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The Interrelation of Scheme and Purpose Under Part IVA

Maurice J Cashmere *

Abstract

The way in which a scheme is defined under Part IVA is emerging as the principal factor which circumscribes the purpose of the scheme. Context is critical to this inquiry. If the identified tax benefit is not referenced to its practical context, then the inquiry regarding whether obtaining the tax benefit is the dominant purpose is largely a forgone conclusion. This essay examines the principles which have been established to date and argues for the need to determine dominant purpose by reference to the practical context of the transaction, in order to ensure that the general anti-avoidance measure does not annihilate all tax benefits.

INTRODUCTION

Part IVA Income Tax Assessment Act 1936 ("ITAA") contains the statutory test which applies in Australia for determining what transactions are arrangements for the avoidance of tax. To do this, it establishes a purposive test. The statutory framework provides that where there is a scheme from which a taxpayer has obtained a tax benefit, the Federal Commissioner of Taxation ("Commissioner") may cancel the tax benefit obtained and issue an amended tax assessment where, having regard to eight listed criteria, it would be concluded that the taxpayer entered into, or carried out the scheme, for the dominant purpose of obtaining the tax benefit.¹

Before the Commissioner may make such a determination, three elements must be established. There must be:-

- a) a tax benefit;
- b) which arises out of a scheme; and
- c) the existence of a dominant purpose on the part of the taxpayer, or one of those involved with the scheme, to obtain the tax benefit.

While each of these elements is a separate part of the statutory test, each is interrelated.

A tax benefit arises where either:-

- an amount was not included in the taxpayer's assessable income when it would, or might reasonably otherwise have been expected to be included; or

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¹ S177D

- an amount was deducted from the taxpayer's assessable income where it would not, or might reasonably have been expected not to be deducted otherwise.²

There is no qualification on the word "amount," so it is not limited to tax advantages which are contrived or artificial, or have been created by self-cancelling paper transactions. A tax benefit is any tax advantage.

The tax benefit must, however, arise out of a scheme to which ITAA applies. A scheme is:-

- 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
- including any unilateral scheme, plan, proposal, action, course of action or conduct.³

This definition is wide. In fact, it is so wide, that it can relate to any course of action, or any single act, including a unilateral act. So broad is the definition of the concept of a scheme, that a tax benefit could arise out of any course of action so long as a purpose, which is a dominant purpose, to obtain the tax benefit, can be ascertained.

What has become apparent from the cases which have come before the courts to date is that the definition of the scheme is critical to the finding relating to the purpose of the taxpayer in entering into the scheme. The more narrowly the scheme can be defined just by reference to the facts which generate the tax benefit, the easier it will be for a dominant purpose of obtaining that tax benefit to be established. In fact, it is this issue which is at the heart of the current tussle between the Commissioner and the courts, as manifest in the appeal in *Hart v FCT*⁴ at present before the High Court.

If the Commissioner is able to convince the High Court that schemes can be identified just by reference to the tax benefit – ignoring the context in which the tax benefit was obtained – then the Commissioner will have achieved the power to annihilate any commercial or family transaction where a tax advantage is found, which is something which no general anti-avoidance measure has succeeded in doing to date. So far, the courts have held the line by ensuring that:

- the purpose test is assessed in relation to the factual context in which the taxpayer operated; and that
- the scheme whose purpose is relevant is not so narrowly defined that it ignores the factual basis of the transaction which the taxpayer entered into or carried out.

As a consequence, the identification of the scheme has become critical to the finding which the Court can make about purpose. This paper seeks to examine the manner in which the courts have narrowed the breadth of Part IVA by insisting upon the concepts of both “scheme” and “purpose” being identified by reference to the practical reality of the circumstances out of which the tax benefit emerged.

² S177C

³ S177A(1) and (2)

⁴ 2002 ATC 4608

THE SCHEME

Scheme Identification

Part IVA is not concerned with any old scheme. It is concerned only with those schemes which produce a tax benefit, where the requisite purpose has been established. This is underscored by observations made by Hill J. in *Hart v FCT*.

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.⁵

As the purposive test has been developed, it has become apparent that the concept of a tax benefit and the test of purpose depend very much on the way in which the scheme is identified.

The importance of identifying the scheme properly was emphasised by the High Court in *FCT v Peabody*⁶ - the first Part IVA case to reach the High Court.

Under S177F(1), the Commissioner's discretion to cancel a tax benefit extends only to a tax benefit obtained in connection with a scheme to which Part 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 connection with a Part IVA scheme. Those are positioned as objective facts. The erroneous identification by the Commissioner of a scheme as being one to which Part 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 S177F(1).⁷

The point here is that the discretion vested in the Commissioner can only be exercised where it has been established, as a matter of objective fact, that a tax benefit exists and that it arises out of a scheme to which Part IVA applies.

So far, there appears to have been little difficulty in establishing what the tax benefit is. The difficulty has been in identifying the Part IVA scheme.

In identifying the scheme certain elements must be established. The critical elements are:-

- the parties to the scheme, in so far as they are known;⁸
- the terms or content of any agreement, arrangement, understanding, promise or undertaking;⁹ and
- the steps or stages of any course of action or proposal in so far as they are relevant.¹⁰

⁵ Ibid 4618-4619

⁶ [1994-95] 181 CLR 359

⁷ Ibid 382

⁸ Ibid 382, *FCT v Spotless Ltd* 95 ATC 4775, 4805

⁹ *FCT v Spotless Services Ltd* 95 ATC 4775, 4805

It is critical that the parties to the scheme are identified - particularly the taxpayer who has had a tax benefit cancelled. If the taxpayer is not correctly identified, this will result in the revised assessment being set aside. Further, the terms of the scheme need to be identified with some degree of particularity. It is not sufficient for the whole of the facts to be relied upon. The Commissioner must establish which facts constitute the scheme. If facts less than the whole of the circumstances constitute the scheme, they must be particularised.

The difficulties of identification are illustrated by the lengthy consideration given to this issue by the Full Federal Court in *FCT v Spotless Services Ltd.*¹¹ (There was no consideration given to this issue by the High Court in this case as by the time the matter reached the High Court, the parties had decided on the identification of the scheme). There, a resident Australian company had invested Australian-based funds in Australian dollars on short-term deposit with a financial institution in the tax haven of the Cook Islands. Because of perceived credit risk on the part of the financial institution, the deposit was supported by credit enhancement documentation. This deposit was made offshore to obtain a better after-tax return than would have been possible by leaving the funds invested in Australia. The advantage lay in the fact that interest on foreign funds was subject to a low withholding tax in the Cook Islands, and at the time the ITAA exempted from tax, any income which had been taxed offshore in a country with which Australia had no double tax treaty. Australia had no double tax treaty with the Cook Islands.

