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Part IVA, Partnerships and Dominant Purpose

Abstract

In the taxation laws of Australia Part IVA of the Income Tax Assessment Act 1936 is the primary means by which the Commissioner punishes tax evasion schemes. The Commissioner has not been hesitant to attack partnerships.¹ However, a consideration of the legislation and case law reveals major problems inherent in doing so. This article canvasses the basic problems the Commissioner faces when attacking partnerships under Part IVA, and suggests some simple solutions. It is concluded that Part IVA is the legally incorrect way to attack partnerships as tax evasion schemes.

Keywords

taxation law, income tax, Commissioner of Taxation

PART IVA, PARTNERSHIPS AND DOMINANT PURPOSE

*By Thomas Ritchie**

In the taxation laws of Australia Part IVA of the *Income Tax Assessment Act 1936* is the primary means by which the Commissioner punishes tax evasion schemes. The Commissioner has not been hesitant to attack partnerships.¹ However, a consideration of the legislation and case law reveals major problems inherent in doing so. This article canvasses the basic problems the Commissioner faces when attacking partnerships under Part IVA, and suggests some simple solutions. It is concluded that Part IVA is the legally incorrect way to attack partnerships as tax evasion schemes.

The law

Part IVA has been drafted very broadly. The Commissioner has the discretion to apply it where three criteria are met. Its operation was well summarised in the joint judgment of the High Court in *Federal Commissioner of Taxation v Spotless Services Ltd*:¹

Part IVA operates where (i) there is a 'scheme' as defined in s 177A; (ii) there is a 'tax benefit' which, in relation to income amounts, is identified in par (a) of s 177C(1) as an amount not included in the assessable income of the taxpayer where that amount would have been included or might reasonably be expected to have been included in that assessable income for the relevant year of income if the scheme had not been entered into or carried out; (iii) having regard to the eight matters identified in par (b) of s 177D, it would be concluded that there was a necessary dominant purpose of enabling the taxpayer to obtain the tax benefit; and (iv) the Commissioner makes a determination that the whole or part of the amount of the tax benefit is to be included in the assessable income of the taxpayer (s 177F(1)(a)). The Commissioner then 'shall take such action as he considers necessary to give effect to that determination' (s 177F(1)).

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1 (1996) 141 ALR 92, 95.

The definition of 'scheme' is simple enough. It is sufficiently broad as to include virtually any course of conduct whatever.² The definition of 'tax benefit' is also uncontentious. Of particular interest (for reasons that will be revealed later) is the definition of 'dominant purpose'. Section 177D (b) contains eight matters which the decision-maker shall have regard to when deciding the 'dominant purpose' of a taxpayer entering a scheme. It is an exclusive list. The section relevantly reads:

- (b) having regard to -
 - (i) the manner in which the scheme was entered into or carried out;
 - (ii) the form and substance of the scheme;
 - (iii) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;
 - (iv) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;
 - (v) any change in the financial position of the taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;
 - (vi) any other consequences for the relevant taxpayer, or for any person referred to in subparagraph (vi), of the scheme having been entered into or carried out; and
 - (vii) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in subparagraph (vi);

It would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with the scheme...

The generality of the Part IVA provisions is a boon to the Commissioner. It is difficult to imagine any activity that is not caught by the definition of 'scheme'. When investigating an activity that has the effect of reducing tax, the Commissioner need only satisfy himself the dominant purpose behind the taxpayer's entry into the scheme is the pursuit of a tax benefit. The Commissioner then has the discretion (Part IVA is not self-executing)³ to cancel any tax benefits taxpayers may have

2 Including unilateral actions. The difficulty here lies in whether to adopt a narrow or broad definition of 'scheme': see eg *Hart v Commissioner of Taxation* [2002] FCAFC 222 per Hely J at 84-88. The narrower the scheme, the more likely it will satisfy the dominant purpose test. However, the 'scheme' cannot be defined so narrowly as to be 'robbed of all practical meaning': *Federal Commissioner of Taxation v Peabody* (1994) 181 CLR 359.

3 *Deputy Commissioner of Taxation v Richard Walter Pty Ltd* [1995] HCA 23.

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received in connection with the scheme. The need for the discretion is critical for many legitimate activities can be caught by the Part. For example, the Commissioner will not usually cancel tax benefits derived from a donation of money to charity, even though the activity may satisfy all three limbs of the Part IVA test.

How then to predict the Commissioner's use of Part IVA? The difficulty in applying such broad legislation has been judicially recognised.⁴ The High Court summarised the situation well in *John v Commissioner of Taxation*,⁵ 'The difficulty is readily understandable....the section has to be applied in a context in which for a long time certain specific taxation advantages have been expressly permitted.'

