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Inclusion in Cost Base of Investment Property of Interest Denied Deductibility under a Split Loan Because of Part IVA: Some Follow Up Analysis

Abstract
Inclusion in the capital gains tax (CGT) cost base of the investment property of interest denied deductibility under a split loan because of Part IVA of the Income Tax Assessment Act 1936 (ITAA 1936) (general anti-avoidance rule (GAAR)) is a troublesome issue. It raises fundamental structural issues concerning the effect of the GAAR, the effect of the compensating adjustment mechanisms, and the effect and the relationship between the GAAR, the compensating adjustment mechanisms in Part IVA and other rules in the income tax. This article has come about in response to feedback on a previous article I had written. That previous article was highly critical of a determination (Taxation Determination TD 2005/33) issued by the Australian Taxation Office (ATO) dealing with the inclusion of further interest and compound interest in the cost base of the investment property under a split loan. The ATO's determination rejected cost base inclusion. The central criticism in that previous article was that the determination was technically flawed. Feedback on the original article raised two issues: (1) Does the application of the GAAR have the effect of setting aside the relevant scheme, or does the GAAR only set aside the relevant tax benefit? And (2) What is the proper order of application of the relevant tax rules in regard to a split loan? The answer to these questions may be determinative of the issue debated here. Regrettably, there is little judicial consideration of these issues in the authorities. This article has two main parts. Section 1 deals with the effect of the GAAR operating in regard to a scheme. Section 2 deals with the order in which relevant tax rules apply. As a matter of policy, the further interest and the compound interest under a split loan should not be included in the cost base of the investment property. However, the conclusion in this article is that, unless the ATO can make the GAAR apply to the further interest and the compound interest as a tax benefit in the form of cost base inclusion - something the ATO has not yet asserted let alone analysed - cost base inclusion is very unlikely to be defeated.

Keywords
income, tax, taxation, australia, cgt, gaar, ato, investment, property, interest, denied, deductibility, Part IVA

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INCLUSION IN COST BASE OF INVESTMENT PROPERTY OF INTEREST DENIED DEDUCTIBILITY UNDER A SPLIT LOAN BECAUSE OF PART IVA: SOME FOLLOW UP ANALYSIS

DALE BOCCABELLA*

Inclusion in the capital gains tax (CGT) cost base of the investment property of interest denied deductibility under a split loan because of Part IVA of the Income Tax Assessment Act 1936 (ITAA 1936) (general anti-avoidance rule (GAAR)) is a troublesome issue.[1] It raises fundamental structural issues concerning the effect of the GAAR, the effect of the compensating adjustment mechanisms, and the effect and the relationship between the GAAR, the compensating adjustment mechanisms in Part IVA[2] and other rules in the income tax. This article has come about in response to feedback on a previous article I had written.[3] That previous article was highly critical of a determination (Taxation Determination TD 2005/33) issued by the Australian Taxation Office (ATO) dealing with the inclusion of further interest and compound interest in the cost base of the investment property under a split loan. The ATO's determination rejected cost base inclusion. The central criticism in that previous article was that the determination was technically flawed.

Feedback on the original article raised two issues: (1) Does the application of the GAAR have the effect of setting aside the relevant scheme, or does the GAAR only set aside the relevant tax benefit? And (2) What is the proper order of application of

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1 See, eg, K Wilson, 'More on *Hart* - Disallowed Interest Forms Part of Cost Base of Property?' (2004) 25 *Weekly Tax Bulletin* [1002]; L Wolfers, A Curkowicz and K Wilson, 'CGT View - How to Mend a Broken Hart' (2004) (July) *inTAX* 14; D Boccabella, 'Does the interest expenditure denied deductibility in Hart's Case enter the CGT cost base of the investment property?: An examination of the key issues' (2004) 33 *Australian Tax Rev* 216; D Boccabella, 'ATO's Determination on CGT Cost Base Inclusion for Interest Expenditure Denied Deductibility under Split Loans because of Part IVA is Flawed and Misleading' (2005) 15 *Revenue Law Journal* 15.

2 Subsection 177F(3) *Income Tax Assessment Act 1936* (ITAA 1936).

3 D Boccabella, 'ATO's Determination on CGT Cost Base Inclusion for Interest Expenditure denied deductibility under Split Loans because of Part IVA is Flawed and Misleading' (2005) 15 *Revenue Law Journal* 15. The Australian Taxation Office (ATO) determination involved is Taxation Determination TD 2005/33.

the relevant tax rules in regard to a split loan?[4] The answer to these questions may be determinative of the issue debated here. Regrettably, there is little judicial consideration of these issues in the authorities.

This article has two main parts. Section 1 deals with the effect of the GAAR operating in regard to a scheme. Section 2 deals with the order in which relevant tax rules apply.[5] As a matter of policy, the further interest and the compound interest under a split loan should not be included in the cost base of the investment property. However, the conclusion in this article is that, unless the ATO can make the GAAR apply to the further interest and the compound interest as a tax benefit in the form of cost base inclusion - something the ATO has not yet asserted let alone analysed - cost base inclusion is very unlikely to be defeated.[6]

1. EFFECT OF THE GAAR OPERATING IN REGARD TO A SCHEME

1.1 Two competing views on the effect of the GAAR operating in regard to a scheme

There are only two views in this area. The first is that when the GAAR operates in regard to a scheme, it does not expressly strike down or extinguish the scheme. Instead, the GAAR merely cancels the relevant tax benefit obtained from the scheme such that the scheme (ie, actual transaction(s)) still exists as a taxable event(s) on which other tax rules operate.[7] The second view is that when the GAAR operates, it strikes down or extinguishes the scheme so that no tax rules can operate on that scheme (ie, actual transactions(s)).

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4 It is arguable that these two issues were dealt with, albeit in an indirect way, in the previous article. However, this article makes the treatment of the issues more express.

5 It is assumed that readers are aware of the facts in *FCT v Hart* 2004 ATC 4599 and/or the facts involved in a standard split loan situation: see D Boccabella, 'ATO's Determination on CGT Cost Base Inclusion for Interest Expenditure denied deductibility under Split Loans because of Part IVA is Flawed and Misleading' (2005) 15 *Revenue Law Journal* 15, 17-21.

6 It should be remembered that the Australian Taxation Office (ATO) indicated in para 32 of Taxation Ruling TR 98/22 that further interest (and quite possibly, compound interest) could form part of the cost base of the investment property. Note that along with a number of other paragraphs, paragraph 32 of Taxation Ruling TR 98/22 was withdrawn on 11 August 2004: Addendum to Taxation Ruling TR 98/22 issued on 11 August 2004.

7 Even though the word 'cancellation' appears in the heading to s 177F ITAA 1936, and the word 'cancel' appears in the heading to s 177F(1), the terms 'cancel', 'cancelling' or 'cancellation' do not appear in subsection 177F(1) ITAA 1936. Instead, in the case of the 'generation of deductions', s 177F(1)(b) refers to the deduction not being allowable. In the case of a 'dropout from assessable income', s 177F(1)(a) refers to an amount that shall be included in assessable income. In this article, references to 'cancel', 'cancellation', etc, should be understood as a shorthand reference to the operative terms of s 177F(1).

