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Part IVA - A Toothless Tiger?

Abstract

[Extract] Tax avoidance has been a problem for governments since taxes were introduced. Thirteenth century English property taxes were avoided by taxpayers moving their assets outside the sheriff's jurisdiction. Even more conniving were the citizens of 17th century England who avoided the Window Tax by covering their windows before the tax collector's visit.

Keywords

tax avoidance, Australia, income tax, tax

“Part IVA – A toothless tiger?”¹

1. Introduction

Tax avoidance has been a problem for governments since taxes were introduced.² Thirteenth century English property taxes were avoided by taxpayers moving their assets outside the sheriff's jurisdiction.³ Even more conniving were the citizens of 17th century England who avoided the Window Tax⁴ by covering their windows before the tax collector's visit.⁵

Combating tax avoidance in the modern world is no less difficult. To this end, modern Australia has had an unfortunate history of tax avoidance. In the 1970's and early 1980's tax accountants and legal practitioners were openly marketing and selling tax avoidance schemes.⁶ This tax avoidance was largely facilitated by the Australian High Court's interpretation of the then general anti-avoidance provision, s 260 *Income Tax Assessment Act 1936* (Cth) ('ITAA'). As a result of the High Court's excessive literal interpretation⁷ of the provision and the development of judicial extrapolations, such as the 'choice principle'⁸

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² Cf Woellner, Barkoczy and Murphy *2000 Australian Taxation Law*, 10th ed (CCH Australia Ltd, Sydney, 2000) at 1-080. See also A Thompson, "Some Thoughts on Tax Avoidance" (1978) *New Law Journal* at 629.

³ G Lehmann and C Coleman, *Taxation Law in Australia*, 3rd ed (Butterworths, Sydney, 1994) at 1.8.

⁴ Under this tax the extent of a householder's wealth was measured by the number of windows in his / her house.

⁵ Woellner, Barkoczy and Murphy *2000 Australian Taxation Law*, 10th ed (CCH Australia Ltd, Sydney, 2000) at 1-080.

⁶ Grbich "Problems of Tax Avoidance in Australia" in JG Head (ed) *Tax Issues of the 1980s* (Australian Tax Research Foundation, 1983) at 416 and 424-426; Woellner, Barkoczy and Murphy *2000 Australian Taxation Law*, 10th ed (CCH Australia Ltd, Sydney, 2000) at 1-090. The author believes that, unfortunately, in recent years this practice has been resurrected. The government is also very concerned as to the increase in mass advertised tax schemes: Australian Tax Office, *Annual Report 1999-2000*, chap 6.

⁷ Under the lead of Barwick CJ. See, for example, *Mullens v FCT* (1976) 135 CLR 290; *Patcorp Investments Ltd v FCT* (1976) 140 CLR 247; *Slutzkin v FCT* (1977) 140 CLR 319; *Cridland v FCT* (1977) 140 CLR 330; *FCT v Westradars Pty Ltd* (1980) 80 ATC 4357 esp at 4358. Contrast Murphy J's approach in *FCT v Westradars Pty Ltd* (1980) 80 ATC 4357 at 4369-4370.

⁸ Under the choice principle, that the transaction was entered into deliberately to obtain a tax benefit did not prevent a taxpayer taking advantage of these 'exempting' doctrines: *Cridland v FCT* (1977) 140 CLR 330 at 339 and 340.

and ‘antecedent transactions’ test⁹, which further limited the scope of s 260, this provision was rendered largely ineffective.¹⁰

Initially, the Australian public viewed tax avoidance as praiseworthy. In essence the notion was that “they (the Government) take too much and waste it!” Spurred, however, by a new awareness that such tax avoidance was generally undertaken by the wealthy and as a consequence the tax burden was largely being borne by salaried taxpayers,¹¹ the public attitude changed in the 1980’s. With this change in attitude and revelations of significant revenue losses arising from tax avoidance,¹² the government decided to enact a new general anti-avoidance measure, Part IVA ITAA.¹³

Part IVA did not, however, prove to be the ‘white knight’ the government had hoped. While the legislation is very broadly worded, the judiciary has placed what the author has always viewed as very sensible limits upon its scope.¹⁴ Thus in earlier articles it has been submitted

⁹ Under this doctrine there must be a change to an existing arrangement before s 260 will apply: *Europa Oil (NZ) Ltd v IRC* [1976] 1 WLR 464 at 475; *Mullens v FCT* (1976) 76 ATC 4288 at 4294; *Cridland v FCT* (1977) 77 ATC 4538 at 4541-4542; *FCT v Gulland*; *Watson v FCT*; *Pincus v FCT* (1985 - 1986) 160 CLR 55 at 73 and 111; *FCT v Bunting* (1989) 89 ATC 4358 at 4363; *Rippon v FCT* (1992) 92 ATC 4186 at 4191-4192. Under this doctrine, s 260 will not apply where there has been no alteration of a pre-existing source of income, but rather a tax effective structuring of a new source of income.

¹⁰ See further *FCT v Peabody* (1993) 93 ATC 4104 at 4110; *John v FCT* (1989) 89 ATC 4101 at 4108; *Davis & Anor v FCT* (1989) 89 ATC 4377 at 4399; *Case W58* (1989) 89 ATC 524 at 533.

¹¹ *Royal Commission on the Activities of the Federated Ship Painters and Dockers Union, Final Report, (“Costigan Report”)* Vol 1 at 100-102. Recent reports suggest that high income earners still pay a lower rate of tax than those persons earning less. See Toohey “How the rich slip through the net” *Sun Herald* 21 March 1999 and “Murdoch media empire ‘evades’ tax collector” *Newcastle Herald* 20 March 1999. Note, however, that in Coleman and Freeman “Cultural Foundations of Taxpayer Attitudes to Voluntary Compliance” (1997) 13 *Australian Tax Forum* 311 at 315 it is suggested that the small business sector is “generally and substantially less compliant than salary and wage earners and larger businesses.”

¹² Grbich estimates that at least \$10,000m was lost through tax avoidance during the 1970’s: Grbich “Problems of Tax Avoidance in Australia” in JG Head (ed) *Tax Issues of the 1980s* (Australian Tax Research Foundation, 1983) at 413.

¹³ Part IVA generally applies to schemes entered into after 27 May 1981. See s 177D. Where the tax benefit is the incurring of a capital loss the scheme must have been entered into after 3 pm 29 April 1997. Where the tax benefit is the obtaining of a foreign tax credit the scheme must have been entered into after 4 pm 13 August 1998. Where the tax benefit arises from avoiding withholding tax, this must occur after 20 August 1996.

¹⁴ See, for example, Cassidy, J., “Observations on the application of Part IVA: Peabody v FC of T,” (1993) 21(6) *Aust Business Law Rev* 424; Cassidy, J., “Peabody v FC of T and Part IVA” (1995) 5 *Revenue Law Journal* 197; Cassidy, J., “Are Tax Schemes Legitimate Commercial Transactions? Commissioner of Taxation v Spotless Services Ltd and Commissioner of Taxation v Spotless Finance Pty Ltd” (1996) 2 *High Court Review* 23; Cassidy, J., “Osborne v FCT - The Lost Opportunity?” (1999) 3(1) *Tax Specialist* 9; Cassidy, J., “Osborne v FCT - The Lost Opportunity?” (1999) 34(2) *Taxation in Australia* 97.

that while aspects of the initial decisions¹⁵ considering Part IVA have affirmed the existence of significant limits upon the scope of Part IVA, generally,¹⁶ the Courts' interpretations of Part IVA have provided an appropriate balance between preventing tax avoidance without discouraging business and family transactions.¹⁷ However, the appropriateness of limiting Part IVA in this manner has not been shared by all. At times the government and Australian Tax Office have lamented that Part IVA is as ineffective as its predecessor, s 260. To this end it is pertinent to note that the failure of Part IVA was identified by the government¹⁸ as the key reason for enacting the personal services income legislation contained in, *inter alia*, *New Business Tax System (Alienation of Personal Services Income) Act 2000*.

It was these comments that spurred the author to revisit Part IVA, to identify what were the potential limits to Part IVA that have arisen from either its legislative context or judicial interpretation of its terms. The conclusions of this revisit are set out in the first half of this article. The potential limits of each element of Part IVA are identified and then exemplified through leading Part IVA cases. The second part of the article then evaluates the true effect of these potential limitations by examining the successful application of Part IVA in two recent cases, *Egan v FCT* [2001] AATA 449 and *FCT v Consolidated Press Holdings Ltd* (2001) HCA 32.¹⁹ These cases show how the potential limitations of Part IVA may be overcome by the courts and thus, ultimately, it is submitted that Part IVA is not a 'toothless tiger' in the fight against tax avoidance.

¹⁵ See, for example, *Peabody v FCT* (1992) 92 ATC 4585; (1993) 93 ATC 4104; (1994) 94 ATC 4663; *Osborne v FCT* (1995) 95 ATC 4323; *Spotless Services Ltd v FCT* (1993) 93 ATC 4397; (1995) 95 ATC 4775; (1996) 96 ATC 5201.

