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Coming out of the Dark? The Uncertainties that Remain in Respect of Part IVA: How Does Recent Tax Office Guidance Help?

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Abstract

This article considers several issues that make the application of Part IVA uncertain and whether recent tax office guidance, in the form of PS LA 2005/24 and the Guide, provide any further clarity on these issues. It is suggested that PS LA 2005/24 and the Guide fail to provide further clarity and this is largely due to the fundamental problem that it is unclear what particular activities Part IVA seeks to target at a policy level. Consequently, Part IVA has been drafted in a manner that is amorphous and uncertain in order to combat these indeterminate activities.

INTRODUCTION

Despite the existence of a substantial body of Part IVA case law, it can still be an extremely difficult task for a practitioner to determine if Part IVA will apply to a transaction. Many commentators have remarked on the significant uncertainty surrounding the application of Part IVA,¹ rendering taxpayers partially blindfolded when entering the self-assessment battleground. In what appears to be an attempt to address some of these uncertainties, the Commissioner has released a guide for taxpayers outlining the “basic principles” as to how and when Part IVA will apply to an arrangement (“the Guide”). Accompanying the release of the Guide is the release of Practice Statement PS LA 2005/24,² which is designed to assist tax officers who are considering the potential application of Part IVA of the *Income Tax Assessment Act 1936 (Cth)* (“ITAA 1936”), or another General Anti Avoidance Rule (“GAAR”), such as Division 165 of *A New Tax System (Goods and Services Tax) Act 1999 (Cth)* and s 67 of the *Fringe Benefits Assessment Act 1986 (Cth)*.

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¹ See, for example Justice Ronald Sackville, ‘Avoiding tax avoidance: The primacy of Part IVA’ (2004/2005) 39(6) *Taxation in Australia* 295. Sackville states at 295: “It is notoriously difficult to distinguish, as a matter of principle, between tax avoidance and legitimate tax minimisation.” See generally, N Orow, ‘Part IVA - Seriously Flawed in Principle’ (1998) 2(5) *Journal of Australian Taxation* 57;GT Pagone, ‘Anti-avoidance Provisions and Tax Reform.’ (2001) 30(2) *Australian Tax Review* 80.

² PS LA 2005/24 is entitled “Application of General Anti-Avoidance Rules” and it replaces PS LA 2000/10. Notably, however, by considering the operation of the other GAARs (Division 165 and s 67) PS LA 2005/24 breaks new ground. PS LA 2000/10 did not address the application of these other GAARs.

The focus of this article is not to give a comprehensive summary of the information covered by PS LA 2005/24 and the Guide regarding Part IVA. Rather, this article will identify and discuss several of the issues that make the application of Part IVA uncertain. It will consider whether PS LA 2005/24 and the Guide effectively assist practitioners to further clarify these issues in respect of Part IVA.

This article will focus on:

- the uncertainty that arises in attempting to identify the mischief that Part IVA seeks to target;
- several of the issues that arise when attempting to establish the preconditions in Part IVA: scheme, tax benefit and a dominant purpose to obtain a tax benefit;
- the uncertainty that surrounds establishing when the Commissioner will exercise his discretion to apply Part IVA;
- issues that arise in applying the compensating adjustment provisions;
- the relationship between Part IVA and other provisions in the ITAA 1936 and the *Income Tax Assessment Act 1997(Cth)* (“ITAA 1997”); and
- analysing an example in the Guide where the tax office have stated that they will not apply Part IVA.

It is suggested in this article that PS LA 2005/24 and the Guide fail to provide any further clarity on the application of Part IVA. It is asserted that this failure to provide certainty is largely due to the fundamental problem that it is unclear what particular activities Part IVA seeks to target at a policy level.³ Consequently, Part IVA has been drafted in a manner that is amorphous and uncertain in order to combat these indeterminate activities.

BACKGROUND TO PART IVA: DEFINING THE MISCHIEF PART IVA AIMS TO TARGET

The Explanatory Memorandum to Part IVA (“EM”) states that Part IVA is designed to target “tax avoidance activities” that are “blatant, artificial or contrived”.⁴

In this regard the question arises whether the EM is prescribing that Part IVA is designed to apply to activities that have two distinct characteristics. The first characteristic is that the activity constitutes tax avoidance. The second characteristic is that the tax avoidance activity is “blatant, artificial and contrived.”

From a literal reading of the words in the EM the next question one is invited to ask is: can there be different “degrees” of tax avoidance? Is the EM contemplating that some types of tax avoidance activities are “normal” and not intended to be caught by Part IVA? Likewise, is the EM contemplating that other types of tax avoidance are “blatant, artificial and contrived” and therefore, targeted by Part IVA? Based on the fact that the EM does not expand further on such a dichotomy, perhaps the preferable view is that Part IVA is designed to target all types of tax avoidance.

Tax avoidance occurs when a taxpayer, although complying with the black letter of the law, minimises their tax liability in a manner that is inconsistent with the intent of the legislation. Thus, tax avoidance is only possible when there is incongruence

³ See generally N Orow, *General Anti-Avoidance Rules - A Comparative International Analysis* (2000).

⁴ Explanatory Memorandum to Income Tax Laws Amendment Bill (No 2) 1981.

between the words of the tax act and the policy in which it has its basis. Parsons summarises it effectively, stating: “Tax avoidance is the greater, the more the law fails to express its policies”.⁵

By targeting tax avoidance, Part IVA and GAARs in general occupy a unique position by aiming to tax amounts that “would otherwise not be caught” by the operative provisions of the relevant taxing act.⁶ Furthermore, when a GAAR is enacted, the particular types of tax avoidance activities that they will target may be unknown. Cooper states that the enactment of a GAAR is, in this regard, a peculiar acknowledgment by parliament that they will penalise activities that cannot be foreseen and, therefore, specifically legislated against.⁷ When this fact alone is considered, it appears that PS LA 2005/24 and the Guide face an impossible task. How can these documents provide clarity or further significant guidance on what will be a tax avoidance activity when such an activity may not yet be in existence? It is true that some guidance can be provided in relation to whether existing activities constitute tax avoidance. Equally, however, it may be impossible to predict with certainty whether an innovative tax structuring product will or will not constitute tax avoidance and therefore, contravene the provisions of Part IVA.

“Warning Signs” that Part IVA may apply

PS LA 2005/24 and the Guide do, however, attempt to provide some “warning signs” that will indicate an arrangement may be tax driven and susceptible to the application of Part IVA.⁸ PS LA 2005/24 instructs that, if any of the following factors exist, a tax officer must consider the application of Part IVA to the arrangement. These factors include:

- The arrangement differs from the normal arrangements used to achieve the commercial objectives of the transaction;
- The arrangement is more complex than is necessary to achieve the relevant objective (family or commercial). There are, for example, steps in the arrangement

⁵ Parsons R W, *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting* (1985),84, paragraph 16.55.

⁶ GT Pagone, ‘Part IVA the general anti avoidance provision in Australian taxation law.’ Dec (2003) 27 (3) *Melbourne University Law Review*, 770 states at page 771:

“General anti-avoidance provisions occupy a very special role in tax laws because their role is to underpin the effectiveness of the primary operative provisions when those primary provisions fail to achieve their purpose.”

⁷ G Cooper ‘International Experience with General Anti-Avoidance Rules’ 54 *SMU L. Rev.* 83 states at page 86:

“It is a strange admission by legislators to introduce a law which says, in effect: Parliament is enacting a rule to reverse something which it does not otherwise prohibit and cannot foresee, and so must either prevent by deterring *ex ante* or else cure by *ex post* reversal.”

⁸ PS LA 2005/24 states at paragraph 113:

“The presence of any of the following features whether alone or in combination in an arrangement means that Part IVA may apply to the arrangement. These features represent warning signs that the arrangement may be ‘tax driven’ and lead to a conclusion that the arrangement was entered into for the dominant purpose of enabling a taxpayer to obtain a tax benefit. The list of features is not meant to be exhaustive or exclusive and is provided only by way of guidance to officers who must consider and apply the provisions of Part IVA. The purpose in paragraph 177D(b) can only be objectively ascertained by reference to the eight factors. When any of the following features are present officers must consider the possible application of Part IVA in undertaking audits or issuing rulings to taxpayers.”

that serve no purpose other than to obtain a tax benefit, such as a company being interposed for no other purpose than to access a tax benefit;⁹

- The tax result is “at odds” with the overall commercial result of the transaction. A tax loss, for example, is claimed for a profitable commercial transaction;
- There is little or no risk in the transaction, in circumstances where significant risks would normally be expected;
- The terms of the arrangement are non-commercial; and/or
- There is a gap between the substance and the form of the arrangement.¹⁰

Many of these indicia actually do little to extend a practitioner’s understanding of what types of activities will constitute “tax avoidance” and, consequently, what Part IVA is aiming to target.

For example, a test relying on identifying when an arrangement differs from “normal arrangements” is problematic. The question that inevitably arises is: what is a “normal arrangement”? As Professor Parsons states: “In any case what is artificial at one time may become natural when it is generally practised.”¹¹ Does a test that focuses on normality mean that a taxpayer should not consider, for example, financial products with innovative tax structures because such structures are new and therefore, not normally used? Many practitioners may have thought that Phillips Trusts were “normal arrangements” as they were so widely utilised, but the tax office announced last year, that they considered that Part IVA may apply to some Phillips Arrangements.¹² Furthermore, the question arises: how does determining whether an activity is widely practised correspond with the legislative provisions of Part IVA that focus on whether an arrangement is entered into for the dominant purpose of obtaining a tax benefit?

Moreover, another of the warning signs identified by PS LA 2005/24 is that: “the arrangement is more complex than is necessary to achieve the relevant objective (family or commercial)”. Attempting to identify when an arrangement is more complex than is necessary to achieve a particular commercial objective is an inexact test. In Australia’s current business environment business people must consider an extremely complex web of tax and corporations laws. In such an environment, it is a difficult (if not impossible) task to draw a coherent line between what is “necessarily” and what is “unnecessarily” complex.

Unfortunately, neither the Guide, nor PS LA 2005/24, provides any further effective guidance on determining whether a particular activity will constitute tax avoidance. This is because, as discussed, attempting to define tax avoidance is a futile task. Part IVA (and GAARs in general) aim to tax activities, which cannot necessarily be foreseen at the time of enactment. In this sense, the activities that a GAAR targets are fundamentally uncertain. This may indicate that, ultimately, Part IVA (or any GAAR) is unworkable in the context of a self-assessment system which, to be effective, requires certainty in taxation laws. The self-assessment system of taxation places the

⁹ *Federal Commissioner of Taxation v Consolidated Press Holdings Ltd* 2001 ATC 4343.

¹⁰ Paragraph 113 of PS LA 2005/24.

¹¹ Parsons above n 5.

¹² See Draft Tax Ruling 2005/D5 Income tax: deductibility of service fees paid to associated service entities: Phillips arrangements and the draft tax office booklet “Service Arrangements”.

onus on taxpayers to assess their own taxation liability and, consequently, the cornerstone of the self-assessment system is the ability of the taxpayer or their adviser to understand and apply the taxation laws. Indeed, this inability to define with precision the targets of Part IVA left the drafters of Part IVA in a difficult predicament: how can the provisions of Part IVA be expressed in a certain manner when the activities they target are uncertain? As Sir John Donaldson stated in *Merkur Island Corporation v Laughton*¹³:

ministers when formulating policy...should at all times be asking themselves and asking parliamentary counsel: 'Is this concept too refined to be expressed in basic English? If so, is there some way in which we can modify the policy so that it can be so expressed?'

Arguably, the policy behind Part IVA to combat tax avoidance is far too broad to constitute a sensible policy basis from which the legislative drafters could work.