SPLIT LOANS AND PART IVA

In some circumstances involving a tax benefit in the form of the 'generation of a deduction',[8] the difference will not matter, as there may only be one cost recognition rule that the relevant expenditure can fall within (ie, no 'back-up' rule for taxpayer's expenditure aside from the relevant deduction section). However, the difference is important in a split loan situation because of the existence of more than one cost recognition rule (ie, general deduction section,[9] CGT asset cost base recognition rule for revenue expenditures that have not attracted a deduction).[10] That is, there is a 'back-up' rule for the taxpayer's expenditure.

The following table summarises the different income tax rules that would apply and the different tax outcome, for each alternative in a split loan situation:

[8] Subsection 177F(1)(b) ITAA 1936.

[9] Section 8-1 of the *Income Tax Assessment Act* 1997 (ITAA 1997).

[10] Subsection 110-25(4) ITAA 1997. Subsection 110-25(4) does not expressly state that the expenditures need to be revenue in nature, but this is the general effect of the subsection.

Scheme Set Aside, Struck Down, Extinguished or Eliminated	Scheme is Not Set Aside, Struck Down, Extinguished or Eliminated, but Tax Benefit Only is Cancelled
1. Scheme that generated any 'tax advantage' or 'tax advantages' is treated as not having occurred (ie, actual transactions are ignored for the purpose of applying substantive tax rules). 2. Need to determine transaction(s) that is 'left' in order to apply the tax law, including the GAAR. This requires determination of the counterfactual. The counterfactual becomes the only transaction(s) left, and it assists in quantifying the tax benefit from the actual transaction(s) (scheme). 3. The counterfactual involves the borrowing of two sums, one for the purchase of a main residence and the other for an investment property, and the repayment of interest and principal on those sums in proportion to the borrowed amounts. 4. Further interest and compound interest would not have arisen on the investment property loan, and therefore, no deduction or CGT asset cost base recognition would have been possible (ie, no expenditure). Under the counterfactual, the further interest and compound interest amounts are reflected in higher interest payments on the main residence borrowing. 5. There is no deduction for interest on the main residence borrowing, and there is generally no CGT asset cost base recognition for such interest because the gain or loss on sale of a main residence is disregarded for CGT purposes.	1. Tax benefit comprised of the deduction for further interest and compound interest is cancelled by the GAAR because under the counterfactual, these expenditures would not have generated a deduction. 2. The transactions entered into that comprised the scheme under the GAAR still stand (ie, taxpayer incurred and paid further interest and compound interest on a borrowing to purchase an investment property). 3. Other tax rules apply to the transactions. The further interest and the compound interest seem to fit within the third element of the cost base rule in subsection 110-25(4). 4. The cost base exclusion rules in subsections 110-40(2) and 110-45(1b) do not operate as the further interest and compound interest are not deductible under the general deduction section because of the GAAR. 5. There was no GAAR determination made in regard to the tax benefit of cost base inclusion of the further interest and compound interest. And, to date, the ATO has not set out a case that the GAAR would apply to exclude further interest and compound interest from the cost base of the investment property. 6. Accordingly, the further interest and the compound interest are included in the cost base of the investment property.

Subject to the order of application of relevant rules discussed in Section 3 below, the above table shows that the tax outcome can differ markedly in a split loan situation depending on what is the correct effect of the GAAR operating in regard to a scheme.

1.2 Arguments against striking down or extinguishment of the scheme, so that the GAAR only effects the cancellation of the tax benefit

The following supports the conclusion that when the GAAR operates in regard to a scheme, the GAAR does not strike down or extinguish the scheme. Rather, the GAAR only cancels the identified tax benefit that arose from the scheme.

1 Subsection 177F(1) of the ITAA 1936 is the key provision that confers power on the ATO to make a GAAR determination. Provided certain objective facts are established (eg scheme, tax benefit, dominant purpose),[11] the ATO is empowered - not obliged - to make a GAAR determination. In regard to a tax benefit that is referable to a deduction, the ATO may 'determine that the whole or a part of the deduction or of the part of the deduction, as the case may be, shall not be allowable to the taxpayer in relation to that year of income….'[12] The wording of the three other paragraphs dealing with the other forms of tax benefit (eg dropout of, or from, assessable income, creation of a capital loss) are worded in a similar manner.[13] It is hard to imagine the language adopted being more clear. This wording is clearly focusing on the 'cancellation' of the tax benefit. There is no indication in the extracted words that the scheme is struck down or extinguished when the GAAR operates.[14]

2 The old GAAR, namely s 260 of the ITAA 1936, was worded quite differently to s 177F(1).[15] The relevant part of s 260 read: 'Every contract, agreement or arrangement made or entered into, orally or in writing, … shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly: (a) altering the incidence of any income tax … be absolutely void, as against the Commissioner, or in regard to any proceeding under this Act, but without prejudice to such validity as it may have in any other respect or for any other purpose.' The language of s 260 is also very clear. The section clearly did set aside the 'scheme' for the purpose of the whole income tax.[16]

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[11] Definition of a 'scheme', concept of a 'tax benefit' and 'dominant purpose of obtaining a tax benefit from the scheme': ss 177A(1) and (3), 177C and 177D ITAA 1936.

[12] Subsection 177F(1)(b) ITAA 1936.

[13] Subsections 177F(1)(a), 177F(1)(c) and 177F(1)(d) ITAA 1936.

[14] No authority is required to support the conclusion that the language of s 177F(1) ITAA 1936 is focused on the cancellation of the tax benefit. However, a brief glance at some High Court authorities will confirm the conclusion: *FCT v Peabody* 94 ATC 4663, 4667; *FCT v Spotless Services Ltd* 96 ATC 5201, 5205; *FCT v Consolidated Press Holdings Ltd* 2001 ATC 4343, 4360; *FCT v Hart* 2004 ATC 4599, 4607 (Gummow and Hayne JJ).

[15] Section 260 ITAA 1936 does not apply to any contract, agreement or arrangement made or entered into after 27 May 1981: s 260(2) ITAA 1936.

[16] See eg, *FCT v Gulland; Watson v FCT; Pincus v FCT* 85 ATC 4765, 4771 (Gibbs CJ), 4789 (Brennan J), 4798 and 4801 (Dawson J).

Given that the role of Part IVA was to replace s 260, and that the legislature did not keep the formulation that struck down or extinguished the scheme in s 260, on statutory interpretation grounds it would be defying the legislature to interpret Part IVA as retaining the same approach. Indeed, the failure to adopt the s 260 wording in Part IVA can be seen as an express rejection of the 'strike down or extinguishment' approach.