¹⁶ It was submitted, however, in, *inter alia*, Cassidy, J., "Are Tax Schemes Legitimate Commercial Transactions? Commissioner of Taxation v Spotless Services Ltd and Commissioner of Taxation v Spotless Finance Pty Ltd" (1996) 2 High Court Review 23 and Cassidy, J., "Have the ghosts of s 260 come back to haunt the Commissioner of Taxation?" (1997) 51 Bulletin for International Fiscal Documentation 20 that, Cooper J's interpretation of s 177D in *FCT v Spotless* (1995) 95 ATC 4775 at 4810-4812 rendered Part IVA useless.

¹⁷ See, again, for example, Cassidy, J., "Observations on the application of Part IVA: Peabody v FC of T," (1993) 21(6) Aust Business Law Rev 424; Cassidy, J., "Peabody v FC of T and Part IVA" (1995) 5 Revenue Law Journal 197; Cassidy, J., "Are Tax Schemes Legitimate Commercial Transactions? Commissioner of Taxation v Spotless Services Ltd and Commissioner of Taxation v Spotless Finance Pty Ltd" (1996) 2 High Court Review 23; Cassidy, J., "Have the ghosts of s 260 come back to haunt the Commissioner of Taxation?" (1997) 51 Bulletin for International Fiscal Documentation 20; Cassidy, J., "Osborne v FCT - The Lost Opportunity?" (1999) 3(1) Tax Specialist 9; Cassidy, J., "Osborne v FCT - The Lost Opportunity?" (1999) 34(2) Taxation in Australia 97.

¹⁸ Cf "Taxation Institute's President Alice McCleary says PSI changes akin to 'Russian Roulette'" Australian 11 July 2001; Taxation Institute media release, 31 August 2001.

¹⁹ Note, these are not the only cases when Part IVA was successfully applied, but they serve to evidence the application of Part IVA in two very different tax effective schemes. It should be noted, however, that in *FCT v Metal Manufacturers* [2001] FCA 365; *Eastern Nitrogen v FCT* [2001] FCA 366 Part IVA was unsuccessfully applied. At the time of writing these latter cases are the subject of special leave applications to the High Court

To this end it is pertinent to note that even the government now seems to recognise that Part IVA is not a 'toothless tiger'. While the government does intend to amend Part IVA,²⁰ it no longer appears to see the existing provisions as ineffective. Thus, for example, the government has asserted that it will continue to apply Part IVA to arrangements even though they may satisfy the new personal services income rules, contained in, *inter alia*, *New Business Tax System (Alienation of Personal Services Income) Act 2000*.²¹

2. Part IVA

Before we turn to the limits of Part IVA it is pertinent to briefly consider Part IVA itself. For Part IVA to apply there must be:

- * a "scheme" as defined in s 177A(1) and (3);
- * under s 177D the scheme must provide the "relevant taxpayer"²²;
- * with a "tax benefit" as defined in s 177C; and
- * a person must have entered into the scheme for the sole or dominant purpose of enabling the relevant taxpayer to obtain a tax benefit: s 177D.²³

Each of these elements must be satisfied before Part IVA will apply. As a consequence, not only the Commissioner, but also any court or tribunal considering Part IVA, must also make a finding with respect to each of the elements. If, as in *Case 22/93* (1993) 93 ATC 281, a particular element is not considered, this will constitute an error of law: *Blackman v FCT* (1993) 93 ATC 4538; *Osborne v FCT* (1995) 95 ATC 4323.

²⁰ It is proposed that Part IVA will be strengthened through amendments in accordance with the proposals of the *Review of Business Taxation* (1999) ("*Ralph Report*"): *Treasurer's Press Release No. 16*, 22 March 2001. While originally these were to be effective from 11 November 1999, the Treasurer has announced that such measures will only be effective from the date they are introduced into Parliament: *Treasurer's Press Release No. 16*, 22 March 2001. To date the amendments have not been introduced into Parliament.

²¹ Division 86 of the *New Business Tax System (Alienation of Personal Services Income) Act 2000* is to operate side by side with Part IVA, in preventing the alienation of personal services to an interposed entity, known as a "personal services entity": ss 86-10 and 86-15(2) and (3). See *Explanatory Memorandum* at para 1.17; *Taxation Ruling TR 2001/7*. See also "Taxation Institute's President Alice McCleary says PSI changes akin to 'Russian Roulette'" *Australian* 11 July 2001; President Alice McCleary, 'Letter to the Editor' *Australian Financial Review*, 27 August 2001; Taxation Institute media release, 22 August 2001.

²² Note that under s 177F the Commissioner need not issue a notice on the relevant taxpayer; that is, the person who obtains the tax benefit; but merely needs to give notice of his determination to a party(s) to the arrangement: *Grollo Nominees Pty Ltd v FCT* (1997) 97 ATC 4585. It is proposed that amendments will allow the Commissioner to issue a single determination that will apply to every person participating in the scheme: *Treasurer's Press Release*, 11 November 1999.

²³ Part IVA also applies to dividend stripping schemes (s 177E) and franking credit schemes (s 177EA). See further these provisions for the prerequisites necessary for Part IVA to apply to these specific schemes.

If all elements are satisfied, Part IVA allows the Commissioner to cancel the whole or part of the tax benefit stemming from the subject scheme: s 177F. Thus, unlike s 260 which automatically rendered the whole arrangement void²⁴ and did not allow for any reconstruction by the Commissioner,²⁵ under Part IVA the Commissioner changes the tax consequences of an arrangement by making a determination under s 177F: *FCT v Spotless Services Ltd* (1996) 96 ATC 5201 at 5205.²⁶

3. Limits to Part IVA

Each element of Part IVA is now considered to identify how the potential scope of Part IVA has been narrowed.

(i) *Scheme v subscheme*

“Scheme” is defined in exceptionally broad terms in s 177A(1):

- "(a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable by legal proceedings and;
- (b) any scheme, plan, proposal, action, course of action or course of conduct."²⁷

While this wide definition means that the first element of Part IVA will be readily satisfied, it does not mean it is a non-issue. It may sound trite, but the particular scheme that has been so identified must also satisfy the other elements of Part IVA. This may prove difficult in light of (i) the courts’ definition of a scheme and (ii) that the courts have asserted it is insufficient if only a part of that scheme, a ‘subscheme’, satisfies the further elements of Part IVA. It will be seen below that where these rules require the scheme to be more broadly framed, it will

²⁴ *Casuarina Pty Ltd v FCT* (1970) 70 ATC 4069 at 4077-4078; *Peate v FCT* (1966) 116 CLR 38 at 44.

²⁵ *Bell v FCT* (1951-1952) 87 CLR 548 at 572-573; *Newton v FCT* (1958) 98 CLR 2 at 10; *Bayly v FCT* (1977) 77 ATC 4045 at 4056-4057; *Jones v FCT* (1977) 77 ATC 4058 at 4064-4065; *FCT v Kareena Hospital Pty Ltd* (1979) 79 ATC 4667 at 4671 and 4673; *John v FCT* (1989) 166 CLR 417 at 432 and 433; 89 ATC 4101 at 4108-4109; *Spotless Services Ltd v FCT* (1993) 93 ATC 4397 at 4417; *Richard Walter Pty Ltd v FCT* (1996) 96 ATC 4550 at 4565 and 4573-4574.

²⁶ See *Case 3/99* (1999) 99 ATC 134 at 142-143 in regard to the Commissioner’s determination under s 177F.

²⁷ This definition is extended by s 177A(3) to include unilateral schemes. Unilateral schemes may involve more than one person if those persons can be viewed as a single force: *Peabody v FCT* (1992) 92 ATC 4585 at 4594; *FCT v Spotless Services Ltd* (1996) 96 ATC 5201 at 5212. O’Loughlin J in *Peabody* found the facts before him to involve such a unilateral scheme. A single body implemented the subject course of action. “Mr Peabody: he and his advisers, Mr Dutney, Mr Wruck and others ...” were viewed by O’Loughlin J as a single force: at 4594.

also be more difficult to assert that the dominant purpose underlying the scheme is tax avoidance, rather than legitimate commercial purposes.

In regard to this first point, in *FCT v Peabody* (1994) 94 ATC 4663 at 4670 the High Court asserted that to be a scheme, as opposed to a subscheme, the circumstances must be capable of “standing on their own without being 'robbed of all practical meaning'.” Cooper J in *Spotless Services Ltd v FCT* (1995) 95 ATC 4775 at 4805 also stressed that the definition of scheme in s 177A “requires that the parties to the scheme, insofar as they are known, must be identified and the terms or content of any agreement, arrangement, understanding, promise or undertaking and the steps or stages of any course of action or proposal insofar as they are relevant, be identified.”

In regard to the second, interrelated point, the High Court in *FCT v Peabody* (1994) 94 ATC 4663 at 4670 asserted that “Part IVA does not provide that a scheme includes part of a scheme and it is possible, despite the very wide definition of a scheme, to conceive of a set of circumstances which constitutes only part of a scheme and not a scheme in itself.” Moreover, Hill J added in *Peabody v FCT* (1993) 93 ATC 4104 at 4111 that “where, as a matter of fact, a scheme consists of a course of action comprising several steps the Commissioner may [not] isolate out of that a course of action one step and classify that as a scheme. ... [I]n a case where a series of steps constitutes a scheme, that whole series of steps is to be considered, the individual steps being seen as parts of the scheme rather than each step being capable of being seen as a scheme in itself.”