ISSUES ASSOCIATED WITH ESTABLISHING THE PRECONDITIONS OF PART IVA

The operation of Part IVA is two staged. The first stage is to establish the preconditions in Part IVA. That is, there must be a scheme,¹⁴ a tax benefit¹⁵ and the dominant purpose to obtain a tax benefit¹⁶. The existence of the preconditions are posited as objective facts and do not depend on an exercise of the Commissioner's discretion.¹⁷ The second stage is that the Commissioner must exercise his discretion to apply Part IVA.¹⁸

PS LA 2005/24 and the Guide examine the jurisprudence relating to the preconditions of Part IVA in detail. A complete summary of the information covered will not be repeated below. The purpose of the following sections is to consider the way that PS LA 2005/24 and the Guide deal with some of the more controversial issues that arise in respect of establishing each of the preconditions.

Notably, at the outset, it must be acknowledged that, although the application of Part IVA can be divided into these different elements, the sections must be construed as a whole. PS LA 2005/24 states that:

Focussing on the various elements of Part IVA should not obscure the way in which the Part as a whole is intended to operate. What constitutes a scheme is ultimately meaningful only in relation to the tax benefit that has been obtained since the tax benefit must be obtained in connection with the scheme. Likewise, the dominant purpose of a person in entering into or carrying out of the scheme, and the existence of the tax benefit, must both be considered against a comparison with an alternative.¹⁹

¹³ [1983] 2 A.C. 570, 595.

¹⁴ Scheme is defined in s 177A of the ITAA 1936. Notably, the scheme must have been entered into after 27 May 1981.

¹⁵ Tax benefit is defined in s 177C of the ITAA 1936.

¹⁶ The factors to be considered in ascertaining the dominant purpose are contained in s 177D of the ITAA 1936.

¹⁷ See *Federal Commissioner of Taxation v Peabody* (1994) 181 CLR 359, 382.

¹⁸ Notably the exercise of the discretion must take place after the preconditions have been satisfied. PS LA 2005/24 states: "47. Before the Commissioner can exercise the discretion contained in s 177C(1) the requirements of Part IVA must be satisfied."

¹⁹ See paragraph 53 of PS LA 2005/24.

Precondition One: A Scheme

A “scheme” is defined very broadly in s 177A to include: “any agreement, arrangement, understanding, promise or undertaking.” It also includes agreements that are not enforceable, unilateral schemes and even inaction can constitute a scheme.²⁰

The High Court decision of *Commissioner of Taxation v Hart*²¹ has confirmed that the definition of a scheme in s 177A is extremely broad. Accordingly, in most cases it will rarely be a matter for dispute whether a scheme exists.

It is also accepted that the Commissioner is entitled to advance a narrow scheme within the wider scheme, provided that, when the alternate formulation is introduced, it does not cause “undue embarrassment or surprise to the other party to the dispute.”²² PS LA 2005/24 interprets this requirement very liberally to mean that a reformulation of the scheme will only be impermissible after the close of evidence if it effects the evidence that the other party, to the dispute, might have presented.²³ This is a very biased interpretation of when the Commissioner changing the formulation of the scheme will result in unfairness to the taxpayer to the dispute. It would appear reasonably arguable that a taxpayer could assert that the point at which the Commissioner should be precluded from changing the formulation of the scheme arises at an earlier time in the litigation process. The taxpayer could argue that they need sufficient time to digest and appreciate the differences in the formulation of the scheme and to consider the impact such a change has on their case and any new evidence they may wish to introduce. This may, however, prove to be a moot point, as it is likely the Commissioner will, in most cases, advance a wide and a narrow scheme at the beginning of the case. Therefore, the Commissioner will not need to change the formulation of the scheme during trial.

One of the issues arising from the judgement in *Hart*²⁴, however, is the importance that should be attributed to the scheme. More specifically, whether determining if there is a scheme is simply a matter of “procedural fairness” or whether it is fundamental to the operation of Part IVA. Two different views were taken by the High Court in *Hart*²⁵ on this issue.

Gleeson CJ and McHugh J expressed the view that identifying a scheme is central to the operation of Part IVA. They state: “The significance of the definition of the scheme extends beyond a question of procedural fairness to the taxpayer. It is central to the application of ss 177C, 177D and 177F.”²⁶

Gummow and Hayne JJ, on the other hand, saw the identification of a scheme as a matter of “procedural fairness” only.²⁷

The view of Gleeson CJ and McHugh J appears to be the preferable one. Indeed, the tax benefit must be obtained in connection with the “scheme” that has been

²⁰ See *Corporate Initiatives Pty Ltd v Commissioner of Taxation* 2005 ATC 4392.

²¹ (2004) 217 CLR 216.

²² *Federal Commissioner of Taxation v Peabody* (1994) 181 CLR 359, 382.

²³ Paragraph 58 of PS LA 2005/24.

²⁴ (2004) 217 CLR 216.

²⁵ *Ibid.*

²⁶ *Ibid.*, 223.

²⁷ *Ibid.*, 237-241.

identified.²⁸ Furthermore, there is a clear relationship between the eight factors in s 177D and the scheme: for example, factor one focuses on the manner in which the “scheme” (as identified) was entered into or carried out. When the impact the formulation of the scheme has on the other preconditions is considered, it is difficult to understand how the formulation of the scheme could be seen as anything other than “central” to the operation of Part IVA.

The tax office, however, appears to support the view of Gummow and Hayne JJ. PS LA 2005/24 states that: “The need for the Commissioner to identify the scheme is simply an aspect of the requirement for a party to legal proceedings to particularise the case the other party or parties will have to meet.” PS LA 2005/24, however, does not offer any explanation as to why the tax office has not adopted the equally viable and arguably, preferable view of Gleeson CJ and McHugh J.²⁹

There are some further outstanding issues that remain relating to the formulation of the “scheme” identified by the literature, but not addressed by PS LA 2005/24 and the Guide. These issues include:

- Whether, after *Hart*³⁰, it is contemplated that there may still be cases where a set of circumstances only constitute “part” of a scheme (as contemplated in *Peabody*³¹), rather than a whole scheme.³²
- When a taxpayer will be engaging in several schemes (rather than one scheme) as part of an arrangement.³³

Precondition Two: Tax Benefit

Establishing that there has been a tax benefit can potentially present a substantial hurdle for the Commissioner. In fact, in some Part IVA cases, the taxpayer has been successful because the Commissioner has failed to establish a tax benefit.³⁴ There are four main types of tax benefits outlined in s 177C(1):

- an amount not included in assessable income;
- a deduction;
- a capital loss; and

²⁸ Gleeson CJ and McHugh J provide in *Hart* Ibid, 225: “in any case a wider or narrower approach may be taken to be the identification of the scheme but it cannot be an approach that divorces the scheme from the tax benefit.”

²⁹ See generally Chris Branson, ‘Hart’s Case What May Constitute A Scheme’ (2004/2005) 39(6) *Taxation in Australia* 315-319; G Cooper, ‘Part IVA Report Card’ (Paper presented at the Taxation Institute of Australia State Convention (Western Australian Division) National Convention, Perth, March 2005).

³⁰ (2004) 217 CLR 216.

³¹ *Federal Commissioner of Taxation v Peabody* (1994) 181 CLR 359.

³² Cooper above n 29, 4. It appears from the judgement Gleeson CJ, McHugh and Callinan JJ’s judgements in *Hart* Ibid that whilst they did not specifically affirm *Peabody*, they all still contemplated a situation where a set of circumstances could constitute part of a scheme rather than a whole scheme. The opposite view was adopted by Gummow and Hayne JJ who firmly rejected an interpretation of *Peabody* which necessitated a scheme “standing on its own feet.” See generally D Carbone and J Tretola, ‘FCT v Hart: An analysis of the impact of the High Court decision on the application of Pt IVA’ (2005) 34(4) *Australian Tax Review* 196.

³³ Cooper above n 29, 4.

³⁴ See for example *FCT v Peabody* (1994) 181 CLR 359 and *Vincent v Federal Commissioner of Taxation* 2002 ATC 4742.

- a foreign tax credit.

There are two alternate tests to ascertain if the tax benefit has been obtained in connection with the scheme:

- the tax benefit **would not have been obtained** if the scheme had not been entered into or carried out; or
- the tax benefit **might reasonably be expected not to have been obtained** if the scheme had not been entered into or carried out (“reasonable expectation test”).

If it can be established that the tax benefit **would not** have been obtained if the scheme had not been entered into or carried out, there is no need to consider the reasonable expectation test. If this cannot be predicted with certainty, however, regard must be given to the reasonable expectation test.

The reasonable expectation test

A reasonable expectation involves more than a possibility, it embodies making a prediction as to what would have taken place if the scheme had not been entered into or carried out (“the counterfactual”).³⁵ Identifying the counterfactual is imperative not only with regard to establishing that there is a tax benefit but also because it forms the “backdrop” for determining the purpose of the taxpayer under s 177D.³⁶

Formulating the counterfactual

Identifying the counterfactual can be an extremely difficult task as it necessarily involves hypothetically recreating what would have happened. Where a clear arrangement existed before the scheme was entered into it may be easy to formulate the counterfactual.³⁷ However, substantial problems can arise in the formulation of the counterfactual when no prior transaction can be identified and therefore used to assist in predicting what might reasonably have happened.

Puckridge and Werbik provide:

The reasonable expectation test can be applied easily where there is strong evidence as to what the taxpayer would have done in the absence of the scheme. For example, where there is a clear antecedent arrangement or transaction which is being altered. In such cases it is reasonable to expect that in the absence of the scheme the antecedent arrangement or transaction would have continued. The results that would have been achieved under the antecedent arrangement or transaction would form the basis of the reasonable expectation.

However it may be difficult to apply where the evidence:

- is silent as to what the taxpayer might reasonably have done in the absence of the scheme;
- indicates the taxpayer would have done nothing in the absence of the scheme;

³⁵ See *FCT v Peabody* Ibid, 385.

³⁶ Paragraph 70 of PS LA 2005/24.

³⁷ Robert Puckridge and Andrew Werbick, *An Improved General Anti-Avoidance Rule* (2000) <http://www.ato.gov.au/printcontent.asp?doc=/content/Professionals/GAAR_talk_4.html>

- does not establish whether the taxpayer who received the monetary benefit in a particular income year would have obtained that benefit in the same income year;
- shows other schemes where available which would have given substantially the same taxation result.³⁸

General guidance for formulating the counterfactual

Despite these difficulties, PS LA 2005/24 and the Guide attempt to provide some general assistance in formulating the counterfactual that would need to be considered, including:

- The financial and other consequences of the scheme and whether the same outcomes (other than the tax advantage) could be achieved in a more straightforward, ordinary or convenient way;
- The commercial and social norms for the arrangement including standard industry behaviour or family obligations;
- The behaviour of the parties before or after the scheme compared with their behaviour during the scheme; and
- The actual cash flow of the scheme.

More than one counterfactual

An issue may arise where there is more than one potential counterfactual. PS LA 2005/24 gives some guidance on this matter by stating that the Commissioner may rely on more than one counterfactual in making a determination under Part IVA.³⁹ From a practitioner's point of view, therefore, it would appear to be prudent to consider all possible alternatives in formulating the counterfactual.

The counterfactual and discretion

The difficulties with identifying the counterfactual are intensified where discretionary powers are involved in the scheme. For example, in respect of a scheme where a discretionary trust is involved, it may be necessary to determine whether a particular beneficiary or the trustee would have received a distribution if the scheme had not been entered into or carried out. This will necessarily involve predicting how a trustee would exercise their discretion and could present great difficulties in predicting what might reasonably be expected to have happened.⁴⁰ In *Case VI60*⁴¹ the AAT provided in respect of Part IVA and trusts: "This provision does not in my opinion apply at all comfortably in a trust situation, especially where there are numerous beneficiaries who might take."⁴² Perhaps, considering the history of trust distributions to beneficiaries may be relevant. However, where there is no history of distributions or the trust is relatively new there may be no or limited distributions to refer to in attempting to

³⁸ Ibid.

³⁹ Paragraph 73 of PS LA 2005/24.