On these facts, the Commissioner identified two schemes. The more broadly drawn scheme was identified as the calculated steps taken to source income overseas in order to attract a tax benefit where, but for the scheme, the funds would have been invested in Australia. The alternative scheme was identified as the loan which, ostensibly would have been entered into on commercial terms in Australia, was made offshore on unusual commercial terms to attract a special tax concession.

In neither of these formulations was there any mention of a taxpayer. That was held to be a fatal flaw. Likewise, in neither formulation had the steps of the relevant course of action been identified accurately. For instance, the Commissioner had maintained that the taxpayer had a choice about where the deposit was made and that it could have been made in Australia. That was held to be incorrect, since the deposit actually made could only have been made in the Cook Islands. That inaccuracy failed to satisfy the basic requirements of identification.

In addition, the Court criticised the attempt to portray the scheme as a deliberate device to render income immune from tax by siting the transaction offshore, when it would ordinarily have been expected to be sited in Australia. This was regarded as hypothesis, rather than fact or reality. Furthermore, the Commissioner cannot allege, as he did here, that the scheme is a sham if it is not.

IDENTIFICATION PRINCIPLES

The First Identification Principle

While the formal identification of the scheme has presented difficulties, the real battleground is over whether the scheme can be so narrowly drawn that it encapsulates

¹⁰ Peabody 181 CLR at 382, Spotless 95 ATC at 4805

¹¹ 95 ATC 4775

just the identified tax benefit, or whether it must take into account the substance of the transaction which the taxpayer entered into. It is axiomatic that the more narrowly the scheme is identified as the facts whereby the tax benefit was obtained, the more likely it is that the necessary dominant purpose of obtaining the tax benefit will be found.¹² This was apparent from the very first case to go to the High Court, *FCT v Peabody*.

Peabody's case involved inter-related corporate transactions, being the acquisition of shares with borrowed funds and a corporate reduction in capital which provided the funds whereby the loan could be repaid. The narrowly drawn scheme, which the Commissioner relied upon, was the reduction in capital, because that was the part of the overall transaction which produced the tax benefit. However, at the first instance hearing, the Commissioner had particularised the steps of the scheme more broadly. The High Court concluded that the Commissioner could not single out the reduction of capital as the relevant transaction, divorced from the share acquisition part of the corporate restructuring. The High Court took the view that the narrow scheme relied on by the Commissioner was not a scheme for the purpose of Part IVA because:-

... Part IVA does not provide that a scheme includes part of a scheme and it is possible, despite the very wide definition of a scheme, to conceive of a set of circumstances which constitutes only part of a scheme and not a scheme in itself. That will occur where the circumstances are incapable of standing on their own without being 'robbed of all practical meaning'.¹³

This was the approach taken subsequently by the majority of the Full Federal Court in *FCT v Spotless Services Limited*. There, the majority emphasised that it was necessary to ensure that, where part of an overall set of facts is identified as a scheme for the purposes of Part IVA, it must be capable of standing on its own and having practical effect severed from its antecedent or subsequent conduct.¹⁴ What this establishes is that the identification of the scheme is not an abstract exercise to be carried out in a vacuum, divorced from the practical reality of the factual situation.

This analysis was borne out by observations made by the Full Federal Court in *FCT v Consolidated Press Holdings Ltd*.¹⁵

In particularising his case in appeal proceedings the Commissioner may identify one scheme and alternatively rely upon another which is a subset of the first ... (a) scheme identified as such may ... be a scheme for the purposes of Part IVA even if it can also be regarded as part of a larger scheme. The first resort in determining whether what the Commissioner ... identified as a 'scheme' properly answered that description must be the words of the description S177A. The caveat in *Peabody* sets a broadly stated outer limit upon those words. It is evaluative in character. Whether circumstances 'standing on their own' are 'robbed of all practical 'meaning' is a matter of judgment rather than logical analysis.¹⁶

On appeal in the High Court these observations were not criticised.

¹² Hely J. *Hart v FCT* 2002 ATC at 4626

¹³ 181 CLR at 383-384

¹⁴ 95 ATC at 4805

¹⁵ 1999 ATC 4945

¹⁶ *Ibid* 4967

This is the very issue which is central to *Hart v FCT*, which is currently before the High Court on appeal. This case involved an attack by the Commissioner on a home loan product which has been marketed in Australia by financial institutions with great success. The product - in this instance known as a wealth optimiser loan - provided for a loan in two facilities. One facility related to the loan in respect of the taxpayer's residence; the other related to the loan for an investment property. The special feature of this product was that all the payments of interest and principal were directed to the facility relating to the owner-occupied residence until it was completely repaid. Meantime, interest on the investment property facility accrued at compound rates, which increased the principal amount and consequently the interest payable. Once the loan in respect of the owner-occupied residence facility was repaid, the loan payments were directed towards the investment facility; the deductions for interest on the investment facility were consequently higher than they would otherwise have been.

The Commissioner identified the scheme as the provision in the loan for the division into two facilities, whereby the borrower could direct that loan payments be applied towards repaying the home loan facility prior to the investment facility.

In identifying the scheme so narrowly, the Commissioner equated the scheme just with the loan structure which enabled the tax benefit to be obtained. But the scheme so identified took no account of the fact that there was a taxpayer involved, who had refinanced his house in order to acquire another residence in which to live and to enable him to retain his existing house as an investment. So, the narrow scheme ignored the making of the loan and the incurring of interest payments under it, and the context in which the loan was made.

That approach did not find favour with the Court. The Court took the view that a definition which did not include the raising of the loan by the taxpayer to finance and refinance the two properties on the terms of the wealth optimiser loan and the incurring of interest payments under it, could not stand on its own two feet having any practical contextual meaning. What the Commissioner had done was to identify part of a series of steps as a scheme, whereas the scheme should have been defined as a series of steps which encapsulated the essence of the transaction which the taxpayer had entered into.

One of the grounds upon which special leave to appeal to the High Court was granted, was that the Full Federal Court had erred in declining to accept that the Commissioner could rely on the narrowly defined scheme. It was argued that the narrow scheme could stand by itself without being robbed of all practical meaning. Objection was also taken to the fact that the scheme must take the factual context into account.

This is a direct attack on the *Peabody* principle of identification which has been adopted consistently ever since. It is clear from *Peabody* that the High Court was referring to the need for a scheme to reflect a transaction which made practical sense by itself. Indeed, it made reference to the shape of transactions being influenced by revenue considerations. If the Commissioner were able to identify the scheme just as the situation which gave rise to the tax benefit, this would escalate the situation which gave rise to the tax benefit into the transaction itself, and the shape of the transaction would be irrelevant.