That this interpretation of the first element of Part IVA may mean that Part IVA is not satisfied in a particular case is evident from the decision in *Spotless Services Ltd v FCT* (1993) 93 ATC 4397; (1995) 95 ATC 4775; (1996) 96 ATC 5201. The taxpayer companies invested funds with a bank in the Cook Islands. The arrangement was designed to try to source the interest paid on the investment in the Cook Islands to take advantage of s 23(q) *ITAA* that at that time exempted foreign source income that was taxed in the source country. In this case the funds were subject to withholding tax in the Cook Islands at a rate substantially lower than Australian income tax rates. Part of the arrangement involved the taxpayer companies sending an officer to the Cook Islands to effect the loan arrangement and, on maturity, to surrender the certificate of deposit in return for the principal and interest (\$2.96m). The Commissioner assessed the taxpayer companies on the interest on the basis that either the income was sourced in Australia or Part IVA applied to the arrangement.

Both Lockhart J, at first instance, and the majority of the Full Court of the Federal Court (Cooper and Northrop JJ, Beaumont J dissenting) on appeal, rejected the Commissioner’s suggestion that Part IVA applied to the arrangement. Both Courts held that the Commissioner's original formulation of the scheme, which was confined to the taxpayers' officer travelling to the Cook Islands with the relevant authority to effect the transactions, was too narrow and not capable of standing on its own within the High Court's test: (1993) 93 ATC 4397 at 4416; (1995) 95 ATC 4775 at 4805. This formulation wrongly ignored other

integral aspects of the arrangement that occurred both prior to and after the officer travelled to the Cook Islands to effect the loan arrangement: (1993) 93 ATC 4397 at 4416; (1995) 95 ATC 4775 at 4805. Cooper and Northrop JJ also rejected the Commissioner's later formulation of the scheme; being a purported agreement between the parties to source the income in the Cook Islands to take advantage of s 23(q); because this was not based on "fact and reality", but rather speculation: (1995) 95 ATC 4775 at 4805.

Both Beaumont and Cooper JJ believed the scheme had to incorporate all of the relevant facts of the case: (1995) 95 ATC 4775 at 4797 and 4805. Once the scheme was so broadly defined, this allowed the majority of the Full Court, Cooper and Northrop JJ, to conclude that the dominant purpose underlying the scheme was not tax avoidance, but commercial concerns.²⁸

While on appeal, the High Court reversed the Full Court's ultimate conclusion, this was because the High Court disagreed with the lower Court's findings as to the taxpayers' dominant purpose. The High Court ultimately concluded that the dominant purpose was to obtain a tax benefit within Part IVA: *FCT v Spotless Services Ltd* (1996) 96 ATC 5201 at 5210 and 5212. The case is nevertheless instructional as to the potential limiting effect of requiring the notion of scheme to be broadly framed before determining if that scheme also meets the further elements of Part IVA.

Before moving to the next element of Part IVA, it may be evident from this discussion of *Spotless Services Ltd v FCT* (1993) 93 ATC 4397; (1995) 95 ATC 4775; (1996) 96 ATC 5201 that the Commissioner is not bound by his original formulation of the scheme. Thus if the Commissioner's formulation of the scheme is held to be too narrow, the Commissioner or the Court/Tribunal may suggest an alternative, broader formulation: *FCT v Peabody* (1994) 94 ATC 4663 at 4669-4670. It will be seen that this is particularly important to our consideration of *Egan v FCT* [2001] AATA 449, below.

(ii) *Relevant taxpayer*

While the courts have held that the 'relevant taxpayer' "need not be 'the person, or one of the persons, who entered into or carried out the scheme'" (*Peabody v FCT* (1992) 92 ATC 4585 at 4595), there are limits to this notion too. The 'relevant taxpayer' is the individual who obtains the tax benefit stemming from the scheme: s 177D. Thus the notion 'relevant taxpayer' is tied to the notion of 'tax benefit' as defined in s 177C. As a consequence, the Commissioner's "choice of 'relevant taxpayers' cannot be arbitrary; it is governed by s 177C(1)": *Peabody v FCT* (1992) 92 ATC 4585 at 4595. Thus 'the relevant taxpayer' in s 177D "must be one and the same as the person who is 'the taxpayer' in s 177C": *Peabody v*

²⁸ Beaumont J dissented, concluding that the overall arrangement had as its dominant purpose(s) tax considerations and Part IVA consequently applied.

FCT (1992) 92 ATC 4585 at 4595. It will be seen below that the notion of ‘tax benefit’ also has significant limits that will, therefore, impact on the notion ‘relevant taxpayer.’

(iii) *Tax benefit*

The original definition of ‘tax benefit’ was confined to the non-inclusion of an amount that would or might reasonably be expected to be included in the taxpayer's income²⁹ or the allowance of a deduction that would or might not have been expected to be allowable, but for the scheme: s 177C(1). As this definition was exhaustive, any other tax benefit, such as a rebate or credit, did not fall within the definition, and thus was not be subject to Part IVA: *Peabody v FCT* (1993) 93 ATC 4104 at 4117. The scope of s 177C(1) has been extended by subsequent amendments. The notion of a tax benefit now includes:

- * a capital loss that would or might not have been reasonably expected to be incurred but for a scheme entered into after 3 pm 29 April 1997; or
- * a foreign tax credit that would or might not have reasonably been expected to be allowable but for a scheme entered into after 4 pm 13 August 1998.

Section 177CA also includes in the notion of tax benefit an amount that the taxpayer would or might reasonably have been expected to be liable for in withholding tax after 20 August 1996. It is proposed to extend the definition of tax benefit so that it will apply generally to any reduction or deferral of tax, whether through the non-inclusion of income or allowance of a deduction, loss, rebate or credit.³⁰

However, even post these amendments, there are still some limits that impact upon the scope of the notion ‘tax benefit’. In particular, s 177C(1) requires that before Part IVA applies we must be able to say with some certainty that, but for the subject tax avoidance scheme, the income might have been derived, or the deduction not allowed. As to that requisite certainty, in *Peabody v FCT* (1993) 93 ATC 4104 at 4111-4112; (1994) 94 ATC 4663 at 4671 both the Full Court of the Federal Court and the High Court held that s 177C(1)(a) requires a reasonable probability, not a mere possibility, that the taxpayer would have derived the income, but for the scheme.³¹ This test requires a prediction of the events that may have

²⁹ The first limb of the s 177C(1) definition of tax benefit is now clarified by s 177C(4). This provides that a tax benefit is made within s 177C(1)(a) if instead of income being included in the taxpayer's assessable income, the taxpayer makes a discount capital gain.

³⁰ Note, under the proposed amendment of Part IVA it is intended to amend the section to ensure that the “reasonable expectation” requirement in s 177C is more readily established, in particular, to ensure such a submission would not succeed: Treasurer's Press Release, 11 November 1999.

³¹ See also *FCT v Spotless Services Ltd* (1995) 95 ATC 4775 at 4807-4809; (1996) 96 ATC 5201 at 5211; *WD & HO Wills (Australia) Pty Ltd v FCT* (1996) 96 ATC 4223 at esp 4255-4256; *CC (NSW) Pty Ltd (in liq) v FCT* (1997) 97 ATC 4123; *Grollo Nominees Pty Ltd v FCT* (1997) 97 ATC 4585.

occurred if the scheme had not been entered into and the "predication must be sufficiently reliable for it to be regarded as reasonable": (1994) 94 ATC 4663 at 4671.

This interpretation of the notion of tax benefit proved to be decisive in *Peabody v FCT* (1993) 93 ATC 4104; (1994) 94 ATC 4663, the Courts ultimately concluding that Part IVA did not apply. The Pozzolanic group of companies was controlled by T Co (as trustee of the Peabody Family Trust) and Mr K and his associates. The beneficiaries of the trust were the taxpayer (Mrs Peabody) and her two children. The taxpayer and her husband were the sole shareholders and directors of T Co. Mr Peabody wanted to float 50% of the group, the 'Peabody interests', retaining the other 50%. The consequent need for the Peabody interests to purchase Mr K's shares was problematic. The sale would have to be revealed in any disclosure document and tax would have been payable under s 26AAA on any profit made on the sale of Mr K's shares. These problems were avoided by using a shelf company, L Co, to purchase Mr K's interest (through a complex financing arrangement with Westpac) and then transforming those shares into virtually worthless 'Z-class' shares. The public float of 50% of T Co's shares was a great success. The Commissioner included \$888,005 in the taxpayer's income, this representing one third of the net capital gain that would have arisen had T Co bought and then on-sold Mr K's shares to the public within 12 months.

Applying the above test to these facts the Full Court of the Federal Court and the High Court rejected O'Loughlin J's conclusion at first instance that Part IVA applied to the arrangement. Both the Full Court and the High Court held that the scheme did not provide the taxpayer with a tax benefit within s 177C: (1993) 93 ATC 4104 at 4116-4117 and (1994) 94 ATC 4663 at 4671. They found that it was not reasonably probable that, but for the scheme, T Co would have bought Mr K's shares as T Co faced considerable difficulties in financing the purchase. Moreover, even if T Co had avoided these difficulties and purchased Mr K's shares, the taxpayer would not have any present entitlement to any portion of the profits arising from the sale of the shares. Hence, there was no reasonable expectation that, but for the scheme, this profit would flow to T Co and, in turn, to the taxpayer: (1994) 94 ATC 4663 at 4671.