3 The effect of striking down or extinguishing a scheme is that no income tax rules are permitted to operate on the scheme. A scheme involves actual transactions that the taxpayer has entered into. Where the tax law is not to operate in regard to actual transactions, that legislative intent must be very clear. The clarity of that intent must be similar to the clarity of intent required in order that the tax rules operate in regard to hypothetical transactions.[17] Striking down or extinguishing a whole scheme when the GAAR operates, as opposed to merely cancelling a tax benefit in regard to the scheme, can exclude the income tax rules from operating in regard to transactions that are 'left'. The language of s 177F(1) only manifests an intent that the tax law should not operate on the scheme in regard to the tax benefit obtained.

4 Supporters of the strike down or extinguishment approach could argue that s 177F(1) was only drafted in the form it is in, in order to link up with the notion of a tax benefit in s 177C(1) (ie, list of the four types of tax benefits). That is, the effect of the GAAR operating (s 177F(1)) necessarily had to be linked to the type of tax benefit identified. This argument invites the implication that s 177F(1) should also be read to be extinguishing the scheme that generated the cancelled tax benefit because the legislature could not explicitly state this. The argument must be rejected. The legislature could easily have made the requisite link between the GAAR operating and the identified tax benefit, as well as being able to explicitly state that the scheme is struck down or extinguished when the GAAR operates for all purposes of the income tax. In other words, the two objectives could easily have been achieved by the draftsperson, if that was the intention. There was nothing preventing the express statement that the scheme is struck down or extinguished.

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[17] Otherwise deductible rules provide one example where the tax law is applied to hypothetical transactions (eg, s 21A(3) ITAA 1936; s 24 of the *Fringe Benefits Tax Assessment Act* 1986). In these circumstances, the tax law is clear that this is the intent. The normal rule is that the tax law does not operate on hypothetical transactions: *FCT v Western Suburbs Cinemas Ltd* (1952) 9 ATD 452; *P & G Rocca Pty Ltd v FCT* 2002 ATC 4543, 4557.

5 While little weight is placed on this, the heading to s 177F only refers to the 'Cancellation of Tax Benefits, Etc.'. And, the heading to s 177F(1) only refers to '[Commissioner's discretion to cancel tax benefit]'.[18]

1.3 Arguments supporting the striking down or extinguishment of the scheme

There are probably only two bases in support of the strike down or extinguishment approach. The first, and most plausible, comes from the terms of s 177F(3) of the ITAA 1936, namely, the compensating adjustment mechanisms in Part IVA. The second comes from a statement in the explanatory memorandum accompanying the introduction of the bill that introduced Part IVA.

1.3.1 Subsection 177F(3): Compensating Adjustment Mechanisms in Part IVA

The compensating adjustment mechanism dealing with 'assessable income' is contained in s 177F(3)(a) of the ITAA 1936. It reads as follows:

> Where the Commissioner has made a determination under subsection (1) or (2A) in respect of a taxpayer in relation to a scheme to which this Part applies [GAAR in Part IVA], the Commissioner may, in relation to any taxpayer (in this subsection referred to as the 'relevant taxpayer') -
>
> (a) if, in the opinion of the Commissioner -
>
> (i) there has been included, or would but for this subsection be included, in the assessable income of the relevant taxpayer of a year of income an amount that would not have been included or would not be included, as the case may be, in the assessable income of the relevant taxpayer of that year of income if the scheme had not been entered into or carried out; and
>
> (ii) it is fair and reasonable that that amount or a part of that amount should not have been included in the assessable income of the relevant taxpayer of that year of income,
>
> determine that that amount or that part of that amount, as the case may be, should not have been included or shall not be included, as the case may be, in the assessable income of the relevant taxpayer of that year of income;…' (emphasis in original)

Subsection 177F(3)(b) of the ITAA 1936, which deals with the compensating adjustment mechanism regarding 'deductions', is in similar terms to s 177F(3)(a) of

[18] See D C Pearce and R S Geddes, *Statutory Interpretation in Australia* (5th ed, Butterworths, Sydney, 2001) paras 1.31, 4.36-4.37, 4.39, 4.41 and 4.47 for a discussion of the use of headings as an aid to interpretation of a section.

the ITAA 1936. There is no need to extract the provision.[19] If one of the compensating adjustment mechanisms in s 177F(3) of the ITAA 1936 is invoked, the ATO 'shall take such action as [it] considers necessary to give effect to any such determination.'[20]

It is arguable that the presence of compensating adjustment mechanisms, and more particularly, the reference to the words 'if the scheme had not been entered into or carried out' in those mechanisms, supports the strike down or extinguishment approach. The reasoning is that the compensating adjustment mechanisms are effectively applying the tax rules or some tax rules to circumstances/transactions that would have occurred had the scheme not been entered into or carried out (ie, hypothetical transaction(s)). Is this not tantamount or equivalent to the striking down or extinguishment of the scheme? This argument does have considerable force as an indicator of the legislature's intent. However, it is submitted that the argument cannot be sustained.

First, the compensating adjustment mechanisms do not expressly state that the scheme is struck down or extinguished once the ATO has made (and defended) a GAAR determination.[21] Indeed, the statement in s 177F(3) that 'if the scheme had not been entered into or carried out' remains just a hypothesis.

Secondly, the function of the compensating adjustment mechanisms is limited to the making of a particular adjustment (eg exclusion from assessable income, conferral of a deduction, conferral of a capital loss) thought desirable because of the operation of the GAAR, in regard to an identified tax benefit. The focus is to prevent unfairness that would arise if the remaining tax law that applied to the scheme (ie, actual transaction(s)) were left to operate. The compensating adjustment mechanisms do this by making an advantageous adjustment/correction, and it is to be expected that the hypothesis for such adjustment/correction is the absence of the scheme entered into and the transaction(s) that would have been entered into, absent the scheme. Indeed, it is hard to imagine any other hypothesis that could have been adopted to achieve the manifest purpose of a provision like s 177F(3). Accordingly, the focus of the compensating adjustment mechanisms is much narrower than the extinguishment of the scheme per se. Further, no imaginable barrier could have prevented the draftsperson from drafting a compensating adjustment mechanism(s) so that it displaced the scheme in its entirety, thereby leaving the counterfactual (ie, the hypothetical transaction(s)) as the transaction(s) upon which all the tax rules

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19 The compensating adjustment mechanisms dealing with 'capital losses' and 'foreign tax credits' are also in similar terms: ss 177F(3)(c) and 177F(3)(d) ITAA 1936.

20 Closing words in s 177F(3) ITAA 1936.

21 Note the comment of Emmett J in *Asiamet (No 1) Resources Pty Ltd v FCT* 2003 ATC 4117, 4144 that it is appropriate to defer the making of a compensating adjustment until it has been determined whether the general anti-avoidance rule (GAAR) operates in regard to a scheme.

could operate even where there was no need to make a positive adjustment. This was not done. Rather, the approach stopped short of this.

