# PART IVA & ANTI-AVOIDANCE – WHERE ARE WE NOW?*

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Part IVA has produced many articles. This article discusses the current interpretation of elements of Part IVA. It focuses on the meaning of a Scheme, the tax benefit obtained in connection with the Scheme, and the dominant purpose in entering into a Scheme. It is timely, given the spate of recent cases.

If the title to this article looks a little familiar, you are not mistaken. From the time the High Court of Australia was first called upon to construe the provisions of Part IVA,[1] and consider their application to a given set of facts, we have seen an avalanche of articles and papers with similar titles. Some of these include:

Part IVA: Commentary on Key Issues (after *Peabody*)[2]

Part IVA: Where to Draw the Line[3]

Part IVA: The *Spotless* Case[4]

The 'New Improved' Part IVA[5]

Part IVA after the *CPH* Case[6]

Part IVA: Future Issues[7]

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* This is an edited version of a paper the author delivered to the Taxation Chapter of the Business Law Section of the Law Council of Australia at the Hyatt Regency, Coolum, Queensland on 9 November 2002.

1 *FC of T v Peabody* (1994) 181 CLR 359.

2 M D'Ascenzo, Vol 4, *Taxation in Australia* ('TIA'), (Red Ed) No 3 (Feb 1996) 129.

3 M Carmody, National Convention of the Tax Institute of Australia ('Tax Institute'), 19-21 March 1997, reprinted in TIA Convention Papers, 1996-1997, 176.

4 J Emmerson QC, ibid 187.

5 M Brabazon, Vol 1, *The Tax Specialist* No 1 (Aug 1997) 28.

6 GT Pagone QC, Tax Institute, Victorian Convention 2001, reprinted in TIA Convention Papers 133.

7 GT Pagone QC, Tax Institute, Victorian Convention, 2002, September 2002 (unpublished).

The authors of these publications and others[8] have, to a greater or lesser extent, sought to find enlightenment from the reasoning in the cases that have been decided from and including *Peabody*, in the hope that guidance will be forthcoming as to the proper construction of Part IVA and its application to a given set of facts. As each new case is decided, new writings appear which seek to reconcile the decision, and the reasons for the decision, with earlier decisions and the reasons underlying them; and to make predictions as to the future, a task which, if not impossible, is akin to being asked to predict the unpredictable.

## Uncertainty of application

Accepting that one can discern a certain distillation of principle emerging from decided cases in relation to the proper construction of the critical provisions of Part IVA why, it may be asked, is there still so much uncertainty, and indeed difference of opinion, as to its application in a given case? [9]

There are a number of reasons for this, not the least of which is that whether or not Part IVA applies in a given case, will depend on the facts of that case. This adage is somewhat trite, but so often it is forgotten. Where the application of a provision such as Part IVA is so dependent on the relevant findings of fact, it is not surprising that the end conclusion to be drawn in terms of s 177D uncertain.

The uncertainty as to outcome is exacerbated by the need to evaluate these primary findings of fact against eight objective criteria for the purpose of drawing the ultimate conclusion. This is very much a judgmental exercise and fertile ground for different views.

Another reason for the uncertainty which attends the application of Part IVA is that the Commissioner, in his administration of the *Income Tax Assessment Act*, has arguably sought to apply it to cases to which it was never intended to

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8 There have been many others, including: 'Tax Avoidance Legislation & the Prospects for Part IVA', D Mossop 21 TIA (June 1997) 70; 'Anti-Avoidance Principles – New Directions for Tax & Business Resulting from the High Court Decision in *Spotless*', A Greenbaum, (1997) 25 *Australian Business Law Review*, 142; '*Spotless*: A Lesson in Form and Substance but not in Substance over Form', J Azzi, (1998) 8 *Revenue Law Journal* 175; 'Part IVA of the Income Tax Assessment Act after *Spotless* – a Brave New World?', MJ Watts, (1998) 72 *Australian Law Journal*, 303; 'Tax Planning & Tax Avoidance', GT Pagone QC, 29 *Australian Tax Review* (June 2000) 196; 'Part IVA and the Commonsense of a Reasonable Person', M D'Ascenzo, 37 TIA No 2 (Aug 2002) 70.

9 This is, arguably, best exemplified in position papers issued by the ATO in cases under audit and the decisions of the internal ATO Part IVA Panel on the one hand, and the position taken by advisers for the taxpayers concerned on the other.

be applied – to arrangements which are neither 'blatant, artificial or contrived'. I say arguably, because this is very much a subjective view on my part. Others, particularly those from within the Commissioner's office, will undoubtedly refute this view. On the other hand, in the Explanatory Memorandum to the Bill[10] circulated by the then Treasurer, it was acknowledged that these words – blatant, artificial or contrived – were, in legal terms, inexact. That inexactness also provides fertile ground for differences of opinion as to whether a particular arrangement is blatant, artificial or contrived. The Commissioner's apparent zeal to rely on Part IVA as an alternative ground of assessment or as a ground of last resort is no doubt motivated by its perceived interrorem effect (in particular the penalty regime its application triggers) and/or the forensic advantages in relation to discovery and other interlocutory processes that might not otherwise be secured. In a number of cases I have seen, the Commissioner's relevant redress should have been confined to reliance on a specific anti-avoidance provision or, if one did not exist, to promote its introduction, rather than rely on the 'backstop' of Part IVA.[11] The consequence of him not doing so has, in my view, led to greater uncertainty in its application.