Thus again the courts' interpretation of the element 'tax benefit' has potentially confined the scope of Part IVA. Particularly where the taxpayer has not previously earned such income, it will be difficult to say with any great degree of certainty that, but for the scheme, the taxpayer would have derived the subject income within s 177C. Absent the previous receipt of this income, taxpayers can argue, as in *WD & HO Wills (Australia) Pty Ltd v FCT* (1996) 96 ATC 4223 at 4245-4246, that had the scheme not been entered into, no action at all would have been taken.

This argument finds some support in the decision in *Osborne v FCT* (1995) 95 ATC 4323. The taxpayer had not previously conducted a valuation business and it was his evidence that he would not personally conduct such a business without the protection of limited liability

that a corporate structure afforded. On appeal, Olney J rejected the Tribunal's finding at first instance that the conduct of the valuation business by the subject corporate trustees was to enable the taxpayer to obtain a tax benefit, namely the diversion of the taxpayer's personal services income into the family trust: at 4329-4330 and 4331. The Court so concluded because, *inter alia*, the taxpayer had not previously derived the subject valuation: at 4329-4330. The Court found that without a pre-existing receipt of such income there could be no "diversion" of income, nor any suggestion that the corporate trustees were established with that purpose in mind: at 4329-4330 and 4331. Olney J stated that once it was established that the taxpayer "was not, and had never been, liable to tax on the valuation income derived by [the corporate trustee], the Tribunal's approach ... [was] no longer appropriate": at 4331. Given such facts, the Tribunal's suggestion that the arrangement altered the incidence of the taxpayer's income tax was erroneous and thus no tax benefit was derived from the scheme. Judicial support for this interpretation of s 177C is not extensive and the government has stated that it intends to amend Part IVA to ensure that such an argument cannot be made.³² However, until the amendment is effected, this interpretation of s 177C could potentially resurrect the antecedent transaction test,³³ which, as noted above, had proved to significantly limit the scope of s 260.

Before leaving this element there is a further limitation to the scope of s 177C that must be mentioned. The section itself includes certain exclusions. Section 177C(2) excludes from the notion of tax benefit the non-inclusion of income, the allowance of a deduction, the incurring of a capital loss or allowance of a foreign tax credit that is "attributable to the making of an agreement, choice, declaration, election or selection, the giving of a notice or the exercise of an option" expressly provided for by the *ITAA* or *ITAA 1997*, subject to certain exclusions. The section includes, however, an extra caveat that requires that the scheme was not entered into or carried out to create a circumstance or state of affairs "which is necessary to enable the declaration, agreement, election, selection, choice, notice or option to be made, given or exercised ...". See further s 177C(2A) and (3).

While at first glance this exclusion may be seen as resurrecting the choice principle³⁴ which also was a key force in rendering s 260 ineffective, s 177C at most embodies the 'narrow', rather than 'broad', choice principle. Section 177C(2) is confined to "an agreement, choice, declaration, election or selection, the giving of a notice or the exercise of an option" *expressly* provided for by the Act. Unlike the broad choice principle, it would not extend to arrangements that are based on the use of provisions which merely provide for the tax

³² Treasurer's Press Release, 11 November 1999. Originally it was proposed that the amendments would be operative from this date, but now they will only operate from the date the legislation is introduced into Parliament.

³³ See footnote 9.

³⁴ See footnote 8.

consequences of particular arrangements, such as the use of a particular business entity: *Case W58* (1989) 89 ATC 524 at 536-537. In a manner akin to the narrow choice principle, however, it would, *prima facie*, validate schemes that utilise specific choices provided for under the Act, such as those that extend a choice between alternative accounting methods and trading stock elections.

Moreover, unlike the s 260 choice principle, s 177C includes a further caveat that limits the availability of the 'Part IVA choice principle.' Unlike s 260, where the choice principle could operate even where the taxpayer purposely entered into the arrangement with the sole or dominant purpose of obtaining a tax benefit (*Cridland v FCT* (1977) 140 CLR 330; 77 ATC 4538 at 4542), s 177C(2) will not exempt the tax benefit when the scheme was entered into to enable the tax benefit to be attracted. Thus where taxpayers purposely enter into an arrangement to enable them to take advantage of a tax benefit extended expressly by some provision of the Act, s 177C(2) will not 'exempt' the arrangement from Part IVA.

Nevertheless in s 177C we see aspects of the antecedent transactions test and the choice principle that had rendered s 260 ineffective. A combination of the courts' interpretation of the degree of probability as to events that would have occurred but for the scheme and the express inclusion of an exemption has placed further potential limits on the applicability of Part IVA to a particular case.

(iv) *Sole or dominant purpose of obtaining a tax benefit*

The final element of Part IVA requires that a person, not necessarily the taxpayer, must have entered into the scheme with the sole or dominant³⁵ purpose of enabling the taxpayer to obtain a tax benefit: s 177D. This purpose must exist at the time the scheme was entered into. See *FCT v Consolidated Press Holdings Ltd (No 1)* (1999) 99 ATC 4945 at 4971. In *FCT v Spotless Services Ltd* (1996) 96 ATC 5201 at 5206 and 5210 the Court asserted that the dominant purpose is the "most influential and prevailing or ruling purpose". The dominant purpose is to be determined through an objective consideration, having regard to each and every one of the eight factors listed in s 177D(b): *Peabody v FCT* (1993) 93 ATC 4104 at 4113-4114.³⁶

³⁵ Section 177A(5) provides Part IVA may apply to a scheme involving more than one purpose where the dominant purpose is the obtaining of a tax benefit.

³⁶ See further *Spotless Services Ltd v FCT* (1993) 93 ATC 4397 at 4417; (1995) 95 ATC 4775 at 4810; (1996) 96 ATC 5201 at 5210; *H D & H O Wills (Australia) Pty Ltd v FCT* (1996) 96 ATC 4223 at 4252-4255; *FCT v Consolidated Press Holdings Ltd (No 1)* (1999) 99 ATC 4945 at 4970-4973; *FCT v Metal Manufacturers* [2001] FCA 365; *Eastern Nitrogen v FCT* [2001] FCA 366. See also *Taxation Ruling TR 98/22*. In *FCT v Metal Manufacturers* [2001] FCA 365 and *Eastern Nitrogen v FCT* [2001] FCA 366 the subjective test adopted by Drummond J at first instance in the *Eastern Nitrogen case* was rejected.

Once again, the final element of Part IVA, particularly s 177D(b)(viii), has also been held to embody a test that originated with s 260, namely the 'predication test'.³⁷ Under the predication test, as espoused by Lord Denning in *Newton v FCT* (1958) 98 CLR 1 at 8, "to bring the arrangement within the section you must be able to predicate - by looking at the overt acts by which it is implemented - that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealings, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section."

Hill J in *Peabody v FCT* (1993) 93 ATC 4104 at 4110 examined the explanatory memorandum³⁸ and found that Part IVA was enacted to, *inter alia*, "restore the law to what it was thought to be after the decision of the Privy Council in *Newton v Federal Commissioner of Taxation*." Accordingly, he concluded that Part IVA would "seldom, if ever, ... [apply] where the overall transaction is in every way commercial, although containing some element which has been selected to reduce the tax payable. Part IVA is no more applicable to such a case than was its predecessor, s 260": at 4118. Hence, if the dominant purpose(s) underlying a transaction is, *inter alia*, a business or family reason, Part IVA will not apply: *Peabody v FCT* (1992) 92 ATC 4585; (1993) 93 ATC 4104; (1994) 94 ATC 4663; *HD & HO Wills (Australia) Pty Ltd v FCT* (1996) 96 ATC 4223 at 4254.

Thus in *Osborne v FCT* (1995) 95 ATC 4323, discussed above, the taxpayer submitted that the use of the subject corporate trustees to conduct a valuation business was an ordinary commercial and family arrangement within the predication test. Citing a number of s 260 cases,³⁹ the taxpayer submitted, *inter alia*, that the courts have accepted that the use of a trust does not necessarily bear the stamp of tax avoidance and that using corporate entities to obtain the protection afforded by limited liability was accepted as a legitimate commercial purpose. It was also submitted that these cases recognised that it was legitimate to use corporate trustees to enable goodwill to accrue in an entity with perpetual. The taxpayer also

³⁷ Both the former Commissioner of Taxation, Mr Boucher, and the then Treasurer, Mr Howard, have confirmed the embodiment of the Predication test in s 177D. Mr Boucher has stated as relevant to the possible exclusion of Part IVA any family connection between the taxpayer and other parties to the alleged "scheme". He also noted that commercial matters carried out for family reasons do not come within the scope of Part IVA: These comments were made at a seminar conducted by the Taxation Institute of Australia. See also Second Commissioner Nolan's address of 15 June 1990. Similarly, the then Treasurer stated in his Second reading speech "the arrangements of a normal business or family kind, including those of a tax planning nature" will be beyond the scope of Part IVA. Part IVA was introduced, he said, "to strike down blatant, artificial or contrived arrangements, but not cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of the opportunity available for the arrangement of their affairs."