⁴⁰ Paragraph 77 of PS LA 2005/24 states:

"It may be difficult for a Tax officer to obtain evidence to support the counterfactual, i.e., the reconstructed version of events. In applying the reasonable expectation test in situations where there is a lack of information, reasonable inferences may be drawn, and reasonable assumptions may be made. For example, care needs to be taken in applying the reasonable expectation test to a scheme involving a trust. Officers may need to consider whether it was reasonable to expect that a particular beneficiary of a trust would, but for the scheme, have received a trust distribution."

⁴¹ 88 ATC 1058.

⁴² Ibid, 1070.

formulate the counterfactual. Furthermore, the question arises: what is the conceptual basis for using previous distributions to predict how future distributions would be made? One of the reasons the trustee is given a discretion is that it should be able to be exercised without the constraint of previous distributions. Thus, formulating a counterfactual on the basis that past distributions are predictive of future distributions appears to be formulating a counterfactual that is based on a fallacious assumption.

Whilst the tax office acknowledges these difficulties exist in respect of trusts, PS LA 2005/24 does not provide specific guidance to practitioners who are trying to formulate the counterfactual where a discretion exists.

The counterfactual that nothing would have been done

PS LA 2005/24 and the Guide acknowledge that, in some circumstances, it may be that nothing would have been done had the scheme not been carried out. The Guide states:

In some cases, it may be that nothing would have been done by the taxpayer if the scheme had not been carried out. This is particularly likely to be true if the scheme mainly results in a taxpayer artificially obtaining a tax deduction.

⁴³

Practitioners should also consider the scenario where the tax benefit is an amount not included in the assessable income of a taxpayer (s 177C(1)(a)) and the taxpayer argues that the counterfactual is that nothing would have been done. If such an argument could be sustained, the fact that nothing would have been done (for example, no scheme entered into and no assessable income derived) may work in favour of the taxpayer. Such an argument allows the taxpayer to assert that no assessable income would have been derived in any event and therefore, there is in fact **no** tax benefit.

The fact that this type of argument could work in a taxpayer's favour was obviously contemplated by parliament. In the Ralph Report⁴⁴ it was proposed that the reasonable expectation test be strengthened to address this kind of argument. The Ralph Report states at 6.4:

That operation of the existing reasonable hypothesis test (in s 177C) be improved by ensuring the counterfactual to a tax avoidance scheme reflects the commercial substance of the arrangement.

Currently, in order to demonstrate the existence of a tax avoidance scheme, the Commissioner of Taxation is required to construct a reasonable alternative transaction or counterfactual which does not give rise to the tax benefit. In some tax avoidance cases promoters of the scheme have argued that the reasonable alternative to the scheme may be that the taxpayer would not have done anything. The recommendation will confirm that this is not the case. For example, if the sale of property had an attached tax benefit, the alternative transaction would be constructed on the basis that the sale of property, without the tax benefit, would have taken place.

⁴³ PS LA 2005/24 also addresses this issue and states at Paragraph 75 that:

“If the scheme had no effect or outcome other than the obtaining of the relevant tax benefit(s), it will be reasonable to assume that nothing would have happened if the scheme had not been entered into or carried out.”

⁴⁴ Australian Government, 'Review of Business Taxation A Tax System Redesigned (Ralph Report)' (1999).

The “amount” of a tax benefit

A question also arises as to whether a tax benefit exists where an amount is not included in a taxpayer’s assessable income under one provision of the ITAA 1936 or ITAA 1997, however, it is included in the taxpayer’s assessable income by another provision. Woellner, Barkoczy, Murphy and Evans give the example of a scheme designed to transform a payment to an employee to an amount that is assessable as an eligible termination payment in order for the employee to obtain the special tax treatment accorded to such payments.⁴⁵ PS LA 2005/24 attempts to address this situation and states:

the fact that an amount was included in the assessable income of the taxpayer under the scheme by virtue of a different provision or circumstance does not affect the amount of a tax benefit, nor the provision by virtue of which it is to be included. Paragraph 177C(1)(a) focuses on what has been left out of assessable income by the scheme – not on what has been included.⁴⁶

Thus, the position adopted by the tax office on this issue is that the fact that an amount is included in the taxpayer’s assessable income by virtue of another provision does not affect its classification as a tax benefit. However, the tax office does recognise that this would become relevant in considering the dominant purpose of the taxpayer and the application of the compensating adjustment provisions in Part IVA.⁴⁷

Notably, this view of a tax benefit is controversial. Woellner, Barkoczy, Murphy and Evans state that a tax benefit does not arise where the amount is included in the taxpayer’s assessable income under another section. They state:

It is submitted that sec 177C(1)(a) does not apply to these characterisation schemes as they do not involve any overall reduction in a taxpayer’s assessable income. This argument is based on the proposition that the reference to “an amount not being included in assessable income” in sec. 177C(1)(a) is a reference to the global concept of assessable income (ie the total of all amounts included in the assessable income of the taxpayer). In other words, it does not matter how amounts enter assessable income provided there is no overall reduction in the total amount of assessable income.⁴⁸

The identification of the incorrect tax benefit

Furthermore, PS LA 2005/24 and the Guide do not address the situation where the Commissioner identifies the incorrect amount or type of tax benefit.⁴⁹ De Wijn and Alpins⁵⁰ argue that in some circumstances the fact that the wrong tax benefit is identified may affect the validity of a Part IVA determination as it will impact the validity of the exercise of the Commissioner’s discretion to apply Part IVA. They argue that where the quantum of the tax benefit has been *understated* this is likely to not effect the validity of a Commissioner’s discretion in relation to Part IVA.

⁴⁵ Woellner et al, *Australian taxation law 2006* (2006), 1511 Para 25-625.

⁴⁶ Paragraph 63 of PS LA 2005/24. See also the tax office’s similar view that is reflected in IT 2456: Income Tax Avoidance Schemes – Tax Benefit.

⁴⁷ IT 2456: Income Tax: Tax Avoidance Schemes – Tax Benefit.

⁴⁸ Woellner above n 45, 1511 Para 25-625.

⁴⁹ In relation to the incorrect identification of a tax benefit see generally J De Wijn and F J Alpins, ‘Part IVA: Twenty-two years on ... In a state of maturity? - Part II’ (2004) 38(7) *Taxation in Australia* 372.

⁵⁰ *Ibid.*

However, they provide that where the amount of the tax benefit is *overstated* this may effect the exercise of the Commissioner discretion. They give the example of the Commissioner making a determination to cancel a tax benefit of \$100,000 when the real amount of the tax benefit is \$100. They state that this may impact the conclusion reached under the dominant purpose test and therefore, the validity of the Commissioner's determination under s 177F. De Winj and Alpins provide that where the amount of the tax benefit is *overstated* whether this will affect the Commissioner's determination will depend on the difference in amount between the actual and the incorrectly identified tax benefit.⁵¹

De Winj and Alpins further state that where the qualitatively wrong tax benefit is identified by the Commissioner this will result in a miscarriage of the Commissioner's discretion:

in our view the Commissioner's discretion will automatically miscarry if it is exercised taking account of a qualitatively different tax benefit than the true tax benefit identified for the purpose of s 177C...s 177F(1) requires not only that there be a tax benefit within the terms of s 177C, but also that the Commissioner exercise his discretion by reference to that tax benefit as it is defined in a qualitative sense in paras (a) and (b) of s 177C(1). Accordingly, if the Commissioner exercises his discretion having regard to an incorrect tax benefit having a different nature or source, he will in our view have failed to address himself to the question s 177F(1) formulates.⁵²

Exceptions to Precondition Two – A Limited Choice Principle?

In considering whether there is a tax benefit, another important consideration for a practitioner is to determine whether the exception contained in s 177C(2) may apply.⁵³ Section 177C(2) provides that the term "tax benefit" should be read as not including a reference to tax benefits that are attributable to the making of:

- an agreement;
- a choice;
- a declaration;
- an election;
- a selection; or
- a notice or option (the above are together referred to as a "choice")

expressly provided by the ITAA 1936 or the ITAA 1997. This exclusion will not apply however, if the scheme was entered into or carried out (by any person) "for the purpose of creating any circumstance or state of affairs", which must exist to enable the choice to be made. An initial reading of the section suggests it may be a significant

⁵¹ Ibid. De Winj and Alpins Ibid, 374 state:

"Rather the issue will be whether taking into account the correct amount of the tax benefit would have materially affected the Commissioner's determination. This would raise issues such as the extent to which the quantum of the tax benefit has been overstated. The result of such analysis, depending on the facts of the case, may show that the Commissioner's discretion has miscarried."

⁵² Ibid.

⁵³ Other exceptions are contained in s 177C(2A) of the ITAA 1936 which deals with the non-inclusion of assessable income or the incurring of a capital loss where the tax benefit is attributable to making a CGT rollover election or agreement under Subdivision 170B and the scheme consisted solely of the making of the election.

exception for taxpayers. Hartigan J referred to the section in *Case W58*⁵⁴ as the “escape hatch to Pt IVA.”

There has, however, been little judicial consideration of this exception. In *Case W58*⁵⁵ the Tribunal held that the mere recognition of trusts by the ITAA 1936 did not mean that the use of a trust to divert income was a choice “expressly provided for” by the Act. The recent AAT decision in *Case I/2006*⁵⁶ also considers s 177C(2) briefly. In *Case I/2006* the taxpayers argued that the tax benefit they obtained (an uplift in the cost base of their shares) was attributable to an election made under Division 122-A of the ITAA 1997 and therefore, was not an exception to the definition of a tax benefit under section 177C(2). The AAT, however, rejected this argument stating that the tax benefit resulted from the steps or arrangements entered into after the election was made. Thus, the decision in *Case I/2006* appeared to focus on the words “attributed to” and the AAT held that the tax benefit could not be attributed to the election. The AAT were interpreting the words “attributed to” as requiring (not surprisingly) a nexus between the election made and the tax benefit. The exact strength of the nexus necessary between the election and the tax benefit may however be a matter for some debate in the future.

Section 177C(2) was also considered by the AAT in *Ryan v Commissioner of Taxation*⁵⁷. In this case it was held that s 82AAA(2), 82AAC(1), (2) and (2A) relating to the deductibility of superannuation payments did not constitute a declaration, election, selection, notice or option.

Notably a “request” or “nomination” is not referred to in s 177C(2).⁵⁸ An example of a request can be found in s 80A of the ITAA 1936. Presumably, given it is not specifically referred to, a “request” could constitute a tax benefit. However, it is unlikely that Part IVA would ever be applied in such a situation. Where a request is granted by the Commissioner, even if this does constitute a tax benefit, this would probably be a circumstance where the Commissioner would not exercise his discretion to apply Part IVA, as considered below.

Purpose in s 177C(2)

Another issue is what type of “purpose” is being referred to in s 177C(2). Challoner and Richardson state that the purpose in s 177C(2) would be the subjective purpose of the party. This is because there is no legislative direction how to otherwise determine the purpose of a party. Challoner and Richardson state:

However, in contrast to the provisions of sec. 177D(b), there are no statutory directions as to what matters regard should be had in determining the purpose for which the scheme was entered into or carried out. It is thought, therefore that the “dominant purpose” in sec. 177C(2)(a)(ii) and (b)(ii) should be given the same meaning as in relation to sec. 26(a), i.e. that it is the subjective purpose of the person which must be determined. This may be contrasted with the objective conclusion which has to be reached in relation to sec. 177D...where it is suggested that regard should not be had to the

⁵⁴ 89 ATC 524, 536.

⁵⁵ Ibid.

⁵⁶ *Re Taxpayers and Federal Commissioner of Taxation* [2005] AATA 1251 (16 December 2005).

⁵⁷ 2004 ATC 2181.

⁵⁸ NE Challoner and RJ Richardson, *Tax Avoidance Implications of 1981 General Provisions (Part IVA)* (1981), 48.

taxpayer's own statements, because the conclusion which has to be reached is a conclusion having regard to certain specified matters that do not include any statements by the taxpayer.

