the third factor of s 177D was considered.

Sleight[68]

> "The scheme was entered into on the last day of the year of income. This was not accidental as it was necessary for a large portion of the deductions to be incurred in the 1995 year of income. If what may be called the tea tree or investment purpose predominated, then there would be no need for a 'flurry of activity' to occur, as it did, at the end of the year of income. The investment could be entered into at any time."

Lenzo[69]

> "Why were all the transactions, and in particular the round robin, carried out on 30 June and not on any one of the other 364 days in the year? The choice of that day had nothing to do with sandalwood production. It had everything to do with maximising the tax benefits for investors."

The relevant question is why the particular time for entering into the transaction was chosen. Commercial factors will regularly influence questions of timing of transactions.

Transactions are often timed to coincide with a year end or period end for valid commercial reasons. For example, business sale transactions will often be timed in this way so as to facilitate a clear close off of the accounts for the seller and take-over point for the purchaser. Tax may be a relevant consideration (the timing of tax payments is materially different if a business is sold in June rather than July), but the commercial rationale may also be strong.

British American Tobacco

30 June is not the only tax-sensitive date. The timing of transactions can be relevant for obtaining roll-overs or a particular tax treatment:[70]

> "The Taxpayer contends that the timing of the scheme was dictated entirely by the requirements of the global and Australian merger, particularly the timing of regulatory, shareholder and court approvals. It says that the timing and duration point towards the purpose of achieving the merger. That must be so in so far as the object of disposition to Imperial was to facilitate

68 *FCT v Sleight* [2004] FCAFC 94 at [83] per Hill J.

69 *FCT v Lenzo* [2008] FCAFC 50 at [62] per Heerey J.

70 *British American Tobacco Australia Services Ltd v FCT* [2009] FCA 1550 at [93] per Emmett J.

> the merger. However, the timing of the disposition by the Taxpayer to Rothmans was critical to achieving the tax benefit."

In the case of a wash sale transaction, the timing of the transaction to realise a capital loss is dictated by the timing of the derivation of a capital gain. The proximity of transactions to other events can be an indicator of the presence or absence of a tax purpose.

Consolidated Press

Hill J in the Federal Court decision in *Consolidated Press*[71] identified two purposes for the interposition of a company between the Australian purchaser (ACP) and the foreign target:

(1) obtaining a deduction under s 79D ITAA36 (which would constitute a tax benefit under s 177C ITAA36); and

(2) adopting a structure which would not detract from the foreign tax credit relief (which would not have constituted a tax benefit under s 177C as it stood at the time).

The question was which of these two purposes should be seen to be dominant in the Pt IVA sense:[72]

> "The s 79D advantage would be of no particular consequence unless no immediate foreign source income was anticipated to flow by way of dividend from the United Kingdom companies, for once an adequate stream of foreign income flowed, the interest deduction would be available to offset it. Until that time, on the Commissioner's interpretation of s 79D, the interest deduction would not be available to offset anything on the assumption that it could reasonably have been expected that ACP would have invested by way of share subscription in the United Kingdom. Because the structure adopted involved no foreign income being derived, the interest [expense] would be able to be deducted without regard needing to be had to s 79D, and as against Australian source income.
>
> Likewise, the tax credit advantage would arise only where foreign income was included directly or indirectly in assessable income of a resident taxpayer. That too could reasonably have been expected to arise in the future. It was, however, not an immediate problem. While it is clear on the facts that a substantial income stream was expected and that there was substantial foreign tax payable on foreign income in subsidiaries of the United Kingdom companies, it was more likely than not that any question of tax credit availability would arise in a year of income subsequent to the year in which the investment was made.
>
> With some doubt I am of the view that a conclusion would be drawn that the dominant purpose of some person who participated in the scheme ... was to bring about the result that a deduction would be allowed to the [taxpayer] which, but for the scheme, would have been disallowed to them because of the application of s 79D. I reach this conclusion because it seems to me that the interest deduction was more immediate than the adoption of a neutral structure for non interference with tax credits."

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71 *CPH Property Pty Ltd & Ors v FCT* [1998] FCA 1276.

72 *CPH Property Pty Ltd & Ors v FCT* [1998] FCA 1276.

As the High Court stated on this point:[73]

> "At this point, questions of timing became important. Once a sufficient flow of profits, and dividends, from the anticipated BAT takeover was established, s 79D would cease to matter. But the immediate problem, certainly for the year ended 30 June 1989 and probably for the year ended 30 June 1990, was that until such a sufficient flow was established the quarantine [under s 79D] was a significant problem. On the other hand, the tax credit problem lay further in the future."

Mochkin

The timing of a transaction can also be supportive of the objective purpose for the scheme or particular steps within the scheme:[74]

> "The scheme was formulated and implemented under the shadow of the Bridges litigation. The timing had little to do with tax planning, but much to do with the legal proceedings instituted by Bridges against the Taxpayer."

Eastern Nitrogen

The length of time over which a scheme is carried on can be an indicator of non-tax motivations. An ongoing scheme with ongoing implications, or where the tax benefit is obtained over a longer period of time, may be less likely to be viewed as presenting a dominant purpose of obtaining a tax benefit:[75]

> "The tax benefit was not immediate, but spread over the period of the scheme."

A longer scheme does not necessarily lead to the conclusion that the requisite tax purpose of obtaining a tax benefit is not present. For example, it was observed in many of the tax-effective investment schemes that, while the scheme was carried out over many years, the tax benefit was achieved upfront and was certain (but for its subsequent denial under Pt IVA), whereas the commercial benefits did not accrue until many years later and were contingent on various events and subject to high levels of commercial risk.

A shorter scheme does not necessarily mean that a dominant purpose of obtaining a tax benefit will be found. If short is appropriate for the commercial objectives, then short may be acceptable.

¶12-330 Tax result

The fourth of the factors in s 177D is "the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme". Assessment of this factor requires consideration of the actual tax result achieved by the scheme. The actual tax result provides a useful prism through which to view the scheme.

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73 *FCT v Consolidated Press Holdings* [2001] HCA 32 at [92].

74 *FCT v Mochkin* [2003] FCAFC 15 at [90] per Sackville J.

75 *Eastern Nitrogen Ltd v FCT* [2001] FCA 366 per Carr J.

The tax result is more than a quantification exercise. Once the tax outcome is quantified, it is instructive to assess it based on, first, relative size:

- How large is the difference between the tax result of the scheme and the tax result of the alternative postulate?
- In a relative sense, how significant/large is the tax benefit when compared to the size of the taxpayer and the value of the commercial outcomes of the scheme?

Where the tax result/tax benefit is small in an absolute sense and small in a relative sense (relative to the taxpayer's size and/or the commercial outcomes of the scheme), this factor may point to the absence of a dominant purpose of obtaining a tax benefit on the basis that the tax benefit is not significant. The contra position would also be valid.

The second issue to consider is economic gain:

- What is the true economic gain produced by the scheme?
- Has tax at the appropriate rate (eg the corporate tax rate if the taxpayer is a company) been levied on the economic gain made by the taxpayer?

Tax under Australian law is not based on a concept of economic gain as such. However, as a point to consider, it can be helpful.

If a taxpayer has made a realised gain, it would generally follow that tax would be imposed on the gain. For example, a gain made on the sale of shares would generally be taxable under the CGT provisions unless a roll-over or other concessional tax treatment applied under those provisions. If this is not the tax result of the scheme, say, because of the way in which the transaction was structured, then this s 177D factor may point towards the presence of the requisite dominant purpose of obtaining a tax benefit (as may the form and substance factor).

The last point to consider is whether the tax result/tax benefit of the scheme is a timing benefit (ie tax is shifted between income years) or a permanent benefit (ie an amount escapes tax altogether).

Part IVA is applied based on discrete income years, so a timing benefit is as much a tax benefit as is a permanent benefit. However, if these were to be placed on a spectrum, a permanent tax benefit would be more towards the "tax purpose" end of the spectrum when compared with a short-term timing benefit.

The following quotes are from leading cases which address the "tax result" factor.

Eastern Nitrogen[76]

> "Due and proper management of the business required assessment to be made of the net cost of finance after taking into account the extent to which any outgoings associated with that cost were allowable deductions from assessable income. In the circumstances of this case, to say that the appellant was attracted by a proposal that provided finance at a lower after-tax cost than another means of obtaining funds for the business would not, without more, support an objective conclusion that the appellant obtained finance for the dominant purpose of obtaining

76 *Eastern Nitrogen Ltd v FCT* [2001] FCA 366 per Lee J.

> the tax benefit constituted by the deductibility from assessable income of the outgoings incurred in connection with the obtaining of that finance.
>
> To show that a business which depends upon financiers to provide the recirculating capital needed for the operation of the business, has obtained that finance at a net cost, after taking into account provisions of the Act, that is less than the net cost of obtaining finance by another method, will not, in itself, show that the dominant, ruling or supervening purpose of the operator of the business is to obtain the tax benefit constituted by the extent to which deductible outgoings incurred in respect of that borrowing will be greater than the deductible outgoings that would have been incurred under another method of obtaining finance. That is to say, something more must be shown than that the business has obtained finance at best available net cost after-tax before it can be said that a tax benefit has arisen to which s 177C(1)(b) applies."

Hart[77]

> "The bare fact that a taxpayer pays less tax, if one form of transaction rather than another is made, does not demonstrate that Part IVA applies."

¶12-340 Change in financial and other positions

The next three factors are often considered together. They are:

> "(e) 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;
>
> (f) 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;
>
> (g) any other consequence for the relevant taxpayer, or for any person referred to in subparagraph (vi) [connected persons], of the scheme having been entered into or carried out;"

To support a position that the dominant purpose is not the obtaining of a tax benefit, it would almost always be necessary to substantiate the other objective purpose(s) of the participants in a scheme.

Being able to demonstrate material changes in the financial position of the taxpayer or other parties would normally be necessary to show a dominant purpose other than obtaining a tax benefit. The changes can be positive or negative. Changes could include:

- acquiring or disposing of an asset;
- obtaining or repaying debt funding;
- cost savings;
- deriving income or creating a revenue stream; and
- disposing of or ending a loss-making venture.

77 *FCT v Hart* [2004] HCA 26 at [53] per Gummow and Hayne JJ.

The changes for the taxpayer may be offset by corresponding changes for their associates such that, overall, little may change.

The third of the above factors (the seventh in the s 177D list) refers to other changes. The use of the word "other" suggests that the consequences to be considered are other than fiscal or financial.[78] Other factors could include:

- competitive advantages;
- improved asset protection;
- more effective succession planning; and
- simplifying a complex structure.

These points, as they apply to the taxpayer (this particular factor only refers to other connected persons, not the taxpayer), will often be relevant in other s 177D factors, for example, manner, form and substance, and timing.

Evidence is going to be important. The personal services income cases are illustrative of this. *Mochkin* succeeded for a number of reasons, including that the asset protection benefits obtained by use of a corporate structure could clearly be justified, given the recent history of litigation that the taxpayer was involved in.[79] *Case* 3/99 failed with a similar argument as there was no history of claims (successful or otherwise), and the contractual agreements actually required the other party to the contract to maintain insurance cover for such claims.[80]

To support a non-tax purpose, the change in financial and other positions should be consistent with the substance of the scheme and what would be expected to be the normal commercial implications of the transactions that have been entered into.

In *Hart's* case, the court observed that:[81]

> "... other things being equal, it may make commercial sense for a taxpayer who is considering the relative levels of borrowing to be undertaken for the purposes of acquiring a residential property, and an investment property, respectively, to arrange for the latter to be more highly geared than the former. If such a taxpayer took out two separate loans, and the terms of the loan for the investment property were different from the terms of the loan for the residential property in that they provided for a higher ratio of debt to equity, and for payments of interest only, rather than interest and principal, during a lengthy term, then ordinarily that would give rise to no adverse conclusion under s 177D. It may mean no more than that, in considering the terms of the borrowing for investment purposes, the taxpayer took into account the deductibility of the interest in negotiating the terms of the loan. How could a borrower, acting rationally, fail to take it into account?"

78 *Eastern Nitrogen Ltd v FCT* [2001] FCA 366.

79 *FCT v Mochkin* [2003] FCAFC 15.

80 *Case 3*/99, 99 ATC 134.

81 *FCT v Hart* [2004] HCA 26 at [3] per Gleason CJ and McHugh J.

However, what the court noted in respect of the wealth optimiser loan feature was that capitalisation of interest on the investment property portion of the loan would have the result that the loan balance would increase to a point where it exceeded the value of the investment property. This distinguishes it from a "two loan" scenario. It would mean that the primary residence would need to be maintained as security for the investment property portion of the loan. The apparent benefits of paying off the home loan sooner were illusionary, not real.

How the tax result/tax benefit impacts on the change in financial position is important. Does the change in financial position cause the tax result, or does the tax result cause the change in financial position?

Spotless[82] is a good example of this. The interest rate on the investment was actually lower than the rate on an equivalent Australian-based investment. However, the tax treatment (the exemption) meant that, on an after-tax basis, the taxpayer was actually better off. The change in financial position of the taxpayer in this case was more a result of obtaining the particular tax result, rather than the investment of funds.

Hill J noted in *Sleight*[83] that the deductions obtained were considerably in excess of the funds contributed, and the return on the commercial interest in tea trees which the outlays obtained was considerably less certain than the tax benefit. These factors pointed to a dominant purpose of obtaining a tax benefit.

Below are extracts from cases which considered these three s 177D factors.

Hart[84]

> "The 'wealth optimiser structure' depended entirely for its efficacy upon tax benefits generated by arrangements between the respondents and the lender that had no explanation other than their fiscal consequences. What 'optimised' the respondents' 'wealth' was the tax benefit earlier described: not the deductibility of interest as such; but the deductibility of additional interest on loan account 2 contrived by the particular form of the borrowing transaction."

Eastern Nitrogen[85]

> "The evidence shows that there were some significant changes in the financial position of the appellant which resulted from the scheme. First, the scheme resulted in the appellant having $71.4 million in cash available to it for the purposes of its business. Secondly, it can be seen that instead of being reliant from time to time upon the short-term money market, the appellant secured a financial facility which extended over a period of 5 years. Again in financial terms, the scheme reduced its exposure to interest rate risks. The appellant had previously relied on short-term debt for its largely seasonal or cyclical financial requirements. It had to take rates

82 *FCT v Spotless* [1996] HCA 34.

83 *FCT v Sleight* [2004] FCAFC 94 at [88] per Hill J.

84 *FCT v Hart* [2004] HCA 26 at [18] per Gleason CJ and McHugh J.

85 *Eastern Nitrogen Ltd v FCT* [2001] FCA 366 per Carr J.

> on offer from time to time. Under Clause 3 of the Agreement for Lease the appellant had the right to choose between a variable rate of interest or a fixed rate of interest to be applied in the calculation of the rental for the year in question or for two years, or for three years or for the balance of the term of the lease."

The evidence presented to the court included a subsequent report prepared on the company by a ratings agency noting that "it will substantially lengthen the company's debt maturity profile and help reduce the average costs of finance".

Citigroup[86]

> "Put shortly, while HKBT 2003 [being the arrangement under consideration] was pre-tax positive, it was post-tax negative prior to taking into account the foreign tax credits arising from the payment of Hong Kong Profits Tax on the transaction; this was so, irrespective of whether or not the pre-tax profit was inclusive of a 'margin' over cost of funds utilised in the transaction.
>
> Moreover, CPL's other foreign source income facilitated the immediate utilisation of the foreign tax credits.
>
> In my view, these are matters which point strongly in the direction that the conclusion to be drawn by the Court under s 177D, having regard to the matters set out in subparas (i) to (v) inclusive of para (b) thereof, is that CPL entered into HKBT 2003, and it follows HKBT 2004, with the dominant purpose of obtaining a tax benefit in the form of those foreign tax credits.
>
> I believe this to be consistent with what Mr John Walker [of Citigroup] said in response to a question I put to him during the course of his cross-examination (T-120):
>
>> 'So a decision to use an Australian company as the bond purchaser had been decided upon before this memorandum was written? — I think that is correct.
>>
>> Yes?— Because, in essence, we knew that — that vehicle — or Citibank — Citigroup Proprietary Limited would be actually paying the tax itself in Hong Kong. So if we didn't have the ability to then claim that back as an FTC in Australia, we are obviously — we are underwater by $12 million. *So the transaction then made no sense. So it was critical that we actually broke even in a tax sense*, and then we had the benefit of that upfront payment from the Bank of China, which, in essence, was 65 per cent of the Hong Kong tax benefit.' [emphasis added]
>
> Mr Walker's response has a resonance with what was said in *Spotless* at 422 in the joint judgment when referring to the dissenting judgment of Beaumont J in the Full Court. Absent the foreign tax credits, the HKBTs did not make sense."

Case Y4[87]

> "I am furthermore satisfied that both Dr Kildare and Mr Halbert were keenly alive to the taxation benefits to be derived from entering the mortgage agreement with the National Australia Bank Ltd, as evidenced by the doctor's cross-examination extracted above. It is true that for a fleeting moment in time, some $40,000 found their way into the hands of Kildare. However, put

86 *Citigroup Pty Ltd v FCT* [2010] FCA 826 at [142]-[146] per Edmonds J.

87 *Case* Y4, 91 ATC 114.

> bluntly, the purpose of substituting one mortgagee for another was to create a tax deduction by recourse to an 'incestuous' relationship of prohibited degree; cf sec 177D(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.' Such 'incest' creates a tax benefit to which Part IVA applies — in this case the conversion of a non-deductible interest payment on a domestic home into a deductible expenditure in the accounts of the company."

¶12-350 Nature of connections

The last of the s 177D factors is "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) [connected persons]". This factor can be relevant on its own, but also (and commonly) in conjunction with consideration of other factors.

An oversimplification, but one which illustrates the point, would be to compare a commercial transaction on arm's length terms negotiated between unrelated parties with a non-commercial transaction on non-arm's length terms between related parties. It is clear which would be more indicative of a dominant purpose of obtaining a tax benefit.

This factor looks more broadly than merely related/unrelated parties. For example, business relationships are relevant. This factor can be important when considering the purpose of a third party (such as an adviser) who is a participant in the scheme. The purposes and motivations of third parties connected by a business relationship may often be explained by reference to the nature of that business relationship.

The nature of a connection may take on more relevance in particular factual circumstances. An unrelated but connected party may act not in their own interests as such, but for the purpose of obtaining benefits for the taxpayer (tax or otherwise). An employee/employer, supplier/major customer, or economic dependence (business or personal) relationship may be indicative of such situations.