³⁸ The Treasurer, *Income Tax Laws Amendment Bill (No. 2) 1981: Explanatory Memorandum* (Canberra AGPS, 1981).

³⁹ Such as *Newton v FCT* (1958) 98 CLR 1 at 8; *Bayly v FCT* (1977) 77 ATC 4045 at 4056, *Jones v FCT* (1977) 77 ATC 4058 at 4067 and *Rippon v FCT* (1992) 92 ATC 4186 at 4190-4191.

asserted that these cases provided that the use of corporate structures for family reasons, such as the sharing of financial benefits and assets between spouses and the provision of financial security for the taxpayer's spouse, placed the creation and use of the corporate trustees outside the reach of both s 260 and Part IVA.

On appeal, Olney J rejected the Tribunal's finding at first instance that the subject corporate trustees were established for the dominant purposes of obtaining a tax benefit, namely diverting the taxpayer's personal services income (valuation income) into the family trust. The Court asserted that it was lawful for the valuation business to be carried on by a company and that all aspects of the arrangement complied with the ethical standards of the valuation profession: 4329.⁴⁰ While the Court did not comment on the other aspects of the taxpayer's submissions based on the predication test, it is submitted that this decision, and the earlier s 260 cases cited, evidence that many tax effective arrangements may escape Part IVA if the dominant purpose underlying the arrangement is such a family or business purpose.

Before concluding the discussion of this element, it should be briefly noted that in *FCT v Spotless Services Ltd* (1995) 95 ATC 4775 at 4810-4812 Cooper J took this interpretation of s 177D one step too far, by suggesting that under Part IVA tax rates are a relevant commercial consideration. Thus Cooper J said that where, as in that case, the "operation of the foreign taxation laws", when compared to the Australian taxation laws, gave rise to a higher net return after tax, tax rates were a legitimate commercial consideration that could place an arrangement outside Part IVA. In such a case, he asserted, the dominant "purpose is to obtain the maximum return on the money invested after the payment of all applicable costs, including tax. ... The dominant purpose of the taxpayers was not to obtain a tax benefit": at 4810-4812.

It has been submitted that this interpretation of s 177D would have rendered Part IVA useless as even blatant tax schemes, where the tax benefit is acknowledged as a primary factor, would not be caught as long as the taxpayer makes a commercial profit from the illegitimate scheme.

⁴¹ Most importantly, this view was rejected on appeal by the High Court: *FCT v Spotless Services Ltd* (1996) 96 ATC 5201 at 5206 and 5210. The Court held that just because an arrangement bore a commercial character that did not mean that it was not "tax driven."⁴² It

⁴⁰ See further the discussion of the *Valuation of Land Act* 1960 (Vic): *Osborne v FCT* (1995) 95 ATC 4323 at 4325-4327.

⁴¹ See Cassidy, J., "Are Tax Schemes Legitimate Commercial Transactions? Commissioner of Taxation v Spotless Services Ltd and Commissioner of Taxation v Spotless Finance Pty Ltd" (1996) 2 High Court Review 23 and Cassidy, J., "Have the ghosts of s 260 come back to haunt the Commissioner of Taxation?" (1997) 51 Bulletin for International Fiscal Documentation.

⁴² Note, however, that while McHugh J agreed with this conclusion, he asserted that Part IVA would not apply merely because "a taxpayer has arranged its business or investments in a way that derives a tax benefit": at 5212. While these comments may suggest that McHugh J agrees with the sentiments expressed by Cooper J, arguably he is simply agreeing with Hill J that Part IVA will not be attracted to commercial arrangements that have merely incidental tax benefits.

should be noted, however, that the High Court's finding in this regard was not a denial of the applicability of the predication test to Part IVA.⁴³ The High Court was merely asserting that in determining if the dominant purpose under s 177D was obtaining a tax benefit or merely commercial considerations, avoiding the payment of tax to ensure a larger commercial return was not a legitimate commercial consideration.

(v) *Conclusion on Part IVA*

Thus there are many factors potentially limiting the effectiveness of Part IVA:

- Part IVA only applies to a scheme, not a subscheme;
- the relevant taxpayer cannot be arbitrarily identified, but rather must be the person obtaining the tax benefit;
- but for the scheme we must be able to say that it was reasonably probable that the taxpayer would have, for example, derived the subject income; and
- we must be able to predicate that the arrangement was entered into to obtain that tax benefit, rather than for a family or business reason.

When viewed cumulatively, it is no wonder the government questioned Part IVA's effectiveness. We now consider two recent cases where Part IVA was successfully applied by the Commissioner to see how these potential limitations were overcome. It will be seen that these potential hurdles have not rendered Part IVA a 'toothless tiger'.

4. **Egan v FCT**

(i) *Facts*

The relevant facts of *Egan v FCT* [2001] AATA 449 have to be detailed in some length because, at first glance, many aspects provided Mr Egan with quite a strong case.

Mr Egan and his wife established a company, TM Co, in 1987 to undertake IT contract work. In 1993 Mr Egan and a third party, Mr Doubtfire, agreed to establish a company, AOS Co. This company was to be owned in equal shares by TM Co and a company owned by Mr and Mrs Doubtfire, 81P Co. It was decided that the initial funding of AOS Co would be by loan accounts from TM Co and 81P Co, funded from each company's bank overdraft. Both TM Co and 81P Co were to provide contracting services to AOS Co for an equal fee with any surplus

⁴³ See, for example, *FCT v Spotless Services Ltd* (1996) 96 ATC 5201 at 5210 and 5212. Similarly, in *Case W58* (1989) 89 ATC 524 the Tribunal applied the predication test, but ultimately concluded on the facts that the dominant purpose underlying the scheme was the obtaining of a tax benefit.

profits retained for development of AOS Co. In time it was agreed that each company would be entitled to a fixed amount, called a management fee, of \$11,000 per month. It was said that this amount was to be paid irrespective of the hours worked or availability of either Mr Egan or Mr Doubtfire.

In 1998, EMC Co acquired a 20% interest in AOS Co. It was Mr Egan's evidence that EMC Co required some formalisation of the arrangement between TM Co, 81P Co and AOS Co. At the time no written agreements were in existence. While the consequent contracts were not prepared until at least 1998, they showed a commencement date of 1 January 1995. The TM Co / AOS Co contract named TM Co as a contractor that was engaged to perform consultancy services through capable personnel for a fee of \$11,000 per month. Mr Doubtfire said in evidence that he considered the \$11,000 paid to TM Co and 81P Co per month, not to be dividends, but rather management fees for services provided by the two companies. He said the amounts were what AOS Co could afford to pay; although considerably lower than the amounts he and Mr Egan could earn in the marketplace and lower than amounts paid to most contractors engaged by AOS Co.

AOS Co's first big contract was with Telstra. Mr Doubtfire accepted that Mr Egan was crucial to providing the initial project design and scope and managing the project. One requirement of the contract was that any contractor intending to work on the project had to sign a confidentiality agreement. Initially, Mr Egan was the only contractor and was the only person to sign the confidentiality agreement. Over the five years of the contract, however, four additional contractors signed the confidentiality agreement and worked on the project. Mr Moxon, who was the project manager of the Telstra project, said that he had always regarded Mr Egan as a principal partner of AOS Co rather than an individual contractor. He believed that both Mr Egan and Mr Doubtfire were important for AOS Co to deliver on its contract.

The Telstra contract provided for an hourly rate fee. It was Mr Egan's evidence that he typically worked 70 to 80 hours a week on AOS Co work, of which 40 hours on average was billed to Telstra. It was also his evidence that while working at Telstra, he would receive up to seven or eight telephone calls a day relating to other clients and business of AOS Co.

It will be apparent from these last statements that during this period the Telstra contract was not the only source of AOS Co's income. The company had other clients. In the 1994-1995 financial year AOS Co's gross revenue was \$680,114 (the Telstra contract contributed \$369,000), in the 1995-1996 financial year AOS Co's gross revenue was \$887,957 (the Telstra contract contributed \$493,000) and the 1996-1997 financial year the gross revenue was \$1,048,995 (the Telstra, contract contributed \$635,000).

Several contractors in addition to Mr Egan were engaged by AOS Co to provide services to clients of AOS Co and to assist in the development of services. At the time of the hearing AOS Co also had three employees that worked at the company's office in South Melbourne. While Mr Egan said that both he and Mr Doubtfire supervised such staff, Mr Doubtfire said

in his evidence that his own role in AOS Co became management, administration and seeking new business, while the role of Mr Egan was primarily the technical management of the more significant projects.

Mrs Egan said that her predominant role was that of financial controller of TM Co and personal assistant to Mr Egan. Similarly, Mr Egan maintained that Mrs Egan was responsible for all book keeping and financial affairs of TM Co and acted as a communication link with Mr Doubtfire when Mr Egan was overseas or interstate. Mrs Egan accepted that TM Co would have no business without her husband. During the 1995-1996 and 1996-1997 financial years Mrs Egan also worked part-time with the ANZ bank, involving 10 to 15 hours per week. Mrs Egan considered that she spent at least the same number of hours per week working for TM Co; although no records of hours were maintained. Mrs Egan also said that she did "occasional things" for AOS Co such as writing cheques and taking telephone calls for her husband. Mr Egan said that TM Co owned computers, a fax machine, printers and other office equipment located at his home. TM Co also owned two motor vehicles.