In *Taxation Appeals No VT90/96-99* the Administrative Appeals Tribunal said Part IVA was not ambiguous and no use need be made of extrinsic sources.⁶ More recently, higher courts have had reference to the second reading speech to the *Income Tax Laws Amendment Bill (No 2)* (which introduced the Part into the Act).⁷ The then Treasurer John Howard said the Part would 'strike down blatant artificial or contrived arrangements, but not [inhibit] normal commercial transactions by which taxpayers legitimately take advantage of opportunities available for the arrangement of their affairs'.⁸

Partnerships

The Commissioner has sought to apply Part IVA to partnerships (that is, the act of entering a partnership and splitting income among partners). Undoubtedly, these are 'schemes'. Income-splitting makes them inherently tax-effective. Often the objective purpose of taxpayers appears to be a tax benefit. If this is so, it would seem to make them subject to Part IVA.

It is submitted the analysis is not so simple. Part IVA should not be used to attack partnerships. They are fundamentally different legal animals to most others -

4 See eg McHugh J's comments in his (dissenting) judgment in *Spotless*.

5 (1989) 166 CLR 417.

6 AAT No 6412 Taxation 21 ATR 3801 (2 November 1990). Also the comments of the High Court in *Spotless* militate against looking outside the statute to construe its meaning: above n2, 96.

7 The Full Court of the Federal Court in *Commissioner of Taxation v Mochkin* [2003] FCAFC 15; the High Court in *Commissioner of Taxation v Consolidated Press Holdings Ltd* (2000) 179 ALR 625, 638.

8 Commonwealth *Parliamentary Debates*, House of Representatives, 27 May 1981, 2684 (John Howard, Prime Minister).

attacking them under Part IVA belies a fundamental misunderstanding of partnership law. Before going any further it is necessary to explore the nature of partnerships a little.

A partnership will come into existence if the requirements of the *Partnership Act*⁹ are met. That Act defined a partnership as ‘the relationship which subsists between persons carrying on a business in common with a view to profit’. Section 6 describes matters to have regard to when determining if a partnership exists. They are not exhaustive, and each case turns on its own facts. What is important to note is they are practical tests – the term ‘partnership’ represents a commercial reality. It is not a legal construct. In *Weiner v Harris*¹⁰ Cozens-Hardy MR said:

Two parties enter into a transaction and say ‘it is hereby declared there is a partnership between us’. The Court pays no regard to that. The Court looks at the transaction and says ‘Is this, in point of law, really a partnership?’

Similarly in *Commissioners of Inland Revenue v Williamson*¹¹ Lord Clyde said:

My Lords, you do not create...a partnership by saying there is one. The only proof that a partnership exists is proof of the relations of agency and of community in losses and profits...

It is clear partnerships are a different sort of legal animal to others. They are self-defining. They do not require any legal formality to come into existence – they come into existence through commercial transactions between two or more persons in a business relationship. The *Partnership Act* did not create a new legal entity, but merely placed a label on a commercial reality and accorded it rights and responsibilities. Partnerships are thus utterly unlike companies, trusts and other legal arrangements that can be created by a discrete legal action.

9 Partnership legislation is state-based. For this article’s purposes, the various Partnership Acts do not vary significantly. This article refers to the *Partnership Act 1891* (Qld).

10 [1910] 1 KB 285, 290.

11 (1928) 14 TC 335, 340.

Problems

There are several major problems with applying Part IVA to partnerships. They have to do with the nature of partnerships already described.

Having regard to the second reading speech to the Bill, it is apparent Part IVA is aimed at schemes that are 'blatant and contrived'. It is submitted the creation of a partnership can never be blatant or contrived. The *Partnership Act* dictates that a partnership must be – by definition – a real business arrangement between two or more people with a view to profit. An activity that is entered into for another purpose (for example, tax minimisation) is not a partnership.

(Of course this point is predicated on the assumption that tax minimisation cannot equate 'profit'. 'Profit' has been notoriously difficult to define, and it is not proposed to trawl through decades of case-law here. The definition of Fletcher Moulton LJ in *Re The Spanish Prospecting Company Ltd*¹² is often cited as a starting point, as in *The Duke Group (in Liq) v Pilmer*.¹³ The term is understood (however unhelpfully) to mean different things in different contexts.¹⁴ It is submitted 'profit' in the context of the *Partnership Act* is not so broad as to include tax benefit.)

When the legislation is read with the second reading speech, it is clear Part IVA ought not be used against valid partnerships. Of course, this argument will only have effect if courts are willing to examine extraneous sources when construing the provisions. (Section 15AB AIA 1901 allows them to do so, in certain circumstances. So do common law rules of statutory interpretation.) As noted above, they have not always been willing to do so.

There is a more tangible reason why partnerships ought have immunity against Part IVA prosecutions. It has to do with the 'dominant purpose' limb of the Part IVA test. The eight factors decision makers must have regard to have been reproduced above. Recent decisions of the Federal and High Courts have substantially enlightened our understanding of the test. They have said the dominant purpose test is objective - the subjective intent of the taxpayer is not relevant.¹⁵ The relevant 'purpose' is that of the

12 [1911] 1 Ch 92, 98.