The unique situation of family arrangements can be relevant. It is only to be expected that family members will enter into transactions and arrangements that arm's length parties would not. There will be things that will be done on a concessional basis between family members, eg the gifting of assets, interest-free loans etc. Factors such as succession planning, the *Family Law Act 1975* (Cth) and the sharing of property between husband and wife are unique to family relationships and may provide a relevant context in a Pt IVA analysis.

Section 4

The case law

This section of the guide includes a summary of each of the main cases decided in respect of Pt IVA. The summaries include an outline of the core facts and an explanation of the main reasons that Pt IVA was held to apply or not apply. Where the case contributes significantly to the interpretation and understanding of Pt IVA, the key points (takeaways) from that case are discussed.

Most of the major cases are also referred to in the discussion in section 3 of this guide.

Understanding the case law is important in being able to interpret and apply Pt IVA. It is the case law which has provided the “meat” to the “bones” of the words of the legislation.

The four foundation cases that form the core of the interpretation of Pt IVA are *Peabody*, *Spotless*, *Consolidated Press* and *Hart*. These cases are discussed in chapter 13.

The remaining cases can be divided between other Federal Court decisions and those dealing with tax-effective investment schemes. The discussion of these cases is grouped on this basis and presented in chronological order in chapters 14 and 15.

Chapter 13

Foundation cases

¶13-100 Peabody

Case name: FCT v Peabody
Court: High Court of Australia
Year: 1994
Reference: [1994] HCA 43
Decided: Taxpayer (7:0)
Judges: Mason CJ, Brennan, Deane, Dawson, Toohey, Gaudron and McHugh JJ

Part IVA trigger

Peabody was the first High Court decision on Pt IVA and is one of four "foundation cases". Along with *Spotless*, *Consolidated Press* and *Hart*, these foundation cases form the basis for much of the current interpretation of Pt IVA.

Although *Peabody* was decided in favour of the taxpayer, the court did consider that there was a tax benefit in respect of a scheme to which Pt IVA applied. The Commissioner simply selected the wrong taxpayer — the tax benefit did not relate to Mrs Peabody.

Key for the High Court was the fact that there was a step within the scheme that served no real purpose but for reducing a gain that would have otherwise arisen and triggered a tax liability. This step was the devaluation of the shares through changing their rights (note: this is something that the value shifting provisions could now apply to).

In a nutshell

Mrs Peabody was a beneficiary of the Peabody Family Trust that had owned shares in a group of companies which conducted a fly ash business (Pozzollanic Group). The holding company was listed on the stock exchange and a substantial gain was made on the disposal of the shares. The gain was non-taxable as the shares were pre-CGT.

In preparation for listing, the trust established a new wholly owned company (Loftway) that was used as the vehicle to buy out a minority shareholder in the business (Mr Kleinschmidt). By using Loftway to acquire the shares rather than the Peabody Family Trust, the cost of finance was able to be reduced.

Mr Kleinschmidt did not want the price of his shares to be disclosed publicly and so a plan was developed in respect of those shares to remove the need to disclose this transaction in the prospectus for the listing. (The price was $8.6m — it's proudly stated in the fourth paragraph of the High Court decision. Mr Kleinschmidt's plan didn't turn out as intended.)

An element of the plan (which is the element that the High Court decision focuses on) was a change in the rights of the shares acquired by Loftway from Mr Kleinschmidt. The change in rights effectively stripped all value from these shares (the value dropped from $8.6m to $476). This meant that these shares did not need to be sold as part of the float and the transaction with Mr Kleinschmidt did not need to be disclosed in the prospectus.

So where is the tax issue? The shares acquired from Mr Kleinschmidt were to be resold within 12 months at a profit as part of the listing process. Any such profit would be included in taxable income under the former s 26AAA ITAA36. By devaluing the shares through varying the rights, this gain was avoided.

The High Court agreed with the Commissioner that a tax benefit arose in connection with a scheme to which Pt IVA applies. The High Court decided in favour of the taxpayer, though for one reason — the Commissioner picked the wrong taxpayer. The tax benefit was not obtained by Mrs Peabody, it was obtained by Loftway.

Key takeaways

Peabody was the first Pt IVA case to be decided by the High Court and so it forms the seed of many of the interpretations of Pt IVA that we now apply. Two key points to take from this case are:

(1) the role of "scheme" in Pt IVA; and

(2) the interpretation of "reasonably be expected".

Role of "scheme" in Pt IVA

Scheme, along with "tax benefit" and "purpose", is one of the key concepts in Pt IVA. The definition of a scheme in Pt IVA was recognised as being a "very wide definition".

For Pt IVA to apply to cancel a tax benefit, the tax benefit must arise in connection with the scheme. In addition, the dominant purpose of a participant in the scheme must be to obtain the tax benefit for the taxpayer. If the dominant purpose exists in respect of part of a scheme but not the scheme as a whole, Pt IVA cannot be applied to the part of the scheme.

The court indicated that it was possible "to conceive of a set of circumstances which constitutes only part of a scheme and not a scheme in itself", although it does not give any examples other than saying "[t]hat will occur where the circumstances are incapable of standing on their own without being 'robbed of all practical meaning'".[1]

Given that a scheme can include a unilateral action, there will probably only be very limited circumstances where something constitutes only part of a scheme and not a scheme in itself.

The Full Federal Court (in deciding for the taxpayer)[2] had stated that the Commissioner needed to identify a scheme and, once that scheme was identified, it was the only relevant scheme, and the decision on Pt IVA applying needed to be made in respect of that scheme and that scheme alone.

The High Court disagreed. While the Commissioner needed to supply details of the scheme being relied on, "the Commissioner is entitled to put his case in alternative ways". What this means in practice

1 *FCT v Peabody* [1994] HCA 43 at [28].

2 *Peabody v FCT* [1993] FCA 74.

is that the Commissioner can propose a range of different schemes and see whether any one of them fulfils the requirements of Pt IVA.

The way that this tends to be applied is through the identification of a broad scheme (ie the whole series of events undertaken by the taxpayer) and then a narrow scheme within the broader scheme (ie only those steps directly related to the tax benefit).

A broader scheme may have an overriding commercial purpose. This was the case in *Peabody*, where the overall scheme had the commercial purpose of listing the company. However, the narrow scheme — in *Peabody's* case, the devaluation of the shares — was not necessary to achieve the overriding commercial purpose. Considered as a scheme itself, the devaluation indicated the dominant purpose of achieving a tax benefit.

Interpretation of "reasonably be expected"

Section 177C(1)(a) ITAA36 provides that a tax benefit includes "an amount not being included in the assessable income of the taxpayer of a year of income where that amount would have been included, or might *reasonably be expected* to have been included, in the assessable income of *the taxpayer* of *that year of income* if the scheme had not been entered into or carried out" (emphasis added).

The trustees of the Peabody Family Trust had resolved to distribute the whole of the income of the trust (including amounts arising as a result of amended assessments) equally among Mrs Peabody and two other beneficiaries.

Absent the scheme, the Commissioner considered that it was reasonable to expect that Mrs Peabody would have included one-third of the profit arising under s 26AAA ITAA36 (on the sale of the shares acquired from Mr Kleinschmidt) in her assessable income in that year. The High Court disagreed.

The actual purchaser of the shares was Loftway. This was a rational, commercial decision as it enabled cheaper finance to be obtained. The Commissioner did not challenge this decision.

The action which gave rise to the tax benefit was the devaluation of the shares after they had been acquired by Loftway. If this step had not been entered into, a taxable gain would have arisen for Loftway. There was no reasonable expectation that Loftway would have declared a dividend to the Peabody Family Trust in that year of income, and so no reasonable expectation that the Peabody Family Trust would have in turn distributed that gain to Mrs Peabody.

Alternatively, it was not considered reasonable that the trustee of the Peabody Family Trust (TEP Holdings) would have acquired the shares from Mr Kleinschmidt (either as trustee or in its own right). If TEP Holdings was the purchaser, the arrangements which enabled access to cheaper finance would not have been possible.

The High Court stated:[3]

> "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 ...
>
> But the method adopted by Loftway, apart from the devaluation of the Kleinschmidt shares, was found below to be *entirely explicable upon a commercial basis* and it could not be said of any of the examples advanced [by the Commissioner as the alternative postulate] that, even if commercially possible, they would have been adopted in the absence of the devaluation as a matter of reasonable expectation." (emphasis added)

¶13-105 Spotless

Case name:	FCT v Spotless Services Ltd
Court:	High Court of Australia
Year:	1996
Reference:	[1996] HCA 34
Decided:	Commissioner (7:0)
Judges:	Brennan CJ, Dawson, Toohey, Gaudron, McHugh, Gummow and Kirby JJ

Part IVA trigger

Spotless was the second High Court decision on Pt IVA and it is one of the four foundation cases.

In *Spotless*, the factor that made the Cook Islands investment attractive was the tax treatment. The interest income was exempt income under s 23(q) ITAA36, meaning that, although the interest rate was some 4% lower than the rate available for a similar investment in Australia, the after-tax return was actually higher.

Making the investment was a significantly more complicated process than a standard term deposit-style investment. The complexity was needed to achieve the tax outcome, as well as to achieve particular commercial objectives, specifically, to ensure that the investment was adequately secured (which would not have been an issue if the funds were deposited with a major Australian bank).

Although the investment funds never actually left Australia, the form of the transactions was designed so as to ensure that the source of the interest was in the Cook Islands and the exemption under s 23(q) was obtained.

Without the tax benefit, the arrangement "made no sense".

In a nutshell

Spotless Services Ltd and an associated company, Spotless Finance Ltd, had approximately $40m of surplus funds available for short-term investment.

3 *FCT v Peabody* [1994] HCA 43 at [31] and [34].

Mr Williams, the Executive Director, Finance, of Spotless Services, invited proposals from a number of financial institutions for the short-term investment of the money. The proposals included both Australian-based and overseas-based investments. The proposals were evaluated and the Cook Islands proposal was selected.

Implementing the arrangement was complicated. This was not a matter of merely opening an account and depositing funds into it. The outline in the High Court decision provides good context. Relevantly, the funds were held (prior to the transactions) in an account with Westpac and, after the transaction, the funds continued to be held in an account (albeit a different one) with Westpac.

Key takeaways

"Amount" of the tax benefit

The tax benefit is based on the additional amount that would reasonably be expected to be included in assessable income but for the scheme.

Spotless Services Ltd contended that "the amount" should be the Cook Islands interest and that, absent the scheme, the Cook Islands interest would not have been derived (as no investment in the Cook Islands would have been made) and so, by definition, no tax benefit arose.

The court rejected this argument, stating that the amount referred to in the tax benefit definition is identified more generally. The amount that would reasonably be expected to be included in assessable income but for the scheme is that amount of assessable income that would arise under the transactions that the taxpayer would reasonably be expected to undertake but for the scheme, ie the alternative postulate.

Framing the alternative postulate

In the *Spotless* case, it was clear from the evidence that the company was determined to place the $40m in a short-term investment. The company had considered and dismissed all other overseas investment options presented to it. The reasonable expectation was therefore that, if it had not invested in the Cook Islands, the company would have invested the funds in a similar short-term interest-bearing investment in Australia.

The argument that no investment would have been made was discounted as the facts clearly demonstrated the company's intent to make some sort of short-term investment. The court's reasoning on this point is quite consistent with what the new s 177CB ITAA36 requires.

Apparent commercial purpose

Spotless was a case where the transactions were both "tax-driven" and "commercially driven". The commercial objective was to maximise the after-tax income generated from the investment. The tax effect of the transactions was clearly central to this.

Part IVA cannot apply merely because the most tax-effective way to undertake a transaction is chosen. Part IVA only applies if the dominant purpose of a participant in the scheme is to obtain a tax benefit for the taxpayer.

As the High Court noted:[4]

> "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 ...
>
> A person may enter into or carry out a scheme, within the meaning of Pt 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."

It was clearly stated in the materials promoting the investment that a tax exemption for the interest income could be obtained in Australia. The possibility of Pt IVA applying was considered in a legal opinion appended to the proposal provided to Spotless Services Ltd. Tax was clearly central to the design of this investment.

The interest rate on the investment was some 4% lower than the interest rate available on a similar short-term investment in Australia. What made the transaction attractive was not the interest rate, but the tax exemption.

The funds did not leave Australia. It was the form of the transaction that caused in the interest income to be sourced in the Cook Islands and eligible for the tax exemption.

The arrangements to implement the investment were significantly more complex that what would normally be required to make a short-term investment of funds (eg a standard term deposit).

As stated by McHugh J in his separate concurring judgment:[5]

> "The facts of the present case show much more than a switch of investments resulting in a tax benefit. The elaborate nature of the scheme and its attendant circumstances lead inevitably to the conclusion that the scheme was not merely tax driven but that its dominant purpose was to enable the taxpayer to obtain a tax benefit by participating in the scheme."

4 *FCT v Spotless Services Ltd* [1996] HCA 34.

5 *FCT v Spotless Services Ltd* [1996] HCA 34.

¶13-110 Consolidated Press

Case name:	FCT v Consolidated Press Holdings Ltd
Court:	High Court of Australia
Year:	2001
Reference:	[2001] HCA 32
Decided:	Commissioner (5:0) in respect of the core Pt IVA issue. The dividend stripping issue was decided in favour of the taxpayer.
Judges:	Gleeson CJ, Gaudron, Gummow, Hayne and Callinan JJ

Part IVA trigger

Together with the earlier decisions in *Peabody* and *Spotless* and then the later decision in *Hart*, *Consolidated Press* is one of the four foundation cases on Pt IVA.

In *Consolidated Press*, based on specialist tax advice, a step was inserted into a (broadly) otherwise commercially focused transaction. That step was the interposition of the Murray Leisure Group Pty Ltd between CPH Property Pty Ltd (formerly Australian Consolidated Press Ltd) and an overseas investment.

By interposing the company, a tax deduction was available for interest where, if a direct investment had been made in the overseas entity, that interest would have been subject to quarantining under the foreign-sourced income provisions. This aspect of the transaction did little to alter the commercial (non-tax) outcomes of the transaction, but it fundamentally altered the tax outcomes.

In a nutshell

Consolidated Press (Finance) Ltd acted as an internal finance entity for the group, and it lent funds at interest to CPH Property Pty Ltd. The funds were intended to finance an overseas acquisition (of British American Tobacco).

Rather than invest directly in the overseas entity, CPH Property Pty Ltd acquired shares in Murray Leisure Group Pty Ltd, which in turn acquired shares in the overseas entity.

The structure addressed two tax issues:

(1) in the initial years when no income was being derived from the overseas investment, the structure enabled CPH Property Pty Ltd to claim a tax deduction for its interest expenses, rather than have the deduction quarantined and deferred until sufficient foreign-sourced income was derived; and

(2) in the later years once income was being derived, the structure meant that foreign-sourced passive income was attributed to and taxed in Australia, generating franking credits and avoiding a double taxation issue.

In a previous overseas transaction, CPH Property Pty Ltd had taken a direct equity investment in an overseas entity. The transaction was complex and so, understandably, the taxpayers sought specialist advice on the tax issues. The structure that was implemented was based on the advice received.

Key takeaways

Timing

Timing was important in the *Consolidated Press* case for two reasons.

First, Hill J in the original decision[6] noted that the application of Pt IVA can only be tested with respect to the obtaining of a tax benefit in accordance with the law as applicable to the time when the scheme was entered into and by reference to the law as it stood at that time. It cannot be tested retroactively after the scheme has been entered into merely because, in the meantime, the law has changed. The time for testing dominant purpose must be the time when the scheme was entered into or carried out and by reference to the law as it then stood.

Second, in respect of timing as a factor under s 177D ITAA36, two purposes were identified regarding the scheme: the interest deduction/s 79D issue, and the franking credit issue. The question was, which of these two purposes should be seen as dominant in the relevant sense.

The interest deduction issue was immediate. The scheme addressed this tax issue (allowing for deductibility of the interest). The franking credit issue was something that would arise in the future and was contingent on the generation of profits in the overseas entity that would be repatriated to the Australian shareholder. While it could reasonably be expected to arise, it was not an immediate issue.

The immediacy of the interest deduction issue was a key factor in supporting a conclusion that the relevant purpose existed for the application of Pt IVA.

Selection of the scheme

The original Federal Court decision by Hill J politely criticised the narrow approach to identification of the scheme applied by the Commissioner, but accepted that this was permitted based on the *Spotless* decision:[7]

> "It might perhaps be said that one of the problems in the present case lies in artificially dissecting part of a scheme from the totality of the scheme adopted. The arrangement as a whole was directed to a commercial end much more significant than tax. Part of the structure was devised because of tax, but the separating out of the tax and non tax benefits leaves outside the structure both the borrowing of ACP and the subscription of monies for shares by CPIL(UK). That, however, is a consequence of the decision of the High Court in *Spotless*."

This same narrow scheme was accepted by the Full Federal Court and the High Court on appeal.

6 *CPH Property Pty Ltd & Ors v FCT* [1998] FCA 1276.

7 *CPH Property Pty Ltd & Ors v FCT* [1998] FCA 1276.

The High Court stated that:[8]

> "The fact that the overall transaction was aimed at a profit making does not make it artificial and inappropriate to observe that part of the structure of the transaction is to be explained by reference to a s 177D purpose. Nor is there any inconsistency involved, as was submitted, in looking to the wider transaction in order to understand and explain the scheme, and the eight matters listed in s 177D."

If it was required, the decision in *Consolidated Press* confirmed that a discrete part of an overall arrangement can be identified as the scheme to which Pt IVA applies. This is particularly relevant to cases like *Consolidated Press*, where a specific action is inserted into a commercial arrangement so as to achieve a desired tax outcome.

Global assessment

The original Federal Court decision by Hill J did not include an explicit consideration of each of the eight factors in s 177D. Rather, the decision included an overall discussion of the arrangement and then a conclusion as to the requisite purpose for Pt IVA to be enlivened.

On appeal to the Full Court, the taxpayer criticised the original decision on the basis that Hill J had failed to have regard to the eight factors in s 177D. A decision as to purpose that does not have regard to these eight factors would be flawed.

The Full Federal Court made the following comments:[9]

> "In approaching the application of s 177D(b) under the heading, 'The Section 177D Conclusion', his Honour went directly to the question of dominant purpose and dealt with it holistically without adverting expressly to each of the eight matters that must be considered in reaching a conclusion on purpose. The section requires the decision-maker, be it the Commissioner or the Court, to have regard to each of these matters. It does not require that they be unbundled from a global consideration of purpose and slavishly ticked off. The relevant dominant purpose may be so apparent on the evidence taken as a whole that consideration of the statutory factors can be collapsed into a global assessment of purpose."