Hart's case is on appeal to the High Court. If the High Court were not to uphold the Full Federal Court's decision-based as it is on the principles established by the High

Court itself in *Peabody* – then Part IVA will be capable of annihilating any transaction, something which no general anti-avoidance provision to date has ever achieved before.

The reason why the identification of the scheme by reference to the substance of the transaction is so important, is that the way the scheme is identified affects the inquiry that needs to be made later regarding the purpose of the scheme. If the Commissioner were able to identify just the part of the facts whereby the taxpayer obtained the tax benefit as the scheme, then few, if any, transactions would survive annihilation. The purpose would be clear even without the need to consider the eight specific factors necessary to establish the dominant purpose of the scheme. The *Peabody* approach is clearly an attempt to limit a very broadly drawn anti-avoidance measure.

The Second Identification Principle

Peabody's case established another principle which is that the Commissioner may rely on alternative schemes and is not necessarily bound by the original identification of the scheme. But how far the Commissioner may go in redefining the scheme, or in relying on a newly identified scheme, is a matter of some uncertainty. The view expressed by the High Court in *Peabody* was that the Commissioner was entitled to redefine the scheme even as late as the initial hearing, if it were originally defined too widely. Specifically, the High Court said:-

If, within a wider scheme which has been identified, the Commissioner seeks also to rely upon a narrower scheme as meeting the requirements of Part IVA, then in our view there is no reason why the Commissioner should not be permitted to do so provided it causes no undue embarrassment or surprise to the other side. If it does, the situation may be cured by amendment, provided the interests of justice allow such a course.¹⁷

The High Court in *Peabody* did not go further than that. In the context of the facts in that case it said:-

In this case (the first instance judge) took the view that the Commissioner had particularised the scheme too widely and that it should be confined.... He was not bound to accept the wider scheme advanced by the Commissioner before him and there was no unfairness to the taxpayer in his reaching the conclusion which he did, notwithstanding the apparent failure of the Commissioner to advance alternative schemes.¹⁸

It is clear here that there was no unfairness since the determination had been made in relation to the narrow scheme which had originally been identified.

What this observation shows is that the High Court was acknowledging that the Commissioner could redefine a scheme, if he wished to identify a narrower scheme, within a more widely defined scheme. The High Court also appears to have accepted that the Commissioner's wider formulation in terms of the particularised steps could be regarded as the scheme, notwithstanding the lateness of the formulation. However, all of this took place before or at the initial hearing. There is no support here for the view that the Commissioner can re-identify a scheme at any time subsequent to the initial hearing.

¹⁷ 181 CLR at 382-383

¹⁸ 181 CLR at 383

There are observations to be found which tend to suggest otherwise. In 1999 the Full Federal Court in *FCT v Consolidated Press Holdings Ltd* said that the exercise of the Commissioner's discretion does not depend on the correct identification of a scheme by the Commissioner. The Commissioner's discretion is enlivened so long as there is a Part IVA scheme.¹⁹ The basis of this view must be that the identification of the scheme is posited as one of objective fact and therefore it would follow that so long as a scheme can be identified as a matter of objective fact, Part IVA applies.

But this view is not borne out by what has been said in more recent cases. Nor would it appear to be sustained by the provisions of Part IVA²⁰ or fundamental principles of due process.

In 2002 in *Hart v FCT* Hill J. said that if the Commissioner can re-identify schemes it is only initially and only between narrowly and widely defined schemes. The Commissioner may change his mind, but only subject to considerations of fairness.²¹ This appears to be directed to his ability to choose between the narrowly and widely defined schemes which he has identified. His Honour's observation simply confirms the narrow way in which the High Court in *Peabody* expressed itself.

Nor does the High Court decision in *Peabody* support the proposition that the Court can itself identify a scheme as the Full Federal Court did in *Spotless*. If the Court were to formulate its own scheme at the hearing or on appeal, then the discretion vested in the Commissioner would not have been exercised.

As Hill J. observed in delivering the unanimous judgment of the Court when *Peabody v FCT* was before the Full Federal Court, the determination which the Commissioner makes must be made in relation to the scheme he identifies. The scheme which then has to be considered by the Court is the scheme in respect of which the Commissioner made his determination. As His Honour said:-

...this Court cannot stand in the shoes of the Commissioner and exercise discretions which the legislature has committed to the Commissioner. This Court is confined to deciding whether the Commissioner's decision has been affected by some error of law, whether the Commissioner has addressed himself to the right issue or whether he has taken some extraneous factor into consideration or failed to take into account some relevant factor.²²

Hill J. then went on to address the possibility that the Commissioner could formulate a new scheme, but came to the conclusion that in this situation the Commissioner would have to make a fresh determination and make an amended assessment. Those observations were not commented on or criticised in the High Court.

This approach also appears to be supported by the way in which the Full Federal Court last year in *FCT v Mochkin*²³ handled an attempt by the Commissioner to reformulate the scheme. The Commissioner attempted, before the Full Federal Court, to advance a wider scheme which had not been put to the first instance judge. The Full Federal Court took the view that the Commissioner could not rely on this wider scheme, as the

¹⁹ 1999 ATC at 4967

²⁰ *FCT v Peabody* [1993-94] 181 CLR 359,382

²¹ 2002 ATC at 4619

²² 93 ATC 4101, 4116

²³ 2002 ATC 4465

taxpayer would have been prejudiced by not being able to call additional evidence relating to this scheme.

That approach accords with the principle established by *Peabody* and is consistent with the thrust of the principles formulated in the Full Federal Court subsequently.

The Third Identification Principle

The third principle is that in identifying schemes, the Commissioner must ensure that they exist in fact and reality, and are not simply figments of the Commissioner's imagination. This was referred to by the Full Federal Court in *Spotless* in the following way:-

It is not sufficient to identify a scheme by reference to a hoped for fiscal outcome [Part IVA] requires that a scheme has an existence in fact and reality and is not something based on the Commissioner's view of the facts or their legal effect.²⁴

This was illustrated in *Spotless*. When the case was before the Full Federal Court, the fact that the scheme, which the Commissioner had identified, was said to be a scheme to capture a tax benefit in the form of a special exemption from tax was criticised as being a reflection of the Commissioner's perception of the arrangement.

The Fourth Identification Principle

There is another issue regarding identification and that is whether a scheme can be identified only by what was in fact done, as distinct from what might otherwise have been done.

The issue was raised in *Mochkin*. In *Mochkin*, the taxpayer, who was a stockbroker, had been sued by a firm of stockbrokers for defaults made by clients he had introduced. Subsequently, in order to protect himself from such liability, the taxpayer arranged for his family trust to carry out stockbroking services for stockbroking firms. During most of this time the service trust had the benefit of services from various people to carry on the business. Some work also appears to have been done by the taxpayer. From these circumstances, the Commissioner alleged that the taxpayer had entered into a Part IVA scheme by using the trust to receive commissions which the taxpayer would otherwise have received for personal services. It was alleged that this was a diversion of personal service income, which enabled a tax benefit to be obtained in the form of the distribution of the commission income to members of the taxpayer's family, instead of to the taxpayer himself.