Thirdly, and this point overlaps the first point, the compensating adjustment mechanisms are derivative in nature. That means that they can only be activated after the ATO has made a GAAR determination.[22] Given their derivative nature, the compensating adjustment mechanisms are directed at addressing 'unfairness' that arose from the cancellation of the identified tax benefit by operation of the GAAR; the operation of the GAAR is what formed the basis for the activation of the compensating adjustment mechanism. An intention to give the compensating adjustment mechanisms a broader role or function than this, which could be the case if the strike down or extinguishment approach were adopted, cannot be discerned. Indeed, giving the compensating adjustment mechanism a strike down or extinguishment role would have precisely this effect in a split loan situation. The following explains this point.

The tax benefit that was cancelled by the GAAR was the generation of deductions under the general deduction section for further interest and compound interest.[23] The counterfactual identified for the purpose of quantifying that tax benefit was the repayment of principal and interest in proportion to the amount borrowed for each asset.[24] Accordingly, under the counterfactual, further interest and compound interest on the investment loan would not have arisen. Effectively, these actual interest payments would have resulted in higher interest payments on the loan used to purchase the taxpayer's main residence. In the absence of the scheme, the taxpayer would have incurred this interest on the loan used to purchase a main residence. Such interest does not satisfy the general deduction section. Therefore, there is no unfairness if the ATO (or the tax law) refuses to make a compensating adjustment; any compensating adjustment.

Subject to the analysis in Part 3 of this article below, the denial of deductions for further interest and compound interest (ie, actual transaction(s)) through the GAAR means that this interest is included in the cost base of the investment property because the cost base inclusion provision is satisfied,[25] and the cost base exclusion

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22 See opening words of s 177F(3) ITAA 1936.

23 *FCT v Hart* 2004 ATC 4599, 4602-4 (Gleeson CJ and McHugh J) 4605-7 and 4614 (Gummow and Hayne JJ) and 4625 (Callinan J).

24 *FCT v Hart* 2004 ATC 4599, 4602-4 (Gleeson CJ and McHugh J) 4606-7 and 4614 (Gummow and Hayne JJ) and 4625 (Callinan J).

25 Subsection 110-25(4) ITAA 1997. Note, there is a real issue as to whether 'compound interest' comes within s 110-25(4) ITAA 1997: see D Boccabella, 'Does the interest expenditure denied deductibility in *Hart's* Case enter the CGT cost base of the investment property? An examination of the key issues'(2004) 33 *AT Rev* 216, 230-5 for a discussion of this issue.

provision is not satisfied.[26] If the striking down or extinguishment approach was correct, this further interest and compound interest would not enter the cost base of the investment property because the whole scheme (ie, actual transaction(s)) will be treated as if it did not happen. The hypothetical counterfactual, which is used to quantify the tax benefit, becomes the transaction(s) upon which the whole income tax rules apply. In these circumstances, no further interest or compound interest arises in regard to the investment property so that no cost base inclusion is possible. And, in effect, the higher interest incurred in regard to the main residence loan under the counterfactual will not form part of the cost base of the main residence.[27] Yet, the GAAR has not operated in regard to the 'tax benefit' obtained under the scheme (ie, actual transaction(s)) in the form of inclusion in the cost base of the investment property of the further interest and the compound interest.[28] In these circumstances, one can ask, isn't the compensating adjustment mechanism carrying out a function (ie, cancelling a tax benefit) that was designed for the GAAR? In other words, the striking down of the scheme is actually defeating a tax benefit that has not been struck down by the GAAR.[29] It is submitted that the compensating adjustment mechanism cannot be given such an interpretation in circumstances where the terms of the GAAR expressly fail to provide for this outcome.

Fourthly, and again there is some overlap with earlier points above, the compensating adjustment mechanisms are designed to provide taxpayers with a 'positive correction'. By contrast, the GAAR is clearly designed to provide taxpayers with a 'negative correction'. While the two regimes are linked in the sense that one of the conditions for the compensating adjustment mechanisms to operate is that the GAAR has applied, there is no indication that either regime has more than one role or function. Indeed, the scheme of Part IVA would be unworkable if one regime was to have a role designated for the other. Interpreting the compensating adjustment mechanisms so that they strike down or extinguish a scheme would have the effect of providing the taxpayer under a split loan with a negative correction by excluding the further interest and the compound interest from the cost base of the investment property.

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26 Subsections 110-40(2) and 110-45(1B) ITAA 1997.

27 This is achieved through the rule that the gain or loss on the sale of a main residence is disregarded under the capital gains tax regime: s 118-110 ITAA 1997.

28 At no stage in the *Hart* litigation was the issue raised about cost base inclusion for the further interest and compound interest in the event that the GAAR operated to deny deductions for such expenditure.

29 There is nothing stopping the ATO from asserting that the GAAR applies to cost base inclusion of the further interest and the compound interest. There will be difficulties in this argument succeeding.

The difficulty with the approach that does not strike down or extinguish the whole scheme (transaction(s)) (ie, only the tax benefit is cancelled) for the purpose of the tax law is that at the one time, the tax law can effectively operate on the counterfactual under a compensating adjustment mechanism, and on the scheme (ie, actual transaction(s)) after the GAAR has cancelled a tax benefit. This seems to be a strange outcome, and would tend to create uncertainty in the application of the tax law. Certainly, the strike down or extinguishment of the scheme approach would be less uncertain for the tax law compared to the mere tax benefit cancellation approach. This strangeness of outcome, and the greater uncertainty in application of the tax law, tends to militate in favour of the strike down or extinguishment approach. However, in spite of these concerns, this appears to be the unavoidable consequence of the rules. In any event, uncertainty and difficulty in applying the tax law to 'transactions' is not uncommon. This, on its own, is not enough to support the strike down or extinguishment approach.

1.3.2 Explanatory memorandum to bill introducing Part IVA

The following comment appears in the explanatory memorandum to the bill that introduced Part IVA into the ITAA 1936:

> Against this background [range of matters to which regard should be had in determining the purpose question], the remaining provisions of sub-paragraph (b) of section 177D operate so that Part IVA will effectively strike down a scheme that on its face, and considered in the light of the designated surrounding circumstances just outlined, is one of which it is appropriate to say that it must have been engaged in for tax purposes.[30]

The argument here is that the words 'strike down a scheme' in the above extract supports the strike down or extinguishment approach. There are numerous difficulties with the above as a basis of support for the strike down or extinguishment approach.[31] First, the statement itself when referring to the operation of s 177D(b) is inaccurate. Subsection 177D(b) does not operate to strike down a scheme. Nor does it operate to cancel a tax benefit. There are no words in s 177D(b) that provide any support for the attribution of such roles or functions to s 177D(b). The role or function of cancelling a tax benefit (or 'striking down a scheme') is expressly left to s 177F(1) of the ITAA 1936. This clearly appears from the words of s

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30 Page 13 of explanatory memorandum to the Income Tax Laws Amendment Bill (No 2) 1981.