For the 1994-1995 financial year TM Co's accounts showed fees received as \$158,275 and a net profit of \$38,664 after salaries of \$42,744 to Mr Egan and \$28,496 to Mrs Egan and superannuation contributions for both totalling \$15,550. For the 1995-1996 financial year the company's gross fees were \$132,000, net loss \$96, salary Mr Egan \$22,740, salary Mrs Egan \$15,160 and superannuation contribution \$35,477. For the 1996-1997 financial year the figures were gross fees \$121,013, net profit \$8,618, salary Mr Egan \$50,000, salary Mrs Egan \$15,000 and superannuation \$6,750. While purportedly set at the beginning of the year by a resolution of the directors, Mr Egan acknowledged that the reality was that the salaries were simply based on income less expenses. He also acknowledged that payment of the private housing loan and other private expenditure by T Co had been classified as salary.

The Commissioner issued amended assessments for the 1994-1995, 1995-1996 and 1996-1997 income years. Pursuant to s 177F(2) *ITAA*, the amounts of \$115,531, \$109,260 and \$71,013 were deemed to be included in Mr Egan's assessable income for the respective income years. The amounts included as assessable income represented the difference between the gross fees received by TM Co and the salary from TM Co to Mr Egan. Deductions of \$8,065, \$9,419 and \$9,848 were also allowed. These represented some of the expenses shown in TM Co's profit and loss account, but excluded salaries, superannuation, car expenses, interest and expenses relative to the taxpayer's residence.

(ii) *Scheme*

In disallowing Mr Egan's objections to these assessments, the Commissioner asserted that Part IVA applied to the subject scheme which was an "arrangement under which income from your personal services is diverted to associates including the Tenth Mounpro Superannuation Fund Pty Ltd and in combination with the retention of profits within the company structure,

substantially less income was paid to you”: para 13. Included in the elements which were said to constitute the subject scheme was the incorporation of TM Co and the employment by TM Co for supplying Mr Egan's "personal services to Telstra via AOS": para 13. The audit report stated that Mr Egan had worked "under contract, through an agency, for Telstra" and that "all the taxpayer's consultancy income was in relation to the Telstra contract through AOS" and "income received from AOS directly in respect of John Egan's consultancy work with Telstra": para 13.

The taxpayer submitted that TM Co was established by Mr and Mrs Egan in 1987, “well prior to any contemplation of AOS or a contract with Telstra” and thus could not be said to be part of any scheme relative to these later arrangements: para 15. Further, while the scheme the Commissioner had identified was diversion of fees from Telstra, it was submitted that this ignored the fact that the payment was TM Co’s share of AOS Co’s profits from a variety of sources, only one of which was Telstra, and not for the provision of Mr Egan's personal services: para 15. Moreover, it was contended that the Commissioner’s formulation of the scheme failed to have regard to the fact that an equal fee to that paid by AOS Co to TM Co, was also paid to 81P Co: para 15.

The Tribunal found that the case had been ‘muddied’ by the Commissioner’s inclusion in the scheme the Telstra contract: para 17. This was because the contract between AOS Co and Telstra was a commercial contract for the provision of services using a number of contractors, not just the taxpayer: para 17. Thus the Tribunal held that the Commissioner had correctly accepted that AOS Co was a legitimate commercial organisation carrying on a business of providing consulting services and the development of commercial software: para 16. Moreover, the Tribunal agreed with the taxpayer that the fee paid by AOS Co to TM Co was in respect of services provided to AOS Co which has enabled AOS Co to derive income from not only Telstra, but several other clients and the sale of software: para 16.

However, this finding did not necessarily prevent the fee paid to TM Co being included in the assessable income of Mr Egan pursuant to section 177F(1)(a) of the Act. The Tribunal held that the Commissioner’s erroneous reference to the Telstra fees as part of the scheme was not fatal to the Commissioner’s case: para 25. As noted above, the High Court held in *FCT v Peabody* (1994) 94 ATC 4663 at 4669-4670 that Part IVA may apply to new formulations of the scheme suggested by either the Commissioner or the court or tribunal.

The Tribunal found that the taxpayer provided services over many hours to AOS Co, yet received no director's fees, salary or any other form of income by AOS Co: para 19. The Tribunal rejected the assertion that Mr Egan provided these services to AOS Co in his capacity as a director/employer of TM Co, finding that the fees were paid for the services of Mr Egan: para 19. The Tribunal found that the technical expertise of Mr Egan was the principal or sole reason which enabled TM Co to derive fees: para 19. Moreover, no other services were provided by TM Co to AOS Co: para 19. In this regard the Tribunal found Mrs Egan’s contribution to AOS Co to be “minimal”: para 19.

Having found that the payments from AOS Co to TM Co were for Mr Egan's services, the Tribunal also drew on Mr Doubtfire's evidence that the fees paid to TM Co and 81P Co were less than the market value of his and Mr Egan's services and was less than that paid to other contractors: para 20. Moreover, Mr Egan's salary paid by TM Co was far from appropriate remuneration: para 20. It fluctuated year to year and was not tied to the extent of his services: para 20. For two of the relevant years Mr Egan's salary was only 50% greater than that paid to Mrs Egan: para 20.

In light of these findings the Tribunal had no difficulty concluding there was a scheme within s 177A(1). The Tribunal identified as the scheme the arrangement and course of action whereby TM Co was incorporated to receive fees for the services performed by Mr Egan "initially to outside clients and, from 1993 to AOS and clients of AOS": para 21. The scheme involved TM Co paying Mr Egan a modest salary, paying Mrs Egan a salary and making superannuation contributions for both, the excess being retained by company and taxed at the corporate rate of tax: para 21.

(iii) *Tax benefit*

The Commissioner submitted that the payment made by AOS Co to TM Co was not received in TM Co's capacity as a shareholder, but solely as payment for the provision of the personal services of Mr Egan: para 16. The Commissioner asserted that this was supported by the fact that there was no evidence of anything other than the taxpayer's services being provided by TM Co to AOS Co: para 16. Correspondingly, the arrangement provided the taxpayer with a tax benefit, through, *inter alia*, the payment of a salary to his wife and superannuation contributions for the benefit of his wife that could not be justified commercially: para 16.

The Tribunal agreed with the Commissioner and found there to be a clear tax benefit from the arrangement. Mr Egan's salary from TM Co was significantly less than the fee AOS Co paid for his services and the balance of the fee was used to pay Mrs Egan a salary, to pay superannuation contributions for both the taxpayer and Mrs Egan and to pay some of their domestic expenses that were charged to a loan account in their names: para 22. "As a consequence, the whole of the AOS fee was available for the benefit of Mr Egan and his family with a major part of such fee not being included in his assessable income without the application of Part IVA of the Act": para 22. "If it were not for the interposition of TM between AOS and Mr Egan it would have been reasonable to expect that Mr Egan would have derived assessable income for his services provided to AOS in deriving the income of that company": para 24.

(iv) *Sole or dominant purpose of obtaining a tax benefit*

The Commissioner submitted that while there were commercial reasons behind AOS Co “combining the talents of Mr Egan, Mr Doubtfire and other consultants for an economic result”, this was not the case when it came to TM Co: para 16. TM Co was not capable of providing anything other than the skills of Mr Egan: para 16. Thus the only purpose TM Co served was to insert itself between AOS Co and the taxpayer so as to receive payment for his services: para 16. Moreover, as there was no commercial reasons for the taxpayer to accept such a low salary from TM Co, the Commissioner asserted that the arrangement was tax driven: para 16.

The taxpayer submitted that the payment to TM Co was its share of AOS Co’s profits, not for the provision of Mr Egan’s personal services: para 15. Alternatively, it was submitted that the fees paid by AOS Co were for access to TM Co’s overdraft facility and the provision of office equipment and expertise of TM Co: para 15. Thus it was ultimately submitted that AOS Co was carrying on a commercial business and it could not be said that the contract between AOS Co and Telstra was established or carried on with the dominant purpose of obtaining a tax benefit or to supply Mr Egan’s personal services to Telstra through AOS Co: para 15.

The Tribunal nevertheless agreed with the Commissioner that the sole or dominant purpose of the arrangement was to obtain a tax benefit. The Tribunal concluded that the “predominant or sole role of TM [was] to provide the services of Mr Egan to AOS after 1993 and for the three years in dispute, its sole role”: para 23. In considering the factors detailed in s 177D(b)(i)-(viii), the Tribunal held the “form and substance” of the arrangement was to have TM Co receive Mr Egan’s earnings from services he provided to AOS Co: para 23. As noted above, the Tribunal regarded Mrs Egan’s contribution as minimal and also so regarded the contribution of TM Co’s office equipment: para 23. The Tribunal found that there was no objective commercial explanation for why the fees paid by AOS Co were paid to TM Co, rather than directly to Mr Egan “other than to enable Mr Egan to spread the earnings between himself, his wife and TM”: para 24. Consequently, having regard to the matters set out in s 177D(b), the Tribunal concluded that Mr Egan entered into the arrangement of having the fees paid by AOS Co to TM Co for the purpose of enabling Mr Egan to obtain a tax benefit: para 24.