The Commissioner appears to have contemplated alleging that there was a narrow Part IVA scheme that consisted of the taxpayer not receiving a salary for services performed. In the event, this submission was not pursued. If the Commissioner had pursued this approach, he would have been defining a scheme largely by reference to hypothesis i.e. that the taxpayer would have received the commission income if the trust had not been formed and that the trust should have paid the taxpayer a salary, presumably commensurate with the commissions received.

²⁴ 95 ATC at 4805

However, unlike the definition of a tax benefit, the definition of a scheme does not encompass some hypothesis. The definition is posited as being of objective fact based in reality, not on the fiscal outcome sought by the Commissioner.

Furthermore, the definition of a scheme, in both limbs, uses words which denote positive action. The fact that commissions were not received by the stockbroker, or that no income by way of salary was paid, does not necessarily denote positive action. It denotes passive acquiescence. That appears to be the situation in *Mochkin* as there did not appear to be any evidence of any arrangement or unilateral decision whereby the taxpayer forwent commission or salary.

The Fifth Identification Principle

The issue of whether commerciality is relevant to the identification of a scheme was considered by the Full Federal Court in *Spotless*. As indicated earlier, the Commissioner, in his first formulation, had identified the scheme as a plan which would otherwise have been entered into on normal commercial terms was not.

Notwithstanding the attempts made by the Commissioner to portray the essence of the scheme as artificial and contrived and therefore lacking in commerciality, the Full Federal Court held that the commerciality (or otherwise) of a scheme was not relevant to the issue of identification. Questions of what are, or are not normal commercial practice, are only relevant to the issue of determining the purpose of the scheme. Nor is the purpose of the scheme relevant to the issue of identification. The identification is concerned simply with identified facts.²⁵

Summary

Part IVA cannot apply to all transactions where a tax benefit is obtained. If it did then all deductions for tax purposes would be at risk and income which had not reached the likely recipient identified by the Commissioner would be reallocated at will. This is the result which would arise from an identification of the scheme which is equated just with the perceived tax benefit. That cannot have been the intention of Parliament. A consideration of the Federal Treasurer's second reading speech, when Part IVA was before Parliament, bears this out. The Treasurer said that the new measures sought 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..." The *Peabody* principles in relation to the identification of the scheme, assist in achieving this objective.

PURPOSE

The Relevance of Purpose

The central issue which arises under Part IVA is whether the identified scheme contravenes the anti-avoidance provision. The only schemes which contravene Part IVA are those which were entered into for the dominant purpose of enabling the taxpayer to obtain a tax benefit in connection with that scheme. This issue is determined in relation to the identified scheme by considering eight listed factors. It

²⁵ Ibid

has now been established that by dominant purpose is meant that purpose which is "the ruling, prevailing or most influential purpose."²⁶

The legislation refers to the conclusion about purpose being the purpose of the person, or one of the persons, who entered into or carried out the scheme – not the purpose of the scheme.²⁷

In so far as the meaning of "entered into or carried out the scheme" is concerned, Hill J. in *Peabody's* case, when it was before the Full Federal Court, equated the expression with the word "participate". His Honour also emphasised that the relevant purpose is that of enabling the taxpayer to obtain the necessary tax benefit. In this context His Honour said that the expression "enabling" carried its ordinary meaning of "make able" or "make possible" and probably also meant "assist in making able or possible" or "contribute to making able or possible".²⁸

The legislation refers to the conclusion about purpose being the purpose of the person, or one of the persons, who entered into or carried out the scheme. Therefore, the relevant purpose may be contributed by someone who is not the taxpayer. That does not mean that the purpose of the taxpayer is irrelevant, since the taxpayer may be a person who entered into or carried out the scheme. But, it does mean that anyone connected with the scheme can taint it, even if the taxpayer's purpose is totally untainted, which was the position in *Vincent v FCT*.²⁹

It is also apparent that the requisite purpose may be contributed by someone who is not a party to the scheme. This is borne out by the *Peabody* case itself. There, the person whose purpose was relevant was Mr Peabody, yet he was not a party, in any legal sense, to any of the transactions. He was, however, a participant, in the sense of being the controlling mind behind the scheme.

The legislation highlights another problem. The purpose which is relevant is the purpose of the person, or one of the persons, who entered into or carried out, the scheme. As a scheme for Part IVA purposes can only be a stand-alone scheme, this raises the question of whether the inquiry must relate to the purpose of a person concerned with the stand-alone scheme, or whether the purpose of someone connected with part of a stand-alone scheme will suffice.

The High Court in *Peabody's* case held that if a person participates in only part of a stand-alone scheme, the purpose of that person can be taken into account, but that purpose must be ascertained in relation to the whole of the stand-alone scheme, not just that part of it with which the person was associated.³⁰ Therefore, it would follow that while a person may participate in only part of a scheme (which will be sufficient to provide the physical nexus) the purpose must relate to the whole scheme. The purpose which is relevant to this inquiry, however, is the dominant purpose.

²⁶ *FCT v Spotless Services Ltd* [1996] 186 CLR 404 at 416

²⁷ S177D; Hill J. *Peabody v FCT* 93 ATC 4104 at 4113

²⁸ Hill J. *Peabody* 93 ATC at 4113

²⁹ 2002 ATC 4490

³⁰ 181 CLR at 424

Ascertaining Purpose

If it is the dominant purpose which is relevant, the question is then, how the dominant purpose is to be ascertained. The legislation refers to the conclusion about purpose being drawn from the purpose of the person, or one of the persons who entered into or carried out the scheme. This tends to suggest that the conclusion about purpose can be ascertained from the subjective intention of the taxpayer, or anyone else who was connected with the scheme. However, the High Court has clarified that the relevant purpose is an objective purpose ascertained by having regard to objective facts. Thus, in the main judgment, in the High Court in *Spotless*, is to be found the following passage, regarding the requirement for an objective test:-

Section 177D presents the question whether, having regard to the eight categories of matter identified in part (b), posited as objective facts ... a reasonable person would conclude that the taxpayers entered into the scheme for the dominant purpose of enabling each to obtain a 'tax benefit' in the necessary sense.³¹

The Court also emphasised that the focus is not on the actual purpose of the taxpayer (or anyone associated with the scheme), but on the purpose objectively assessed.