31 The strike down comment in the explanatory memorandum is preceded by the word 'effectively'. In other words, the comment is not stating that a scheme will be struck down per se. This, to some extent, undermines the strike down claim.

177F(1), and is confirmed by the cases.[32] The role of s 177D(b) is to set out the range of matters to which regard must be had in determining the question as to whether a person entered into the identified scheme with the purpose (dominant purpose) of enabling a taxpayer to obtain a tax benefit in connection with the identified scheme. The requirement in s 177D(b) is one of the conditions (the other condition is in s 177D(a)) to be satisfied in order for a finding that the scheme is one to which Part IVA applies (ie, This Part applies). In turn, the conclusion that Part IVA applies to a scheme is a necessary pre-condition to the cancelling of a tax benefit under s 177F(1).[33] Secondly, the above is only a statement in an explanatory memorandum. Statements in explanatory memoranda are not law. At its highest, statements in explanatory memoranda can only be used to assist in the interpretation of a provision of an Act.[34] Accordingly, if there is any inconsistency between the language of the legislation and statements in an explanatory memorandum (or statements by a minister when commenting on the scope of a bill), the language of the legislation must take priority as an indicator of legislative intent.[35]

In the end, the statement in the explanatory memorandum does not provide any support for the strike down or extinguishment approach.

2. ORDER IN WHICH RELEVANT TAX RULES OPERATE

The discussion in this section assumes that the conclusion in Section 1 is correct, namely, that when the GAAR operates, it does not strike down or extinguish the scheme that generated the tax benefit; rather, the GAAR merely cancels the identified tax benefit. The question then becomes, in what order do the normal rules operate in regard to the scheme (transaction(s)) that have occurred. The order in which relevant substantive provisions of the income tax legislation apply to a split loan will affect, if not determine, the question of inclusion of further interest and compound interest in the cost base of the investment property. The relevant provisions regarding further

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32 *FCT v Peabody* 94 ATC 4663, 4667 and 4669; *FCT v Spotless Services Ltd* 96 ATC 5201, 5205; *FCT v Hart* 2004 ATC 4599, 4607-8 (Gummow and Hayne JJ).

33 It is not uncommon for statements in explanatory memoranda to be less than accurate (eg see the comments in the explanatory memorandum accompanying the introduction of s 160M(6) ITAA 1936 stating that s 160M(6) applied to the grant of a lease and the grant of an option, even when there were specific charging sections in the CGT regime dealing with each of these items (ss 160ZS (leases) and 160ZZC (options))).

34 Subsections 15AB(1) and 15AB(2)(e) of the *Acts Interpretation Act 1901* (Cth).

35 *Gray v FCT* 89 ATC 4640, 4643 (grant of a lease for a lease premium after the CGT regime commenced (19 September 1985) over property purchased before the CGT regime commenced was held to be a capital gain pursuant to the words in s 160ZS(1) ITAA 1936, despite the fact that the Treasurer had stated at the time of announcing the introduction of the CGT regime that CGT would only apply to assets acquired after the commencement of the CGT regime).

interest and compound interest are: (1) General deduction provision (s 8-1 of the ITAA 1997) (2) CGT cost base inclusion provision (s 110-25 of the ITAA 1997) (3) CGT cost base exclusion provision (s 110-45 of the ITAA 1997) and (4) The GAAR (s 177F of the ITAA 1936).

In the *Hart* litigation, at all three stages, the ATO and the courts only dealt with the general deduction provision, and the GAAR.[36] At no stage were CGT cost base provisions considered. The ATO now wants to apply the CGT cost base exclusion provision (s 110-45) to the further interest and compound interest under a split loan.[37] Whether it will be able to do so, outside of obtaining a GAAR determination in regard to CGT cost base inclusion (or a GAAR determination in regard to exclusion of a net capital gain from assessable income),[38] will largely depend on whether the income tax legislation decrees an order of application of substantive provisions in the income tax. While the ATO does not expressly state an order of application of the relevant provisions in Taxation Determination TD 2005/33, or for that matter in another document, the ATO would probably argue that the income tax decrees the following order of application of provisions in regard to a split loan:

1 General deduction provision (s 8-1);

2 CGT cost base inclusion provision (s 110-25);

3 CGT cost base exclusion provision (s 110-45);[39] and

4 The GAAR (Part IVA).

If this were the correct ordering of the substantive rules, the interest would be excluded from the CGT cost base of the investment property because the interest was deductible under s 8-1 of the ITAA 1997. By the time it came to applying the GAAR to the scheme (Step 4), the GAAR would only have to defeat the deduction obtained under s 8-1. To the relief of the ATO, the GAAR would not have to defeat CGT cost base inclusion (or exclusion from a net capital gain) as well, because s 110-45 has already done this.

Taxpayers would not want the ATO's contention on ordering to be accepted, as it would frustrate any chance of achieving CGT cost base inclusion. If an ordering is manifested at all by the legislation, taxpayers would most probably want the following ordering:

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36 *Hart v FCT* 2001 ATC 4708 (Gyles J), *Hart v FCT* 2002 ATC 4608 (Full Federal Court), *FCT v Hart* 2004 ATC 4599 (Full High Court).

37 Paragraph 9 of Taxation Determination TD 2005/33.

38 Inclusion of the further interest and compound interest will be governed by s 110-25(4) ITAA 1997.

39 Broadly, s 110-45 ITAA 1997 applies to assets acquired after 13 May 1997. Section 110-40 applies to assets acquired before 14 May 1997.

1. General deduction provision (s 8-1);
2. The GAAR (Part IVA);
3. CGT cost base inclusion provision (s 110-25); and
4. CGT cost base exclusion provision (s 110-45).[40]

The ordering of legislative rules, like the meaning of words in legislation, is an issue of interpretation or construction. This comes down to legislative intent. Even though there is some overlap, the following discussion is arranged around principles or guidelines of statutory interpretation and construction of legislation, and particular features of Australia's income tax regime.

2.1 Absence of an Express Ordering Rule Implies that there is No Ordering Rule

There is no express ordering rule in regard to the provisions that are relevant to a split loan (ie, those mentioned above). Yet, there are express statements as to the ordering rules in other parts of the income tax.[41] This raises the implication that there are no ordering rules in regard to the provisions relevant to split loans.

This position cannot be sustained. The reason is that the cost base outcome is markedly different in regard to further interest and compound interest depending on which sections apply first. The presence of these inconsistent and opposite outcomes means that an ordering approach is required to resolve the 'deadlock'. It is therefore

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40 As far as the taxpayer is concerned, he or she probably does not mind if the cost base inclusion rule is Step 2 and the GAAR is Step 3. The outcome will be the same as the GAAR being Step 2 and the cost base inclusion rule being Step 3 because the GAAR can have no effect on the cost base inclusion provision.