(v) *Conclusion*

Thus Part IVA was successfully applied to the income splitting arrangement in *Egan v FCT* [2001] AATA 449. The ability of the Commissioner, and the Tribunal for that matter, to offer an alternative formulation of the scheme enabled the Commissioner to overcome the hurdles that the notion of scheme may have otherwise placed before the respondent. This enabled the Commissioner, and ultimately the Tribunal, to find Part IVA to be applicable despite the Commissioner’s initial error in formulating the scheme too narrowly, specifically including the relationship between AOS Co and only one of its clients, namely Telstra.

That Mr Egan, the relevant taxpayer, obtained a tax benefit through the scheme was dealt with on a factual, rather than legal level. The Tribunal found that by income splitting Mr Egan's personal services income through TM Co the taxpayer obtained a tax benefit. Moreover, the Tribunal found that but for the insertion of TM Co in between AOS Co and Mr Egan, Mr Egan would have derived the subject income. In this regard there is a notable absence of discussion in the reasons for decision as to Mr Egan's options, but for the scheme, and the degree probability of particular courses of action being taken.

This was not, however, entirely lost on the Tribunal. The Tribunal asserted that it appreciated that the written reasons for decision could be noted for their absence of case references regarding whether the scheme was entered into for the dominant reason of obtaining a tax benefit. The Tribunal noted that this was "no disrespect to counsel": para 26. It was simply that the Tribunal believed that the "particular arrangement or scheme has to be examined against the factors to be taken into account under s 177D and an objective conclusion reached that the taxpayer entered into or carried out the arrangement or the scheme for the dominant purpose of obtaining a tax benefit": para 26. On the facts, the Tribunal believed that such a conclusion could be reached.

In regard to the latter point it should be noted that from the written reasons for decision it appears that the taxpayer did not submit that TM Co had been created or interposed between the taxpayer and AOS Co for any commercial or family reasons. It was simply asserted that the fees paid by AOS Co to TM Co was TM Co's share of profits as a shareholder of AOS Co. Consequently the predication test was not considered by the Tribunal and thus did not limit the application of Part IVA to the subject case.

5. *FCT v Consolidated Press Holdings Ltd*

(i) Introduction

The High Court decision in *FCT v Consolidated Press Holdings Ltd* (2001) HCA 32 provides a further example where Part IVA was recently successfully applied. The subject cases, that were heard together, involved certain members of the Consolidated Press group of companies; namely Australian Consolidated Press Ltd (ACP Co), which later changed its name to CPH Property Pty Ltd, Consolidated Press Holdings Ltd (CPH Co) and Murray Leisure Group Pty Ltd (MLG Co). All the disputes concerned the application of Part IVA, but they fell into two categories:

- the operation of the general provisions of Part IVA; and
- the operation of the special provisions of Part IVA relating to dividend stripping.

For the purposes of this paper, the discussion that follows will be confined to the issue regarding the operation of the general provisions of Part IVA. This issue was raised in regard to financing arrangements made by the corporate group, which is controlled by Mr Kerry Packer, which were designed to combine with other 'friendly' interests in the United Kingdom to take over a UK company, BAT Co. The proposal did not come to fruition. The relevant assessments denied the taxpayer deductions claimed in respect of moneys borrowed in connection with this takeover scheme. The taxpayer succeeded at first instance before Hill J (*CPH Property Pty Ltd v Commissioner of Taxation* (1998) 88 FCR 21), but only because of Hill J's interpretation of s 79D; in obiter Hill J agreed with the Commissioner otherwise as to the application of Part IVA. The Commissioner successfully appealed to the Full Court of the Federal Court (*Commissioner of Taxation v Consolidated Press Holdings Ltd (No 1)* (1999) 91 FCR 524). The taxpayer then appealed to the High Court.

(ii) *Facts*

Once again, the facts, while detailed, are crucial to an understanding of the application of Part IVA.

When the takeover of BAT Co was considered the corporate group consulted their tax advisers, Arthur Young. The advisers repeated advice that had been given in relation to an earlier query regarding refinancing another venture. The advice took into account two announcements by the Australian government concerning proposed future changes to the *ITAA*. First, it was announced that from 1 July 1989 dividends received by Australian resident corporations from non-Australian sources would be treated as exempt income for Australian tax purposes. Second, it was announced that from the 1989-1990 tax year, the income of non-resident entities in which Australian residents had an interest, which was derived in a low-tax or no-tax country, or had benefits from certain kinds of taxation concessions, would be taxed on a particular basis.

Taking account of these and other matters, it was advised to use a mixed debt-equity arrangement. It was recommended that the necessary funds should initially be borrowed by Consolidated Press (Finance) Ltd (CPF Co), which acted as financier to the Australian members of the corporate group, and lent at interest to ACP Co. ACP Co had considerable cash flows and was well placed to service such a debt. Then it was proposed that ACP Co should use the funds to subscribe for shares in MLG Co that would, in turn, use that capital to acquire redeemable preference shares in Consolidated Press International Ltd (CPIL(UK) Co). CPIL(UK) Co was a member of the corporate group that was incorporated in the United Kingdom. While this entity, and another entity, Consolidated Press International Holdings Ltd (CPIHL(UK) Co), was incorporated in the United Kingdom, they were under the tax laws of that country non-resident UK companies. Their central control and management was

outside the United Kingdom, namely Australia; at the time their shares were all beneficially owned by CPH Co. The corporate group acted on this advice in the proposed manner.

In the meantime CP Investment (Singapore) Pty Ltd (CPI(Sing) Co) was incorporated in Singapore. CPI(Sing) Co subscribed for shares in Hoylake Investments Ltd (Hoylake Co), a company incorporated in Bermuda. Interests associated with the corporate group, namely Sir James Goldsmith, and Mr Jacob Rothschild, owned Hoylake Co. CPI(Sing) Co's shares represented 32.5% of the capital of Hoylake Co. Hoylake Co announced its takeover bid for BAT Co on 11 July 1989 and began acquiring shares in BAT Co.

MLG lent, interest-free, the sum of US\$100 million to CPIL(UK). These funds were in turn used to pay for one million redeemable preference shares of US\$100 each in CPIL(UK). When the US\$100 million was received, it was immediately lent by CPIL(UK) to CPI(Sing). Interest was charged on the loan, first at the rate of 15% per annum and later at the rate of 16.25% per annum.

A condition of the takeover bid could not be satisfied and the bid was withdrawn.

(iii) *Scheme*

The interest paid by ACP Co on the funds borrowed for the purpose of acquiring shares in MLG Co was deductible under the predecessor, s 8-1, s 51(1) *ITAA*, subject to the operation of Part IVA. The scheme identified by the Commissioner was not the whole of the facts pertaining to the BAT Co takeover bid: para 52. Rather, the scheme was said to be the interposition of MLG Co between ACP Co and CPIL(UK) Co: para 52. The plan was said to have been conceived by the taxpayer's tax advisors, Arthur Young, and adopted by ACP Co and MLG Co: para 52. The key steps were said to be ACP Co's acquisition of redeemable preference shares in MLG Co and MLG Co's acquisition of redeemable preference shares in CPIL(UK) Co: para 52.

The taxpayer asserted that the Commissioner's formulation of the scheme was too narrow: para 96. The relevant scheme, according to the taxpayer, was the broader notion of taking over BAT Co and the underlying purpose of that scheme was submitted as being commercial: para 96.

The High Court agreed that the Commissioner's formulation of the scheme was quite narrow and as a consequence "the use of various tax haven companies and other tax-related aspects of the wider commercial transaction was irrelevant": para 90. However, the High Court implicitly must have believed the Commissioner's formulation of the scheme as capable of standing on its own and explicitly went on to reject the taxpayer's submission regarding the underlying purpose of the scheme: para 96.

(iv) *Tax benefit*

The Commissioner submitted that but for tax considerations, the subject funding would have been through a loan by CPF Co to ACP Co, an acquisition of shares by ACP Co in CPIL(UK) Co and the funding of CPI(Sing) Co by CPIL(UK) Co: para 43. The scheme provided a tax benefit under Part IVA because had the funding been so arranged the deduction would have been denied under s 79D ITAA: paras 43, 57 and 72. For the purposes of this paper, s 79D is not considered in any detail. The effect of the section is to quarantine interest deductions to foreign source income. In this case the foreign source income would be the dividends that were expected to flow from CPIL(UK) as a result of the BAT Co takeover: paras 43 and 57. The Commissioner asserted that s 79D operated even when no foreign source income was so derived: para 72. While if the takeover had been successful some time in the future it would be expected that there would be a dividend flow from the transaction, in the interim the inability to offset the interest deductions against current income was significant and adverse to ACP Co: para 57. The Commissioner contended that the subject scheme avoided this adverse tax effect: para 57.

The taxpayer argued, and Hill J at first instance held, that the Commissioner's contention was based upon an erroneous interpretation of s 79D. It was contended that as there was no foreign source income derived (because the takeover did not go ahead and thus no dividends were derived), s 79D was inoperative: para 71. “[T]herefore the interposition of MLG between ACP and CPIL(UK) did not have the effect of overcoming any such quarantine, and so there was no relevant tax benefit obtained in connection with the scheme”: para 71. The Full Court of the Federal Court reversed the decision of Hill J on this point and the High Court agreed: paras 74-77.