As pointed out in *Pascoe v FCT* by Fullager J (1956) 11 ATD 108 at p 111, where a person's purpose has to be determined, the statements of that person in a sense provide the best evidence but, for obvious reasons, they must be tested more closely and received with the greatest caution. Nevertheless, in the absence of specific provisions as to the matters to which regard has to be had in determining the purpose for which a person enters into or carries out a scheme, it is thought that it is the subjective purpose of that person which has to be determined...⁵⁹

Arguably, where there is no statutory guidance to the contrary the subjective purpose of the taxpayer would be relevant under s 177C(2).

Unfortunately, however, PS LA 2005/24 only identifies and does not consider s 177C(2). Further guidance regarding the tax office view on this section would be very helpful as s 177C(2) could be a very important exception for practitioners to consider.

Precondition Three: Dominant Purpose Test – The Tunnel

The Guide and PS LA 2005/24 both provide that the pivotal element in determining if Part IVA will apply, is whether a reasonable person would conclude that a person who entered into or carried out the whole or part of the scheme did so for the dominant purpose of obtaining a tax benefit for the taxpayer. Notably, in ascertaining purpose, regard can be had to the taxpayer or a person who entered into or carried out the (or part of the) scheme. Regard can also be had to the objective purpose of an adviser and their purpose can be attributed to the taxpayer.⁶⁰

“Dominant” refers to the “ruling, prevailing or most influential purpose”.⁶¹ However, in reaching the conclusion as to purpose, regard must only be given to the eight factors listed in s 177D. In this sense, the legislation effectively constructs a “tunnel” of factors the Commissioner may consider in determining if the dominant purpose of the taxpayer in entering into the scheme **was** to obtain a tax benefit. Rather than act as an obstacle to the Commissioner applying Part IVA, the tunnel of factors constructed by s 177D, appears to facilitate a finding that the dominant purpose of the taxpayer **was** to obtain a tax benefit, by excluding factors that may support a taxpayer's argument that their dominant purpose was not to obtain a tax benefit. For example, in determining the taxpayer's dominant purpose factors such as the subjective purpose of the taxpayer entering into the transaction cannot be considered.⁶²

⁵⁹ Ibid, 45.

⁶⁰ PS LA 2005/24 provides at paragraph 86:

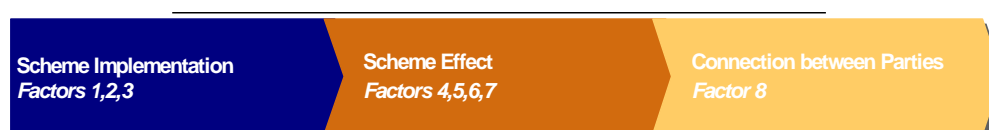
“It may be relevant in determining what objectively was the purpose of any person entering into or carrying out the scheme or any part of the scheme, to have regard to the purposes of the advisers or other agents of any of those persons. This of course, will be appropriate only where a person acts on professional advice and what was done on professional advice is relevant to considering the eight matters required to be considered in applying the purpose test in paragraph 177D(b).”

⁶¹ *Federal Commissioner of Taxation v Spotless Ltd* (1996) 186 CLR 404 and see paragraph 82 of PS LA 2005/24.

⁶² GT Pagone, ‘Part IVA the general anti avoidance provision in Australian taxation law.’ Dec (2003) 27 (3) *Melbourne University Law Review*, 770 states at page 771:

Both the Guide and PS LA 2005/24 divide the 8 factors into three overlapping groups. The first group of factors focuses on the scheme implementation and how the results of the scheme were obtained (manner, form and substance, and timing). The second group looks at the effects of the scheme (the tax results, financial changes and other consequences of the scheme.) The third group focuses on the nature of any connection between the parties and whether this illuminates what may have happened if there had been no connection between them. Notably, the conclusion reached under each of the eight factors will be closely linked to the counterfactual in establishing if there is a tax benefit. For example, under factor one, whether something is “artificial or contrived” may depend largely on comparing it to what is held to be the “normal” alternative way of conducting business.

FIGURE 1: PART IVA TUNNEL OF FACTORS TO CONSIDER FOR DOMINANT PURPOSE



Group One: Scheme Implementation

Factor 1 (manner of implementation), factor 2 (form and substance) and factor 3 (timing issues) are relevant under Group One. PS LA 2005/24 emphasises the importance of these first three factors as they involve an examination of the way in which the scheme achieves its effects. Indeed, this would appear to reflect an analysis of the case law on Part IVA which shows the conclusion reached in relation to the first three factors or the way in which the scheme is implemented appears to be decisive in relation to the overall conclusion reached as to the purpose of the taxpayer.⁶³ Hill J states that, in fact, it appears in *Hart*⁶⁴ it was the **manner** in which the scheme was carried out that led to a conclusion that the dominant purpose of the taxpayer was to obtain a tax benefit and consequently, that Part IVA applied. Hill J stated:

In my view *Hart* should be read as a case where the particular form of the finance agreement, the wealth optimizer aspects, required the conclusion adverse to the taxpayer to be reached. This is but another way of expressing the second part of the *Newton test*, namely the result to be reached if it is predicated that the taxpayer carried out the transaction “in that way” so as to avoid tax. It is not easy to read Part IVA this way. The question posed is: what conclusion would be reached as to the purpose of some person in entering into the scheme, not the alternative, namely the purpose in entering into the scheme in that way.⁶⁵

Factor 1: Manner of Implementation

In looking at factor one it is relevant to consider if the scheme was formed or implemented in a way that was: “contrived to obtain the tax benefit”. If steps are inserted into the transaction that would not be apparent in a comparable more

Part IVA seeks both to tax the amount that 'would otherwise' not be caught, and to do so upon the basis of a judgement made on a partial selection of the actual facts, rather than upon some precise and exacting application of the letter of the law to all of the facts as they are found.

⁶³ See generally *Federal Commissioner of Taxation v Hart* (2004) 217 CLR 216.

⁶⁴ *Ibid.*

⁶⁵ G Hill, ‘The incremental expansion of Part IVA’ (2005) 40(1) *Taxation in Australia* 23.

straightforward way of implementing the transaction this may point towards a purpose of obtaining a tax benefit.⁶⁶

Factor 2: Form and Substance

Factor two requires that the “substance of what is being done” be considered and compared to the form that the transaction takes. Where there is a discrepancy between the commercial or practical effect of the scheme and its legal form, this would point towards a conclusion that Part IVA would apply, particularly if the scheme could be achieved in a more straightforward or commercial manner. PS LA 2005/24 states that⁶⁷:

In practice these first two factors are likely to be related. For example, a divergence between form and substance could involve a roundabout way of implementing the scheme by steps that have no effect on the substance of what is achieved but lead directly to the obtaining of the tax benefit.

Factor 3: Timing Issues

The third factor considers the time the scheme was entered into and the period during which the scheme was carried out. A “flurry of activity” shortly before the end of the financial year may point towards a dominant purpose of obtaining a tax benefit, as may the fact that the timing of the scheme is not related to the commercial opportunity.⁶⁸ The fact that a scheme is carried out before the end of the year will not, however, necessarily point against a dominant purpose of obtaining a tax benefit. PS LA 2005/24 gives the example of a taxpayer who benefits before the end of the year by having their PAYG instalments varied.⁶⁹

Group 2: Scheme Effect

Under this group what should be considered are the tax results, financial changes and other important consequences of the scheme for the taxpayer and related parties. Factor four looks at the tax benefit and any other tax consequences resulting from the scheme, factor five, six and seven focus on the other effects of the scheme for the taxpayer and all other connected parties.

Factor four focuses on the tax benefit. It appears that there would never be a scheme (for which it had already been established that there was a tax benefit) where this factor would not point towards the dominant purpose of obtaining a tax benefit. In order to begin an inquiry as to purpose under the eight factors it must first be established that there is a tax benefit. The Guide states that: “the mere fact that a tax benefit exists does not mean Part IVA will apply.”⁷⁰ However, it does appear to indicate that factor four will always point towards the dominant purpose of obtaining a tax benefit and in this sense it will always contribute to an overall finding that the dominant purpose of the scheme was to obtain a tax benefit. This is because if a taxpayer obtained a tax benefit clearly the tax result of the scheme would be favourable to the taxpayer and thus, factor four would point towards a dominant purpose of obtaining a tax benefit.

⁶⁶ See *Federal Commissioner of Taxation v Consolidated Press Holdings* 2001 ATC 4343; *Federal Commissioner of Taxation v Hart* (2004) 217 CLR 216; *Sleight* 2004 ATC 4477.

⁶⁷ See Paragraph 96 of PS LA 2005/24.

⁶⁸ *Federal Commissioner of Taxation v Sleight* 2004 ATC 4477.

⁶⁹ See paragraph 101 of PS LA 2005/24.

⁷⁰ See page 2 of the Guide.

PS LA 2005/24 and the Guide suggest that the absence of a practical change in a taxpayer's overall financial, legal or economic position will "add weight" towards a conclusion being reached that the dominant purpose was to obtain a tax benefit. It is difficult to understand why PS LA 2005/24 suggests that this conclusion would be reached. Arguably, if the taxpayer entered into a scheme to obtain a tax benefit their overall financial position **would be** financially changed for the better (they would have to outlay less of their financial resources to pay tax). Furthermore, in cases where Part IVA applies to a scheme it is likely that the legal position of the taxpayer has indeed changed. For example in the mass-marketed scheme cases such as *Puzey*⁷¹, *Sleight*⁷² and *Calder*⁷³ it was held that the agreements were legally effective and the participants were carrying on a business. Thus, the legal rights of the taxpayers in these cases and most of the Part IVA cases to date had indeed changed.

PS LA 2005/24 further cautions that the change in a taxpayer's overall position must be considered along with the change of other connected parties positions:⁷⁴

the change in the position of the taxpayer may mean little if there is an inverse change in the position of another person as a result of the scheme, and that other person is an associate or alter ego of the taxpayer such as a spouse or a wholly-owned company. It may also be relevant to observe that an allowable deduction is, or is not, matched by a corresponding amount of assessable income among the other parties who are affected by the scheme. These factors will often require consideration in conjunction with the second factor.

This guidance is surprising. One of the fundamental tenets of income taxation law is that there is no "matching principle". That is, the fact that a deduction is allowable to one taxpayer does not mean that an amount must be assessable to another.⁷⁵ Yet, this factor is suggested by PS LA 2005/24 to point towards a finding that the taxpayer's dominant purpose was to obtain a tax benefit.⁷⁶

Group 3: The nature of the connection between the taxpayer and any other parties to the scheme

The third group consists of factor eight. Factor eight involves considering any connection between the parties to the scheme. Where a relationship exists between the parties to the scheme or/and they are not dealing at arms length this may indicate that the dominant purpose was to obtain a tax benefit. Whether the parties are at arms length will also be relevant to factors in the other two groups such as: the manner the scheme was entered into or carried out, form and substance of the scheme and the tax, financial and other consequences of the scheme. The fact that there is a relationship between the parties will not always work against a taxpayer. In fact, this could assist a taxpayer in some cases. PS LA 2005/24 states that:⁷⁷

Many dealings which would be decidedly odd between strangers may be entirely explicable between family members. For example, a businessman

⁷¹ 2003 ATC 4782.

⁷² 2004 ATC 4477.

⁷³ 2005 ATC 5050.

⁷⁴ See paragraph 106 of PS LA 2005/24.

⁷⁵ Parsons above n 5, Chapter 5 (paragraph 5.34).

⁷⁶ Paragraph 109 of PS LA 2005/24.

⁷⁷ See paragraph 111 of PS LA 2005/24.

who gives assets to strangers for less than they are worth may be subject to suspicion but a gift to his family could stand in a different light. Of course, it would be a different matter again if the family members do not benefit in substance from the arrangement.