Despite this decision, the generally accepted approach is to work through each of the eight factors and assess whether they point towards or away from the requisite dominant purposes of obtaining a tax benefit, or if they are neutral. Taking this approach would be prudent when trying to evaluate the potential application of Pt IVA or argue a matter in the course of an ATO audit.

Purpose of the adviser

Consolidated Press was the first decision where the purpose of the adviser was instrumental in supporting a conclusion that the requisite dominant purpose was present.

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8 *FCT v Consolidated Press Holdings Ltd* [2001] HCA 32 at [96].

9 *FCT v Consolidated Press Holdings Ltd* [1999] FCA 1199 at [93].

Hill J in the original Federal Court decision concluded on Pt IVA as follows:[10]

> "... I am of the view that a conclusion would be drawn that the dominant purpose of some person who participated in the scheme, and in particular those (perhaps not Mr Cherry, but there were others) who advised the group at Arthur Young and later Ernst & Young, was to bring about the result that a deduction would be allowed to the Applicants which, but for the scheme, would have been disallowed because of the application of s 79D."

The Full Federal Court agreed with this conclusion, stating that it should be read in light of the evidence that, on matters of this kind, the officers of the company relied on the advice of their tax advisers.

The High Court stated that the scheme, as defined, was conceived by the tax advisers and adopted by the taxpayer. It would be expected that those who participate in a complex, international, commercial transaction will be concerned about its tax implications, and will seek expert advice:[11]

> "Attributing the purpose of a professional advisor to one or more of the corporate parties in the present case is both possible and appropriate. In some cases, the actual parties to a scheme subjectively may not have any purpose, independent of that of a professional advisor, in relation to the scheme or part of the scheme, but that does not defeat the operation of s 177D. If, in the present case, there had been evidence which showed that no director or employee of any member of the Group had ever heard of s 79D, that would not conclude the matter in favour of the taxpayer. One of the reasons for making s 177D turn upon the objective matters listed in the section, it may be inferred, was to avoid the consequence that the operation of Pt IVA depends upon the fiscal awareness of a taxpayer."

It should be noted that the actual or subjective purpose of the adviser is irrelevant. That the adviser advised on tax and on ways to structure around a tax issue is irrelevant to a conclusion on dominant purpose. A better way of looking at the decision is that it takes away a potential argument by a taxpayer that they merely implemented the transaction as advised and had no understanding or appreciation of the tax implications.

10 *CPH Property Pty Ltd & Ors v FCT* [1998] FCA 1276.

11 *FCT v Consolidated Press Holdings Ltd* [2001] HCA 32 at [95].

¶13-115 Hart

Case name: FCT v Hart

Court: High Court of Australia

Year: 2004

Reference: [2004] HCA 26

Decided: Commissioner (5:0)

Judges: Gleeson CJ, McHugh, Gummow, Hayne and Callinan JJ

Part IVA trigger

Hart was the last of the four "foundation cases" in Pt IVA (the others being *Peabody*, *Spotless* and *Consolidated Press*).

While the court was unanimous in concluding that Pt IVA applied, three separate judgments were delivered and each judgment provides a different approach to reaching that conclusion. That has meant that the decision not only addressed existing questions of interpretation, but it also raised others.

The particular form of transaction adopted by the taxpayer (the wealth optimiser feature) was explainable only by reference to the tax benefits that it produced, as it had no other material effect on the taxpayer or other parties to the transaction.

In a nutshell

Hart was a test case relating to the deductibility of interest under a "split loan facility". Under a split loan facility, a taxpayer borrowed money, applied part of it to a private or domestic venture (in this case, the purchase of a principal place of residence), and applied the balance of it to the acquisition (here, the refinancing) of an asset to be used for the purpose of gaining or producing assessable income.

The loan agreement provided for the borrower to direct the application of the whole of the periodical payments required under the loan agreement to the satisfaction of that part of the loan used for private or domestic purposes. Interest on the balance of the loan was allowed to accrue and be capitalised and compounded.

Because the payments required under the loan agreement would repay the whole of the capital sum lent and the interest which would accrue during the term of the loan, the application of payments to only part of the loan and associated interest (the private portion) would repay that part of the loan quickly.

In the meantime, the amount of interest charged on the balance of the loan would increase, and the capital sum owing on that account would rise, as interest was capitalised and then compounded. On the basis that this second part of the loan was applied to acquire an asset used for the purpose of gaining or producing assessable income, the taxpayer would seek to claim the amount of interest charged as a deduction.

The taxpayers (Mr and Mrs Hart) borrowed $298,000 from Permanent Custodians Ltd. Austral Mortgage Corporation Pty Ltd (Austral) acted as agent for the lender and negotiated the terms on which the taxpayers borrowed the money. The Harts applied $95,112 of that sum to repay the amount outstanding on the mortgage of an investment property. The balance of the amount borrowed ($202,888) was applied to pay the purchase price of a house which they intended to occupy, some expenses that they incurred, and an amount owing on a property which Mrs Hart's mother owned which was to be provided as additional security for the transaction.

The taxpayers directed that all of their monthly repayments be applied in satisfaction of that part of the loan which they had used for private purposes, not the investment property portion of the loan.

Key takeaways

Connection between tax benefit and scheme

The only real major point of disagreement between the various judges who considered this case (originally in the Federal Court, then on appeal in the Full Federal Court and the High Court) centred around how the scheme should be defined and, more particularly, the connection between the tax benefit and the scheme.

The original decision accepted a narrowly defined scheme which consisted of the steps to implement the splitting of the loan but not the taking out of the loan itself.[12] The Full Federal Court felt that the borrowing itself needed to be included in the scheme:[13]

> "... it is clear that the definition of a scheme which did not include the loan itself and the incurring of interest under it could not stand on its own feet. It is the loan and the application of funds under it which gives rise to the deduction for interest, even if it is the way the loan is structured that is fastened upon by the Commissioner as indicating the tax avoidance conclusion."

The purpose that was discernible from taking out the borrowing (ie financing the two properties) is central to the Full Federal Court's conclusion that the requisite dominant purpose was not present. Relevantly, when considering just the "wealth optimiser" aspect of the scheme, the Full Federal Court indicated that the manner in which this was entered into was explicable only by taxation consequences.

Gleeson CJ and Mason J in their joint judgment agreed with the Full Federal Court that the scheme should include the borrowing itself:[14]

> "The members of the Full Court were correct to insist that it is inappropriate to exclude the fact of borrowing from the putative scheme. The tax benefit in question was the obtaining of part of a deduction of interest on borrowed money. A taxpayer is not allowed such a deduction for agreeing to a term in a contract of loan, or giving a direction about allocation of payments, or taking some other step in the exercise of rights conferred under the contract. The definition of 'scheme' in s 177A is wide, but it must be related to the tax benefit obtained. The deduction here was for the incurring of a liability to pay interest on borrowed money. The tax benefit

12 *Hart v FCT* {2001} FCA 1547.

13 *FCT v Hart* [2002] FCAFC 222 at [44] per Hill J.

14 *FCT v Hart* [2004] HCA 26 at [9] per Gleeson CJ and Mason J.

> in connection with the relevant scheme was part of an allowable deduction for interest. This, it seems to us, is what was meant by references in the judgments in the Full Court to the scheme being capable of standing on its own feet. The judges were making the point, which is undoubtedly correct, that, where the tax benefit in question is part of an allowable deduction for interest, a search for the purpose of a scheme, identified in a manner that does not include the borrowing, is not an undertaking that conforms with the requirements of the legislation. In a given case, a wider or narrower approach may be taken to the identification of a scheme, but it cannot be an approach which divorces the scheme from the tax benefit. Here, the borrowing was an indispensable part of that which produced the tax benefit. A description of the scheme that did not include the borrowing would make no sense."

However, they came to a different conclusion as to the dominant purpose, which is discussed further below.

Gummow and Hayne JJ were less concerned with the inclusion or exclusion of the borrowing from the scheme, noting that the way scheme is defined means that it may not always permit the precise identification of what are said to be all of the integers of a particular scheme. In their view, the narrow scheme — being just the split loan features and not the borrowing itself — fell within the definition of scheme. Their preferred route for resolving any apparent difficulty between the narrowly defined scheme and the identified tax benefit was to focus on the question of dominant purpose. This is what the recent amendments to Pt IVA also seek to achieve.

The varying positions are partially reconciled by a comment in the judgment of Callinan J:[15]

> "Nor is there any doubt that the respondents obtained a tax benefit under s 177C '*in connection with a scheme*'. The use of the word 'connection' is significant. It is a word of wider import than, for example, 'result'. The benefit is obvious: a deduction from each respondent's taxable income of the whole of the interest payable in respect of a loan to finance not just the acquisition or holding of an investment property but of both it and a residence, the interest on the financing of which is not tax deductible."

So, while a tax benefit must be connected with a scheme, the scheme does not need to include everything to enable the tax benefit to be calculated. When identifying the scheme, the objective is to find the steps which impact on the tax position so as to produce the different tax outcome that is the tax benefit.

After *Hart's* case, the use of a narrowly defined scheme has received greater acceptance and the interpretation of "in connection with" has been interpreted more broadly. Numerous subsequent decisions and the recent amendments would indicate that these two questions are not the "real" questions to be addressed — the real question is purpose.

15 *FCT v Hart* [2004] HCA 26 at [91] per Callinan J.

Form of the transaction

The other element which assists in reconciling the various decisions is a focus on the particular form of the transactions adopted by the taxpayers. Gleeson CJ and McHugh J described it this way:[16]

> "The benefit was not the whole of the interest on loan account 2 (the investment part of the borrowing); it was that part of the interest which resulted from the special, or non-standard, features of the arrangements between the lender and the borrowers. Those were the features to which the respondents were invited to pay attention in deciding whether to enter into the *particular* transaction. Those features, which defined the 'wealth optimiser structure' and distinguished it from 'standard financing arrangements', were definitive of the scheme in connection with which the tax benefit, identified by all four members of the Federal Court, was obtained ...
>
> It was the wealth optimiser aspect of the structure, not divorced from the borrowing, but giving the borrowing its distinctive character, that constituted the scheme."

Gummow and Hayne JJ addressed this point in their consideration of purpose (noting that their judgment emphasised the role of purpose), observing that:[17]

> "There could be no doubt in these matters that the terms on which the loan was made available were explicable *only* by the taxation consequences for the respondents. If the scheme was identified as 'all the steps leading to, and the entering into, and the implementation of the loan arrangements' the manner in which *that* scheme was entered into strongly suggested that the respondents (each a relevant taxpayer) entered into that scheme for the dominant purpose of obtaining a tax benefit."

Callinan J, in his comments concluding that Pt IVA applied, said:[18]

> "It may be that the respondents did wish to make an investment and to change their residence. These were entirely irreproachable and proper objectives. But the means adopted to achieve these results could readily, and should be objectively concluded to be a scheme for the [dominant] purpose of enabling the respondents to obtain a tax benefit, and that is so no matter which of the alternative definitions as to the width of the schemes, within which what occurred here falls, is preferred."

This aspect of the High Court's decision builds on earlier decisions where narrower schemes were put forward (*Consolidated Press*) and the tax aspects of otherwise commercial transactions were the focus of the Pt IVA analysis (*Spotless* and *Consolidated Press*). The *Hart* decision highlights the fact that attention should be directed to the choice of the transactions constituting the scheme compared with other options for achieving similar commercial outcomes.

16 *FCT v Hart* [2004] HCA 26 at [6] and [12] per Gleeson CJ and McHugh J.

17 *FCT v Hart* [2004] HCA 26 at [68] per Gummow and Hayne JJ.

18 *FCT v Hart* [2004] HCA 26 at [96] per Callinan J.

Purpose as the fulcrum

Hart's case emphasised the central role of "purpose" in applying Pt IVA. The following comments are even more relevant after the recent amendments:[19]

> "Although it will often be convenient to begin any consideration of the application of the Part by attending to the operation of these elucidating and definitional provisions, approaching a particular case in this way must not be allowed to obscure the way in which the Part as a whole is evidently intended to operate.
>
> Taking Pt IVA as a whole, it is clear that ss 177D and 177F(1) are the two provisions about which the Part pivots."

And:[20]

> "The next question, which is of purpose, is whether under s 177D the scheme is one to which Pt IVA applies. This will, in my view, in most cases be the critical question. The answer to it, both as a matter of statutory interpretation and as the Explanatory Memorandum indicates, was intended to be the fulcrum upon which most Pt IVA cases will turn, because the definition of a scheme, being as wide as it is, will relatively easily be satisfied, and the presence or absence of a tax advantage will also usually be readily apparent."

19 *FCT v Hart* [2004] HCA 26 at [36]-[37] per Gummow and Hayne JJ.

20 *FCT v Hart* [2004] HCA 26 at [92] per Callinan J.

Chapter 14

Other Federal Court cases

¶14-100 Eastern Nitrogen

Case name:	Eastern Nitrogen v FCT
Court:	Full Federal Court
Year:	2001
Reference:	[2001] FCA 366
Decided:	Taxpayer (3:0)
Judges:	Lee, Carr, Sunberg JJ

In a nutshell

Eastern Nitrogen manufactures fertiliser and for that purpose produces ammonia. It owned an ammonia plant on Kooragang Island in New South Wales. The ammonia plant was a fixture to the land.

In August 1989, Eastern Nitrogen entered into a sale and lease-back transaction with two financiers, BBL Australia Ltd (BBL) and State Bank of South Australia (SBSA) in respect of the ammonia plant.

Under an instalment purchase agreement dated 2 August 1989, Eastern Nitrogen agreed to sell the ammonia plant to the financiers. Under an agreement for lease, also dated 2 August 1989, Eastern Nitrogen agreed to lease the plant back from the financiers for a period of five years. The land to which the ammonia plant was affixed was not part of the sale and lease-back transaction. The sale transaction and the lease transaction were interdependent.

The sale price for the ammonia plant was $71.4m, which the financiers paid to Eastern Nitrogen by two instalments. Eastern Nitrogen would pay lease payments over the term of the lease of $71.4m, plus an agreed "packaging fee" and an amount calculated by way of interest.

On the expiration of the extended term, Eastern Nitrogen paid the financiers the agreed residual value of the plant and they in turn resold their interest in that plant to Eastern Nitrogen. Throughout the period of the lease, the ammonia plant remained affixed to the company's land and was operated and maintained by it for the purposes of its business of producing ammonia.

Eastern Nitrogen sought to claim a tax deduction for the full lease payments made by it under the arrangement. The Commissioner sought to disallow that portion of the lease payments which was, in his view, a repayment of the capital sum advanced to Eastern Nitrogen as opposed to interest on the sum advanced.

Key takeaway

Dominant commercial purpose

The Full Federal Court held that the sale and lease-back agreements were effective to create an equitable interest in the ammonia plant in the financiers, which was sufficient to support the "leasing" by the financiers of the ammonia plant to Eastern Nitrogen and the "taking on lease" of the ammonia plant by Eastern Nitrogen.

The lease payments were a recurrent expenditure necessarily connected with the conduct of the company's business and so were deductible under s 51(1) ITAA36.

In respect of Pt IVA, the Full Federal Court considered that the requisite dominant purpose was not present.

It was clear that Eastern Nitrogen entered into and carried out the scheme for more than one purpose. One of the purposes was to obtain a tax benefit. However, this was not considered to be the dominant purpose.

The raising of finance and achieving the financial benefits of this particular form of finance were considered to be the dominant purpose. The company ceased to be dependent on short-term finance and obtained greater control over its interest rate exposures. An independent ratings agency confirmed the positive effect of the arrangement on the company's financial position.

The conclusion of Lee J was:[1]

> "I agree ... that the facts do not show that the dominant purpose of the appellant in entering that transaction which provided for the sale and lease-back of assets of the appellant was to obtain a tax benefit. In applying s 177D it is important not to elide the question posed by Part IVA, namely, what was the dominant purpose of a relevant party in entering the transaction (or scheme), with the inquiry, would the transaction (or scheme) have been entered into 'but for' the tax benefit? The dominant purpose of the appellant was to obtain funds on the best available terms for use in the conduct of the appellant's business. The fact that the arrangements entered into to provide the funds included outgoings deductible under the Act was incidental to the purpose, but not the dominant purpose, of the transaction."

Metal Manufactures

Metal Manufactures[2] was another case occurring at the same time as *Eastern Nitrogen* which also dealt with a similar sale and lease-back arrangement. As far as the application of Pt IVA was concerned, *Metal Manufactures* was decided in favour of the taxpayer for the same reasons as *Eastern Nitrogen* and with specific reference to the decision in that case.

1 *Eastern Nitrogen v FCT* [2001] FCA 366.

2 *FCT v Metal Manufactures* [2001] FCA 365.

¶14-105 Zoffanies

Case name:	FCT v Zoffanies Pty Ltd
Court:	Full Federal Court
Year:	2003
Reference:	[2003] FCAFC 236
Decided:	Commissioner (3:0)
Judges:	Hill, Hely and Gyles JJ

In a nutshell

The relevance of the *Zoffanies* case is in the way that the evidence of the subjective purpose of parties to the scheme was taken into account by the AAT when determining the dominant purpose under s 177D ITAA36.

The actual arrangement was an R&D syndicate. The participants included the entities associated with the University of Adelaide (the original owner of the intellectual property), a United States-based investor, Cyanamid, and Macquarie Bank which structured and financed the transaction.

The R&D project related to using transgenic technology to produce more food-efficient, faster-growing and leaner pigs. While the project was successful from a technical perspective, the technology was not commercialised as government approval for human consumption of meat from transgenic animals was not granted.

Zoffanies was a part of the Macquarie Bank group of companies. The Pt IVA determination related to deductions claimed by Zoffanies in relation to the R&D syndicate under the specific R&D tax concession provisions.

The court considered an appeal by the Commissioner from the AAT decision.[3] Relevantly, the Commissioner contended that the AAT had not applied the test in s 177D correctly due to reliance on the subjective purpose of parties to the scheme. The court (not without expressing some doubt) held this to be the case and remitted the matter to the AAT.

Key takeaway

Subjective purpose

Section 177D requires a conclusion as to whether there is a person who entered into or carried out a scheme or any part of if it for the purpose (or the dominant purpose) of enabling the relevant taxpayer to obtain a tax benefit in connection with the scheme.