41 The following examples are provided: (1) When an expenditure falls within the general deduction section (s 8-1) and s 25-105 (medical protection support payment), priority of application goes to s 8-1: s 25-105(3) (2) If an amount of expenditure falls within the positive elements of the cost base of a CGT asset and s 40-880 (business related costs), priority of application goes to cost base inclusion: s 40-880(5)(f) (3) Upon the receipt of a sum, CGT events are applied in the following order: CGT events, aside from D1 and H2, apply first, then D1 and then H2: s 102-25(3) (4) Losses of previous years (both revenue losses and net capital losses) are used in future years in the order in which they are made: ss 36-15(5), 36-17(7) and 102-15(1) (5) Current year capital losses and net capital losses of previous years must be applied (used) against current year capital gains before the discounting rule applies: Method Statement in s 102-5(1) (6) The tax offset for franking deficit tax ranks last in terms of usage of tax offsets by corporate tax entities: s 205-70(3) and (7) Subsection 40-230(1) ITAA 1997 first reduces the cost of a car by input tax credits obtained under the *A New Tax System (Goods and Services Tax) Act* 1999 (GST regime), before the cost of the car is reduced down to the car depreciation limit. It is arguable that some of these examples are better characterised as 'ousting rules' or 'priority of application rules', rather than ordering rules.

submitted that the judiciary must discern an ordering rule by implication. The fact that the interpretation of particular legislation, in this case, discerning the applicable ordering rule, proves difficult, should not release the judiciary from performing this function.[42]

2.2 Taxpayer can make an election as to the order of application of the rules, or the ATO can make an election as to the order of application of the rules

The suggestion here is that where the tax legislation is silent on providing an ordering rule in circumstances where an ordering rule is required to resolve a deadlock or inconsistency, the taxpayer or the ATO should be given an election to decide the order in which they want the relevant rules applied. The suggestion must be rejected.

First, the problem of determining which 'actor' (taxpayer or ATO) is to be conferred the election, on its own, is enough to indicate the rejection of such a suggestion. Secondly, it is hard to envisage the conferral of an election on a taxpayer as to the measurement of their tax base for an income year that is not explicit. There are many examples where taxpayers are expressly given a choice, as to the measurement of the tax base.[43] There is a compelling case that in the absence of an express choice, taxpayers cannot arrogate to themselves 'extra' choices. Or to put that another way, there is no room for the conferral of implied choices. Giving taxpayers an election as to the order of application of the rules that relate to a split loan would be implying a choice into the tax legislation. It should also be noted that refusing to confer an election on taxpayers regarding an ordering rule does not infringe the principle that genuine doubts or ambiguities as to whether a charging provision applies should be resolved in taxpayers' favour.[44] That principle is one of construction of a charging

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42 See D C Pearce and R S Geddes, *Statutory Interpretation in Australia* (5th ed, Butterworths, Sydney, 2001) para 1.3 for a discussion of the fundamental duty of the courts to give meaning to legislation.

43 The following provides some examples where the income tax legislation expressly provides a choice or election that affects the measurement of the tax base for an income year: (1) Choice between prime cost method or diminishing value method of determining the decline in value (depreciation) deduction for a depreciating asset: s 40-65(1) ITAA 1997, (2) Choice amongst a range of methods for claiming deductions for car expenses: s 28-20 ITAA 1997, (3) Choice provided to certain taxpayers in certain circumstances to use the indexation of the cost base of an asset in determining the capital gain made on the asset, as opposed to using the discount capital gain approach on sale of the asset: s 114-5(2) ITAA 1997 and, (4) Choice conferred on taxpayers as to the capital gains against which capital losses and net capital losses should be applied: Steps 1 and 2 in the Method Statement in s 102-5(1) ITAA 1997.

44 *Hepples v FCT* 91 ATC 4808, 4818 (Deane J).

provision. Even though ultimately, an amount of tax is in issue, the present circumstance is quite different.

Thirdly, the comments above regarding elections conferred on taxpayers as to the measurement of the tax base apply equally in regard to the conferral of an election on the ATO as to the appropriate ordering rule. In short, if the ATO is to have an election as to the measurement of taxpayers' tax base, the legislation must expressly confer the election. And, where such an election exists, the exercise of that election would have to be amenable to independent review. Accordingly, the suggestion that the ATO can elect what the ordering rule is in regard to substantive provisions that operate on a split loan must be rejected.

2.3 Order of enactment of relevant provisions as basis for an ordering rule

If the ordering rule were based on time of enactment of relevant provisions, this would be beneficial to taxpayers (and detrimental to the ATO), as the GAAR would be applied before the CGT cost base exclusion rule. The CGT cost base rule(s) were enacted to commence on 20 September 1985.[45] There was no need for such rules before 20 September 1985 because Australia did not have a broad-based CGT regime. The GAAR, even if limited to its present form, commenced on 28 May 1981.[46] As the GAAR only excluded a deduction in the Hart litigation (and not CGT cost base inclusion achieved under s 110-25), the CGT cost base exclusion rule in s 110-45(2) would not apply because the further interest and compound interest has 'not been deducted' and it 'cannot be deducted'. Provided the further interest and the compound interest fall within s 110-25(4), such interest will form part of the cost base of the investment property.

It is submitted that the time of enactment of relevant provisions should not govern the ordering issue. There is no natural link between the time of the enactment of tax provisions and the order of application of those enacted rules. Further, it would be quite unreal to draw the inference that the legislature was somehow dealing with ordering rules at the same time of enacting new regimes or new provisions. The priority on the enactment of new provisions is usually to locate them in the appropriate place in the Act. For example, an assessable income charging provision is located amongst other assessable income charging provisions,[47] a deduction denial provision is located amongst other deduction denial provisions[48] and a deduction

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45 The predecessor to s 110-45 ITAA 1997 was s 160ZH ITAA 1936.

46 Section 260 ITAA 1936 was the predecessor to the GAAR in Part IVA ITAA 1936.

47 Section 15-50 ITAA 1997 (work in progress payments) is located in Division 15.

48 Section 26-54 ITAA 1997 (expenditure related to illegal activities) is located in Division 26.

conferral provision is located amongst other deduction conferral provisions.[49] Another priority may be to ensure that new regimes co-ordinate with the old provisions so that unintended consequences are minimised. Overall, attention to the order of application of the provisions (including the new rules) is non-existent. Therefore, time of enactment of relevant provisions cannot be the basis for an ordering rule.

2.4 Sequence of provisions in legislation as the basis for an ordering rule

It can be argued that the ordinary rule that sections of an Act (as well as other documents) should be read (and applied) in the order in which they appear,[50] can, for present purposes, be equated with an ordering rule. That is, sections in an Act are to be read sequentially and applied sequentially (ie, Section 1 first, s 2 next, s 3 next, and so on). It is submitted that no guidance can be obtained from the sequence of sections in the income tax legislation. Therefore, the 'ordinary rule' or guide that a piece of legislation or sections in a piece of legislation should be read in the order in which they appear cannot also provide an ordering rule. There are two main reasons.