Issues regarding the balancing act

Even with the additional guidance provided by PS LA 2005/24 and the Guide, it may still be extremely difficult for a practitioner to predict the conclusion that would be reached under the dominant purpose test. This is because, perhaps the most difficult element of forming a conclusion under s 177D is balancing or weighting the factors in order to form an overall conclusion as to what is the dominant purpose. For example, how does one determine whether Part IVA will apply when there appears to be an equal number of factors pointing towards and against a dominant purpose to obtain a tax benefit? Where a conclusion reached with respect to one of the factors is neutral does that support or detract from an overall finding that the dominant purpose is to obtain a tax benefit? ⁷⁸Accordingly, it can be difficult to predict what overall conclusion will be reached under the dominant purpose test.

There also appears to be significant analytical tension between the decision in *Cooke*⁷⁹ and those in cases such as, for example, *Calder*⁸⁰ and *Iddles*⁸¹. It seems in *Cooke*⁸² that one of the most decisive factors in saving the taxpayers from a finding that Part IVA applied was that they entered into the scheme to plan for their retirement. However, in *Calder*⁸³ and *Iddles*⁸⁴ a finding that the taxpayer's subjective purpose for entering into the scheme was to plan for their retirement was held not to be a matter that could be considered in s 177D. Despite *Cooke*⁸⁵ appearing to be an outlier decision, this highlights the fact that reasonable people can differ on the conclusion to be reached as to dominant purpose under Part IVA by placing greater weight on some factors than on others.

PS LA 2005/24 and the Guide provide scant guidance as to the weighting that should be given to each of the factors. PS LA 2005/24 stating that: "not all of the matters will be equally relevant in every case." The Guide states that one must: "consider and weigh them together in a practical and common sense way to get at the substance of what is really going on."⁸⁶ Unfortunately, such direction in practical terms provides little guidance for a practitioner.

When should the question as to purpose be tested?

The question of purpose is usually ascertained by examining the factors at the time the scheme is entered into, but according to the Full Federal Court in *Vincent*⁸⁷ purpose can also be "tested" while the scheme is being carried out.

The Full Federal Court in *Vincent*⁸⁸ state:

⁷⁸ Cooper above n 27.

⁷⁹ (2004) 55 ATR 183.

⁸⁰ 2005 ATC 5050.

⁸¹ 2005 ATC 2254.

⁸² (2004) 55 ATR 183.

⁸³ 2005 ATC 5050.

⁸⁴ 2005 ATC 2254.

⁸⁵ (2004) 55 ATR 183.

⁸⁶ See page 1 of the Guide.

⁸⁷ 2002 ATC 4742.

...the question of dominant purpose will usually be determined by reference to the time when the scheme is entered into. We accept that there can be cases where purpose is tested when the scheme is still being carried out. But in all cases the question of dominant purpose arises before there has been an assessment and by reference to a date no later than the expiration of the year of income in which the scheme is either entered into or being carried out.

PS LA 2005/24 gives no guidance on this issue but arguably it could be an important issue. For example if the scheme turns out to be profitable, will this (or should this) influence the conclusion reached under s 177D?

Procedural Issue – is the conclusion reached as to the dominant purpose of the taxpayer a conclusion of fact, a conclusion of law or a mixed conclusion of fact and law?

Recently commentators have suggested that an issue may arise as to whether the conclusion reached under s 177D is a conclusion of fact, a conclusion of law or a “conclusion reached by operation of a quasi-discretion”.⁸⁹ This is an issue on which clarification is needed, as what the conclusion under s 177D is classified as, is significant in determining the appeal rights of a taxpayer who is issued with a Part IVA determination.⁹⁰ Chang outlines the consequences as follows:

Clearly if the conclusion as to dominant purpose is something other than a question of law, the range of matters in which a taxpayer will be entitled to review of the conclusion beyond an initial proceeding under Part IVC TAA will be substantially reduced.⁹¹

The arguments as to whether a conclusion as to the application of Part IVA is a question of fact, law or a quasi-discretion will not be addressed in detail, however, a broad overview is provided below.

Conclusion of Fact

Chang suggests that some support for the proposition that the conclusion reached under s 177D is a conclusion of fact, appears in decisions such as the Full Federal Court decision in *Mochkin*⁹² and *Peabody*⁹³. In *Mochkin*⁹⁴ (with respect to one of the schemes identified in that case) the Full Federal Court considered whether the question of dominant purpose should be reconsidered and pointed to anterior errors in the Federal Courts reasoning in order to re-examine the issue.⁹⁵

Conclusion of a Quasi Discretion

Chang further suggests another alternative is that the conclusion may be a conclusion reached by operation of a “quasi discretion”. This is neither a conclusion of law or

⁸⁸ Ibid, 4760.

⁸⁹ See generally GT Pagone, ‘The Legal Nature of a Conclusion: Finding of fact vs Decision of law: some comments on *Mochkin*’ (2003) 37(9) *Taxation in Australia* 478; Jeffrey Chang, ‘Part IVA and the conclusion as to dominant purpose: preconditions for appeal and the impact of *Mochkin*’ (2004) 7(3) *Tax Specialist* 151; J H Momsen, ‘Part IVA - a matter for discretion’ (2004) 7(3) *Tax Specialist* 119.

⁹⁰ Chang Ibid; Momsen Ibid.

⁹¹ Chang above n 89, 154.

⁹² 2003 ATC 4272.

⁹³ (1994) 181 CLR 359

⁹⁴ 2003 ATC 4272.

⁹⁵ Chang above n 89, 154. Chang states:

“If the conclusion were the product of a quasi-discretion the preconditions for appeal would appear to be the same as if it were a finding of fact.”

fact. The consequences of being a conclusion of this type would mean that the appeal rights of a taxpayer (with regard to a Part IVA determination) would be limited.⁹⁶

Conclusion of law

Chang provides that cases such as *Eastern Nitrogen*⁹⁷ and *Hart*⁹⁸ would indicate that the conclusion reached under s 177D is a question of law, as the Court in these cases did not identify an “anterior error of principle” before re-examining the issue before it.⁹⁹

PS LA 2005/24 does not express any view on this issue. This could, however, prove to be an important issue for clarification in the future given its pervasive effect on appeal rights.

AN EXERCISE OF THE COMMISSIONER’S DISCRETION

What is equally (if not more) difficult than predicting the outcome of the dominant purpose test is determining when the Commissioner will exercise his discretion to apply Part IVA to an arrangement. Recent case law has significantly assisted practitioners in forming a view as to whether objectively the dominant purpose of a taxpayer would be to obtain a tax benefit. Cooper summarises this effectively when he states:

It is much less easy to understand why it [Part IVA] applies - or rather, why it is applied by the Commissioner – in some circumstances and not in others. Does (or should) Part IVA apply to an *Everett* – type assignment of a right to receive future income? Does (or should) it apply in the circumstances of *Galland* where the assignment of the right to income is made on 29 June but with effect for the whole of the year’s income, and the taxpayer is a potential beneficiary of the assignment? The Commissioner has indicated that he will not seek to apply Pt IVA to either of these transactions, but why not? Why he should *not* do so is less than obvious when it is recalled that neither in *Everett* nor *Galland* did the High Court consider s. 260. Or consider the interest offset accounts offered by various financial institutions. The Commissioner considers these not to be avoidance when they meet certain conditions and yet he has attacked split and linked loan arrangements and line of credit facilities which operate by generating deductions, rather than through income omission.¹⁰⁰

This statement is even more pertinent when examined in light of the example provided regarding husband and wife partnerships in the Guide, discussed below. Indeed, it does appear that the Commissioner accepts some forms of avoidance by not exercising his discretion to apply Part IVA in these scenarios.

However, neither the case law, nor the tax office guidance, has explored in depth the issue of when the Commissioner’s discretion to apply Part IVA will be exercised. This lack of guidance is very disappointing as when the Commissioner will exercise his discretion to apply Part IVA is one of the most important issues from a practitioner’s point of view. Even if the preconditions are satisfied, if the

⁹⁶ Ibid.

⁹⁷ 2001 ATC 4164.

⁹⁸ (2004) 217 CLR 216.

⁹⁹ Chang above n 89.

¹⁰⁰ Cooper above n 29.

Commissioner does not exercise his discretion to apply Part IVA, the taxpayer's arrangement will still be "safe". This is because, Part IVA is not a self-executing provision; it depends on the exercise of the Commissioner's discretion under s 177F. Once the Commissioner has determined to exercise his discretion to cancel a tax benefit the section enables him to: "take such action as he considers necessary to give effect to any such determination."

Does the word "may" in s 177F in Part IVA provide the Commissioner with a true discretion?

When analysing the Commissioner's discretion under s 177F, the first question is: does Part IVA provide the Commissioner with a true discretion?

One view is that Part IVA does not really provide the Commissioner with a discretion and the word "may" would be interpreted by the Courts to read, "must". The corollary of this view is that the Commissioner must apply Part IVA if the preconditions are satisfied.¹⁰¹ Support for this view can be found in the High Court decision in *Finance Facilities Pty Ltd v FCT*.¹⁰²

Finance Facilities involved the application of s 46(3) of the ITAA 1936. Section 46(3) sets out certain circumstances where the Commissioner "may allow" a shareholder a rebate for dividends. Subsection 46(3) states that the Commissioner "may allow" the shareholder a rebate in the following circumstances:

- (3) Subject to the succeeding provisions of this section, the Commissioner may allow a shareholder, being a company that is a private company in relation to the year of income and is a resident, a further rebate in its assessment of the amount obtained by applying the average rate of tax payable by the shareholder to one-half of the part of any private company dividends that is included in its taxable income if the Commissioner is satisfied that:
- (a) the shareholder has not paid, and will not pay, a dividend during the period commencing at the beginning of the year of income of the shareholder and ending at the expiration of ten months after that year of income to another private company;
 - (b) where the shareholder has paid, or may pay, a dividend during the period:
 - (i) commencing at the beginning of the year of income of the shareholders; and
 - (ii) ending at the expiration of ten months after that year of income, to a company, being a private company in relation to the year of income of the company in which the dividend was, or may be, paid, the company has not paid, and will not pay, dividend during the period -
 - (iii) commencing at the beginning of the year of income of the company in which the dividend has been, or may be, paid by the shareholder; and
 - (iv) ending at the expiration of ten months after that year of income, to another private company; or
 - (c) having regard to all the circumstances, it would be reasonable to allow the further rebate.

¹⁰¹ See generally M L Brabazon, 'Tax avoidance: the "new, improved" Part IVA' (1997) 1(1) *Tax Specialist* 28. Brabazon refers to the view that "may" means "must" in Part IVA and rejects it.

¹⁰² (1971) 127 CLR 106.

In interpreting this provision the High Court held that the Commissioner was required to allow a rebate, where the conditions were satisfied, despite the use of the words "may allow". Windeyer J stated:

The question, which comes back to the words "may allow", is not to be solved by concentrating on the word "may" apart from its context. Still less is the question answered by saying that "may" here means "shall". While Parliament uses the English language the word "may" in a statute means may. Used of a person having an official position, it is a word of permission, an authority to do something which otherwise he could not lawfully do. If the scope of the permission be not circumscribed by context or circumstances it enables the doing, or abstaining from doing, at discretion, of the thing so authorized... Here the scope of the permission or power given is circumscribed. Conditions precedent for its exercise are specified as alternatives. The question then is, must the permitted power be exercised if one of those conditions be fulfilled? ... This does not depend on the abstract meaning of the word "may" but of whether the particular context of words and circumstance make it not only an empowering word but indicate circumstances in which the power is to be exercised - so that in those events the "may" becomes a "must"... If the Commissioner, having considered the matter, is satisfied of facts out of which the power to allow a rebate arises, he cannot nevertheless refuse to allow it. That is obvious in the case of condition (c): and it seems to me to be so also in the case of the alternatives (a) and (b).