The conclusion required to be drawn is not a conclusion about the transaction itself but the state of mind of a person who entered into or carried out all or part of the transaction (scheme). The conclusion

3 *Zoffanies Pty Ltd and FCT* [2002] AATA 758.

is one that must be reached having regard to the eight matters in s 177D and no other matters. None of the eight matters refers to the actual purpose of any person.

While the conclusion required to be drawn is one that requires consideration of the purpose or dominant purpose of a person, that conclusion cannot take into account evidence of the actual purpose of a taxpayer or other person. The only exception would be where the actual purpose was forensically relevant to any one of the matters specifically referred to in s 177D, for example, the manner in which the scheme was entered into.

Evidence of what may be referred to as the actual or subjective purpose of the taxpayer is therefore generally irrelevant.

Section 177D requires an objective assessment of the purpose of the person. Expressed another way, it is not so much what the person states was their actual purpose (this is the subjective purpose), but what a reasonable person would consider was their purpose having regard to the eight factors in s 177D.

The AAT set out its findings as follows:[4]

> "In conclusion, the Tribunal finds that the tax deductions facilitated by s 73B and s 73CA of the Act were important influences on how the scheme was structured, and on MBL through the involvement of its wholly owned subsidiary companies. Clearly, the Government intended tax deductions to be an incentive to encourage private investment in R and D. However, while obtaining a tax benefit in connection with the scheme was undoubtedly an important purpose of the scheme, the Tribunal finds that a reasonable person would conclude that it was not the dominant purpose.
>
> MBL is in the business of banking, finance and investment. In this case, it decided to invest in the Syndicate and, in the Tribunal's view, the evidence supports a finding that this investment was its dominant purpose. The extent of Mr Phillips' [the MBL representative for this transaction] involvement in the project both in the period before the finalisation of the terms of the transaction on 30 June 1992/1 July 1992 and in the three year period afterwards, *and his stated reasons for this, described above, supports this conclusion*. Mr Phillips' evidence is, in turn, supported by that of Dr Smeaton and the Applicant's other witnesses who attested to the Bresatec team's optimism about the successful commercialisation of the transgenic pig technology. The events under consideration took place against the backdrop of the Government's tax incentives for such investments. As Hely J recognised in *Hart* (supra) at paragraph 83, 'Where the line is drawn is a matter of degree, having regard to the eight factors itemised in s 177D'. Having had regard to those factors, the Tribunal finds in favour of the Applicant." (emphasis added)

(Note the reference to the purpose of the scheme rather than the purpose of a person — the Full Federal Court felt that this was referring perhaps to a particular submission of counsel for the taxpayer.)

The court felt that the reasons were capable of being read as concerned only with objective matters. However, it can be also read as support for the view that Mr Phillips' subjective purpose was taken to be a matter which was relevant in reaching a conclusion about the taxpayer's purpose. This being the case, the test is that s 177D was not correctly applied.

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4 *Zoffanies Pty Ltd and FCT* [2002] AATA 758 at [170]-[171].

As Gyles J commented:[5]

> "I should add that I have no great surprise at the nature of the error. The difference between the actual purpose of a taxpayer, on the one hand, and the purpose which is to be imputed to the taxpayer based upon an exclusive set of criteria, on the other hand, is not without subtlety and has been misunderstood before."

¶14-110 Cumins

Case name:	Cumins v FCT
Court:	Full Federal Court
Year:	2007
Reference:	[2007] FCAFC 21
Decided:	Commissioner (3:0)
Judges:	Ryan, Tamberlin and Middleton JJ

In a nutshell

Mr Cumins was the sole trustee and a general beneficiary of a family trust (Trust 1). Trust 1 participated in a management buy-out of Cash Converters International Ltd (CCIL) in late 1997. The transaction was funded via debt from the National Australia Bank. By way of security for the debt, National Australia Trustees Ltd was appointed as custodian of the securities with a right to buy, sell and otherwise deal with the shares, and to receive any funds from dividends or sale of the shares.

On 11 June 1998, Mr Cumins as trustee sold a parcel of shares and generated a gain of $787,375.

On 12 June 1998, a second trust (Trust 2) was settled. Mr Cumins was also the trustee of Trust 2. On the same day, he sold 8 million CCIL shares to Trust 2 for $1.6m, which was market value. No bank account was opened for Trust 2 and the $1.6m was not actually paid. This transaction purported to crystallise a capital loss of $800,000.

On 30 June 1998, Trust 1 and Trust 2 transferred 4 million and 8 million CCIL shares, respectively, to Mr Cumins at market value. The gains made by the respective trusts for the year were also distributed to Mr Cumins.

The net position was that a significant number of shares had been transferred to Mr Cumins without a material net capital gain arising. At no stage was the bank informed of these transactions.

The court upheld the application of Pt IVA to disallow the capital loss. This could not be described as "a genuine transaction which crystallised losses actually incurred on the value of listed shares". There was no economic loss suffered as a result of the scheme. Beneficial ownership of the shares remained under the complete control of Mr Cumins. Legal ownership of the shares remained with the bank.

5 *FCT v Zoffanies Pty Ltd* [2003] FCAFC 236 at [91].

As Nicholson J commented in the Federal Court decision:[6]

> "... the scheme in the present case could hardly be described as 'a genuine transaction which crystallises losses actually incurred on the value of listed shares'. No economic loss was suffered as a result of the scheme. The beneficial ownership of the shares remained under the sole and complete control of the applicant who retained the power to distribute the benefit of the shares to himself and/or to such other members of his family as he thought fit and in his unfettered discretion. The legal ownership of the shares remained with the Bank as security for the debt owed by the Trust. The scheme was such that it was open for it to be found that it was in the character of a contrivance to create a capital loss for the purpose of the income tax legislation in order to reduce the amount of the net capital gain that the Trust would otherwise be required to return by reason of other sales that had given rise to capital gains."

This case is the basis of the case study in ¶8-125.

Key takeaway

Section 177F determination process

One of the arguments made before the court was that the wording of s 177F ITAA36 (under which the Commissioner makes a Pt IVA determination) requires the Commissioner to exercise discretion or form an opinion before issuing a determination. This was on the basis that the section provides that the Commissioner "may" issue a determination. It was purported, therefore, that additional factors could (and should) be taken into account by the Commissioner when deciding whether to issue a determination.

The court rejected this argument, holding that, once the conclusion under s 177D was reached, there was no "superimposed obligation" to take into account other matters when deciding whether to cancel a tax benefit.

The decision to cancel a tax benefit under s 177F(1) does not involve two stages. Once the Commissioner is empowered to cancel a tax benefit because the requirements in s 177D are satisfied, there is no further opinion that he has to form. It follows that the power to cancel a tax benefit under s 177F(1) may be discretionary in the sense that it is not compulsory for the Commissioner to exercise the power, but it is not discretionary in the sense of being dependent on his forming an opinion, or state of satisfaction, which could be subject to judicial review.

6 *Cumins v FCT* [2006] FCA 43 at [37].

¶14-115 McCutcheon

Case name:	McCutcheon v FCT
Court:	Federal Court
Year:	2008
Reference:	[2008] FCA 318
Decided:	Commissioner (1:0)
Judge:	Greenwood J

In a nutshell

Mr and Mrs McCutcheon, through various controlled entities, owned two businesses — a fuel distribution business in Townsville and a related fuel retail business. Shell had approached them with a view to acquiring the businesses.

The McCutcheon's intended to acquire two new businesses. However, the tax cost of the sale of the existing businesses meant that insufficient funds were available to finance the acquisition of the new businesses.

The taxpayers' accountant referred them to Cleary & Hoare who designed a series of transactions (35 steps in all) whereby the tax on the sale transaction was reduced to nil. The arrangement involved the utilisation of existing losses incurred by another entity unrelated to the taxpayers but rather "supplied" by the law firm. Put crudely, the profit was "washed" through the loss entity.

The Commissioner made Pt IVA determinations to assess the trustee of the McCutcheon's family trust (P & A Trust) or, alternatively, Mr and Mrs McCutcheon as beneficiaries of the trust (as to 50% each), on the gain made on sale of the businesses.

The court concluded that Pt IVA applied to the arrangement.

Key takeaways

Evidence of subjective intent

The Commissioner's alternative postulate was based on the premise that the gain made by the trust would be distributed 50% to Mr McCutcheon and 50% to Mrs McCutcheon.

Mr McCutcheon sought to establish that, had the scheme not been entered into or carried out, the trustee would not have made the distributions to him and his wife:[7]

> "Further, the P & A Trust has never distributed large amounts of income to either my wife or I and *would never have distributed such a substantial portion to either my wife or I*."

The court considered that it was perfectly clear that a deponent, when seeking to demonstrate (and discharge the onus of proof) that an assessment is excessive having regard to a prediction as to whether

7 *McCutcheon v FCT* [2008] FCA 318 at [36].

an amount might reasonably have been included in the assessable income of the taxpayer, cannot simply give evidence that the answer is to be found in the deponent speculating as to what he or she would or would not have done in the absence of the scheme.

While a taxpayer can state what they would have done, but for the scheme, the statement needs to be supported by evidence and foundation facts. In this case, Mr McCutcheon did not put forward anything other than the history of distributions and his desire to make the most tax-effective distributions possible to support his assertion.

The Commissioner, although not bearing the onus, sought to support the alternative postulate on the following basis:

- the McCutcheons ultimately owned and controlled each of entities in the group;
- they were the economic owners of the income derived from the sale of the businesses leading to the adoption of the scheme;
- they led no evidence as to what distributions would have been made by the P & A Trust, if any, had the scheme not been entered into; and
- the history of distributions was not reflective of likely future distributions due to changes in the situation of the beneficiaries, eg the vesting of trusts, the utilisation of prior year tax losses.

The AAT in the first instance and the court on review were satisfied that the alternative postulate proposed by the Commissioner was reasonable. Further, and more importantly, they were of the view that the taxpayer had failed to lead evidence which demonstrated a basis for concluding that the prediction or hypothesis of the Commissioner was unreasonable. Thus, the appellants failed to discharge the onus of demonstrating that an assessment reliant on the determination was excessive.

As Greenwood J stated in the Federal Court decision:[8]

> "It is perfectly clear that a deponent in seeking to demonstrate (and discharge the onus of proof) that an assessment is excessive having regard to a prediction as to whether an amount might reasonably have been included in the assessable income of the taxpayer, cannot simply give evidence that the answer is to be found in the deponent speculating as to what he or she would or would not have done in the absence of the scheme (*WD & HO Wills (Australia) Pty Ltd v FCT* (1996) 65 FCR 298). The Commissioner accepted in the course of argument on the appeal that it is perfectly proper for a deponent in the position of Mr McCutcheon to say in evidence that the trustee (controlled by the taxpayers) would not have made distributions of the amounts postulated by the Commissioner to the taxpayers, provided the foundation for that observation or conclusion is given in evidence. In other words, Mr McCutcheon might have said that 'the trustee would never have distributed such a substantial portion to either my wife or I' *because* (or for that reason that) and then identify factual circumstances which support the proposition. The vice said to exist in Mr McCutcheon's evidence is that it is simply speculative evidence on the ultimate question unsupported by any evidence of material facts from which the conclusion Mr McCutcheon contends for could be drawn ...

8 *McCutcheon v FCT* [2008] FCA 318 at [37], [39] and [45].

> It seems to me that the Tribunal is entitled to receive into evidence the statement objected to by the respondent provided foundation facts are given in evidence which support what would otherwise be a bald speculative statement. Those foundation facts would in the ordinary course of events be detailed and comprehensive and seek to explain why the prediction could not reasonably be entertained in the context of a full understanding of the matrix of fact. Such an approach would be consistent with principle and enable the taxpayer to state a position derived from a factual foundation ...
>
> The Tribunal also concluded that it was a matter for the Commissioner to demonstrate to the Tribunal that a basis for sufficiently reliable prediction subsisted once the appellants put the determination and assessments in issue. There is no doubt that the onus and burden of proof falls upon the appellants to demonstrate that the assessment issued to each taxpayer is excessive. That necessarily involves each taxpayer adducing evidence which would discharge the onus of demonstrating that the Commissioner's prediction or hypothesis was not sufficiently reliable for it to be regarded as reasonable. The appellants sought to do that by reliance upon the history of distributions."

Multiple determinations

The first ground for appeal was that, by issuing multiple determinations, the Commissioner had failed to identify "a tax benefit" obtained by the taxpayer. Instead, the Commissioner was said to have identified multiple tax benefits based on one stream of income and, on this basis, the determinations were invalid.

The multiple determinations were issued to the trust and to the beneficiaries of the trust (in relation to the portion of the adjustment to taxable income that the Commissioner considered would flow to them). The court noted that the Commissioner is entitled to adopt, especially in the context of complex arrangements, alternative views of what would or might reasonably have been expected to have occurred and to make alternative determinations.

The court also considered that the capacity in which a taxpayer acts is central to the assessments which issue consequent upon a determination. A determination issued to a taxpayer in its capacity as trustee, where a beneficiary is presently entitled to 100% of the income of the trust for the particular year of income, can support an assessment issued to the beneficiary.

In this case, the assessments were held to be valid.

¶14-120 News

Case name: FCT v News Australia Holdings Pty Ltd

Court: Full Federal Court

Year: 2010

Reference: [2010] FCAFC 78

Decided: Taxpayer (3:0)

Judges: Stone, Jessup and Jagot JJ

In a nutshell

The *News* case involved a complicated internal global corporate restructure of the News Group. The restructure had the effect of relocating the ultimate holding company for the News Group from Australia to the US. The outline below is a significantly simplified account of the actual transactions.

The first stage of the restructure was called the "flip". The flip created a "sandwich" structure whereby a US company (News Corp US) would hold the shares in two Australian companies (News Corp Australia and News Australia Holdings), which in turn would hold shares in a US company (News Publishing).

The second stage of the restructure was called the "spin". Under the spin, News Corp Australia would transfer News Publishing and News Corp UK to the new US parent (News Corp US) and eliminate the sandwich structure. The spin was divided into the first spin and the second spin.

The first spin involved the distribution of the News Publishing and News Corp UK shares by News Corp Australia to News Australia Holdings.

The second spin involved an off-market buy-back by News Publishing of its shares from News Australia Holdings. The buy-back occurred at market value and resulted in a capital loss of approximately $1.5b arising for News Australia Holdings. It was this capital loss that the Commissioner sought to deny through the application of Pt IVA. The Commissioner's alternative postulate would then result in a significant gain being included in the assessable income of the taxpayer.

News Group was successful in arguing that Pt IVA did not apply. The conclusion was reached that the necessary dominant purpose of obtaining a tax benefit was not present.

Key takeaway

"No tax, no tax risk" objective

News Group asserted that the restructure proceeded on a "no tax, no tax risk" basis. That is, if a proposed transaction would trigger a material tax liability or a significant tax risk, that aspect of the restructure would be redesigned or would not proceed.

The Commissioner appealed the original AAT decision on the basis that the "no tax, no tax risk" requirement of News Group was a subjective purpose and the AAT erred by taking it into account.

News Group was able to substantiate by evidence that this was an objective rather than a subjective purpose. For example, the taxpayer could demonstrate how taxation rulings (both in Australia and overseas) had been obtained on higher-risk aspects of the transactions and lower-risk but large dollar value aspects of the transactions. In other instances, it could point to where a transaction was reassessed once a material tax risk was identified. This purpose was then relevant for consideration of the s 177D factors, such as the manner in which the scheme was entered into and carried out, and the form and substance of the scheme.

Under the recent amendments, the tax cost of an alternative postulate is not a ground for concluding that the alternative postulate is not reasonable. News Group did not seek to argue that the alternative postulate was unreasonable. Rather, the taxpayer and the court/AAT focused on the question of purpose and concluded, having regard to the tax cost of the alternative and the "no tax, no tax risk" objective purpose, that the requisite dominant purpose was not present. This may be an avenue open to taxpayers under the amended legislation.

Relevantly, this case was dealing with a voluntary internal restructure that did not result in an economic gain accruing to the News Group as a whole. Requiring such a transaction to be revenue-neutral would be more reasonable that requiring a commercial transaction with a third party to be revenue-neutral. This may limit the situations when a similar argument could be raised by other taxpayers.

Also relevantly, the taxpayer could be seen to have been acting to mitigate what was referred to as "capricious and uncertain outcomes". One example was exchange rate fluctuations, with the Australian–US exchange rate moving significantly over the period. As the AAT noted:[9]

> "Comparable profit and loss exchange rates for the calendar years 2003 to 2006 show a variation of more than 20 cents during the period. The rate one year earlier, on 9 June 2004, was 0.7130 and one year later, on 9 June 2006, was 0.7478. Calculations made on behalf of the applicant show that those rates would have yielded a gain of more than $600 million and an approximate break even respectively. Had the exchange rate on 8 June 2005 been as it was three months earlier (0.7419) there would have been a break even and three months later (0.7584) a loss of more than $100 million. At the extremes, there would have been a gain in the billions (1 January 2003: 0.5537) or a substantial loss approximating $350 million (29 December 2006: 0.7632).
>
> Taking into account that a decision to proceed by way of buy-back had been taken in principle in 2003, these calculations tend against the suggestion that that decision would have been taken for

9 *News Australia Holdings Pty Ltd and FCT* [2009] AATA 750 at [76]-[77].

> the dominant purpose of obtaining a tax benefit. A dominant purpose would more likely have been the avoidance of a capricious and uncertain outcome."

The risk mitigation strategy being employed by News Group may well have been much broader than the "no tax, no tax risk" position. A broader strategy, rather than one just focused on tax, would likely be more acceptable as a basis for concluding that the dominant purpose was not the obtaining of a tax benefit.

¶14-125 Trail Bros

Case name:	FCT v Trail Bros Steel & Plastics Pty Ltd
Court:	Full Federal Court
Year:	2010
Reference:	[2010] FCAFC 94
Decided:	Commissioner (3:0)
Judges:	Dowsett, Edmonds and Gordon JJ

In a nutshell

Trail Bros Steel & Plastics Pty Ltd employed Mark and Allan Trail under written employment contracts executed on 1 April 1996. Each employment contract required the company, in addition to remuneration, to make superannuation contributions to the Trail Bros Superannuation Fund totalling $297,000 during the first four years of trading.

In the year ended 30 June 1996, $120,000 was paid by the company to the superannuation fund. A deduction was claimed under s 82AAC(2D) ITAA36.

In the 1997 year, the operation of s 82AAC was amended to limit the deductibility for superannuation contributions under employment contracts to annual age-based deduction limits for each employee. In response, the company and the two employees orally agreed to vary the employment contracts so that, instead of making superannuation contributions to the superannuation fund, the company would make payments to the newly created Trail Bros Pty Ltd Employee Welfare Fund.