First, the income tax, in terms of the rules for determining a taxpayer's tax base,[51] and, as a consequence, tax liability, involves sections in two Acts of parliament, namely, the ITAA 1936 and the ITAA 1997. More particularly, in regard to split loans, the relevant provisions are in two Acts. The problem posed by this is, which Act is to be read first? This problem could be overcome by 'going back', and 'including' and locating the ITAA 1997 provisions into their equivalent place in the ITAA 1936. But this would not include all of the new substantive regimes introduced directly into the ITAA 1997. These provisions do not have an ITAA 1936 history. Unless a 'reconstruction' of the ITAA 1936 is undertaken to 'insert' these new substantive provisions at their places, finding an acceptable sequence is not achievable.

It could be argued that this method at arriving at an ordering rule can be used where the range of provisions in issue, as they relate to a particular transaction, lends itself to such an ordering. In other words, just because 'reconstruction' of the ITAA 1936 is not possible for all of the income tax provisions, it does not mean that reconstruction of some provisions ought not be pursued. In regard to the provisions in issue under a split loan, reading and ordering the provisions in the ordinary way would be beneficial to the ATO (and detrimental to taxpayers). The reason is that the order

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49 Section 25-100 ITAA 1997 (travel between unrelated income-producing activities) is located in Division 25.

50 See D C Pearce and R S Geddes, *Statutory Interpretation in Australia* (5th ed, Butterworths, Sydney, 2001) at para 4.3 and the cases cited therein.

51 The tax base under Australia's income tax is 'taxable income': s 4-10 ITAA 1997.

under the reconstructed ITAA 1936 would be: (1) General deduction provision (s 51(1) of the ITAA 1936) (2) CGT cost base inclusion rule (s 160ZH(1)(ba) of the ITAA 1936) (3) CGT cost base exclusion rule (s 160ZH(6B) of the ITAA 1936) and (4) The GAAR (Part IVA (ss 177A-177H) of the ITAA 1936). It is submitted that this approach would be hard to justify. Not only would it appear arbitrary, it essentially 'freezes' the income tax as at 30 June 1997.

Secondly, and to make use of an absurdity argument, an ordering rule based on the sequential basis of the income tax legislation would mean that the GAAR would be precluded from applying to a number of assessable income charging provisions in the income tax. For example, the GAAR could not apply to a scheme involving, for example, a 'dropout from assessable income' in provisions appearing after Part IVA in the ITAA 1936. The charging provisions under the controlled foreign companies rules (s 456 of the ITAA 1936) and the foreign investment fund rules (s 529 of the ITAA 1936) provide two examples. Or, perhaps more importantly, the GAAR could not apply to a scheme involving the 'generation of deductions' in provisions appearing after Part IVA in the ITAA 1936 (eg deductions for premiums paid by a superannuation fund: s 279 of the ITAA 1936; expenditure on drought mitigation property: s 628(1) of the ITAA 1936[52]). One doubts that such an intention can be attributed to parliament.

2.5 Ordering rule based on the last resort nature of the GAAR in regard to anti-avoidance provisions

The most credible basis for the ordering rule the ATO would want (ie, the GAAR applies after the CGT cost base exclusion rules) comes from the nature and function of the GAAR, and some terms in the GAAR itself. The GAAR is a provision of last resort in terms of 'attacking' tax planning the ATO finds unacceptable.[53] If the tax planning involved has been defeated, to the satisfaction of the ATO, by a general provision in the income tax,[54] or a specific anti-avoidance provision,[55] the GAAR will

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52 Note that this deduction is not available in regard to expenditure on items unless they are first used or installed before 1 July 2001: s 628(4) ITAA 1936.

53 While the meaning of s 177B(3) ITAA 1936 is somewhat elusive, it should be noted that the heading to s 177B(3) reads: 'Specific provisions to apply before Part IVA [GAAR]'.

54 The 'tax planning' in *FCT v Whitfords Beach Pty Ltd* 82 ATC 4031 and *FCT v The Myer Emporium Ltd* 87 ATC 4363 was defeated by the ordinary income section, and the tax planning in *Ure v FCT* 81 ATC 4100 and *Fletcher v FCT* 91 ATC 4950 was defeated by the general deduction section.

55 Three examples are: (1) Income shifting by natural persons: s 26-35 ITAA 1997 (2) Inflated outgoing incurred for purchase of trading stock: s 70-20 ITAA 1997 and (3) Alienation of personal exertion income: s 86-15 ITAA 1997.

not be required and/or activated.[56] The contention here is that this framework provides the basis for an ordering rule that the GAAR is a provision of last resort, and that all other provisions of the income tax should be applied before the GAAR.

The counter argument is that the GAAR deals with the topic of tax planning, or unacceptable tax planning, and that it only deals with rule ordering in regard to anti-avoidance or anti-tax planning provisions. Another way to put it is to say that the GAAR only deals with rule ordering in regard to those provisions that impact on the GAAR. One key part of the GAAR is the notion of a 'tax benefit'. A tax benefit is exhaustively defined to mean: (1) The dropout from assessable income[57] (2) The generation or manufacture of deductions[58] (3) The generation or manufacture of a capital loss[59] and (4) The generation or manufacture of a foreign tax credit.[60] The first two items in the notion of a tax benefit are clearly the most important in terms of taxpayers' tax base (taxable income), and as a consequence, tax payable. Accordingly, these two items are the most important in terms of tax planning, and therefore, anti-avoidance provisions.

The CGT cost base exclusion rule (s 110-45) does not deal with tax planning. There is nothing in the terms of s 110-45 that indicates it contains a rule attacking certain types of tax planning. This cost recognition exclusion rule deals with the topic of preventing the double counting of expenses. The prevention of double counting of expenses is required from a policy perspective.[61] The need for such prevention arises from the multiplicity of deduction and cost base conferral rules in the income tax. In short, the prevention of double counting is quite removed from tax planning situations, and therefore cannot be identified with the function performed by the GAAR.

The GAAR, because of its function, does provide an ordering rule in regard to anti-avoidance provisions. However, the GAAR does not provide an ordering rule in regard to provisions that are not anti-avoidance provisions. The cost base exclusion rule cannot be characterised as an anti-avoidance provision. Accordingly, the last resort nature of the GAAR does not require the conclusion that s 110-45 applies to an expense from a transaction or scheme before the GAAR applies to that expense.

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56 In practice, in most cases, the ATO would activate the GAAR just in case a specific anti-avoidance provision was ultimately found not to defeat the tax planning involved. See, eg, the ATO's approach in *Puzey v FCT* 2002 ATC 4853.

57 Subsection 177C(1)(a) ITAA 1936.

58 Subsection 177C(1)(b) ITAA 1936.

59 Subsection 177C(1)(ba) ITAA 1936.

60 Subsection 177C(1)(bb) ITAA 1936.

61 The overwhelming intent of the income tax legislation is to prevent the double counting of a cost: see, eg, s 82 ITAA 1936 and s 8-10 ITAA 1997.