Section 46(3), is structurally different and has a different intended operation, from Part IVA. Unlike s 46(3), s 177F is separate from the sections in Part IVA that deal with the preconditions. Accordingly, s 177F does not have any conditions circumscribing its operation. In this respect, s 177F does appear to allow the Commissioner a choice between whether to disallow the whole or part of the tax benefit. Further, unlike s 46(3), s 177F does not provide that the Commissioner may exercise his discretion where the preconditions are satisfied.

Rather s 177F provides, once the preconditions have been established, **then** the Commissioner may exercise his discretion to cancel the whole or part of the tax benefit obtained from the scheme. Thus, although the preconditions in Part IVA must be satisfied in order to enliven s 177F, the preconditions do not circumscribe how the discretion should be exercised. In this respect, s 177F appears to give the Commissioner a real and virtually unfettered discretion to refuse to apply Part IVA.¹⁰³

Another point of differentiation is that s 46(3) is a provision designed to assist taxpayers, whereas s 177F is a very powerful provision that will assist the Commissioner. The consequences of Part IVA applying can have very serious implications for a taxpayer. It may be that Courts will be more likely to construe s 46(3) in a stricter manner because it assists a taxpayer. Even though recent decisions have indicated that courts will take more of a purposive approach to interpreting tax legislation, traditionally courts have interpreted tax legislation in a strict literal manner. This literal interpretation has its basis in the presumption that tax imposes a substantial obligation on taxpayers and an obligation should only be imposed on a taxpayer if the legislation that seeks to impose it is drafted in a clear and unambiguous

¹⁰³ A number of commentators also suggest that it is a real discretion. See generally Brabazon above n 101 and Terry Murphy, 'Part IVA: From Here To...' (2000) 3(3) *Journal of Australian Taxation* 198.

manner.¹⁰⁴ Thus, it may be that the Courts would still be more likely to interpret “may” as “must” where doing so would impose an obligation on the Commissioner to assist a taxpayer.

Challoner and Richardson¹⁰⁵ suggest a legislative indication that s 177F(1) bestows a discretionary power on the Commissioner is the clause at the end of the section “and, where the Commissioner makes such a determination, he shall take such action as he considers necessary to give effect to that determination”. Clearly, the words “**and where** the Commissioner makes such a determination” indicate that the Commissioner does indeed have a choice as to whether to apply Part IVA.

IT 2627 Income Tax: Application of Part IVA to dividend stripping arrangements indicates that the tax office also views s 177F as conferring a discretion on the Commissioner. IT 2627 states:

Subsection 177F(1) uses the word “may”. That gives the Commissioner a discretion whether or not to make a determination ...A determination will usually be made where the Commissioner believes the provisions of Part IVA are satisfied. However, the discretion will not be exercised if cases arise where the view is formed that there is no real avoidance of tax. This may be particularly relevant to the application of section 177E, where there need not be a tax benefit or a tax avoidance purpose before the section applies.¹⁰⁶

Again, this indicates that the Commissioner treats s 177F(1) as if it provides him with a true discretion.

Whilst not specifically discussing the discretion, PS LA 2005/24 appears to recognise that a discretion exists that can be exercised once the preconditions are satisfied. PS LA 2005/24 states:

Subsection 177F(1) gives the Commissioner a discretion to make a determination cancelling a tax benefit that has been obtained, or would but for section 177F be obtained, in connection with a scheme to which Part IVA applies. The discretion can only be exercised when a tax benefit has been obtained, or would but for the section be obtained, by a taxpayer in connection with a scheme to which Part IVA applies.

Another view is, that whilst s 177F does bestow upon the Commissioner a real discretion this discretion is limited to considering **the amount** of the tax benefit that should be cancelled. Batrouney states:

The Explanatory Memorandum which was circulated...seems to assume that the discretion in s 177F is confined to the amount of the tax benefit to be cancelled rather than the fact of cancellation.¹⁰⁷

Indeed, this view is reflected by the EM which states that:

Section 177F is the ‘reconstruction’ provision of Part IVA and will come into play once section 177D, together with section 177C (for the general run

¹⁰⁴ See for example *Duke of Westminster v IR Commrs* (1936) 19 T.C. 490.

¹⁰⁵ Challoner above n 58, 112.

¹⁰⁶ Paragraph 31 of IT 2627.

¹⁰⁷ Jennifer Batrouney SC, ‘Challenging the Commissioner's exercise of discretion’ (Paper presented at the Part IVA Masterclass, Crown Towers, Southbank, Melbourne, 19 July 2001).

of cases)...has done its work of both exposing for annihilation a sought-for 'non taxable' position and quantifying the amount of the 'tax benefit' that stands to be cancelled. The essential function of section 177F is to enable the Commissioner of Taxation, against the background of the other sections mentioned, to determine precisely what tax adjustments would be made in the assessments of the taxpayer concerned and of other taxpayers affected by the scheme.

Sub-section 1 effectively calls on the Commissioner to make a formal determination as to how much of the amount of the identified tax benefit is to be cancelled and directs him, where he has made such a determination, to take such assessing and other action as he considers necessary to give effect to it. There are two kinds of determination possible – under paragraph (a), that the whole or a part of any amount that is not otherwise included in assessable income be so included and, under paragraph (b), that the whole or a part of a deduction or of a part of a deduction that is otherwise allowable be not allowable.

The EM appears to contemplate that the Commissioner **may not** exercise his discretion to apply Part IVA, even when the preconditions are satisfied, by determining that no tax adjustment should be made. Specifically, the Commissioner could determine the amount of the adjustment made to the taxpayer's income is zero. In any case, as Batrouney suggests, even if the EM was intending that the discretion be limited to the amount of the tax benefit that should be cancelled for the reasons discussed above, the legislative provisions in Part IVA do not appear to reflect this limitation on the Commissioner's discretion.

When will the Commissioner refuse to exercise his discretion to apply Part IVA?

If it is accepted that s 177F supplies the Commissioner with a real discretion as to whether to apply Part IVA, the next questions that arise are:

- What factors will the Commissioner consider in determining whether to exercise his discretion to apply Part IVA?
- When will the Commissioner exercise his discretion **not** to apply Part IVA?

These two questions are linked. It is important to determine what are relevant and irrelevant considerations to the exercise of the Commissioner's discretion, as these will help predict when the Commissioner will exercise his discretion not to apply Part IVA. For the discretion to have any purpose (and for the structure of Part IVA to make sense) the factors the Commissioner will consider under s 177F must differ from those that will be considered in establishing the preconditions. For example, it is unlikely that factors such as the deductibility of the expenses under other provisions of the ITAA 1997 or ITAA 1936 would be relevant, as this has already been considered in determining if there is a tax benefit.

Commentators have suggested the Commissioner may not exercise his discretion to apply Part IVA in some of the following circumstances:

- The tax benefit resulted from an ordinary family or business transaction.¹⁰⁸ The difficulties with relying on a test of "normality" were discussed above. Such a criteria is highly problematic because what is "normal and ordinary" could mean

¹⁰⁸ Brabazon above n 89, 34.

different things to different people depending on their knowledge of the particular area concerned. The test of normality also appears to have no relationship with the legislative set up of Part IVA.

- The conduct was something, which as a matter of policy should be allowed. Such conduct may not fall within s 177C(2) but it would still be (as a matter of policy) desirable that it be allowable (for example something that the taxpayer was intended to have as a deduction under the ITAA 1936 such as deductions for film expenditure or superannuation or the concessions from the consolidation regime).¹⁰⁹ Certainly this appears to be a most compelling reason for not exercising the discretion, because the taxpayer is obtaining a deduction that was intended by the Act. But this is not a choice under the Act (so that the exception in s 177C(2) would not apply).
- Where the taxpayer has acted in accordance with tax office advice or the agreement of the Commissioner. This factor appears to suggest that the Commissioner may not exercise his discretion to apply Part IVA in order to maintain horizontal equity between taxpayers. For example, consider the scenario where a taxpayer had received a favourable private ruling on a particular scheme. Another taxpayer then entered into this scheme but did not obtain a private ruling. The Commissioner subsequently determines Part IVA could apply to the scheme. The Commissioner may decide that he would not exercise his discretion to apply Part IVA to the other taxpayer (despite technically being able to) in order to maintain horizontal equity between the taxpayers.
- Where no fiscal loss occurs to the tax office. Murphy provides in this regard:

where there is no loss to the revenue. In the context of income tax this could arise for a number of reasons such as, in the case of an assignment of income, the assignee being liable to pay the same amount of tax as the assignor would otherwise have been liable to pay. Another circumstance is where a taxpayer structures an arrangement to make it tax neutral by ensuring that it does not itself give rise to assessable income which would not have otherwise arisen. It may also arise in the context of other taxes such as fringe benefits tax, if, for example, the Commissioner were to disallow a deduction in circumstances where the transaction gave rise to a liability to fringe benefits tax (which, not being income or a deduction, cannot be mitigated under the compensating adjustment provisions of s 177F(3)).¹¹⁰

It is unlikely that this would be a reason why the Commissioner would not exercise his discretion as arguably, the Commissioner would want the correct taxpayer to be assessed, so the fact that another taxpayer was assessed for that and the scheme presented no “fiscal risk” would appear not to be a relevant consideration.

- Where the Part IVA determination would not increase the tax actually payable.¹¹¹ On this issue Murphy states:

where the making of the determination (and any consequential assessment) would not give rise to an increase in the tax actually payable. This may be because the taxpayer is a bankrupt. It is also possible to envisage some

¹⁰⁹ Brabazon above n 89, 34. Also see Murphy above n 103, 204.

¹¹⁰ Murphy above n 103, 205.

¹¹¹ Murphy above n 103, 205.

circumstances in which the revenue might suggest because of the requirement in s 177F(3) that the Commissioner make compensating adjustment. This would be the case if the taxpayer was bankrupt and the person in respect of whom the compensating adjustment was to be made would, as a consequence of the scheme, derive assessable income or not be entitled to a deduction.

Arguably, however, where the taxpayer was bankrupt the Commissioner would still make a Part IVA determination to ensure in the event (albeit unlikely) that any funds were available for distribution, the tax office would obtain its rightful share.

Another interesting factor the Commissioner may consider in choosing not to exercise his discretion to apply Part IVA is public policy reasons. For example, consider the scenario where a corporate taxpayer makes a donation to a registered charity on 29 June 2005. The taxpayer has no knowledge of the charity or what the proceeds of its donations will go towards. The donation is made following advice by its accountant that the taxpayer will have a substantial profit this year. The accountant advised that a way in which the company could reduce its assessable income is to make a donation to a particular charity. Despite it being highly arguable that objectively the dominant purpose of the transaction is to obtain a tax benefit it is unlikely for public policy reasons the Commissioner would ever apply Part IVA to a transaction involving a charity. This is because encouraging taxpayers to make donations to charities is desirable from a public policy point of view.

Another factor the Commissioner may take into account when deciding whether to exercise his discretion under s 177F is the maintenance of “economic parity” between transactions. For example, in the recent case of *Cumins v Commissioner of Taxation*¹¹² Mr Cumins claimed a capital loss under Part 3-1 of the ITAA 1997 for a transaction that resembled an ordinary, widely accepted, profit washing transaction. Mr Cumins owned shares which were mortgaged to the bank. Under the terms of the agreement with the Bank he was unable to assign or transfer his rights in the shares without its consent. Mr Cumins had significant unrealised losses on the shares and attempted to sell them to another wholly owned trust in order to realise the loss to offset against a gain he had on another parcel of shares. This transaction was similar to a “wash sale”, in most respects, as Mr Cumins was seeking to lock in a temporary capital loss. However, because Mr Cumins’ shares were mortgaged he had to attempt to create artificially circumstances in which he could realise the loss. This case is on appeal from the Full Federal Court and it is interesting to consider whether it is held that one of the factors the Commissioner may be able to take into account in determining whether or not to exercise his discretion is that the economic result of Mr Cumins’ transaction would not be any different to that achieved by wash sales which are sanctioned by the tax office.