In both the 1997 year and the 1998 year, the company paid $210,000 to the welfare fund and claimed a deduction for each payment.

The Commissioner disallowed the deductions on the basis that the amounts were not deductible or, if they were, that Pt IVA of the ITAA36 operated to disallow the deductions.

The court held that Pt IVA applied. The tax benefit was determined to be the difference between the contribution to the welfare fund and the amount of the age-based deduction limit. It was considered reasonable to expect that superannuation contributions up to the age-based limit would have been made in the absence of the scheme. However, the evidence before the court did not allow a reasonable alternative postulate to be formed in respect of the balance of the payment.

Key takeaways

Evidencing the alternative postulate

The taxpayer submitted that the Commissioner, not the taxpayer, had the burden of identifying the alternative postulate, and that only when the Commissioner had established an alternative postulate did the burden shift to the taxpayer to show that the Commissioner's alternative postulate was only a "possibility not a prediction sufficiently reliable for it to be regarded as reasonable".

The court rejected that submission, confirming that the onus rested with the taxpayer to show that the assessment was excessive. This means that the taxpayer needs to establish that there is no tax benefit in connection with a scheme. How the taxpayer does that is a matter for the taxpayer.

As Greenwood J stated:[10]

> "The alternative postulate that represents a reasonable prediction of future events absent the scheme is that the taxpayer would have made payments to the two brothers up to the age-based limits provided for by the Act and would have sought to negotiate a variation to the contracts as to the balance payments which *may have* resulted in a new set of arrangements that *may have* given rise to an allowable deduction. However, in the absence of any real content or evidence of the relevant activity, it cannot be said that a deduction of the kind claimed under the scheme *would have* been allowable to the taxpayer or might reasonably be expected to have been allowable to the taxpayer absent the scheme, and thus the taxpayer has obtained a tax benefit in connection with the scheme in the amount of the allowable deductions in excess of the age-based limits." (emphasis added)

This is an example of the requirement for an alternative postulate as set out in the *Peabody* decision:[11]

> "A reasonable expectation requires more than a possibility. [The alternative postulate requires a] prediction as to events which *would have* taken place if the relevant scheme had not been entered into or carried out and that prediction *must be sufficiently reliable for it to be regarded as reasonable*." (emphasis added)

In the *Trail Bros* case, the taxpayer may have benefited from leading evidence to support their subjective intention (of making other payments), noting the issues with subjective versus objective purposes, or other evidence on alternative options that had been considered when the existing superannuation laws changed.

Same kind of deduction

A question raised before the court was whether the deduction under the alternative postulate (in this case, the deduction for the superannuation contributions) needs to be of the "same kind" as the deduction under the scheme (for the contribution to the welfare fund). The court unequivocally rejected this approach, holding that it was inconsistent with s 177C ITAA36. The tax benefit is the difference

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10 *FCT v Trail Bros Steel & Plastics Pty Ltd* [2009] FCA 1210 at [58].

11 *FCT v Peabody* [1994] HCA 43 at [31].

between the position under the scheme and the position under the alternative postulate. It relates to the quantum of the deduction or assessable income, not the kind of deduction or kind of assessable income that gives rise to the tax position.

¶14-130 Citigroup

Case name:	Citigroup Pty Ltd v FCT
Court:	Federal Court
Year:	2010
Reference:	[2010] FCA 826
Decided:	Commissioner (1:0)
Judge:	Edmonds J

In a nutshell

Citigroup Pty Ltd was the head company of the Citigroup Pty Ltd consolidated group. It was a member of the global group of companies headed by Citigroup Inc (referred to collectively as Citigroup), a company listed on the New York Stock Exchange.

Until the transaction the subject of this case, Citigroup had not participated in a Hong Kong bond transaction, although a number of its clients had approached it about doing one and it was a market that Citigroup wanted to be in.

The Hong Kong bond transactions were sufficiently commonplace that the Hong Kong Inland Revenue Department (HKIRD) had issued guidelines to assist those contemplating entering into such transactions with preparing their advance ruling requests.

The guidelines set out in some detail the structure of the transaction that would be necessary to ensure that the transaction was acceptable to the HKIRD.

Citigroup identified a potential bond transaction with the Bank of China. The transaction was complex, at least on its face, and involved a number of different parties in the Citigroup global group, including Citigroup Pty Ltd (the transaction is set out in some detail in the court's decision).

The transaction, which occurred in 2003, can be grouped into two steps: a bond issue and then a coupon strip. In short, the scheme involved the subscription for an interest-bearing bond and the immediate sale of the interest coupons attached to the bond for a lump sum payment.

A second similar transaction was undertaken in 2004, this time with BNP Paribas.

HKIRD imposed tax on the gross amount of the consideration received by the bond purchasing partnership (of which Citigroup Pty Ltd was a partner), whereas the income base subject to tax in Australia was spread over the life of the bonds to equate with their financial accounting treatment. This meant that Citigroup Pty Ltd had access to a significant amount of foreign tax credits in year one of the transaction. Citigroup Pty Ltd had other foreign income against which it could utilise the foreign tax credits.

The decision focused on an assessment of purpose.

The structure of the scheme was no doubt dictated by the guidelines issued by the HKIRD. However, the participants in the scheme were not set by the guidelines. Citigroup Pty Ltd was selected to participate in the scheme not because of any particular commercial advantage that it could bring to the transaction, but because of its ability to claim a foreign tax credit.

In form, the scheme was complex, largely due to the requirements of the guidelines. In substance, the scheme was more transparent, ie the subscription for an interest-bearing bond and the immediate sale of the interest coupons attached to the bond for a lump sum payment.

Tellingly, the pre-tax profit of Citigroup Pty Ltd from the transaction was positive, but the post-tax profit from the transaction (ignoring the utilisation of excess foreign tax credits) was negative. It was only once the benefit of the utilisation of excess foreign tax credits was taken into account that Citigroup Pty Ltd achieved a positive profit position.

The court concluded that the factors in s 177D pointed strongly to the conclusion that Citigroup Pty Ltd participated in the transaction for the dominant purpose of obtaining a tax benefit in the form of the excess foreign tax credits. The reasoning in a way is similar to *Spotless* in that it was the tax benefit that enabled the arrangement to produce a commercial outcome.

Key takeaway

Foreign tax offsets

Section 177C includes descriptions of various types of tax benefits, one of which relates to foreign tax offsets (formerly credits). The *Citigroup* case is the only Federal Court or High Court decision to date that considers the application of Pt IVA to this type of tax benefit. The case includes a detailed discussion of the background to the introduction of this specific aspect of Pt IVA and the types of arrangements that it is targeting.

¶14-135 AXA

Case name:	FCT v AXA Asia Pacific Holdings Ltd
Court:	Full Federal Court
Year:	2010
Reference:	[2010] FCAFC 134
Decided:	Taxpayer (2:1) (note that the decision in respect of Pt IVA was unanimous)
Judges:	Dowsett and Edmonds JJ, and Gordon J (dissenting on the question of s 124-M ITAA97)

In a nutshell

AXA operated a health insurance business. The company had determined that the business was unsustainable in the long term. A number of courses of action were considered, including acquiring another health insurance business or entering into an alliance with another provider. Ultimately, it was determined that the sale of the business was the preferable option.

AXA engaged Macquarie Bank to assist in an approach to MBF. An extended period of negotiation ensued. Price was an issue, as were other conditions.

In parallel with these negotiations, Macquarie Bank (through another arm of its business) made an approach to acquire the entity that conducted the AXA Health business. Macquarie Bank was acting in part on behalf of BUPA and in part with a view to on-selling its interest in AXA Health to other parties.

The transaction was complex but, in essence, was structured such that AXA would receive an amount of cash, shares in the special purpose entity (MB Health) established to make the acquisition, and a share of any profit made on the on-sale of Macquarie Bank's interest. The scrip-for-scrip roll-over was available to defer any CGT on the shares received as consideration, which was the majority of the consideration.

Ultimately, a deal with MBF could not be negotiated and the sale under the Macquarie Bank offer was accepted by AXA.

The Commissioner sought to apply Pt IVA on the basis of an alternative postulate whereby AXA sold the shares in AXA Health directly to MB Health (the special purpose entity established by Macquarie Bank), bypassing the more complex transaction structure and, in doing so, ceasing to be eligible to obtain scrip-for-scrip roll-over relief.

The court considered that it was not reasonable to expect that the transaction would have proceeded in this way as MB Health had no capacity to enter into such a transaction (it was essentially a shelf company) without support from Macquarie Bank, and Macquarie Bank would not proceed with a transaction that denied it the ability to charge its fees. As such, no tax benefit arose for the purposes of Pt IVA.

Interestingly, the alternative postulate of a sale to MBF was not pursued by the Commissioner, even though this was the most likely alternative action of AXA. The transaction being negotiated by AXA was the sale of the business of AXA Health, not the shares. This meant that any capital gain would arise for a different taxpayer being AXA Health, not AXA, meaning that a tax benefit would not arise for the purposes of Pt IVA.

Key takeaways

Evidence to support the subjective intent

AXA reiterated the comments in earlier decisions (notably, *McCutcheon* and *Trail Bros*) about evidence supporting the subjective purposes of a party, such that those purposes are sufficiently reliable and objective, to be taken into account in an assessment of purpose.

The evidence supported that the objective facts before the trial judge were that the underwriting agreement with Macquarie Bank and the equity sell-down agreement with Macquarie Bank would not have been entered into had the scheme not been carried out. This meant that the fees payable to Macquarie Bank under those agreements would have been lost. Macquarie Bank's participation in the Commissioner's alternative postulate was critical to that alternative being a reasonable hypothesis. Macquarie Bank could not reasonably be expected to participate in a transaction where it would not be able to charge its commercial fees. These objective facts were identified by Mr Facioni (the Macquarie Bank executive in charge of this deal) and accepted by the trial judge, thereby discharging AXA's onus of demonstrating that the Commissioner's alternative postulate "was not sufficiently reliable for it to be regarded as reasonable".

AXA was then able to demonstrate an alternative course of action that was reasonable to expect it would have undertaken and under which a tax benefit did not arise for the relevant taxpayer.

Timing of the inquiry

The court considered that the alternative postulate needed to be formulated at a similar time to when the scheme was actually entered into. This meant that the facts and circumstances that existed at the time would need to be taken into account when assessing whether an alternative postulate is reasonable.

In *AXA*, this approach meant that the various agreements with Macquarie Bank (for example, the underwriting agreement) would be in place and could not be ignored when formulating and evaluating the alternative postulate.

¶14-140 British American Tobacco

Case name:	British American Tobacco Australia Services Ltd v FCT
Court:	Full Federal Court
Year:	2010
Reference:	[2010] FCAFC 130
Decided:	Commissioner (3:0)
Judges:	Dowsett, Jessup and Gordon JJ

In a nutshell

British American Tobacco dealt with the CGT implications of the divestment of brands as part of the global merger of the BAT Group and the Rothmans Group in 1999.

In Australia, the merger involved WD & HO Wills Holdings Ltd (Wills Holdings) and Rothmans Holdings Ltd (Rothmans Holdings) and their respective subsidiaries. The Rothmans Holdings Group, which had a larger market share and a larger market capitalisation than the Wills Holdings Group, was to take over the Wills Holdings Group.

The Australian Competition and Consumer Commission (ACCC) expressed concern with the merger. It took the view that the merger would be likely to have the effect of substantially lessening competition in the cigarette market in Australia. A divestment of individual brands was signalled as likely to be required.

On 30 April 1999, a term sheet was signed on behalf of BAT UK and the Imperial Group Pty Ltd (Imperial). The term sheet provided for the sale and purchase of a number of Australian and New Zealand cigarette brands, tobacco brands and tobacco paper brands, together with their related intellectual property rights. Some were Wills Holdings brands, some were Rothmans Holdings brands.

On 20 May 1999, Mr Dunkley, the Group Taxation Manager for Rothmans Holdings, wrote to Mr Kingsley, the Chief Finance Officer of Rothmans Holdings, reiterating the need to complete the merger prior to entering into any contractually binding agreements for the sale of brands to Imperial to utilise the tax losses which were to exist in Rothmans Asia.

Rothmans Asia had carried forward capital losses of $63.3m that arose from the sale of an investment in the Philippines. As a result of the sale of Rothmans Indonesia, a capital loss in excess of $100m would also arise in Rothmans Asia. In total, therefore, the Rothmans Holdings Group had in excess of $163m of capital losses, which could be utilised and set off against capital gains arising in the Rothmans Holdings Group.

Mr Kingsley outlined the following strategy for utilising the capital losses:

(1) complete the merger prior to entering into any contractually binding agreements for the sale of the brands to Imperial;

(2) transfer the nine Wills Holdings brands to Rothmans Holdings (while that would give rise to a stamp duty liability, no capital gain would be generated, as a roll-over would be available in respect of assets transferred between group companies);

(3) complete the contractually binding agreements between Rothmans Holdings and Imperial for the disposal of all brands, including the nine Wills Holdings brands, giving rise to a significant capital gain in Rothmans Holdings; and

(4) transfer the available capital losses from Rothmans Asia to Rothmans Holdings.

In essence, this is what then occurred.

The court (both in the original trial and on appeal) held that Pt IVA applied to the scheme. The requirements signalled by the ACCC for the disposal of the brands as a condition for approval of the merger clearly identified the purpose of the transaction for the disposal of the brands. But that is not the inquiry required under Pt IVA. The Pt IVA inquiry is to be directed at the particular scheme adopted by the taxpayer to undertake that disposal.

As was stated by Emmett J in the Federal Court:[12]

> "... the essential element is to be found in the disposal of the 9 Wills Brands by the Taxpayer to Rothmans and the subsequent disposal by Rothmans to the Imperial Group of the 9 Wills brands, together with the Rothmans Brands. The desired objective of the disposition of all of the relevant brands, both the 9 Wills brands and the Rothmans Brands, to the Imperial subsidiaries could have been achieved by a transfer direct from the Taxpayer to the Imperial subsidiaries of the 9 Wills Brands and a transfer direct from Rothmans to the Imperial subsidiaries of the Rothmans Brands. The requirements of the Commission would have been satisfied and the intended object of the merger would have been achieved. There was no commercial or legal reason why the disposition to the Imperial subsidiaries of both the 9 Wills Brands and the Rothmans Brands should have been effected from a single vendor, transferor or disposer rather than a disposition from separate vendors, transferors or disposers. Precisely the same commercial and legal object could have been achieved without the transfer, sale or disposal by the Taxpayer to Rothmans followed by transfer, sale or disposal by Rothmans to the Imperial subsidiaries."

The reason for the adoption of this particular form for the transaction, this scheme, was to enable the capital losses of Rothmans Holdings to be utilised to offset the capital gains made on the disposal of the brands of Wills Holdings.

12 *British American Tobacco Services Ltd v FCT* [2009] FCA 1550 at [89].

Key takeaway

Section 177C(2A) exclusion

British American Tobacco includes a detailed discussion of the scope of s 177C(2A) which operates to exclude from the concept of tax benefit, for Pt IVA purposes, tax benefits that are attributable to an election to apply the Subdiv 126-B ITAA97 roll-over (which was the subject of this case) or the Subdiv 170-B ITAA97 loss transfer.

The taxpayer was attempting to argue that s 177C(2A) applied on the basis that the scheme consisted solely of the making of the choice under Subdiv 126-B. The court held that s 177C(2A) did not apply as the scheme (as identified by the court) was broader and included steps that were entered into for the purpose of creating the conditions necessary for the making of the choice.

¶14-145 Ashwick

Case name:	FCT v Ashwick (Qld) No. 127 Pty Ltd
Court:	Full Federal Court
Year:	2011
Reference:	[2011] FCAFC 49
Decided:	Taxpayer (3:0)
Judges:	Bennett, Edmonds and Middleton JJ

In a nutshell

The taxpayers were members of the Foster's Group, which was headed by Foster's Group Ltd (Fosters). Among the group's diverse range of business activities was a financial services business (the Finance Group).

The stock market crash in 1987 and the introduction of capital adequacy guidelines by the Reserve Bank of Australia had a material adverse impact on the Finance Group. While the Finance Group continued to grow during the financial year ended 30 June 1988, two key financing entities suffered operating losses and required additional capital in order to report positive net assets and retain the licences necessary to operate their businesses.

In March 1990, Fosters announced that it would focus solely on its brewing business and divest itself of all of its other businesses, including those conducted by the Finance Group. From that point on, the Finance Group focused on selling its assets and recovering loans which it had made to external borrowers.

As external lenders increasingly withdrew their funding from the Finance Group, replacement funding was provided through two chains of loans.

The continued debt funding was intended to allow an orderly realisation of the residual assets of the Finance Group. Another reason for the debt funding was the need to address potential claims by litigation creditors, with the funding structure being part of a security arrangement that was intended to ensure that Fosters would have priority over litigation creditors.

In early 1998, a review was conducted to assess the prospects of recovering debts owed within the group, which resulted in a recommendation that substantial amounts be written off as bad debts. Various members of the group subsequently claimed deductions of approximately $2.4b for unpaid principal and/or interest on loans made to other members of the group which were written off as bad debts.

Deductions of almost $450m were also claimed by certain members in respect of interest on borrowings from other members of the group.

Other members of the group (including Ashwick) claimed deductions for losses transferred to them by the members who had claimed the bad debt and interest deductions.

The Commissioner issued amended assessments to the various members of the group denying the deductions claimed under s.8-1 or s 25-35 ITAA97. Alternatively, he determined that Pt IVA applied to deny the deductions.

The court at first instance and on appeal held that Pt IVA did not apply on the basis that the requisite dominant purpose was not present.

Key takeaway

Assessment of purpose

Ashwick is focused on the claiming of bad debt deductions and capital losses on related party debts.

Assessing the question of purpose in this type of transaction can often be difficult as, on its face, the tax benefits loom large.

Ashwick includes a detailed and structured consideration of the eight factors in s 177D to the particular arrangement. The arrangement is more complex than what most taxpayers will confront, but it highlights some important factors which point away from the dominant purpose, ie to obtain a tax benefit:

- consistency in actions over a sustained period;
- commercial explanation for actions;
- evidence of external factors which necessitated changes in existing practices; and
- writing off of bad debts when they are genuinely bad.

Where the debts arise due to objectively commercial transactions and subsequently the debts become genuinely bad, this would indicate that something more is needed before the Commissioner can use Pt IVA to disallow the resultant tax benefits.