2.6 Identity of subject-matter dealt with in provisions requiring an ordering as basis for an ordering rule

The proposition here is that ordering rules should be based on the idea that all the rules impacting on, or affecting, a particular subject-matter must be exhausted before moving onto the rules dealing with a different subject-matter. This is based on the idea that it would have been the intention of parliament to deal with a particular subject-matter in a comprehensive manner before 'moving onto' another subject matter. The alternative is to attribute an intention to only partially deal with a subject-matter, and to then return to it at some later, unspecified, point. This latter approach is far less likely.

The potential subject-matters dealt with in regard to further interest and compound interest under a split loan are 'deductions' and 'cost base inclusion'. On the other hand, given that both deductions and cost base inclusion deal broadly with the notion of 'cost recognition' under the income tax, there is a case that they are not separate subject-matters. The constitutional law case of *Resch v FCT*[62] provides some support for the argument that there is only one subject-matter here. In that case, under s 16B of the *Income Tax Assessment Act 1922* (ITAA 1922), the ATO sought to tax the taxpayer on the receipt of a liquidation distribution. It was conceded that such a distribution was on capital account under general principles. The Full High Court held that s 16B did not breach s 55 of the *Commonwealth Constitution* even though the section brought to tax capital receipts, and that other charging provisions in the ITAA 1922 brought to tax income/revenue receipts. Amongst other things, s 55 of the Commonwealth Constitution prohibits a law imposing taxation from dealing with more than one subject of taxation. By having charging provisions that capture income and capital receipts, the ITAA 1922 was held to not deal with more than one subject of taxation.

On the other hand, it can be argued that deductions are quite different in character from cost base inclusions. Most deduction provisions, or at least many of them, provide immediate recognition for costs, whereas cost base recognition (rather than inclusion) is only available at the time an asset is sold. Indeed, an asset might not be sold for many years, if at all.[63] Even if an asset is sold, there is still the possibility that the sale may give rise to a loss.[64] A loss on a CGT event can only be used if the taxpayer has capital gains, in the current year, or in a future income year.[65] That is, a

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62 *Resch v FCT* (1942) 6 ATD 203.

63 Cost recognition is only available when a CGT event happens to an asset: s 102-20 ITAA 1997.

64 Subsection 104-10(4) ITAA 1997.

65 Sections 102-5, 102-10 and 102-15 ITAA 1997.

loss on a CGT asset cannot be recognised against non-CGT assessable income.[66] Thus, loss recognition is contingent on the presence of capital gains from other assets. On the other hand, even deductions for depreciation or amortised expenditure are conferred before the sale of an asset (ie, during the holding period of asset or advantage). And, they are generally not subject to the range of contingencies associated with recognition of expenditure in the cost base of a CGT asset. The exception is if the taxpayer is in a tax loss situation (ie, deductions exceed assessable income).[67] The central notion in the GAAR, namely, a tax benefit, has separate rules for deductions and cost base inclusion. This provides support for the separate subject-matters conclusion. Thus, even though the broad category of cost recognition encompasses both deductions and cost base inclusion, there appear to be two subject-matters involved. The decision is *Resch v FCT* can be distinguished as it was dealing with a provision in the Commonwealth Constitution dealing with political relations.[68] The current problem is far removed from those circumstances.

On the basis that there are two subject-matters, the provision in the GAAR that denies deductions must be applied before going on to examine the rules dealing with the inclusion of costs in the cost base of a CGT asset. Accordingly, the GAAR denies the deduction (otherwise available under s 8-1) for further interest and compound interest. In turn, none of the requirements in s 110-45 that the taxpayer 'has deducted', or that the taxpayer 'can deduct' the further interest and the compound interest, are met.[69] Accordingly, s 110-45 does not exclude cost base inclusion.

From there, it would be a matter of applying the rules dealing with the inclusion (or exclusion) of the further interest and compound interest from the cost base of the investment property. The ordering in regard to this subject-matter would be: (1) Cost base inclusion rule: s 110-25(4) (2) Cost base exclusion rules: s 110-45[70] and (3) The GAAR, to examine whether it defeats cost base inclusion.

2.7 Provisions raised by ATO and/or taxpayer ought not provide a basis for an ordering rule

The ATO did not present an argument to the court for the exclusion from the cost base of the investment property of the further interest and compound interest in the

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66 Subsection 102-10(2) ITAA 1997.

67 See ss 36-10 and 36-15 ITAA 1997 for entities other than companies, and s 36-17 ITAA 1997 for companies.

68 *Resch v FCT* (1942) 6 ATD 203, 219 (Dixon J).

69 See D Boccabella, 'ATO's Determination on CGT Cost Base Inclusion for Interest Expenditure denied deductibility under Split Loans because of Part IVA is Flawed and Misleading' (2005) 15 *Revenue Law Journal* 15, 42-5 for a discussion of the cost base exclusion rules.

70 Subsection 110-40(2) ITAA 1997 also contains a cost base exclusion rule.

Hart litigation. Further, the taxpayer did not argue for cost base inclusion. It can be assumed that the cost base issue was not raised in the taxpayer's objection.[71]

Put shortly, the fact that the ATO and taxpayer did not make reference to a particular provision(s) in the course of administering their dispute cannot provide any guidance on the ordering rules in regard to a particular transaction. Thus, the fact that the case was conducted on the basis that it only dealt with deduction issues cannot raise the implication that all the rules dealing with deductions must be exhausted before dealing with cost base inclusion. To do so would elevate the parties' procedural strategy, or procedural ignorance, to the status of legislative intent.

3. CONCLUSION

From a tax policy perspective, the further interest and compound interest denied deductibility should not be included in the cost base of the investment property. To do so would, in many cases, give recognition for such expenditure that is equivalent to the giving of a deduction. This obviously undermines the finding supporting the application of the GAAR to the deductibility of such expenditure.

The question is whether the provisions of the income tax implement the preferred policy position? On this question, the better view is that the ATO must activate the GAAR in regard to the tax benefit constituted by cost base inclusion in order to have a chance at achieving the desired policy outcome. The approach in Taxation Determination TD 2005/33 will not achieve it. Nor are the two issues discussed in this article, namely the question of the effect of the GAAR and the order in which relevant tax rules operate under the income tax, likely to assist the ATO.

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[71] It is disappointing that the cost base issue was not raised. Certainly, the ATO was clearly aware of the issue well before presenting its case to Gyles J at first instance in *Hart v FCT* 2001 ATC 4708: see paras 27-32 of Taxation Ruling TR 98/22. Note that, amongst other paragraphs, paras 27-32 of Taxation Ruling TR 98/22 were withdrawn by the ATO on 11 August 2004: see Addendum to Taxation Ruling TR 98/22 issued on 11 August 2004.