The eight categories set out in para (b) of S177D as matters to which regard is to be had 'are posited as objective facts'. That construction is supported by the employment in S177D of the phrase 'It would be concluded that ...'. This phrase also indicates that the conclusion reached, having regard to the matters in para (b), as to the dominant purpose of a person or one of the persons who entered into or carried out the scheme or any part thereof, is the conclusion of a reasonable person. In the present case, the question is whether, having regard, as objective facts, to the matters answering the description in para (b), a reasonable person would conclude that the taxpayers entered into or carried out the scheme for the dominant purpose of enabling the taxpayers to obtain a tax benefit in connection with the scheme.³²

This passage underscores that in considering the question of purpose, the conclusion regarding the objective purpose is not made by attributing a purpose to the taxpayer, or any person connected with the scheme, or by drawing a conclusion about the actual purpose of the taxpayer. It is drawn from making a decision about what a reasonable person would conclude was the purpose of some person connected with the scheme. It follows that it is unnecessary to ascertain the actual purpose of those connected with the scheme, including the taxpayer. Evidence of the subjective purpose of such persons has been held to be irrelevant.

... 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 cannot 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 S177(b), for example, the manner in which the scheme was entered into.³³

Impact of Statutory Criteria

³¹ Ibid CLR at 424

³² Ibid at 421

³³ Hill J. *FCT v Zoffanias Pty Ltd* 2003 ATC 4942, 4954

It is inherent in what the High Court in *Spotless* said, that a conclusion about what the purpose is, must be determined by having regard to the eight factors set out in S177D. It was highlighted in the Full Federal Court decision in *Peabody*, in a passage from the main judgment delivered by Hill J. (that was not questioned by the High Court on appeal), that regard must be had only to these enumerated factors and no others. Regard must also be had to each of the factors:

In arriving at his conclusion, the Commissioner must have regard to each and every one of the matters referred to in S177(b). This does not mean that each of those matters must point to the necessary purpose referred to in S177D. 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 S177D requires in order to reach the conclusion to which S177D refers.³⁴

While it appears from the Full Federal Court decision in *Consolidated Press Holdings Ltd* that a global assessment of purpose is sufficient,³⁵ post *Peabody's* case, the courts hearing anti-avoidance cases have generally taken the approach of considering each of the listed factors in turn.

Even a brief perusal of the eight factors indicates that not all of them are equally important, which might lead to speculation that some are more important than others. From a perusal of the list of factors, it would appear that the more important which are to be considered, are at the top of the list. These include:

- the manner in which the scheme was entered into or carried out;
- the form and substance of the scheme;
- the time at which the scheme was entered into and the length of the period during which the scheme was carried out; and to a lesser degree
- any change in the financial position of any one connected with the scheme.

It would appear from the High Court's decision in *Spotless*, that the evidence which impacted on the first three criteria (manner, form and substance and timing) was critical to the conclusion which the Court drew in relation to the purpose of the taxpayer, since no other criteria were referred to.

From this it might be concluded that it is possible to give more weight to those criteria, than criteria further down the list. But the Full Federal Court has not necessarily followed this approach. The approach consistently stated by Hill J., most recently in *Hart*, is to the effect that while manner, form and substance and timing are more significant issues, no factor should be weighted more than any other. This approach is, however, qualified by the need to have regard to the circumstances of each case.³⁶

There is some difficulty in what Hill J. says in this regard. If some factors are more significant, then it would be reasonable to expect that in the evaluation process that must be carried out, these factors would carry more weight. Evaluation involves a

³⁴ *Peabody v FCT* 93 ATC 4104, 4113-4114

³⁵ 99 ATC at 4971

³⁶ Hill J. *Hart v FCT* 2002 ATC at 4623

balancing exercise. All of the factors may not be relevant. The evidence relevant to each factor may not be equally important. But, the more significant factors and the evidence which supports them could be expected to carry more weight in the balancing process. However, what may be underpinning the observations which Hill J. has consistently made is a desire to ensure that a dominant purpose is not determined primarily by reference to the first few criteria. Some flexibility may be a useful tool in such determinations, particularly since the principles for determining dominant purpose are still evolving.

But, even if manner, form and substance and timing are more significant, this still leaves open the question of how an evaluation is to be made once a tax benefit has been identified as arising from the scheme. Tax benefits do not arise in a vacuum. They arise in a commercial or family context. So it is important to determine how a dominant tax purpose is to be determined in a commercial or family context.

The Importance of Context

This is the dilemma which has consistently dogged discussion on tax avoidance. In the past this dilemma was solved by having regard to the predication test laid down by Lord Denning in *Newton v FCT*.³⁷ The test was formulated as follows:-

In order to bring the arrangement within the section (the predecessor of Part IVA) you must be able to predicate – by looking at the overt acts by which it was implemented – that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section.³⁸

It followed that if there was a commercial or family reason for obtaining the tax advantage, then it could not be said that the transaction had been implemented to avoid tax. Tax avoidance used to be determined on the basis of whether there was a rational commercial or family reason to explain what had been done, or whether what had been done could only be explained on the grounds of avoiding tax. It was only if there was no valid commercial reason to explain the transaction, that the predominant tax avoidance purpose could be established.

However, this approach was rejected by the High Court in *Spotless* as being a fallacy or false dichotomy. The rejection of the fallacy was expressed in the following way:-

...references ...on the one had to a ‘rational commercial decision’ and on the other to the obtaining of a tax benefit as the dominant purpose of the taxpayer in making the investment suggest the acceptance of a false dichotomy. ... A person may enter into or carry out a scheme within the meaning of Part IVA, for the dominant purpose of enabling the relevant taxpayer to obtain a tax benefit where that dominant purpose is consistent with the pursuit of commercial gain in the course of carrying on a business.

“A particular course of action may be, to use a phrase found in the Full Court judgment both ‘tax driven’ and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine the answer to the question whether, within the meaning of Part IVA, a person

³⁷ [1958] 98 CLR 1

³⁸ Ibid 8

entered into or carried out a scheme for the dominant purpose of enabling the taxpayer to obtain a tax benefit.

Much turns upon the identification among various purposes of that which is dominant.³⁹

The key to this new formulation of principle appears to lie in the words “dominant purpose” since the High Court underscored this by saying that “much turns upon the identification, among various purposes, of that which is ‘dominant’”. As indicated above the High Court has interpreted the word “dominant” as indicating “that purpose which was the ruling, prevailing or most influential purpose” and made it clear that the conclusion to be reached “is the conclusion of a reasonable person”.⁴⁰ As a result the real inquiry under Part IVA is to see whether getting a tax benefit is the dominant purpose of the taxpayer, not whether it can be explained away by reference to ordinary commercial or family dealings.

And, that purpose has to be tested at the time the scheme was entered into and by reference to the facts and law in existence at that time.