¶14-150 RCI

Case name:	RCI Pty Ltd v FCT
Court:	Full Federal Court
Year:	2011
Reference:	[2011] FCAFC 104
Decided:	Taxpayer (3:0)
Judges:	Edmonds, Gilmour and Logan JJ

In a nutshell

RCI Pty Ltd (RCI) was a member of the James Hardie Group. RCI was involved in two groups of transactions: a revaluation/dividend transaction and a corporate restructure.

On 31 March 1998, a US-based subsidiary of RCI revalued its investment in a subsidiary company, creating a large revaluation reserve. The US subsidiary then declared a dividend to RCI that was equivalent to the amount of the revaluation. Of the dividend, $20m was paid in cash. The balance of $298m was credited to an intercompany loan. The dividend was exempt income for RCI.

Subsequently, as part of a broader corporate restructure termed "Project Chelsea", RCI sold its shares in its US subsidiary to another James Hardie Group company that was incorporated in Malta. On 17 August 1998, RCI resolved to undertake this transaction.

The market value of the US subsidiary had been reduced by the earlier dividend and therefore the capital gain made on this sale was also reduced. The Commissioner asserted that the revaluation/dividend transaction was part of a scheme to reduce the capital gain made on the subsequent corporate restructure.

The court held in favour of the taxpayer (overturning the decision of the Federal Court).

The Commissioner proposed an alternative postulate that RCI would have entered into the corporate restructure in any event and sought to assess RCI on the basis that the revaluation/dividend transaction did not occur.

The corporate restructure as implemented resulted in costs to the James Hardie Group of $35m, which was 2.5% of its market capitalisation. The company was clearly cognisant of the level of costs that it was incurring.

The Commissioner's alternative postulate would have resulted in $207m of costs being incurred by the James Hardie Group, the additional costs being the tax on the RCI component of the corporate restructure. This was approximately 15% of its market capitalisation and was equal to the portion of the business intended to be listed on the New York Stock Exchange as part of the corporate restructure.

Based on the evidence, the court determined that it was not reasonable to expect that RCI would have entered into the alternative postulate proposed by the Commissioner due to the costs involved. Similarly, other alternative ways of undertaking the corporate restructure were also prohibitive on a cost basis.

The court determined that, if the scheme had not been entered into, the reasonable expectation was that the parties would have either abandoned the proposal, indefinitely deferred it, altered it so that it did not involve the transfer by RCI of the shares or pursued an alternative, but they would not have proceeded with the corporate restructure in its current form.

Key takeaways

Most reliable prediction

Stone J at first instance stated that the taxpayer carries the onus of establishing that the Commissioner's counterfactual is unreasonable and that, if the taxpayer does not establish that the Commissioner's counterfactual is unreasonable, then the taxpayer fails to prove that the assessment is excessive on that ground.

The Full Federal Court said that:[13]

> "Such an articulation of the onus is erroneous, but if not, certainly unhelpful because it can lead one into error. Even if a taxpayer establishes that the Commissioner's counterfactual is unreasonable, it will not necessarily follow that he has established that the assessment is excessive. That is because the issue is not whether the Commissioner puts forward a reasonable counterfactual or not; it is a question of the Court determining objectively, and on all of the evidence, including inferences open on the evidence, as well as the apparent logic of events, what would have or might reasonably be expected to have occurred if the scheme had not been entered into. Thus, even if a taxpayer establishes that the Commissioner's counterfactual is unreasonable, that will not discharge the onus the taxpayer carries if the Court determines that the taxpayer would have or might reasonably be expected to have done something which gave rise to the same tax benefit.
>
> That such an articulation of the onus is at worst erroneous and at best unhelpful, can also be illustrated from the other side of the coin, because it implies that if the Commissioner's counterfactual is reasonable that is the end of the matter; even if the Court were to conclude, on all the evidence, inferences and logic referred to, that if the scheme had not been entered into the taxpayer would have or might reasonably be expected to have done something which did not give rise to a tax benefit, or which gave rise to a tax benefit less than that thrown up by the Commissioner's counterfactual. In our view, that cannot be correct."

"An objective enquiry and determination amongst alternative possibilities as to which is the most reliable prediction" was how the court expressed the exercise that needed to be undertaken to

13 *RCI Pty Ltd v FCT* [2011] FCAFC 104 at [130]-[131].

determine what a taxpayer might reasonably be expected to have done if they hadn't entered into the scheme.

The Full Federal Court emphasised that the taxpayer carried the onus of demonstrating what it would be reasonable to expect the parties to have done, absent the scheme.

In the decision impact statement on this case, the Commissioner noted that the case was authority for the propositions made in relation to the determination of the alternative postulate. However, the Commissioner's view is that the recent amendments to Pt IVA mean that it is no longer necessary for the alternative postulate to be the most reasonable, only that it is reasonable in its own right.

Impact of Pt IVA amendments

The Pt IVA amendments were in part a response to this decision (as well as *AXA* and *Futuris*). If the same case was heard under the amended provisions, it is likely that the same result would arise, ie a decision in favour of the taxpayer, but for a different reason.

The court considered that the alternative postulate was unreasonable due to the tax costs associated with it. Tax costs are required to be ignored when determining the alternative postulate under the amended provisions.

The court did not specify an alternative postulate that the taxpayer would be reasonably expected to have taken; rather, it determined that, if the scheme had not been entered into, the reasonable expectation is that the parties would have either abandoned the proposal, indefinitely deferred it, altered it so that it did not involve the transfer by RCI of the shares or pursued an alternative, but they would not have proceeded with the corporate restructure in its current form. This meant that a tax benefit did not arise.

Under the amended provisions, when determining the alternative postulate in a reconstruction situation, particular regard must be had to the non-tax outcomes for the taxpayer as were achieved under the scheme. In *RCI*, this would mean that the alternative postulate would probably need to include the disposal of the shares in the US subsidiary by RCI — essentially what the Commissioner was proposing as the alternative postulate. This highlights an issue with the amended provisions — an otherwise "unreasonable" alternative postulate can be applied if the reason why it is unreasonable is the tax cost.

Regardless, the Full Court in *RCI* also considered the purpose question and determined that the requisite dominant purpose was not present. So, while under the amended provisions a tax benefit would arise, Pt IVA would not apply as the parties to the scheme did not, objectively, have the dominant purpose of producing the tax benefit for the taxpayer.

¶14-155 Futuris

Case name:	FCT v Futuris Corporation Ltd
Court:	Full Federal Court
Year:	2012
Reference:	[2012] FCAFC 32
Decided:	Taxpayer (3:0)
Judges:	Kenny, Stone and Logan JJ

In a nutshell

Futuris Corporation Ltd was the holding company of a corporate group that conducted a number of different businesses, including a building products business. The building products business was undertaken by various entities owned by two subsidiaries of Futuris — Bristile and Walshville.

A decision was made to undertake a public float of the building products business. This necessitated consolidating the businesses under a single holding company. Walshville was selected as the appropriate holding company.

An internal restructure was undertaken to achieve the desired structure for the float. Included within the restructure transactions were:

- the capitalisation of intercompany debt;
- the sale of shares to a related party at a discount; and
- the capitalisation of a dividend.

The net effect of these transactions was to increase the cost base of Futuris' investment in Walshville and so decrease the capital gain made on the sale of these shares in the public float.

The Commissioner made a determination under Pt IVA to remove the impact of the increase in the cost base and to assess Futuris on a higher capital gain as a result.

The enterprise value of the building products business was $250m. The capital gains that the Commissioner sought to assess Futuris on were some $235m.

The Full Federal Court upheld the decision of the Federal Court in finding that there was no tax benefit as required to enliven Pt IVA.

Based on the evidence before it, including in particular the evidence of an independent expert, the court formed the view that the alternative postulate proposed by the Commissioner was not one that would be reasonably expected to occur. Rather, an alternative postulate identified by the independent expert was preferred. Under this alternative postulate, a different entity (Bristile) would be the entity subject to the public float, and the capital gain would arise for a different entity in the group and not to Futuris. As such, no tax benefit as defined arose for Futuris.

Key takeaway

Expert witness

The major point of interest in this particular case was the use of an expert witness to provide evidence as to what it would be reasonable to expect a taxpayer to do, absent the scheme.

The evidence of the expert witness was accepted by the trial judge both as being permissible to give and as establishing objective facts from which a reasonable expectation could be established.

On appeal, the Commissioner argued that "Mr Duivenvoorde's opinion was mere speculation as to what Futuris 'might' have done unsupported by evidence which would have transformed it into a reasonable expectation".

The Full Federal Court rejected this assertion, stating:[14]

> "There was, of course an element of speculation involved in Mr Duivenvoorde's analysis. But it was not mere speculation. It was a prediction based on given facts, established market values, calculations based on unchallenged financial data, a stated goal and the application of Mr Duivenvoorde's expertise in corporate finance and his experience as a chartered accountant. The definition of 'tax benefit' in s 177C(1)(a) requires that there be a prediction as to what 'might reasonably be expected to have been included in the assessable income of the taxpayer'. That prediction necessarily involves an opinion as to events and transactions that have not taken place. It must be not just a possibility but 'sufficiently reliable for it to be regarded as reasonable': *Peabody* at 385.
>
> The reliability of a prediction might be established by direct evidence of contemporaneous consideration of the alternative postulate; or by evidence from company officers as to established commercial parameters for sale and whether the alternative postulate met those parameters; or evidence from those who were involved in the transactions challenged under Pt IVA. But that is not the only way to establish reliability. To the extent that the Commissioner submits that it is only by such direct evidence that a reliable prediction can be made, we reject that submission. This much was recognised by the Full Federal Court in *Trail* ..."

14 *FCT v Futuris Corporation Ltd* [2012] FCAFC 32 at [79]-[80].

¶14-160 Macquarie Bank

Case name:	FCT v Macquarie Bank Ltd
Court:	Full Federal Court
Year:	2013
Reference:	[2013] FCAFC 13
Decided:	Taxpayer (3:0)
Judges:	Emmett, Middleton and Robertson JJ

In a nutshell

Mongoose was a non-resident company owned by another non-resident, MatlinPatterson. Mongoose held a significant investment in an Australian listed company, Minara Ltd. MatlinPatterson was looking to exit the Minara investment, and Macquarie Bank was liaising with them on the ways that such an exit could be achieved. An arrangement was put to MatlinPatterson that Macquarie Bank would act as agent for Mongoose to dispose of the shares. This transaction would expose Mongoose to fluctuations in the price of the stock (the price for the stock was volatile) and there would be no guaranteed minimum sale consideration.

Macquarie Bank then put an alternative arrangement to MatlinPatterson. The arrangement involved an acquisition by Macquarie Bank of all of the shares in Mongoose. This gave MatlinPatterson a guaranteed minimum sale consideration and limited its ongoing exposure to fluctuations in the price of the stock. After extended negotiations, this was the arrangement that was implemented.

Once Macquarie Bank acquired Mongoose, by changing the tax residency of the company to Australia, Macquarie Bank was able to bring Mongoose into its tax consolidated group and achieve a step up in the tax cost base of the share investment in Minara. This meant that, when the shares were disposed of by Mongoose through an arrangement brokered by Macquarie Bank, the taxable capital gain was reduced.

If the shares had been disposed of under the first arrangement put to MatlinPatterson, a taxable capital gain of approximately $318m would have arisen. The actual capital gain declared by Macquarie Bank under the alternative arrangement was $41m.

The courts considered a number of technical issues on the interaction of Pt IVA and the tax consolidation provisions, which are discussed below.

The key issue was the determination of the tax benefit. The alternative postulate put by the Commissioner and accepted by the courts was that, if the scheme was not implemented, the first arrangement put to MatlinPatterson would have been implemented. Under the first arrangement, Mongoose would have derived a capital gain but Mongoose would not have joined the Macquarie Bank tax consolidated group. As such, the taxable capital gain under the alternative postulate was not an amount that would be included in the assessable income of Macquarie Bank. There was not a tax benefit, in the Pt IVA sense, for Macquarie Bank.

The courts also considered the question of purpose, finding that the requisite dominant tax purpose was not present.

The Full Federal Court was satisfied that the preferred transaction changed from the first arrangement to the scheme that was actually implemented at least in part as a result of MatlinPatterson's commercial needs and wishes as the client in this process (and Macquarie Bank's desire to accommodate those needs and wishes). This was to be expected in commercial deals of this nature. The scheme as implemented was a function of the parties' commercial objectives and the risks of the underlying transaction.

It was noted that the scheme as implemented appeared to have been selected at least in part on the basis that no tax would be directly payable by MatlinPatterson, and that the consolidation provisions were the mechanism by which Macquarie Bank (as the head company) could sell the Minara shares with no tax unless the sale price exceeded the cost of the shares. The mere fact that taxation considerations may have, to some extent, driven the deal or played a part in enabling the profit to be made by all parties does not require a finding of the requisite dominant purpose under s 177D.

Key takeaways

Primacy of Pt IVA

Giving effect to the legislative intent in respect of Pt IVA is not to ignore the purposes or policy of the tax consolidation provision. The benefits of the consolidated group provisions (including the operation of the single entity rule) remain available to those who choose to take advantage of them. However, the mere joining of a consolidated group is not sufficient in and of itself to preclude the operation of Pt IVA in respect of actions taken by that entity if the criteria in that Part are otherwise satisfied. Any argument to the contrary would be wholly inconsistent with the purpose of the Pt IVA general anti-avoidance provisions.

Part IVA determinations and tax consolidations

Part IVA revolves around the concept of a taxpayer who has obtained a tax benefit. A subsidiary of a tax consolidated group technically satisfies the broad definition of "taxpayer" for the purposes of Pt IVA. However, the subsidiary member does not have its own distinct assessable income for the purposes of the application of the provisions of Pt IVA. Although the subsidiary member may technically have been a "taxpayer", it was not liable to be *directly assessed* as such.

In normal circumstances, it is expected that, in order to administer the provisions of Pt IVA, the Commissioner will identify the taxpayer who is alleged to have obtained the relevant tax benefit, and make a determination in respect of that taxpayer. In such a situation, one would expect a clear relationship between the taxpayer, the taxpayer's assessable income, the tax benefit alleged to have been received under the scheme, and the alternative postulate.

However, in the case of a subsidiary of a consolidated group, the entity whose actions give rise to a tax benefit may not be liable to be directly assessed for income tax as such, as they are deemed not to have a separate existence for this purpose.

To apply Pt IVA in this instance, the Commissioner is entitled to make a determination in respect of (and subsequently issue an amended assessment to) the head entity of the tax consolidated group. The taxpayer, in its capacity as head company of the tax consolidated group, is the relevant "taxpayer" for Pt IVA purposes.

Part IVA then needs to be read as referring to the head entity as the relevant taxpayer. Using the example in this case, this means that "tax benefit" falls to be defined under s 177C(1)(a) in the following way:

> "… an amount [$318,507,469] not being included in the assessable income of [Macquarie Bank] of a year of income where that amount would have been included, or might reasonably be expected to have been included, in the assessable income of [Macquarie Bank] of that year of income if the scheme had not been entered into or carried out ..."

The issue in this case was that the amount ($318m) would not have been included in the assessable income of Macquarie Bank as, for the $318m assessable income to arise, Mongoose would not have joined the Macquarie Bank tax consolidated group. Rather, under this alternative postulate, the amount of the tax benefit would have been included in Mongoose's assessable income in the absence of the scheme.

Chapter 15

The “tax-effective investment scheme” cases

In the early 2000s, there were a series of Pt IVA decisions relating to "tax-effective investment schemes". In all but one instance, the cases were decided in favour of the Commissioner.

A brief overview of the cases is provided below. The "red flags" identified by the courts are discussed at ¶2-125.

¶15-100 Vincent

Case name:	Vincent v FCT
Court:	Full Federal Court
Year:	2002
Reference:	[2002] FCAFC 291
Decided:	In part for the taxpayer, in part for the Commissioner
Judges:	Hill, Tamberlin and Hely JJ

In a nutshell

Ms Vincent was a mother, science teacher and part-time property developer. On the advice of her accountant, she invested in a cattle-breeding program operated by Active Cattle Management Pty Ltd.

The project, in essence, involved flushing artificially inseminated embryos from a stud cow and implanting those embryos in a surrogate cow which would carry the embryos to term. The offspring would be marketed and sold.

The arrangements included the lease of the necessary cows, management agreements for the upkeep of the cows, and loan agreements to finance aspects of the transaction.

The project was not successful, and within a few years of establishment, an administrator was appointed.

The Commissioner sought to apply Pt IVA to disallow deductions claimed in respect of the investment in the project.

The court first considered the deductibility of the expenses under the general deduction provisions. It was concluded that no loan was actually made to Ms Vincent as part of the arrangements and so the interest charges on the loan were not actually incurred. Further, part of the costs incurred by Ms Vincent and claimed as a deduction was held to be on capital account. But for the extended amendment period applying to Pt IVA, the Commissioner was out of time to amend the 1997 assessment to disallow these expenses, with more than four years having passed since the assessments were issued.

Key takeaway

Disallowing non-allowable deductions

The key Pt IVA question considered by the courts was whether the Commissioner could rely on a Pt IVA determination to disallow a deduction that had been "allowed" but was not actually an "allowable deduction":[1]

> "... the Act in many places distinguishes between deductions which are allowed and deductions which are allowable ... There is an obvious difference between the two expressions. The former expression is concerned with what the Commissioner has actually done in the assessment process; the latter expression looks to the terms of the legislation to determine whether in calculating the taxable income there is an amount which is by the terms of the Act, allowable ... It is clear from s 177F that the question which is raised for determination is the conclusion as to the dominant purpose of a person who entered into or carried out the scheme or part of it. It would be very unlikely that viewed objectively it would be concluded that the Commissioner would wrongly assess and then not amend the assessment for four years. Yet, for the Commissioner's argument to succeed it would be necessary to ask whether, in a case where a deduction was not allowable as a matter of law (for example, as here, because s 51(1) did not operate to give a deduction) it would be concluded that there was a party who entered into or carried out the scheme or a part of it with the dominant purpose of obtaining a benefit consisting of a deduction which was not allowable, but which was ultimately allowed and which, only as a result of inaction was not reversed within the four year limitation period."

In the view of the court, once it is clear that an amount was not ever an allowable deduction, it follows that Pt IVA would never operate to deny a deduction for that amount.

¶15-105 Puzey

Case name:	Puzey v FCT
Court:	Full Federal Court
Year:	2003
Reference:	[2003] FCAFC 197
Decided:	Commissioner (3:0)
Judges:	French, Hill and Carr JJ

In a nutshell

Mr Puzey entered into an arrangement under which he invested in a project for the planting and development of an Indian sandalwood plantation.