Unfortunately, it is very difficult to determine (with any certainty) what factors the Commissioner would take into account, as there is no statutory or administrative guidance on this issue. Galligan states:

¹¹² [2006] FCA 43 (6 February 2006).

Just what factors must be taken into account where there is no express requirement, and what exactly taking into account means, is one of the recurring problems in the legal regulation of discretion.¹¹³

Thus, it can be seen that many of the issues involving the Commissioner's discretion under s 177F remain virtually unexplored. Like the purpose test, the exercise of the Commissioner's discretion is also pivotal to the application of Part IVA. Some further guidance from the tax office in respect of this discretion would be highly desirable.

THE COMPENSATING ADJUSTMENT PROVISIONS

Sections 177F(3) – 177F(7) of the ITAA 1936 contain the compensating adjustment provisions. Section 177F(3) allows the Commissioner to determine that an amount should not be included in a taxpayer's income where:

- An amount has been included, or would (if s 177F(3) did not apply), be included by virtue of the operation of Part IVA in the taxpayer's income; and
- In the Commissioner's opinion it is "fair and reasonable" that the amount should not be included in the taxpayer's income in that year.

Thus, the provisions effectively allow the Commissioner to reconstruct the position of the taxpayer. The Commissioner is able to take such action as is necessary to give effect to a reconstruction. These actions may include:

- excising an amount from a taxpayer's assessable income;¹¹⁴
- allowing a deduction to a taxpayer;¹¹⁵ or
- allowing a capital loss or foreign tax credit to a taxpayer.¹¹⁶

The taxpayer has the right to request that a compensating adjustment be made. However, the Commissioner may also make a compensating adjustment of his own volition.¹¹⁷

The compensating adjustment provisions should not be overlooked by practitioners as they could provide a useful mitigation tool for taxpayers. However, there has been little judicial consideration of when it will be "fair and reasonable" to make a compensating adjustment.

A real discretion?

A preliminary issue that again arises under s 177F(3) is whether the Commissioner has a real discretion to determine whether it is "fair and reasonable" to make a compensating adjustment. The alternative being (as discussed in respect of s 177F(1)) that "may" in this context ought to be interpreted to mean must, as it did in *Finance Facilities*.¹¹⁸

¹¹³ D Galligan, *Discretionary powers: a legal study of official discretion* (1986), 31.

¹¹⁴ Section 177F(3)(a) of ITAA 1936.

¹¹⁵ Section 177F(3)(b) of ITAA 1936.

¹¹⁶ Section 177F(3)(c) and (d) of ITAA 1936.

¹¹⁷ Section 177F(5). Wilson-Rogers, 'Compensating adjustments: The limits on the Commissioner's discretion' (2004) 7(5) *The Tax Specialist* 273-282.

¹¹⁸ (1971) 127 CLR 106.

The arguments for stating that the Commissioner *must* make a compensating adjustment where it is “fair and reasonable” to do so are far more compelling for s 177F(3) than they are under s 177F(1).

There are more similarities between s 177F(3) and s 46(3) in *Finance Facilities*¹¹⁹ than there are between s 177F(1) and s 46(3). The similarities between s 177F(3) and s 46(3) include:

- Both provisions are designed to assist a taxpayer and therefore, may be more likely to be strictly construed against the Commissioner;
- Both sections circumscribe the exercise of discretion with certain conditions.

Thus, it could be said that where it was found that it was “fair and reasonable” to do so the Commissioner would be compelled to make a compensating adjustment. If this is the case, it highlights the difficulties in applying Part IVA, that in one section of Part IVA (s 177F(1)) “may” is interpreted to grant a discretion, and in another section (s 177F(3)) “may” is held to mean “must”.

In any event, even if “may” is interpreted to mean “must” in the context of s 177F(3) the Commissioner may still retain some discretion in that he determines what is “fair and reasonable”. However, once he determines it is “fair and reasonable” he cannot then, nevertheless, determine not to exercise his discretion to grant a compensating adjustment. Galligan defines discretion very broadly to include: “the scope for personal assessments in the course of a decision”¹²⁰ If this definition of a discretion is accepted, then arguably, given the vague and undefined nature of the phrase “fair and reasonable” the Commissioner does have a discretion. This is especially so because the exact meaning of “fair and reasonable” has been largely unexplored by case law and consequently, is largely undefined.

PS LA 2005/24 does, however, provide some guidance on when the Commissioner will consider it to be “fair and reasonable” to make a compensating adjustment. PS LA 2005/24 states that: “A compensating adjustment must generally be made where the application of Part IVA causes double taxation of the same income.”¹²¹

The example provided in PS LA 2005/24 is where the scheme involves the diversion of personal services income to a family trust. The income has been distributed to beneficiaries and the income was taxed in the hands of the beneficiaries. The Commissioner then makes a determination with respect to the scheme including the income in the assessable income of the taxpayer. In this situation the Commissioner makes compensating adjustments in favour of the taxpayer’s family members so that the income of the beneficiaries from the trust is determined not to have been included in the beneficiaries assessable income.

However, there are obviously many other circumstances in which compensating adjustments may need to be made. For example, in personal services income splitting cases a compensating adjustment may need to be made. Where income paid to a company, for example, is held to be the taxpayer’s personal services income some deductions may still be allowable for the taxpayer against that income. The basis upon

¹¹⁹ Ibid.

¹²⁰ Galligan above n 113.

¹²¹ See paragraph 137 of PS LA 2005/24.

which it is “fair and reasonable” to allow those deductions under the compensating adjustment provisions can be an area of difficulty.

“Fair and reasonable”

In *Re Egan and Federal Commissioner of Taxation*¹²² consulting income earned by a company (wholly owned by a husband and wife) was held to be the husband’s personal services income by virtue of the provisions of Part IVA. The Commissioner did, however, allow some items of expenditure as deductions to the taxpayer under the compensating adjustment provisions. The Commissioner did not allow the taxpayer some additional expenditure items as deductions. The taxpayer objected to the additional items of expenditure that were not allowed (by virtue of the compensating adjustment provisions) as deductions. In that case, the AAT set some limits on what a decision-maker must take into account in determining what will be “fair and reasonable”:

While s 177F(3)(a) and (b) uses the words “fair and reasonable”, the acceptance of Mr James’s submission would require the respondent and the Tribunal to act in the capacity of an advisor to Mr Egan, AOS and TM and make assumptions of an arrangement between the three which might have happened if the advice was properly given, accepted by the parties and acted upon. It requires an assumption that the parties would or may have entered into transactions differently to those which actually happened. While Mr Egan was a director and, therefore, in relation to some provisions of the Act, an employer of AOS, this does not mean that AOS would have paid a particular level of salary, contributed the same amount to superannuation, provided a motor vehicle and provided rented premises closer to its office than was the residence of Mr Egan. It may well have done but it is difficult to accept that s177F(3) allows pure conjecture to be “fair and reasonable”.

It is not really clear what limits this sets on the meaning of “fair and reasonable” in practical terms. Despite the fact that the AAT have indicated it will not engage in “pure conjecture” as to what arrangements a taxpayer may have entered into and therefore, what deductions a taxpayer may be entitled to, what is “fair and reasonable” still remains an open question. Guidance on other types of examples (such as that in *Re Egan*) to what is “fair and reasonable” are not discussed in PS LA 2005/24.

Timing of a compensating adjustment

There are also some issues regarding the time when a compensating adjustment should be made, particularly where an objection is lodged against the Part IVA determination. For example, if the Commissioner makes a Part IVA determination and it is clear he will have to make a compensating adjustment (and he has this knowledge at the time of making the Part IVA determination) is he obliged to do so at that time or can he wait until the issues regarding the objection have been resolved? If he does not make a compensating adjustment at the time of making the Part IVA determination, where such knowledge is present, will the determination and the subsequent assessment be tentative or provisional, because the Commissioner knew it would have to be adjusted at some point in the future?

¹²² AAT Case [2002] AATA 563, *Re Egan and Federal Commissioner of Taxation* 50 ATR 1064.

Some of these issues were considered in *ANZ v Commissioner of Taxation*¹²³. Justice Stone held in this case that generally the Commissioner will not be obliged to make a compensating adjustment at the same time as making a Part IVA determination. This is particularly so where the application of Part IVA is being objected to or reviewed. This is because where an assessment is being objected to if a compensating adjustment was made at that point, such an adjustment would be provisional and may need to be adjusted depending on the outcome of the objection, the Commissioner will only be in a position to determine what is “fair and reasonable” when the application of Part IVA is established. PS LA 2005/24 reiterates this principle and states that in such a situation where it is clear that a compensating adjustment is expected to be made (at some point in the future) when the application of Part IVA is established, the taxpayer should be informed of the expected compensating adjustment.¹²⁴

Given that there is no time limit within which the Commissioner must make a compensating adjustment (or within which the taxpayer must request a compensating adjustment be made) it is unlikely that any timing obligations will be placed on the Commissioner with regard to making a compensating adjustment.

THE RELATIONSHIP BETWEEN PART IVA AND THE OTHER PROVISIONS OF THE ACT

The relationship Part IVA has with other provisions of the Act is peculiar. Only an “allowable” deduction will be capable of being susceptible to the operation of Part IVA. As Verick states: “If a tax avoidance arrangement is not a sham, runs the gauntlet of all the other provisions and manages to survive, it then comes up against Part IVA”.¹²⁵ Likewise, Raphael, further, states: “In a nutshell it is submitted that the operation of Part IVA and the balance of the Act are mutually exclusive...”¹²⁶ For example, where a deduction is not allowed under s 8-1 of the ITAA 1997 the deduction will never be challenged under Part IVA.¹²⁷ Thus, the more purposively s 8-1 of the ITAA 1997 and s 51(1) of the ITAA 1936 are interpreted the smaller the scope for the operation of Part IVA will be. In this respect Part IVA is a “provision of last resort”. Section 177B(3) and (4) reflect this.

Section 177B(3) states:

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

¹²³ [2003] FCA 1410.

¹²⁴ Paragraph 138 of PS LA 2005/24 states:

“Any action to make or give effect to compensating adjustments (for example amendment of assessments) should not as a general rule be undertaken while the application of Part IVA is subject to objection or review. Such an approach does not make the assessment giving effect to the relevant Part IVA determination(s) tentative or other than bona fide. The Commissioner will be in a position to determine whether it is ‘fair and reasonable’ that a compensating adjustment be made when the application of Part IVA is finally established...Where it is clear that a particular compensating adjustment is expected to be made when the application of Part IVA is established, the taxpayer should be informed of the expected compensating adjustment.”

¹²⁵ A Verick, ‘The Progression of Anti-Avoidance Legislation, Cases & Rulings’ (Paper presented at the Taxation Institute of Australia (Queensland Division) State Convention Papers, 20-22 April 1990).

¹²⁶ D Raphael, ‘The Progression of Anti-Avoidance Legislation, Cases & Rulings’ (Paper presented at the Taxation Institute of Australia (Queensland Division) State Convention Papers, Queensland, 20-22 April 1990).

¹²⁷ See for example *Vincent v Federal Commissioner of Taxation* 2002 ATC 4742.

provisions, as the case may be, shall be read as including a reference to subsection 177F(1).

Similarly, Section 177B(4) states:

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.

PS LA 2005/24 confirms that Part IVA is a provision of last resort and states:¹²⁸

Officers should be aware that Part IVA is a general anti-avoidance provision and that there are specific provisions which may or may not apply in a particular case. Officers should be aware of subsections 177B(3) and (4) which reflect the last resort character of Part IVA.