The inquiry is made more complex because, immediately after stating that a dominant tax purpose can be found in an ordinary commercial transaction, the High Court went on to explain that tax considerations may be taken into account in implementing a commercial transaction, without Part IVA coming down on the taxpayer’s head like a ton of bricks. This appears clearly from the High Court’s approval of the dictum of *Harlan J.* in the United States Supreme Court decision in *Commr of IR v Brown*.

[The] 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.⁴¹

Later, the United States Supreme Court stated that it could not “ignore the reality that the tax laws affect the shape of nearly every business transaction”. This statement was again approved in *Spotless* by the High Court, which went on to say:-

A taxpayer within the meaning of the Act may have a particular objective or requirement which is to be met or pursued by what, in general terms, would be called 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, as the Supreme Court of the United States pointed out, is only to be expected. A particular course of action may be, to use a phrase found in the Full Court judgments, both ‘tax-driven’ and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine the answer to the question whether, within the meaning of Part IVA, a person entered into or carried out a ‘scheme’ for the ‘dominant purpose’ of enabling the taxpayer to obtain a tax benefit’.⁴²

In *Spotless*, McHugh J. in a separate judgment, noted that the rejection of the dichotomy between seeking a higher after-tax profit and the pursuit of a legitimate

³⁹ *Spotless* 186 CLR 415-416

⁴⁰ *Hill J. Hart* 2002 ATC 4621; *Attorney-General's Department v Cockcroft* (1986) 10 FCR 180,190

⁴¹ 186 CLR 416

⁴² *Ibid* 416

commercial purpose could cause a problem in future cases. His Honour's comments to this effect (they were not endorsed by the majority in that case, but nor were they rejected) were as follows:-

... However, Pt IVA does not authorise the Commissioner to make a determination ...merely because a taxpayer has arranged its business or investments in a way that derives a tax benefit. More is required before the Commissioner of Taxation can lawfully make a determination under that paragraph. First, the scheme must be examined in the light of the eight matters set out in para (b) S177D. Second, that examination must give rise to the objective conclusion that the taxpayer or some other person entered into or carried out the scheme or a part of the scheme for the sole or dominant purpose of enabling the taxpayer or the taxpayer and some other person to obtain a tax benefit in connection with the scheme. That conclusion will seldom, if ever, be drawn if no more appears than that a change of business or investment has produced a tax benefit for the taxpayers.

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.⁴³

The *Spotless* principles unsettled the established perception of the operation of Part IVA, because it was obvious that even if a transaction were an ordinary commercial transaction, this would no longer save it from being annihilated by Part IVA. Yet, it was difficult to see how the High Court's adoption of the view that a tax dollar saved was as good as any other sat comfortably with the decision on the facts.

The *Spotless* case arose out of a commercial transaction where a decision had been made to adopt a particular investment strategy to take advantage of a tax concession specifically granted by the ITAA. The taxpayer had a substantial sum of money available for short-term investment and deposited the money with a financial institution in the tax haven of the Cook Islands. The interest paid by the Cook Islands institution was less than the interest available in Australia, but because that interest was exempt from tax in Australia, the after-tax amount received was higher than it would have been had the funds been invested in Australia and subject to tax in Australia.

There was no doubt that this was a commercial transaction and that net after-tax returns are important to business. The effect of the High Court's enunciation of principle is that a taxpayer is entitled to take tax considerations into account when considering and implementing a business transaction.

If that is so, it should have followed that the taxpayer in *Spotless* was entitled to have regard to the provisions of ITAA which provided an exemption from Australian tax for all income on which tax had been paid overseas. The fact that the money was taken off deposit in Australia and placed on deposit overseas should not have been relevant, since a change of investment should seldom, if ever, lead to a conclusion that the change has been accomplished to obtain a tax benefit. The fact that the deposit of

⁴³ Ibid 425

the funds in the Cook Islands was accompanied by additional security documents, designed to eliminate the perceived credit risk with the Cook Islands financial institution, should not have been a material factor, since the High Court accepted that the shape of a transaction can take more than one form and the form adopted was explicable on ordinary commercial considerations. Nor should it have mattered that the arrangement produced a better after-tax result, since the High Court approved the approach that a tax dollar saved was as good as any other. Furthermore, the tax dollar which could be saved was provided pursuant to a provision of the ITAA that specifically provided a special tax concession to Australian residents who derived taxed income from overseas.

An assessment of the facts against the criteria adopted by the High Court should have led to a conclusion that the deposit transaction was not one to which Part IVA applied. This was the conclusion of the Full Federal Court in this case. The core of that decision can be seen in the following passage taken from the judgment of Cooper J., who delivered the majority judgment.

Where all other things are equal the investment offering the highest rate of interest will be chosen. Where taxation rates on particular investments are different, the incidence of tax as a cost becomes one of the important matters for consideration in coming to an investment decision. For example, the treatment of income from gold mining operations as exempt ... may be a factor which influences an investment in a gold mine returning income at a lower rate as a percentage of capital invested than an investment of the funds on deposit at a higher gross rate of return but subject to the payment of full income tax. Therefore, when investing outside Australia, the incidence of tax and the operation of any relevant double taxation treaties between Australia and the countries in which investment is being considered will be relevant to a decision to invest overseas or not. Whereby the operation of the foreign taxation laws and the existing Australian taxation laws the net return after the payment of all applicable tax and other costs of the investment is higher investing offshore than within Australia, it cannot be said that, objectively, the dominant purpose of the investor investing offshore is to get a tax benefit; the purpose is to obtain the maximum return on the money invested after the payment of all applicable costs, including tax.⁴⁴

However, on the contrary, the High Court took the view that the dominant purpose of the taxpayer in carrying out the transaction was to obtain a tax benefit.

The Federal Court has subsequently accepted the decision as being correct. The basis for this support appears to lie in the fact that the only explanation for taking the money off deposit in Australia and lodging it in a complicated way overseas at a lower rate of interest, was to obtain a tax benefit. However, this still does not explain why the tax advantage which was obtained as a result was the dominant purpose of the transaction. It is equally possible to say, as Cooper J. said in the Full Federal Court, that the dominant purpose was to obtain a better return on the money invested with the shape of the transaction being dictated by legitimate commercial considerations. The principle that a tax dollar saved is just as good as any other, which was supported by

⁴⁴ Spotless 95 ATC at 4811

the High Court, is equally able, if not better able, to support the Full Federal Court decision.

The Commercial Context

The decision in *Spotless* has raised two difficulties:

1. How can a commercial transaction, in which a tax benefit has been identified, survive on the basis that obtaining the tax benefit was not the dominant purpose?
2. How can any transaction, where it has been structured to obtain a tax benefit, specifically provided by ITAA, survive on the basis that obtaining the tax benefit was not the dominant purpose?