Under the arrangement, Mr Puzey leased two acres of land in the Ord River Irrigation Area, entered into agreements to purchase seedlings, and engaged a plantation manager to attend to the establishment

1 *Vincent v FCT* [2002] FCAFC 291 at [91].

and maintenance of the trees on the leased land. A loan was offered to finance the fees payable under the arrangement. Part of the loan was repayable out of the proceeds from the tax refund expected to be paid to Mr Puzey after lodgment of this return claiming a deduction for the costs of investing in the project. The remaining loan was repayable out of the proceeds from sale of the harvest in 15 years' time.

The deductions claimed by Mr Puzey were disallowed under Pt IVA, largely based on the manner in which the scheme was entered into or carried out. Relevant points included:

- the scheme was promoted with the tax consequences of deduction given prominence. The tax benefits featured heavily in the promotional material;
- tax deductibility was an essential ingredient in funding the participation in the arrangement;
- the tax refunds were intended to be sufficient to meet the payments required to obtain the seedlings for planting;
- the scheme was sold by canvassers and others on behalf of the promoters as "tax-effective";
- unlike what may be seen to be an ordinary investment project, the scheme was to be entered into by a participant signing a series of documents which were pre-prepared, and there were instructions to the participant to take the necessary steps to have the PAYE instalments varied;
- what was certain, or at least was promoted to be certain, were the tax deductions. What was uncertain, were the project's investment consequences. These were highly speculative. However, as long as the tax deduction was available, the uncertainty carried with it little cost; and
- the amount paid for the seedlings was grossly excessive. It was this excessiveness which enabled Mr Puzey to obtain a cash refund in a sufficient sum to finance the initial cash payment of $14,000, and likewise to obtain a PAYE variation to fund the payment in the 1998 year of income of the same amount.

¶15-110 Cooke

Case name:	FCT v Cooke
Court:	Full Federal Court
Year:	2004
Reference:	[2004] FCAFC 75
Decided:	Taxpayer (3:0)
Judges:	Lee, Sunberg, Conti JJ

In a nutshell

Mr Cooke was a partner in the law firm Allen Allen & Hemsley (the case also considered a second partner in the firm, Mr Jamieson). Mr Cooke (and Mr Jamieson) invested in a project known as the Australian Horticultural Project Number 1, promoted to the public by Growth Industries Pty Ltd.

The project was intended to allow investors to conduct a business of growing proteas and Australian native flowers for the domestic and overseas cut flower market. The business was to be managed by a company associated with Growth Industries Pty Ltd.

Mr Cooke made an investment in the project, utilising a finance facility with Mid-West Finance Pty Ltd, also an entity associated with Growth Industries Pty Ltd. It in turn had sourced these funds from the State Bank of NSW.

The investment included payment of management fees, licence fees and the purchase of plantations. Deductions were claimed for approximately 95% of the amount of the investment. The Commissioner sought to apply Pt IVA to disallow the deduction.

In the first instances and on appeal, the court held in favour of the taxpayer and ruled that Pt IVA did not apply to disallow the deductions. Relevant parts of the primary judge's decision are set out below:[2]

> "There has been no suggestion that the AHP No. 1 was a sham. Nor has it been denied by either of the applicants that the taxation advantages of their investment in the project was an important aspect … [Mr Cooke's and Mr Jamieson's] evidence was that they were within some years of retirement and that they had not made adequate provision for income during their retirement. They wanted to provide an income for their retirement and for that reason they wanted a relatively long-term project. At their stage of life there was not much time in which to achieve these goals. The reality of their respective financial positions at that time was that they did not have significant personal resources to finance investment and therefore they needed to borrow for investment. It was also a reality that at the relevant time both were experiencing an increase in income that would generate additional tax liability that had to be met. An investment that did not carry with it a substantial tax deduction would significantly compromise their ability to make an income producing investment for their retirement.
>
> The fact that both applicants elected to take the option of receiving a guaranteed return is consistent with the applicants prudently protecting their investment. While it may not have been of great concern if the investment were not to produce substantial income immediately, it was important not to incur liabilities that would prejudice their retirement situation. It seems to me to be objectively reasonable that the applicants would have regarded the success of AHP No. 1 as important, even while they took steps to protect themselves if it were not successful. Moreover, the guaranteed return did not entirely protect them as the amount of the return was taxable in the hands of the applicants and therefore only the after-tax portion would be available for repayment of their loans.
>
> It is also reasonable to assume that the purpose of the Plantation Manger in providing for a guaranteed return was to facilitate promotion of the scheme and thereby generate more fee income. The fact that the tax deductibility of the outgoings was an integral part of the structure of the arrangement does not support the conclusion that there was a dominant purpose to produce a tax benefit in the hands of the applicants.
>
> In my view the manner in which the scheme was entered into and carried out, the form and structure of the scheme, the time at which it was entered into, and the duration of the scheme are all consistent with the applicants having a dominant purpose of generating income for their retirement rather than enabling them to obtain a tax benefit.
>
> Subparagraph (iv) of s 177D(b) requires one to assume that the applicants would be entitled to the deductions claimed, apart from Part IVA. In relation to the applicants the result would be that they would be entitled to deductions in respect of the outgoings. This is not sufficient

2 Cooke v *FCT* [2002] FCA 1315 at [91]-[96].

> to point to the dominant purpose of the scheme being to obtain that benefit. Subparagraph (v) directs attention to any change in the applicants' financial position resulting from, or reasonably expected to result from, the scheme. At the time the applicants invested in AHP No 1, being the time at which the purpose of persons involved in the scheme must be objectively assessed, they could reasonably expect retirement income if AHP No 1 succeeded, a comparatively small loss if it failed and, in any event, a significant tax deduction. As was pointed out in the applicants' submissions, that tax deduction was "offset by inclusion in their assessable income of an equivalent amount in the 1994 year of income". In the applicants' submission this gave them a timing advantage but does not of itself point to a dominant purpose of obtaining a tax benefit. Subparagraphs (vi), (vii) and (viii) of s 177D(b) are not relevant here.
>
> While the tax benefit that each applicant obtained through their investment in AHP No 1 was important and, as a practical matter, may have made their investments feasible, objectively viewed it is not the case that the investment made no sense without the tax benefit."

This decision highlights the difficulty of distinguishing between a situation where Pt IVA would be applied (as per the other tax-effective investment scheme cases) and where it would not. The case should not be attributed significance much beyond that. The specific situation of the respondents (their retirement plans) played a significant role in the decision in this case. When contrasted against the decisions in the other tax-effective investment scheme cases and subsequent decisions in other cases, it is questionable if the same decision would be reached by the courts in respect of a similar situation now.

Structuring a transaction in a particular way to achieve a tax benefit where that structure (or aspects of the structure) does not have another rationale, for example, to also produce commercial/non-tax benefits, would likely be a factor that strongly points to the requisite dominant purpose being the obtaining of a tax benefit.

¶15-115 Sleight

Case name:	FCT v Sleight
Court:	Full Federal Court
Year:	2004
Reference:	[2004] FCAFC 94
Decided:	Commissioner (3:0)
Judges:	Hill, Carr and Hely JJ

In a nutshell

Mr Sleight, in partnership with his wife, was a participant in the Northern Rivers Tea Tree scheme. Mr Sleight was also an investment adviser and was involved in the promotion of this and similar schemes.

Consistent with many such schemes at the time, the scheme involved the participants acquiring a right to occupy land and conduct farming activities, the appointment of a management company to undertake the farming activities on their behalf, and the acceptance of an offer of finance from an associated finance company. The finance was used to fund the prepayment of management fees and associated costs. Recourse under the loan arrangement was substantially limited to the proceeds from the sale of the tea tree oil produced from the farming activities.

The court upheld the application of Pt IVA to disallow deductions in excess of the cash actually outlaid by the taxpayer for reasons including:

- the transactions were structured so as to maximise tax deductions. The court considered that "but for the tax deductions the form the investment might be expected to take would clearly relate more to the substance of what happened";
- it was the tax deductions that made the scheme commercially viable as an investment. The tax deductions were relatively certain (but for Pt IVA), while the commercial return was speculative. Factoring in the benefit of the tax deductions, the investor was in, or was close to, a cash positive position after year one; and
- the flurry of activity around 30 June to implement the scheme was motivated by tax considerations, not commercial considerations.

This case includes a structured analysis of the eight factors in s 177D ITAA36, a review of which can assist with understanding how to apply the purpose test.

An issue regarding the validity of Pt IVA determinations was also raised before the court (and dismissed). This is discussed in more detail at ¶18-120 (dealing with s 177F ITAA36).

¶15-120 Calder

Case name:	Calder v FCT
Court:	Full Federal Court
Year:	2005
Reference:	[2005] FCAFC 254
Decided:	Commissioner (3:0)
Judges:	French, Stone and Siopis JJ

In a nutshell

Mr Calder, in partnership with his wife, was a participant in the Main Camp Tea Tree Oil Project No. 3. Consistent with many such schemes at the time, the scheme involved the participants acquiring a right to occupy land and conduct farming activities, the appointment of a management company to undertake the farming activities on their behalf, and the acceptance of an offer of finance from an associated finance company. The finance was used to fund the prepayment of management fees and associated costs. Recourse under the loan arrangement was substantially limited to the proceeds from the sale of the tea tree oil produced from the farming activities.

Mr Calder stated that he invested in the project as he considered it a good investment in a growing industry. At a similar time, he also made a series of other investments (primarily equities). Mr Calder was retired and had recently sold an asset. He was actively assessing different investment opportunities when he decided to invest in this project.

The court upheld the application of Pt IVA to disallow deductions in excess of the cash actually outlaid by the taxpayer for reasons including:

- the transactions were structured so as to maximise tax deductions and to "self-fund" the financial obligations of Mr Calder to the project (the tax savings would cover the cash required for the investment); and
- the project relied on the tax deductibility and effect of the initial payments and the gearing-up provided by the loan to show any rate of return. The tax benefit was the key to the commerciality of the investment.

Importantly:

- while the court recognised that the (actual) subjective intention of Mr Calder in making the investment was not to obtain the tax benefit, but rather to make what he considered to be a higher-risk but attractive investment, this was irrelevant to the application of Pt IVA. Part IVA applies based on an objective assessment, having reference to the eight factors only; and
- the fact that Mr Calder was unaware of aspects of the scheme (for example, the round robin financing arrangement between the finance and management companies) was irrelevant for the purposes of Pt IVA. The taxpayer's fiscal awareness is not a factor that affects the application of Pt IVA. The factors in s 177D clearly encompass matters that the taxpayer may be quite unaware of.

¶15-125 Lenzo

Case name:	FCT v Lenzo
Court:	Full Federal Court
Year:	2008
Reference:	[2008] FCAFC 50
Decided:	Commissioner (3:0)
Judges:	Heerey, Sackville and Siopsis JJ

In a nutshell

Mr Lenzo invested in a project for growing sandalwood near Kununurra in Western Australia.
Mr Lenzo's investment primarily took the form of prepayment of maintenance fees over the 16-year life of the project, together with related payments. This was organised in a way that involved, among other things, a loan from the promoters of the project, a round robin between companies controlled by the promoters, and a partial cash repayment of his loan by Mr Lenzo in the tax year immediately following (a payment which was in effect funded by his taxation deduction of the previous year).

Although Mr Lenzo was initially successful before the Federal Court, the decision was overturned on appeal. The decision was made for reasons quite similar to those in *Sleight*, including:

- the cash outlay to invest in the project was substantially funded by the tax benefits;
- the round robin transaction did not result in any funds being made available for the project. It was purely a paper exercise;
- the transactions occurred on 30 June. As the court questioned: why were all of the transactions, and in particular the round robin, carried out on 30 June and not on any one of the other 364 days in the year? The choice of that day had nothing to do with sandalwood production. It had everything to do with maximising the tax benefits for investors; and
- the project itself was genuine and could have been implemented in a manner clearly outside Pt IVA. However, the way that the scheme was structured and put into effect indicated a dominant purpose being the obtaining of tax benefits.

Key takeaways

Lenzo includes discussion on two points which have broader relevance for determining a tax benefit.

Type of deduction

Section 177C(1)(b) presents what the court described, "perhaps loosely, as a question of characterisation". In respect of a deduction case, the concept of tax benefit is based around a deduction that is allowable to a taxpayer in relation to a year of income in circumstances where the whole or part of "that deduction" would or might not have been allowable in the absence of the scheme.

The question was considered as to what the expression "that deduction" means.

The court held that a narrow view (of "that deduction" meaning exactly the same deduction) was inappropriate and inconsistent with the intent and wording of the provision. Such an approach would essentially make the inquiry redundant as rarely, if ever, would exactly the same deduction be available absent the scheme. Rather, a broader interpretation was appropriate: that deduction means that "kind" of deduction, a deduction of the same character.

The Federal Court had rejected a submission that no tax benefit arose because, had Mr Lenzo not invested in the plantation project, he would have obtained a similar tax benefit by putting money into his self-managed superannuation fund. The Full Federal Court concurred with this finding on the basis that a superannuation contribution was not a deduction of the same kind as a deduction for prepaid maintenance fees, rent and indemnity fees in respect of an investment in a sandalwood plantation.

Ignoring the scheme

The second point relates to the need for "the scheme" to be ignored when formulating the alternative postulate. The court observed that:[3]

> "… s 177C(1)(b) requires the entirety of the scheme to be ignored. The statutory mandate is not fulfilled if part only of the scheme is ignored and the rest is assumed to continue intact."

The judge in the Federal Court and submissions made by the taxpayer were based around an alternative postulate whereby the loan component of the scheme was ignored but otherwise the scheme remained intact. This was held to be an inappropriate approach.

As can be seen by later decisions, the alternative postulate does not need to exclude each and every step that was part of the scheme. However, it needs to be different to the scheme and cannot simply be the scheme minus particular steps. A valid alternative postulate may include elements of the scheme, but would also need to include other elements.

3 *FCT v Lenzo* [2008] FCAFC 50 at [136].

Section 5

Other important elements

Chapter 16

Rulings

¶16-100 Issues when seeking a ruling on Pt IVA

Applying for a binding private ruling on the application of the tax laws to a particular situation is an effective way to gain certainty regarding a taxpayer's position. This applies to issues arising under Pt IVA, as it does to any other part of the tax laws. However, Pt IVA does present some unique challenges in a private binding ruling context.

The decision to apply (or not to apply) Pt IVA is dependent on the particular facts and circumstances under consideration. Likewise, a private ruling is only binding on the Commissioner when the facts and circumstances of the actual arrangement that is implemented are consistent with the facts and circumstances on which the ruling is based (which will be set out in the ruling issued by the Commissioner).

It can be very difficult to adequately set out in a ruling application all of the facts and circumstances that will be relevant for assessing the application of Pt IVA. So, while a favourable response may be received for the ruling application, the ruling itself may turn out to be worthless when it is challenged and other facts and circumstances are identified.

A private ruling is based on a static set of facts and circumstances and there is no mechanism (other than applying for a new ruling) to update the facts and circumstances as they change. This is particularly problematic for transactions which are evolving.

It will take a reasonably long period of time to obtain a private ruling that addresses the application of Pt IVA. This is due to various factors, not the least of which being the additional processes that the ATO is required to undertake to ensure proper consideration of the Pt IVA question. The extended period of time to obtain a ruling is an issue for time-sensitive transactions. The ability to have ruling applications prioritised is limited in an SME taxpayer situation.

Part IVA (specifically the eight factors in s 177D ITAA36) refers to matters which can only be assessed after the transaction has been entered into or carried out. This in itself can mean that the Commissioner may be unable to rule on the application of Pt IVA, or that any ruling issued is susceptible to challenge and may later be found not to be binding.

It is suggested that there will only be a limited number of situations where seeking a ruling on the application of Pt IVA will be appropriate. A good example would be a non-time-sensitive internal restructure transaction. Given that the "do nothing" alternative postulate may well have been a key defence to the application of Pt IVA to these types of transaction in the past, obtaining a private ruling may warrant greater consideration in the future as a way of managing tax risks on this type of voluntary transaction.

¶16-105 ATO guidelines on private rulings and Pt IVA

PS LA 2005/24 contains guidance for tax officers when dealing with the application of Pt IVA, including in a private ruling situation.

If a taxpayer requests a private ruling on whether Pt IVA applies to an arrangement, tax officers must follow the practice for dealing with ruling requests on Pt IVA contained in the internal ATO Online Resource Centre for Law Administration. This includes a process for referring to the GAAR Panel for guidance (see chapter 17).

If a taxpayer applies for a private ruling in respect of an arrangement but has not requested a ruling on whether Pt IVA applies to the arrangement, tax officers must consider whether Pt IVA may apply to the arrangement based on the information provided in connection with the ruling application.

If tax officers consider that, on the basis of the information provided in connection with the ruling application, it is either not clear whether Pt IVA applies, or it seems that Pt IVA may apply to:

- the particular arrangement for which the private ruling is requested; or
- an associated arrangement(s) or a wider arrangement of which the particular arrangement for which the ruling is requested is part,

then the following words must be included in the private ruling:[1]

> "Part IVA is a general anti-avoidance rule that can apply in certain circumstances if you or another taxpayer obtains a tax benefit in connection with an arrangement and it can be concluded that the arrangement, or any part of it, was entered into or carried out by any person for the dominant purpose of enabling a tax benefit to be obtained. If Part IVA applies the tax benefit can be cancelled, for example, by disallowing a deduction that was otherwise allowable.
>
> We have not fully considered the application of Part IVA to the arrangement you asked us to rule on, or to an associated or wider arrangement of which that arrangement is part.
>
> If you want us to rule on whether Part IVA applies we will first need to obtain and consider all the facts about the arrangement which are relevant to determining whether Part IVA may apply."

If there is no reason to suggest (on the basis of the information provided in connection with the ruling application) that Pt IVA may apply to:

- the particular arrangement for which the private ruling is requested; and
- any associated arrangement(s) or a wider arrangement of which the particular arrangement for which the ruling is requested is part,

then any ruling that is given does not need to refer to Pt IVA.

1 PS LA 2005/24 at [11].

Applications for private rulings in respect of the application of Pt IVA are not generally referred to the GAAR Panel for advice as this will delay the issue of a ruling. However, a private ruling must be referred to the GAAR Panel where the applicant requests the referral and, by doing so, agrees to a delay in the issue of the ruling.

Any ruling that Pt IVA applies to a particular transaction must be approved by a Tax Counsel Network officer.