However, cases on Part IVA may reflect a different approach of the tax office, which seek to apply Part IVA despite the existence of a specific anti avoidance provision also designed to counter that type of tax avoidance. In this context, Hill J states that the relationship between specific anti-avoidance rules and Part IVA may become a litigated issue in the future. He remarks specifically on the relationship between the personal services income rules in Part 2-42 of the ITAA 1997 and Part IVA:

One might have thought that it would have been Parliament's intention that Part 2-42 would cover the field so that if it did not apply to tax the worker on the income then the worker was immune from further attack. The argument would be that where there is a general anti-avoidance provision (Part IVA) and a specific avoidance provision (2-42), the specific provision should prevail. It is certainly not clearly untenable. That is not the view of the Commissioner who takes the position that Part IVA may nevertheless apply to a case where an individual has incorporated and notwithstanding that, Part 2-42 of the 1997 Act has not operated to treat the income derived as personal income. The question of the interrelationship between Part IVA and Part 2-42 is one that is likely to be litigated soon.

Indeed, it does seem a peculiar result that where parliament has turned its mind to a particular activity and specific anti avoidance provisions are enacted to combat it, and a transaction of that type satisfies those provisions, Part IVA may apply in any event. It further indicates that Part IVA, although it is a provision of "last resort", will always be used as a backstop to the specific anti-avoidance provisions in the ITAA 1936 and ITAA 1997.

AN EXAMPLE IN THE GUIDE OF WHERE PART IVA WILL NOT APPLY: HUSBAND AND WIFE PARTNERSHIPS

The Guide provides an example of where the tax office considers Part IVA would not apply.¹²⁹ The example presented is a husband and wife partnership where only one party performs the bulk of the work and is the main generator of the income for the partnership. The arrangement, however, has the effect of dividing the income of the partnership equally between the parties. The Guide states that: "Part IVA would not

¹²⁸ Paragraph 50 of PS LA 2005/24.

¹²⁹ Page four of the Guide.

apply to a typical husband and wife partnership arrangement where there are no unusual features.”

Interestingly, the Guide states that when regard is had to the “tunnel” of factors in s 177D, it would not be objectively concluded that the dominant purpose of the partnership arrangement was to obtain a tax benefit, through the division of profits and losses.

Entering into a partnership is an ordinary means for a husband and wife to conduct a business together. There is nothing contrived about the manner of sharing profits and losses because that is what the Partnership Act prescribes as the normal consequence of forming a partnership.¹³⁰

The Guide emphasises that the arrangement has real financial consequences for the parties leaving both the husband and wife fully exposed to the debts of the partnership.

The Guide further provides that in such a scenario there is no divergence between the substance and form of the scheme and it is a way of the husband and wife conducting business in the long term. The Guide indicates, however, that there may be some modifications of this scenario where Part IVA will apply. It states:

In the absence of unusual features, therefore, Part IVA would not apply to such husband and wife partnerships. The sort of unusual features that could see Part IVA apply include where the:

- income generating activity was in reality a disguised employment arrangement; or
- use of the partnership is prohibited by regulatory or other laws.

In employee-like arrangements, provisions in the income tax law which specifically deal with the alienation of personal services income may apply in any event. This would mean that the partner performing the main bulk of the work is taxed on all of the partnership income. In such cases, Part IVA would have no application.

In many respects, this example is surprising, as arguably, several of the factors in such an arrangement **would** appear to point towards a dominant purpose of obtaining a tax benefit. Certainly in similar cases before the AAT such as *Case W58*¹³¹ and *Case X90*¹³² it was found that Part IVA would apply to an arrangement. However, the tax office has indicated that it no longer agrees that Part IVA should apply to these arrangements. The tax office states:

For example, the Administrative Appeals Tribunal (AAT) has in the past intimated that Part IVA operates to give effect to a ‘general rule that income from personal exertions is assessable in the hands of the person who earned it by those personal exertions’ (*Case X90 90 ATC 648 at 654*). This emphasis on the nature of the income has arguably been at the expense of an appropriate focus on the artificiality of the underlying arrangement.¹³³

¹³⁰ Ibid.

¹³¹ *Case W58 89 ATC 524*.

¹³² *Case X90 90 ATC 648*.

¹³³ See ATO Test Case Program Statement “Refocus of the income-splitting test case program” available at <http://www.ato.gov.au/corporate/content.asp?doc=/content/67313.htm>.

To explore the application of Part IVA to this scenario an analysis is undertaken below. For ease of analysis it is assumed that the wife is the party that does the bulk of the work and is the main generator of the income. The facts in the scenario provided in the Guide will also be compared to a similar factual scenario in *Case W58*¹³⁴ where it was held that Part IVA applied. In this case the company required the taxpayer to provide his services as a consultant through a company. Accordingly, he acquired a company and provided his services under a consultancy agreement. The taxpayer also created a discretionary family trust, the trustee of which was the company. In all other respects however, the taxpayer was like an employee of X Co. It was concluded in this case that the taxpayer's dominant purpose was to obtain a tax benefit and Part IVA applied. It was held that: "It was not sufficient that the arrangements could be described as normal family arrangements." The Tribunal held that:

4. In the absence of the trust arrangements it could reasonably be expected that the family company would have paid the taxpayer all the income it distributed as trust income to beneficiaries other than the taxpayer. Such income might reasonably have been expected to have been included in the taxpayer's assessable income, within the meaning of sec. 177C(1).
5. The taxpayer could not escape the operation of Pt IVA because of the "choice principle" offered by sec. 177C(2). The mere fact that the Assessment Act recognises such things as trusts and provides how they should be taxed does not mean that the choice of the trust mechanism for income splitting is a choice "expressly provided for" by the Act for the purposes of sec. 177C(2)(a)(i)...
6. In conclusion, the taxpayer entered into and carried out a scheme for the purpose of obtaining a tax benefit and which did in fact produce a tax benefit and the whole of that benefit should be cancelled under sec. 177F(1).

THE APPLICATION OF PART IVA TO THE SCENARIO IN THE GUIDE

Precondition One: Scheme

The broad scheme in the scenario provided in the Guide, would include:

- the establishment of the partnership between the husband and wife;
- the payment of income to the partnership for the services of predominantly of the wife; and
- the splitting of income between the parties unequally so that the wife receives less income than she would have had she billed for her work directly to clients.

It is possible that a narrower scheme for this scenario could also be formulated. The narrow scheme would consist of only the third element listed above: the splitting of the income between the parties unequally.

Precondition Two: Tax Benefit

The tax benefit would be the non-inclusion in the wife's assessable income of the full amount of the income received by the partnership pursuant to s 177C(1)(a).

¹³⁴ *Case W58* 89 ATC 524.

Precondition Three: Dominant Purpose

In relation to the third precondition the dominant purpose to obtain a tax benefit under section 177D, it is arguable that the way in which each of the factors would apply is as detailed below.

Factor 1 The manner in which the scheme was entered into or carried out (s177D(b)(i))

Income is received by the partnership, despite the services being provided mainly by the wife. The manner in which the income is split is that the husband (despite providing little in the way of services) receives an equal amount of income from the partnership. This factor points towards a dominant purpose of obtaining a tax benefit.

The fact that a partnership is a “normal” way of conducting business should not impact on the fact that the manner in which the partnership profits and losses are shared is artificial and contrived. Certainly in *Hart*¹³⁵ the fact that purchasing an investment property was a normal and commonly entered into transaction did not detract from the fact that the manner in which the transaction was structured was not normal and pointed towards a conclusion that the dominant purpose was to obtain a tax benefit.

Factor 2 The form and substance of the scheme s 177D(b)(ii)
Case W58 stated:

The form of a corporate vehicle which employed the taxpayer and controlled the trust belies the real substance of that arrangement which essentially allowed the taxpayer to act in such a way as to attract to himself a lower incidence to personal income tax.¹³⁶

Indeed, in this scenario, it appears that the partnership structure employed “belies the real substance of the arrangement” which essentially allowed the wife to reduce her income tax burden.

Factor 3 Time and Length of Scheme : s 177D(b)(iii)

There is no evidence pointing either way in relation to this factor and accordingly, it is neutral.

Factor 4 Result in relation to the Act that, apart from Part IVA, would be achieved by the scheme s 177D(b)(iv)

The result, but for the application of Part IVA, would be that significant tax advantages were obtained by the wife by splitting her income. This would point towards a dominant purpose of obtaining a tax benefit.

Factor 5, 6 and 7 Any change in the financial position of the taxpayer or people connected with the taxpayer and any other consequences for the taxpayer.

The change in financial position was to reduce the overall tax burden of the family, from what it would have been if the wife had derived (and paid tax) on all the income individually. Therefore, the scheme increased the overall wealth of the family. This would appear to point towards a dominant purpose of obtaining a tax benefit.

¹³⁵ *Federal Commissioner of Taxation v Hart* (2004) 217 CLR 216.

¹³⁶ *Case W58* 89 ATC 524, 535.

Legally the position of the husband and wife has changed and both would be joint and severally liable for the debts of the partnership. This would appear to point against a dominant purpose of obtaining a tax benefit.

Factor 8 The Relationship between the parties.

The partners are husband and wife and therefore, splitting the income will benefit the family as a whole. It is unclear whether this factor would point for or against a dominant purpose of obtaining a tax benefit. In *Case W58* the fact that the arrangement would have benefited the family's overall wealth was not sufficient to stop a finding that Part IVA would apply.

Overall, it appears that objectively viewed this arrangement would appear to point towards a dominant purpose of obtaining a tax benefit. It is difficult to see when comparing the scenario presented in the Guide to that in *Case W58* how the arrangements there were any more reprehensible and susceptible to the application of Part IVA. Indeed, it appears that an arbitrary distinction has been drawn between splitting income through a trust and splitting income through a partnership and it is not clear why.

When one considers all these factors it appears to be strained to state that a conclusion would be reached under s 177D that the dominant purpose was not to obtain a tax benefit. Perhaps this example could be explained more easily if the Commissioner stated that he would not exercise his discretion in these circumstances because he considers this to be an acceptable form of income splitting in a family business. Surely, such a justification would be preferable to the Commissioner trying to justify this conclusion artificially by stating that the dominant purpose, after going through the tunnel, would not be to obtain a tax benefit.

CONCLUSION

When the policy basis of Part IVA is considered, it is not surprising that it is difficult to predict with certainty when Part IVA will apply to a transaction. It is unclear as a matter of policy what will constitute "tax avoidance" and this is reflected in the broad and amorphous words of Part IVA. This wording allows Part IVA the flexibility to apply to a wide variety of transactions; however, with this flexibility comes uncertainty. Therefore, the guidance that the tax office can provide in the form of PS LA 2005/24 and the Guide is correspondingly limited.

PS LA 2005/24 and the Guide do, however, provide a good overview of the basic principles and case law in relation to establishing the existence of the preconditions: a scheme, tax benefit and a dominant purpose to obtain a tax benefit. PS LA 2005/24 and the Guide further illustrate that the three preconditions are inextricably linked and as such Part IVA must be construed as a whole rather than viewing any of the elements in isolation. In addition to providing a useful summary of the operation of Part IVA, it is also necessary that practitioners familiarise themselves with the information in PS LA 2005/24 and the Guide because of the penalty implications. The tax office states at the beginning of the Guide:

If you try to follow the information contained in our written general advice and publications and in doing so make an honest mistake you won't be

subject to a penalty. However as well as the underpaid tax, we may ask you to pay an interest charge¹³⁷

Several of the more intricate issues regarding the three preconditions, however, still remain unaddressed by the tax office in PS LA 2005/24 and the Guide.

The area in which PS LA 2005/24 and the Guide could have provided some invaluable assistance is in what circumstances the Commissioner would choose to exercise his discretion to apply Part IVA. This issue is not, however, addressed in PS LA 2005/24 and the Guide and it remains an area that has been largely unexplored by case law or commentary.

In summary, PS LA 2005/24 and the Guide have only marginally assisted in further illuminating how to establish the preconditions and the tunnel of factors in s 177D. However, at the end of the tunnel when practitioners must determine whether the Commissioner will exercise his discretion to apply Part IVA they still remain, very much, in the dark.

¹³⁷ The first page of the Guide.