Some assistance regarding the interpretative approach which should be taken by the courts in addressing these two issues, is afforded by the Treasurer's statement in the second reading speech at the time the Bill for introducing Part IVA into ITAA was before Parliament, where the Treasurer said:-

The proposed provisions – embodied in a new Part IVA of the Income Tax Assessment Act – 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 ... Some writers on the subject suggest that tax avoidance involves conduct entered into for the sole or dominant purpose of obtaining a particular tax advantage.

That description could be expected to cover the types of tax avoidance that, again using the language of social or political debate, are blatant, artificial or contrived, and which are indeed intended to be covered by this Bill.

But it is also apt to describe other arrangements, including some family arrangements, which are beyond the appropriate scope of general anti-avoidance measures and ought, if need be, to be dealt with by specific measures.

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

The emphasis made by the Treasurer here is to the effect that Part IVA is concerned with controlling 'blatant, artificial or contrived' types of tax avoidance, not normal commercial transactions. While the High Court in *Spotless* has established that Part IVA applies to real commercial transactions, it may be that the Court's approach is directed to sorting out blatant and artificial cases from normal commercial cases through the mechanism of determining whether, without the taxation benefit the particular form, shape or structure makes no sense. Reasonable men and women are bound to differ on where the line should be drawn on this issue. The recent decision of the Full Federal Court in *Eastern Nitrogen Ltd v FCT*⁴⁵ throws considerable light on the way in which the Court is interpreting the purposive test in relation to tax-driven

⁴⁵ 2001 ATC 4164

transactions which would not have been entered into, but for the tax benefit, in a manner consistent with the *Spotless* principles, yet maintaining consistency with the approach outlined in the Treasurer's second reading speech.

In *Eastern Nitrogen* the taxpayer had sold plant affixed to the taxpayer's premises to a financier and then leased the plant back at a commercial rental. This has been a familiar method of financing in Australia for decades. The transaction took the form of a lease. The rental payments under the lease gave a higher tax deduction than interest would have done. That was the identified tax benefit. This arrangement was held, by a unanimous decision, not to be a scheme to which Part IVA applied, notwithstanding that the transaction would not have been structured as a lease, but for the tax advantage.

The tax question confronting the Court was clear - whether the financing transaction, which provided a better after-tax return, could be said to have been entered into for the dominant purpose of obtaining the tax advantage.

The judgments in this case clearly show that the inquiry was directed, at least initially, to a consideration of the manner, form and substance of the transaction. In other words, the approach adopted in *Spotless* was followed. The approach to be adopted was outlined by Lee J. in the following statement:-

For S177D to apply and a determination made under S177F that Part IVA applies it must be shown that the 'maximised ... after-tax return' has been obtained in a manner that speaks of the presence of a purpose above all others to obtain a tax benefit. (*FCT v Spotless Services Ltd.*)⁴⁶

The manner in which the transaction was entered into showed that there had been an exhaustive examination over a lengthy period time about the terms of the deal consistent with the size of the transaction, but the basic transaction was simple and straight-forward, and there was nothing unusual, uncommercial or unexpected about the way in which it had been concluded or carried out.

The form of the transaction was constituted by a lease of equipment which had provided the taxpayer with deductions for the full amount of the rentals that were larger than the deductions for interest, under the pre-existing loan arrangements. The deduction was a tax benefit and it was an important element in the taxpayer's decision to enter into and carry out the transaction. The substance of the transaction was the same.

His Honour then went on to state, in relation to form, that where a transaction is documented and the document creates legally enforceable rights and obligations, an objective assessment of the purpose of the transaction must take into account the rights and obligations undertaken.⁴⁷

And, when considering form and substance the statutory provision does not limit the consideration which needs to be made regarding this factor, simply to a comparison

⁴⁶ Ibid 4166

⁴⁷ Ibid 4167

between the form and substance of the scheme. Both elements have to be considered separately and together.⁴⁸

It was emphasised though that although the rights, obligations and duties arising under an agreement may disclose elements of artificiality, whether in the documents or content, they do not determine purpose in favour of the Commissioner under the *Spotless* principle. Nor do elements of commerciality determine the issue in favour of the taxpayer. They are simply matters to be considered.

The other factors were also considered, but the only one of note was the change in the financial position of the taxpayer. This was significant. The scheme resulted in the taxpayer receiving a large up-front cash payment for its business. Then, instead of being reliant on short-term financing, the taxpayer had a long-term financial facility available which reduced its exposure to interest rate fluctuations. The off-balance sheet nature of the lease financing also had the benefit of enhancing the taxpayer's credit rating, thereby reducing its cost of credit. While none of these considerations was taken to point to a purpose of obtaining a tax benefit, the fact that the taxpayer was able to deduct the whole of the rent payments – which were higher than its previous deductions for interest – pointed towards obtaining a tax benefit, because it resulted in a higher after-tax profit.

The Commissioner attempted to persuade the Court that there were elements of artificiality both in the documentation and the context of the matter, which indicated a dominant tax-driven purpose which tipped the scales in his favour.

First, it was alleged that artificiality was present because there was no connection between the price at which the equipment was sold to the financier and its market value. The Court considered that this did not indicate artificiality. The purchase price was a matter for the financier to be satisfied about. Even if it had been artificial, the presence of artificial elements does not determine the question of purpose. The rights and obligations of the parties still had to be considered.

Second, it was alleged that while the transaction may have been commercial, it was, in substance, a hire purchase agreement, whereby the rental payments were, at least in part, capital payments in reduction of the purchase price of the equipment. This argument required a conclusion that there was an arrangement or understanding arising from the rights and obligations of the parties pursuant to which the taxpayer had a right to acquire the equipment at the end of the lease. As there was no arrangement or understanding of this nature, this argument failed. The substance of the transaction was that the parties had entered into an equipment lease.

Notwithstanding that the transaction would not have been entered into apart from the tax deduction which was available, the Court decided that this transaction was explicable by reference to a commercial rationale. Tax, although a significant element, was not its dominant purpose.

Achieving better after-tax returns

The pursuit of a better after-tax return was at the heart of *Spotless*, and it caused the taxpayer to come to grief.

⁴⁸ Ibid Carr J. at 4180

In *Eastern Nitrogen*, it was also at the heart of the matter and the Court specifically addressed the *Spotless* principles in relation to tax-driven transactions. Lee J., with whom Sundberg J. concurred, maintained that proper business management requires the net cost of financing to be taken into account. Furthermore, where a business relies on borrowings to provide circulating capital, the net cost of that finance, after taking into account any deductions that are available under ITAA, is a relevant consideration, and to adopt one form of financing over the other on such a basis, does not, by itself, lead to a conclusion that a dominant purpose to obtain that tax advantage exists.