A taxpayer who receives a private ruling that Pt IVA applies may request that the matter be referred to the GAAR Panel as part of seeking a review of the ruling. This may be done before the lodgment of an objection against the private ruling or at the same time as, or after, the lodgment of the objection.

> It is strongly recommended that an application for a private ruling on the application of Pt IVA, or an objection or appeal against an unfavourable ruling, be prepared by, or in conjunction with, a specialist tax adviser who is experienced in the application of Pt IVA.

Chapter 17

The GAAR Panel

¶17-100 The role of the GAAR Panel

The GAAR Panel is a non-statutory, consultative body established by the Commissioner to provide guidance on the application of Pt IVA and other general anti-avoidance provisions.

The GAAR Panel is made up of business and professional people chosen for their ability to provide expert and informed advice, with the other members of the Panel being senior tax officers. The Chair of the Panel is a senior tax officer.

The GAAR Panel provides independent advice to tax officers who are assessing the application of Pt IVA. This includes advice regarding the appropriate imposition of penalties. The GAAR Panel does not make a decision but its advice is taken into account by the ATO decision-maker.

The Panel does not investigate or find facts, or arbitrate disputed contentions. Rather, the Panel provides its advice on the basis of the contentions of fact which have been put forward by ATO officers and by the taxpayer.

In an audit situation, a matter is generally referred to the GAAR Panel following the issue of the ATO's position paper and consideration by the tax officer of all available information, including any responses by the taxpayer to the position paper. However, there is a mechanism for a tax officer to obtain preliminary advice from the GAAR Panel before issuing the position paper.

To assist the GAAR Panel in providing advice to tax officers, a taxpayer (and/or a representative of the taxpayer at the taxpayer's election) will usually be invited to attend a GAAR Panel meeting and address the GAAR Panel. (No such invitation will be extended to a taxpayer in relation to matters which are referred to the Panel at an early stage for preliminary advice.)

A taxpayer may accept or decline the invitation as the taxpayer sees fit. No adverse inference will be drawn against the taxpayer should the taxpayer decline to attend the Panel meeting.

An invitation given to a taxpayer to attend a GAAR Panel meeting and address the Panel is not extended on the basis that it will provide a platform for a hearing as part of a quasi-judicial process of review.

A taxpayer who is invited to attend a GAAR Panel meeting must provide a concise written submission prior to the meeting, or notify the GAAR Panel that they intend to rely on previous written submissions made to the ATO. If a taxpayer who has been invited to attend the GAAR Panel meeting fails to provide a written submission, the invitation may be withdrawn.

A taxpayer who is invited to attend a GAAR Panel meeting will, by a reasonable time prior to the meeting, be informed of the contentions of fact giving rise to the issue referred to the GAAR Panel, and of the substance of the ATO's proposed approach to the application of Pt IVA. Generally, this advice will be by way of reference to a position paper already provided to the taxpayer or by an updated paper prepared following consideration of a response by the taxpayer to the position paper.

As a general guide, a taxpayer can expect to be given around 28 days' notice of a Panel meeting and will be asked to make any written submission no later than seven days before that meeting.

The taxpayer will be given an opportunity to address the GAAR Panel. The Chair will set the time for this address as appropriate in each case (one hour is the general time allowed). The GAAR Panel may ask questions to ensure that the taxpayer's submissions are understood, but this is not a forum for debate of the case.

Taxpayers attending a GAAR Panel meeting should address or be prepared to respond to questions relating particularly to the tax benefit and the objective factors in s 177D of Pt IVA.

Written and oral submissions to the GAAR Panel will not be on a without prejudice basis. However, a person appearing before the Panel who is asked a question may request the Chair to allow a particular response to be made on a without prejudice basis. The Chair has a discretion whether or not to accede to any such request.

> It is strongly recommended that any submissions to, or appearance before, the GAAR Panel be prepared/conducted by a specialist tax adviser who is experienced in the application of Pt IVA.

Chapter 18

Part IVA determinations

¶18-100 The legislation

Section 177F ITAA36 is actually the key provision in Pt IVA — it is through issuing a determination under s 177F that the Commissioner applies Pt IVA to deny a tax benefit. The concepts of scheme, tax benefit and purpose are prerequisites for the Commissioner to be entitled to use his powers under this section:

"(1) Where this Part applies to a scheme in connection with which a tax benefit has been obtained, or would but for this section be obtained, the Commissioner may:

(a) in the case of a tax benefit that is referable to an amount not being included in the assessable income of the taxpayer of a year of income — determine that the whole or a part of that amount shall be included in the assessable income of the taxpayer of that year of income; or

(b) in the case of a tax benefit that is referable to a deduction or a part of a deduction being allowable to the taxpayer in relation to a year of income — determine that the whole or a part of the deduction or of the part of the deduction, as the case may be, shall not be allowable to the taxpayer in relation to that year of income; or

(c) in the case of a tax benefit that is referable to a capital loss or a part of a capital loss being incurred by the taxpayer during a year of income — determine that the whole or a part of the capital loss or of the part of the capital loss, as the case may be, was not incurred by the taxpayer during that year of income;

(ca) in the case of a tax benefit that is referable to a loss carry back tax offset, or a part of a loss carry back tax offset, being allowable to the taxpayer—determine that the whole or a part of the loss carry back tax offset, or the part of the loss carry back tax offset, as the case may be, is not to be allowable to the taxpayer; or

(d) in the case of a tax benefit that is referable to a foreign income tax offset, or a part of a foreign income tax offset, being allowable to the taxpayer — determine that the whole or a part of the foreign income tax offset, or the part of the foreign income tax offset, as the case may be, is not to be allowable to the taxpayer;

and, where the Commissioner makes such a determination, he or she shall take such action as he considers necessary to give effect to that determination.

(2) Where the Commissioner determines under paragraph (1)(a) that an amount is to be included in the assessable income of a taxpayer of a year of income, that amount shall be deemed to be included in that assessable income by virtue of such provision of this Act as the Commissioner determines.

(2A) Where a tax benefit that is covered by paragraph 177C(1)(bc) has been obtained, or would but for this section be obtained, by a taxpayer in connection with a scheme to which this Part applies:

(a) the Commissioner may determine that the taxpayer is subject to withholding tax under section 128B on the whole or a part of that amount; and

(b) if the Commissioner makes such a determination, he or she must take such action as he or she considers necessary to give effect to that determination.

(2B) A determination under paragraph (1)(c) or subsection (2A) must be in writing.

(2C) Notice of the determination must be given to the taxpayer and, in the case of a determination under subsection (2A), to the person who paid the amount.

(2D) More than one determination may be included in the same notice.

(2E) A failure to comply with subsection (2C) does not affect the validity of a determination.

(2F) If the Commissioner makes a determination under subsection (2A), the amount that the Commissioner determines is taken to be subject to withholding tax is taken to have been subject to withholding tax at all times by virtue of such provision of section 128B as the Commissioner determines.

(2G) If the taxpayer is dissatisfied with a determination under paragraph (1)(c) or subsection (2A), the taxpayer may object against it in the manner set out in Part IVC of the *Taxation Administration Act 1953*.

(3) Where the Commissioner has made a determination under subsection (1) or (2A) in respect of a taxpayer in relation to a scheme to which this Part applies, the Commissioner may, in relation to any taxpayer (in this subsection referred to as the ***relevant taxpayer***):

(a) if, in the opinion of the Commissioner:

  (i) there has been included, or would but for this subsection be included, in the assessable income of the relevant taxpayer of a year of income an amount that would not have been included or would not be included, as the case may be, in the assessable income of the relevant taxpayer of that year of income if the scheme had not been entered into or carried out; and

  (ii) it is fair and reasonable that that amount or a part of that amount should not be included in the assessable income of the relevant taxpayer of that year of income;

  determine that that amount or that part of that amount, as the case may be, should not have been included or shall not be included, as the case may be, in the assessable income of the relevant taxpayer of that year of income; or

(b) if, in the opinion of the Commissioner:

  (i) an amount would have been allowed or would be allowable to the relevant taxpayer as a deduction in relation to a year of income if the scheme had not been entered into or carried out, being an amount that was not allowed or would not, but for this subsection, be allowable, as the case may be, as a deduction to the relevant taxpayer in relation to that year of income; and

  (ii) it is fair and reasonable that that amount or a part of that amount should be allowable as a deduction to the relevant taxpayer in relation to that year of income;

  determine that that amount or that part, as the case may be, should have been allowed or shall be allowable, as the case may be, as a deduction to the relevant taxpayer in relation to that year of income; or

(c) if, in the opinion of the Commissioner:

  (i) a capital loss would have been incurred by the relevant taxpayer during a year of income if the scheme had not been entered into or carried out, being a capital loss that was not incurred or would not, but for this subsection, be incurred, as the case may be, by the relevant taxpayer during that year of income; and

(ii) it is fair and reasonable that the capital loss or a part of that capital loss should be incurred by the relevant taxpayer during that year of income;

determine that the capital loss or the part, as the case may be, should be incurred by the relevant taxpayer during that year of income; or

(ca) if, in the opinion of the Commissioner:

(i) an amount would have been allowed, or would be allowable, to the relevant taxpayer as a loss carry back tax offset if the scheme had not been entered into or carried out, being an amount that was not allowed or would not, apart from this subsection, be allowable, as the case may be, as a loss carry back tax offset to the relevant taxpayer; and

(ii) it is fair and reasonable that the amount, or a part of the amount, should be allowable as a loss carry back tax offset to the relevant taxpayer;

determine that that amount or that part, as the case may be, should have been allowed or is allowable, as the case may be, as a loss carry back tax offset to the relevant taxpayer; or

(d) if, in the opinion of the Commissioner:

(i) an amount would have been allowed, or would be allowable, to the relevant taxpayer as a foreign income tax offset if the scheme had not been entered into or carried out, being an amount that was not allowed or would not, apart from this subsection, be allowable, as the case may be, as a foreign income tax offset to the relevant taxpayer; and

(ii) it is fair and reasonable that the amount, or a part of the amount, should be allowable as a foreign income tax offset to the relevant taxpayer;

determine that that amount or that part, as the case may be, should have been allowed or is allowable, as the case may be, as a foreign income tax offset to the relevant taxpayer;

and the Commissioner shall take such action as he or she considers necessary to give effect to any such determination.

(4) Where the Commissioner makes a determination under subsection (3) by virtue of which an amount is allowed as a deduction to a taxpayer in relation to a year of income, that amount shall be deemed to be so allowed as a deduction by virtue of such provision of this Act as the Commissioner determines.

(5) Where, at any time, a taxpayer considers that the Commissioner ought to make a determination under subsection (3) in relation to the taxpayer in relation to a year of income, the taxpayer may post to or lodge with the Commissioner a request in writing for the making by the Commissioner of a determination under that subsection.

(6) The Commissioner shall consider the request and serve on the taxpayer, by post or otherwise, a written notice of the Commissioner's decision on the request.

(7) If the taxpayer is dissatisfied with the Commissioner's decision on the request, the taxpayer may object against it in the manner set out in Part IVC of the *Taxation Administration Act 1953*."

¶18-105 Usual process

Section 177F (the making of a Pt IVA determination) is the key provision in Pt IVA as it is this provision which enables the Commissioner to disallow a tax benefit and issue an amended assessment. That said, the determination process is largely procedural and is certainly rarely an issue before a dispute phase (at which time, it is recommended that specialist advice be sought).

Having been through the process of considering the application of Pt IVA, issuing a position paper, considering taxpayer responses, consulting with the GAAR Panel and all the associated steps, if the Commissioner (through his delegates) has determined that the conditions for the application of Pt IVA are satisfied, he will then:

- issue a Pt IVA determination to the taxpayer; and then
- issue the necessary amended assessments to give effect to the determination.

¶18-110 What is in a Pt IVA determination?

A Pt IVA determination will generally follow this type of format:

Determination made pursuant to section 177F of Part IVA of the *Income Tax Assessment Act 1936*

I, Mary Brown, Deputy Commissioner of Taxation, Large Business and International, in the exercise of the powers and functions delegated to me by the Commissioner of Taxation, determine under paragraph 177F(1)(a) of the *Income Tax Assessment Act 1936* (the Act) that the amount of $3,567,900, being a tax benefit that is referable to an amount that has not been included in the assessable income of XYZ Pty Ltd, TFN 99 999 999 (the taxpayer), for the year of income ended 30 June 2003, shall be included in the assessable income of the taxpayer for that year of income.

I further determine under subsection 177F(2) of the Act that the amount shall be deemed to be included in the assessable income of the taxpayer by virtue of section 6-5 of the *Income Tax Assessment Act 1997*.

Dated the 9th day of June 2005.

Mary Brown (handwritten or stamped) .... pp John Citizen

Mary Brown
Deputy Commissioner of Taxation, Large Business and International

¶18-115 Challenging a Pt IVA determination

The comment of Hill J in *Sleight* was that "in other words, it is not open to a taxpayer to challenge an assessment under Part IVA by showing some error in the making of that determination".[1] There will be limited situations where a Pt IVA determination itself can be challenged. Rather, the usual situation will be that the taxpayer will need to challenge the assessment on the basis that it is excessive.

The High Court stated in *Peabody*:[2]

> "Under s. 177F(1), the Commissioner's discretion to cancel a tax benefit extends only to a tax benefit obtained in connection with a scheme to which Pt IVA applies. The existence of the discretion is not made to depend upon the Commissioner's opinion or satisfaction that there is a tax benefit or that, if there is a tax benefit, it was obtained in connexion with a Pt IVA scheme. Those are posited as objective facts ... The erroneous identification by the Commissioner of a scheme as being one to which Pt IVA applies or a misconception on his part as to the connection of a tax benefit with such a scheme will result in the wrongful exercise of the discretion conferred by s. 177F(1) only if in the event the tax benefit which the Commissioner purports to cancel is not a tax benefit within the meaning of Pt IVA ... 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 connexion with a Pt IVA scheme and so susceptible to cancellation at the discretion of the Commissioner."

¶18-120 Is the issue of a Pt IVA determination subject to additional conditions?

One of the arguments made before the court in *Cumins* was that the wording of s 177F (under which the Commissioner makes a Pt IVA determination) requires the Commissioner to exercise a discretion or form an opinion before issuing a determination.[3] This was on the basis that the section provides that the Commissioner "may" issue a determination. It was purported that additional factors could (and should) be taken into account by the Commissioner when deciding whether to issue a determination.

The court rejected this argument, holding that, once the conclusion under s 177D was reached, there was no "superimposed obligation" to take into account other matters when deciding whether to cancel a tax benefit.

The decision to cancel a tax benefit under s 177F(1) does not involve two stages. Once the Commissioner is empowered to cancel a tax benefit because the requirements in s 177D are satisfied, there is no further opinion that he has to form. It follows that the power to cancel a tax benefit under s 177F(1) may be discretionary in the sense that it is not compulsory for the Commissioner to exercise the power, but it is not discretionary in the sense of being dependent on his forming an opinion, or state of satisfaction which could be subject to judicial review.

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1 *FCT v Sleight* [2004] FCAFC 94 at [107].

2 *FCT v Peabody* [1994] HCA 43 at [24].

3 *Cumins v FCT* [2007] FCAFC 21

¶18-125 Multiple determinations

In *McCutcheon*, a ground for appeal was that, by issuing multiple determinations, the Commissioner had failed to identify "a tax benefit" obtained by a taxpayer.[4] Instead, the Commissioner was said to have identified multiple tax benefits based on one stream of income, and on this basis, the determinations were invalid. The multiple determinations were issued to the trust and to the beneficiaries of the trust (in relation to the portion of the adjustment to taxable income that the Commissioner considered would flow to them).

The court noted that the Commissioner is entitled to adopt, especially in the context of complex arrangements, alternative views of what would or might reasonably have been expected to have occurred and make alternative determinations.

The court also considered that the capacity in which a taxpayer acts is central to assessments which issue consequent on a determination. A determination issued to a taxpayer in its capacity as trustee, where a beneficiary is presently entitled to 100% of the income of the trust for the particular year of income, can support an assessment issued to the beneficiary.

In *McCutcheon*, the assessments were held to be valid.

¶18-130 What determinations will the Commissioner generally issue?

If a taxpayer obtains two or more separate "tax benefits" under Pt IVA in the same counterfactual scenario (for example, assessable income is omitted and a capital loss is incurred), a separate determination will be made for each kind of tax benefit.

If a taxpayer obtains a different amount of the same kind of tax benefit in different counterfactual scenarios in connection with a single scheme to which Pt IVA would apply in a particular year, the correct approach is to make a single determination under s 177F(1) for the kind of tax benefit that is obtained. The highest tax benefit of the same kind for the counterfactual scenarios will generally be used in the determination.

If a taxpayer can be assessed to two or more tax benefits under Pt IVA from more than one scheme in a particular year, determinations will be issued in respect of each scheme and, if relevant, for each different kind of tax benefit obtained in connection with each scheme.

The Commissioner can issue determinations (and issue assessments) to more than one taxpayer in respect of the same tax benefit. This can occur where the Commissioner forms the view that each determination and consequent assessment could be correct, based on what is known by the Commissioner at the time. *McCutcheon*, involving a trustee and beneficiaries, is a good example of where this can occur.

4 *McCutcheon v FCT* [2008] FCA 318.

¶18-135 Compensating adjustments

Section 177F(3) gives the Commissioner power to make compensating adjustments where, in his opinion, it is fair and reasonable to do so. There is no time limit for amendment of assessments to give effect to these compensating adjustments.

The underlying policy intent is that, where the application of Pt IVA causes the double taxation of the same income, a compensating adjustment should be made to alleviate the double taxation.

A good example is provided in PS LA 2005/24:

> "A scheme involves the diversion of personal services income to a family trust. The income has been distributed to the beneficiaries (family members) who were taxed accordingly. The Commissioner makes a determination under subsection 177F(1) with respect to the scheme. The determination includes the whole of the personal services income in the assessable income of the taxpayer (the personal services income earner). Compensating adjustments are made in favour of the taxpayer's family members (the beneficiaries), such that the individual beneficiaries' income from the trust is determined not to have been included in their assessable incomes."

Compensating adjustments will not generally be made while the application of Pt IVA is being disputed (ie during the objection or appeal stages). Once the position in respect of the application of Pt IVA in the particular situation is clear, the Commissioner is then able to assess what, if any, compensating adjustments are fair and reasonable to make.

As a general rule, if it is clear that various compensating adjustments are going to be appropriate, taxpayers will be notified of the compensating adjustments that they should expect.

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