The taxpayer also contended that the Commissioner’s alleged tax benefit depended upon the “potential or prospective income to be derived by ACP if it had directly taken up shares in CPIL(UK), without the interposition of MLG, would have been income from a foreign source”, while the taxpayer submitted the income would have had an Australian source: para 80. The High Court disagreed and held the potential income to have a foreign source: para 82-85.

Hill J considered, and both the Full Court of the Federal Court and the High Court agreed, that it was reasonable to expect that, had the scheme not been entered into or carried out, ACP Co would either have subscribed for shares in CPIL(UK) or made loans to that company: para 87. The High Court ultimately concluded that the tax benefit the taxpayer achieved by interposing MLG Co between ACP Co and CPIL(UK) Co was the allowability of a deduction which would not have been allowable or might reasonably be expected not to be allowable, but for the scheme: para 97.

(v) *Sole or dominant purpose of obtaining a tax benefit*

The taxpayer challenged Hill J's and the Full Court's finding on the question of purpose: para 88. As noted above, the Commissioner's formulation of the scheme was quite narrow and as a consequence "the use of various tax haven companies and other tax-related aspects of the wider commercial transaction was irrelevant": para 90.

Hill J found in regard to this issue that there were two purposes underlying the scheme:

- negating of the operation of s 79D; and
- the need to adopt a structure that would not detract from tax credit relief.

Hill J ultimately concluded that at the time of the transaction, the first purpose was the dominant purpose of the scheme: (1998) 88 FCR 21 at 42. The Full Court agreed.

On appeal, the taxpayer argued that Hill J failed to have regard to the factors listed in s 177D(b). Both the Full Court and the High Court noted that it was not necessary for Hill J to refer to each of these matters individually: para 94. The High Court held that an examination of Hill J's reasons for judgment as a whole showed that he took all the specified matters into account in forming "a global assessment of purpose": para 94. It should also be recalled that Hill J found for the taxpayer on the s 79D issue and thus his consideration of Part IVA was only obiter. Thus there was no need for Hill J to fully consider Part IVA. The High Court also noted that the Full Court had meticulously gone through each of the eight matters individually and demonstrated how they had been taken into account by Hill J: para 94.

The taxpayer also criticised the findings of both Hill J and the Full Court on the basis that it was submitted that the dominant purpose had to be that of the persons who entered into the scheme, namely CPIL(UK) Co, MLG Co and ACP Co, rather than their advisers, Arthur Young. The High Court rejected the submission, asserting that in a 'roundabout way' that was exactly what Hill J had done: para 95. Most importantly, the High Court held that in complex international transactions such as these the participants of the scheme were, essentially, attributed with the purposes of their advisors: para 95. Thus the Court held that:

"in some cases, the actual parties to a scheme subjectively may not have any purpose, independent of that of a professional advisor, in relation to the scheme or part of the scheme, but that does not defeat the operation of s 177D. If, in the present case, there had been evidence that showed that no director or employee of any member of the Group had ever heard of s 79D, that would not conclude the matter in favour of the taxpayer. One of the reasons for making s 177D turn upon the objective matters listed in the section, it may be inferred, was to avoid the consequence that the operation of Pt IVA depends upon the fiscal awareness of a taxpayer": para 95.

Finally, as noted above, the taxpayer argued, on the basis of *FCT v Peabody* and *Spotless Services Ltd v FCT*, that the Commissioner's formulation of the scheme was too narrow and that the purpose underlying the broad scheme, namely the takeover of BAT Co, was based on commercial concerns: para 96. The High Court rejected this submission asserting that it "was

held in *Spotless* a person may enter into or carry out a scheme, within the meaning of Pt IVA, for the dominant purpose of enabling the relevant taxpayer to obtain a tax benefit where that dominant purpose is consistent with the pursuit of commercial gain in the course of carrying on a business. The fact that the overall transaction was aimed at profit making does not make it artificial and inappropriate to observe that part of the structure of the transaction is to be explained by reference to a s 177D purpose”: para 96. The High Court ultimately concluded that Part IVA applied to the financing scheme: para 98.

(vi) *Conclusion*

Thus in *FCT v Consolidated Press Holdings Ltd* (2001) HCA 32 the High Court held Part IVA applied to a complex, international financing scheme: para 98. This was despite the taxpayers’ submission on the basis of the subscheme issue. The High Court, while not expressly advertent to such, must have thought the Commissioner’s narrow scheme could stand on its own within the definition of a scheme. It is a pity the High Court did not address this issue at the factual level as it could have provided guidance as to when a step in a broader transaction can be said to be capable of standing alone within the definition of a “scheme.”

Again, the notion of tax benefit was considered from a factual, rather than legal, perspective, the High Court concluding a tax benefit was achieved from the scheme. In this case the Courts simply asserted that it was reasonable to expect that, but for the scheme, ACP Co would either have subscribed for shares in CPIL(UK) or made loans to that company. The interposition of MLG Co between ACP Co and CPIL(UK) Co, therefore, provided a tax benefit, namely a deduction, that would not have been allowable or might reasonably be expected not to be allowable because of s 79D, but for the scheme.

It appears the notion that the transaction would not have gone ahead but for the imposition of MLG Co was not considered. This is because the taxpayers probably believed the takeover of BAT would come to fruition and while in such a case the operation of s 79D would have been adverse, it would not have been fatal to the taxpayers’ plans. The operation of s 79D would merely mean that the deductibility of the expenses would be delayed until the future dividend flow from CPIL(UK).

What was particularly important was the High Court’s approach to the final element of Part IVA, s 177D. The predication test did not serve to defeat the Commissioner’s claim. While the broader purpose of the arrangement was clearly the commercial goal of facilitating a takeover, the High Court held this did not negate a finding that the dominant purpose underlying the Commissioner’s narrowly formulated scheme was achieving the subject tax benefit, avoiding s 79D.

Further, the High Court’s approach to identifying the dominant purpose underlying the scheme provided an important barrier to taxpayers arguing, as they did in this case, that the taxpayers did not have the subjective purpose of tax avoidance. Two points need to be made

in this regard. First, as noted above, in essence the High Court imputed to the taxpayers the illegitimate purpose of their advisers, that is, the purpose of obtaining a tax benefit. Commentators have criticised this aspect of the judgment, but it is submitted such criticism is unwarranted. As noted above, s 177D requires that *a person, not necessarily the taxpayer*, must have entered into the scheme with the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit. Thus it was not necessary for the actual taxpayer companies to have the illegitimate tax avoidance purpose. Moreover, Part IVA applies to unilateral schemes (s177A(3)) and such unilateral schemes may involve more than one person where those persons are viewed as a single force: *Peabody v FCT* (1992) 92 ATC 4585 at 4594; *FCT v Spotless Services Ltd* (1996) 96 ATC 5201 at 5212. Thus similar to O'Loughlin J's conclusion in *Peabody v FCT* (1992) 92 ATC 4585 at 4594 that "Mr Peabody: he and his advisers, Mr Dutney, Mr Wruck and others" were a single force, the High Court was entitled to find the taxpayer companies and their adviser, Arthur Young, were a single force for the purposes of Part IVA, and to look at these entities as one when determining the purpose underlying the scheme.

Most importantly, however, as noted above and recognised by the High Court, s 177D(b) applies an objective, rather than subjective test: *Peabody v FCT* (1993) 93 ATC 4104 at 4113-4114; *Spotless Services Ltd v FCT* (1993) 93 ATC 4397 at 4417; (1995) 95 ATC 4775 at 4810; (1996) 96 ATC 5201 at 5210; *H D & H O Wills (Australia) Pty Ltd v FCT* (1996) 96 ATC 4223 at 4252-4255; *FCT v Consolidated Press Holdings Ltd (No 1)* (1999) 99 ATC 4945 at 4970-4973; *FCT v Metal Manufacturers* [2001] FCA 365; *Eastern Nitrogen v FCT* [2001] FCA 366. Thus the High Court's imputation of intent was simply unnecessary. Thus the objective nature of s 177D allowed the High Court to view the matter in a manner that did not require an investigation into the intent of the subject taxpayer companies.⁴⁴

6. Conclusion

These two cases, dealing with two very different tax schemes, evidence the effectiveness of Part IVA. Despite the potential limitations delineated above, Part IVA is not the "toothless tiger" the government has at times assumed it to be. If these decisions are any indication, Part IVA may prove to be an effective tool in the ever increasing spate of tax avoidance in Australia. The decision in *Egan v FCT* [2001] AATA 449 evidences how Part IVA may be effectively applied to income splitting arrangements and the decision in *FCT v Consolidated Press Holdings Ltd* (2001) HCA 32 provides a timely reminder to tax advisers that tax considerations do not equate to legitimate commercial considerations under Part IVA.

⁴⁴ See also Hill, "Contemporary Tax Practice" 2002 Australasian Tax Teachers' Association Conference, Manukau Business School, Manukau Institute of Technology, Manukau City, New Zealand, 18 January 2002.