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 [ITAA], 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 S177C(1)(b) applies.⁴⁹

This is a significant step forward on the position that existed after the High Court's decision in *Spotless*, because it acknowledges that the pursuit of better after-tax returns is a legitimate commercial objective which will not, of itself, lead to a conclusion that the pursuit of such returns is tax driven. Obviously, in this case there was nothing more which was apparent to lead to a conclusion that a tax benefit had arisen. The conclusion which had been reached, that the transaction was simple and straightforward and there was nothing unusual, uncommercial or unexpected about the way in which it had been concluded or carried out, supported this result. It would seem to follow that if the transaction is a normal commercial transaction carried out in the usual way, this will not invoke Part IVA even if obtaining a tax advantage in the form of deductions is a significant aspect of the matter. Something more is required - something which is significantly unusual, uncommercial or unexpected, particularly about the manner in which the transaction was entered into or carried out. In other words, what is needed is significant blatancy, artificiality or contrivance.

Eastern Nitrogen is also important because it establishes that the dominant purpose is not established by asking whether the taxpayer would have entered into the transaction 'but for' the tax benefit. The taxpayer may not have entered into the transaction but for the tax benefit, but that does not establish that the tax advantage was the dominant purpose. The dominant purpose test requires a higher level of attainment.

Then there is *Hart's* case which held a tax-driven loan transaction did not contravene Part IVA.

While the facts in this case were identified as constituting a tax-driven transaction, the critical importance of *Hart's* case lies in the way in which this conclusion was reached. Critical to the decision was not the form of the loan providing two facilities

⁴⁹ Ibid Lee J. at 4168

which enabled the tax advantage to be available, nor that the substance of the transaction was a single advance; nor the fact that the scheme brought about the obtaining of a greater amount of interest than would otherwise have been available, or the manner in which the transaction was entered into or carried out.

No, the importance of *Hart's* case lies in the fact that it has reconfirmed the necessity to identify the scheme by reference to the commercial reality of what the parties did and then to test dominant purpose against that. Hill J. said:-

It is obvious enough, however, that so long as the scheme is found to include the making of the loan or loans, that one of the objectives of the scheme and indeed an important objective of it, was the financing of the acquisition of the (new house) and the refinancing of the (existing house).⁵⁰

In other words, unless the scheme is identified by reference to what the taxpayer actually did, it is robbed of all practical meaning and cannot be considered to be a Part IVA scheme. Having identified the scheme in this way it is necessary, in order to ascertain the dominant purpose of the scheme by taking into account the eight S177D factors, to weigh the commercial side of the transaction against the income tax advantage arising out of the transaction. Having put the two sides of the transaction on the scales, His Honour said:-

On any view of the matter, the dominant purpose of the scheme which included the borrowing by the (taxpayer) of funds used to finance and refinance the two properties, was the obtaining of funds to permit (him) to do so. ... The scheme was directed to a commercial end, the borrowing of money for use in financing and refinancing the two properties. That is what a reasonable person would conclude was the ruling, prevailing or most influential purpose of the (taxpayer) into or carrying out the scheme.⁵¹

The issue then becomes one of ensuring that evidence relating to the commercial side of the transaction is before the Court. There is nothing in Part IVA itself which indicates that the commerciality of a transaction is relevant. This was a difficulty which obviously troubled Hill J. and he addressed it in the following way:-

[The High Court in *Spotless*] certainly did not say that it would be an error to take into account the commercial outcome of a transaction, at least where that commercial outcome has nothing to do with tax, or that shape, form or structure of a scheme was even the most significant matter to consider under Part IVA. Clearly all relevant circumstances must be considered.⁵²

The statement that "all relevant circumstances must be considered" appears to encompass the view that relevant circumstances include the commercial objectives of the parties. If this is so then it needs to be determined how commerciality is to be taken into account.

The courts have already ruled out the possibility that evidence relating to what the parties were trying to achieve is relevant. The subjective purpose of anyone connected with the scheme is irrelevant – at least in so far as establishing that the dominant purpose was to obtain a tax benefit is concerned. However, Hill J. in *Zoffanies* does

⁵⁰ Hart v FCT 2002 ATC at 4623

⁵¹ Ibid at 4624

⁵² Ibid at 4622

accept that subjective intention may be relevant to one of the eight factors prescribed by S177D, e.g. the manner in which the scheme was carried out. The observation was not developed.⁵³ But, if subjective intention might be relevant to some of the S177D factors, it might equally be a relevant circumstance concerning the identification of the scheme itself.

The issue on appeal in *Zoffanies* was whether the Tribunal had applied the correct test, not the broader issue of what evidence may be admissible to support various S177D factors, or the aspect of commerciality. The ground on which the appeal ultimately succeeded was that the Tribunal had applied the wrong test. The Tribunal was found to have substituted the taxpayer's subjective motive or purpose for the objective test required by Part IVA, using subjective evidence of the taxpayer to do so.

The courts have also indicated that commerciality is not relevant to the identification of a scheme. This emanates from the decision of the Full Federal Court in *Spotless*.⁵⁴

However, what the Full Federal Court said in *Spotless* on this issue needs to be examined. The observations of the majority were directed to criticism that the scheme identified by the Commissioner stated certain terms of the scheme were not normal commercial terms.⁵⁵ The majority judgment does not state that the ambit of what the parties were entering into or carrying out was irrelevant, or that it was irrelevant whether it was of a commercial nature. The Court only said that whether the terms were commercial was a matter to be considered in determining the purpose of the scheme. It said nothing about the commerciality of what the parties did, which is necessarily of critical importance to the identification of the scheme.

The importance of *Hart's* case is that it establishes that there are two tests to be applied in relation to ascertaining whether obtaining the tax benefit is the dominant purpose. First, the eight factors need to be considered with an assessment being made about the impact of tax in relation to each. Then the commercial side of the transaction needs to be weighed against the assessment made under S177D in order to establish whether there was a legitimate commercial objective, which is the overriding purpose of the transaction or, whether within the context of that commercial objective, tax considerations are all encompassing. At present, it appears that the commerciality of what the parties did is to be ascertained from the identification of the scheme and evidence relevant to that issue. If that is the correct reading of the effect of *Hart's* case, then the evaluation required under Part IVA is only two degrees of separation removed from the old Newton predication test.

CONCLUSION

What has emerged is that the way in which the scheme is identified in large measure determines the finding of purpose.

If the scheme is identified as those facts by which the tax benefit was obtained, then the purpose of such a narrowly defined scheme is a foregone conclusion and the inquiry required by S177D to establish the dominant purpose is irrelevant. It is only if

⁵³ 2003 ATC at 4954

⁵⁴ *Spotless* 95 ATC 4805

⁵⁵ *Ibid* at 4805

the scheme is identified by reference to the practical reality of what the taxpayer did, that the S177D considerations have a role to play and it becomes possible to make a determination about whether tax is the dominant purpose of the taxpayer's actions.