A further reason for the uncertainty in application is the way in which the principles to be drawn from the decision of the High Court in *FC of T v Spotless Services Ltd*[12] have been extrapolated and applied by the Commissioner to what might be called 'structured transactions'[13] – those which carry a tax benefit compared to an alternative form of transaction which achieves the same commercial objective. This has manifested itself in cases such as *WD & HO Wills Ltd v FC of T,*[14] *FC of T v Consolidated Press Holdings Ltd,*[15] *C of T v Metal Manufactures Ltd,*[16] *Eastern Nitrogen Ltd v C of T*[17] and, most recently, *Hart v FC of T.*[18] Taxpayers have succeeded in all but one of these cases.

10 Which became Act No 110 of 1981.

11 The Treasurer's Second Reading Speech on the Bill introducing Part IVA into the Act recognized that certain arrangements were beyond the appropriate scope of general anti-avoidance measures and ought, if need be, to be dealt with by specific measures.

12 (1996) 186 CLR 404.

13 This is not my term – see GT Pagone QC, above.

14 (1996) 65 FCR 288, albeit decided before the High Court decision in *Spotless*.

15 (2001) 179 ALR 625.

16 (2001) 108 FCR 150.

17 (2001) 108 FCR 27.

18 [2002] ATC 4608.

## Identification of the scheme

This is a critical aspect to the application of Part IVA, as recent decisions demonstrate.

In my experience, the identification of the scheme at the time of audit and assessment is likely to bear little resemblance to the identification of the scheme that goes to trial.[19] The best example of this is the *CPH* case, where the scheme to be relied upon was still being 'massaged', in the sense of being confined, on the doorsteps of the court. But as the High Court said in *Peabody*:[20]

> the Commissioner is entitled to put his case in alternative ways. If, within a wider scheme which has been identified, the Commissioner seeks also to rely upon a narrower scheme as meeting the requirements of Part IVA, then in our view, there is no reason why the Commissioner should not be permitted to do so (see *X Co Pty Ltd v FC of T* (1971) 124 CLR 343 at p 349 per Gibbs J), provided it causes no undue embarrassment or surprise to the other side. If it does, the situation may be cured by amendment, provided the interests of justice allows such a course (*Bailey v FC of T* (1977) 135 CLR at p 219).

A little later, the High Court said:[21]

> Part IVA does not provide that a scheme includes part of a scheme and it is possible, despite the very wide definition of a scheme, to conceive of a set of circumstances which constitutes only part of a scheme and not a scheme in itself. That will occur where the circumstances are incapable of standing on their own without being 'robbed of all practical meaning' (see *IRC v Brebner* [1967] 2 AC 18 at p 27). In that event, it is not possible in our view to say that those circumstances constitute a scheme rather than part of a scheme merely because of the provisions made by ss 177D and 177A. The fact that the relevant purpose under s 177D may be the purpose or dominant purpose under s 177A(5) of a person who carries out only part of the scheme is insufficient to enable part of a scheme to be regarded as a scheme on its own. That, of course, does not mean that if part of a scheme may be identified as a scheme in itself the Commissioner is precluded from relying upon it as well as the wider scheme.

This passage has, of course, been relied upon by the Commissioner in subsequent cases to identify a scheme far more confined than that upon which he originally assessed.

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19 Usually this is a direct result of the involvement of independent counsel for the first time, whose focus is likely to be more finely honed.

20 Above n 1, 382-3.

21 Above n 1, 383-4.

By the time the *CPH* case got to court, the scheme relied upon by the Commissioner had been confined to two steps:

1. The acquisition by ACP (subsequently CPH Property) of redeemable preference shares in MLG; and
2. the acquisition by MLG of redeemable preference shares in CPIL(UK).

This was the way in which Hill J, at first instance, described[22] the Commissioner's articulation of the scheme relied upon, although in the Full Court it was described 'compendiously as the interposition of MLG between ACP and CPIL(UK)'.[23]

At first instance, Hill J said:[24]

> When one comes to apply the test in s 177D(1)(b) it is clear that there are two purposes which can be seen to have driven the scheme as identified by the Commissioner. The use of various tax haven companies would, if one looked at the overall scheme, suggest tax avoidance in the generally accepted meaning of that term. But it is not the wider scheme upon which the Commissioner chooses to fasten. …
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> It might perhaps be said that one of the problems in the present case lies in artificially dissecting part of a scheme from a totality of the scheme adopted. The arrangement as a whole was directed to a commercial end much more significant than tax. Part of the structure was devised because of tax, but the separating out of the tax and non-tax benefits leaves outside the structure both the borrowing of ACP and the subscription of monies for shares by CPIL(UK). That, however, is a consequence of the decision of the High Court in *Spotless*.