13 (1997) 73 SASR 64.

14 *Bond v Barrow Haematite Steele Company* [1902] 1 Ch 353, 366 per Farwell J; *QBE Insurance Group Ltd v Australian Securities Commission* (1992) 38 SCR 270, 284; *Webb (Commissioner of Taxes for Victoria) v the Australian Deposit and Mortgage Bank Ltd* (1910) 11 CLR 223, 241 per Higgins J.

15 *Federal Commissioner of Taxation v Metal Manufacturers Ltd* (2001) 108 FCR 150.

person who entered the scheme (not that of the scheme itself).¹⁶ The term 'dominant' means 'ruling, prevailing, or most influential'.¹⁷ The test is usually applied at the time of entry into the scheme.¹⁸ Finally while judges must consider each s 177D factor individually, a global assessment of purpose will suffice.¹⁹

The essential truth revealed by these rules is this: Part IVA has no application to valid partnerships. The following logical analysis makes this clear:

The dominant purpose test is (usually) performed at the time of a party's entry into the relevant 'scheme';

The time of entry of a partnership 'scheme' is the time the partnership is created;

The Partnership Act says a partnership is created when parties act in common with a *view to profit*;

Therefore the 'ruling, prevailing or most influential' purpose of the party entering a partnership must by definition be a *view to profit*.

The 'ruling prevailing or most influential' purpose of the party entering a valid partnership cannot be a tax benefit. If that is the dominant purpose the partnership is not valid and does not exist. This simple insight has important ramifications for the Commissioner when he attempts to pursue partnerships via Part IVA.

It is worth noting the Income Tax Assessment Act 1996 has separate definition of 'partnership'. Section 995-1 says:

partnership means:

- (a) an association of persons (other than a company or a limited partnership) carrying on business as partners or in receipt of ordinary income or statutory income jointly; or
- (b) a limited partnership.

Note: Division 830 treats foreign hybrid companies as partnerships.

16 *Spotless*, above n 2, 99.

17 *Ibid* at 93.

18 *Commissioner of Taxation v Mochkin* [2003] FCAFC 15; *Vincent v Commissioner of Taxation* [2002] FCAFC 291.

19 *Commissioner of Taxation v Consolidated Press Holdings Ltd* (2001) 179 ALR 625.

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Clearly the s995-1 definition is broader than the general law definition of partnership. It does not include the requirement of a view to profit. This means an arrangement that merely satisfies the s995-1 definition of 'partnership' may still be open to Part IVA.

However if an arrangement satisfies the general law definition – which requires a view to profit – Part IVA assessments ought to be ineffective. The different definition of partnership in s995-1 ITAA96 does not affect the efficacy of this paper, which concerns the effect of Part IVA on general law partnerships.

Solution

Where partnerships are in issue Part IVA has little application. It is submitted the Commissioner should approach the issue in this way: when confronted by a 'scheme' that appears to be a partnership existing for the sake of income-splitting, the Commissioner must first test whether the scheme is a real partnership. If it is, the arrangement cannot be the target of Part IVA - it fails the dominant purpose test.

If the scheme is not a real partnership, then the Commissioner cannot say the 'scheme' is the partnership. Rather the 'scheme' is the agreement between taxpayers to income-split and submit a partnership tax return as though they were in a valid partnership. If the scheme passes the dominant purpose test he can then apply Part IVA. It may be easier to punish such a scheme under Schedule 1 to the *Taxation Administration Act 1953* – Part 4-25 deals with charges and penalties for schemes. Schedule 1 is beyond the scope of this article. However, it is worth noting it does allow the Commissioner to collect an additional amount of penalty tax.

Recent jurisprudence

While there is little jurisprudence directly on point, a decision of the Administrative Appeals Tribunal suggests decision-makers are aware of the difficulties explored in this article. In *Re Jones and Commissioner of Taxation*²⁰ the applicant was in a partnership with his wife. The Commissioner used Part IVA to cancel a tax benefit derived by the applicant as a result of income-splitting. Although the question of the validity of the partnership became irrelevant, Senior Member McCabe commented at para 33:

20 [2003] AATA 84.

The label partnership is used to describe a state of affairs – specifically, a partnership is ‘a relation which subsists between persons carrying on a business in common with a view to profit’...If the partnership exists...then all rights and obligations created by the Partnership Act and the general law also apply.

Referring to the broad definition of ‘scheme’, McCabe M says at para 35:

One consequence of this extended view of *scheme* is some potentially odd results...There was nothing artificial in the way [the applicants] reported their conduct to the Commissioner. If they had not [been in a partnership] they would not be entitled to have the income assessed on the basis it is a partnership.

This analysis has important implications for taxpayers in partnerships, taxpayers who *think* they are in partnerships, and their advisors. Its major lesson is the importance of ensuring that any purported partnership arrangement satisfies the tests in the relevant *Partnership Act*.