Hill J's view in this regard was confirmed when the case went up to the High Court. The High Court said:[25]

> Objection was also taken to what said to be the artificiality of the selection of part of the overall transaction as the scheme. This, it was said, was not warranted by *Peabody* or *Spotless*. The artificiality was said to result from the fact that the overall transaction was for the clearly commercial purpose of financing the group's participation in the takeover for BAT. However, as was held in *Spotless* (1996) 186 CLR 404 at 415 per Brennan CJ, Dawson, Toohey, Gaudron, Gummow and Kirby JJ, a person may enter into or carry out a scheme, within the meaning of Part IVA, for the dominant purpose of enabling the relevant taxpayer to

22 *CPH Property Pty Ltd v C of T* (1998) 88 FCR 21 at 40E.
23 *C of T v Consolidated Press Holdings Ltd* (No 1) (1999) 91 FCR 524 at 548, para 81.
24 At 41, 42.
25 Above n 15, 643, 644 , para [96].

> 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. Nor is there any inconsistency involved, as was submitted, in looking to the wider transaction in order to understand and explain the scheme and the eight matters listed in s177D.

The argument concerning artificial dissection of the scheme aside, there was no issue in the *CPH* case that the confined scheme ultimately relied upon was incapable of standing on its own feet without being 'robbed of all practical meaning', notwithstanding that the transaction (the borrowing by ACP) giving rise to the tax benefit (the interest deduction) sought to be cancelled, fell outside the scheme so identified.

In this respect, the scheme in the *CPH* case stands in contrast to the narrower of the two schemes identified and relied upon by the Commissioner in the recent Full Court decision in *Hart*. In that case, the Commissioner in his Statement of Facts, Issues & Contentions, initially formulated his case by reference to what may be referred to as the 'wider scheme'. He repeated this identification of the scheme in the written submissions made at first instance. The wider scheme so formulated included the making of the loan. At the hearing at first instance, the Commissioner relied on an alternative identification of the scheme, which may be referred to as the 'narrower scheme'. So formulated, the narrower scheme was:

> The provision in the loan for the division into two portions and the direction of the repayments to one or other portion and the direction by the applicants of the repayments to the home loan portion.

In commenting on the alternative formulation, Hill J said:[26]

> The definition of the scheme is very important. Any tax benefit which is identified must have a relationship to the defined scheme and not some other scheme. The conclusion of dominant purpose must be made by reference to the defined scheme, not some other scheme. Any determination made by the Commissioner must, likewise, be made by reference to the defined scheme and not some other scheme.
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> As can be seen from the definition of scheme set out earlier the word 'scheme' is widely defined. It may be as wide as a course of conduct or as narrow as a single act. It is, as the High Court made clear in *Federal Commissioner of Taxation v Peabody* (1994) 181 CLR 359, for the Commissioner, at least initially, to determine between any narrow or broad definition of scheme and, subject to matters of unfairness, the

26 At paras 41-45.

Commissioner may change his mind. There are, perhaps, however, two qualifications to this. The first is that whatever the Commissioner may put forward as the scheme it must be such that a tax benefit has been obtained in connection with it by the taxpayer. The second, is that the Commissioner could not take a set of circumstances which constituted only part of a scheme *'the circumstances are incapable of standing on their own without being 'robbed of all practical meaning'.'* The words italicized derive from *Inland Revenue Commissioners v Brebner* [1967] 2 AC 18 at 27 and are quoted by the High Court in *Peabody* at 383-4. It is not completely clear whether the High Court intended by the quotation merely to adopt the language of the House of Lords in *Brebner*, or whether they did so by reference as well, to the facts of that case. The legislation under consideration in *Brebner* was rather different from Part IVA. Be that as it may the case involved an interrelated transaction being both the acquisition of shares with borrowed funds and a corporate reduction capital, which provided the funds whereby the loan could be repaid. It was held that the Commissioner could not single out the reduction of capital as the relevant transaction divorced from the share acquisition, notwithstanding that the reduction of capital produced an advantageous tax consequence. It was necessary to take the overall transaction for each part of it was interrelated.

Perhaps because the alternative or narrow definitions propounded by the Commissioner were somewhat abbreviated, there is some ambiguity in them. On one view the alternative definition appears to ignore the making of the loan and the incurring of interest under it, thus excluding them from being part of the scheme. Indeed, in oral argument, senior counsel for the Commissioner appeared prepared to defend a definition of the scheme as excluding the loan and submitted that, however the scheme was defined, Part IVA applied to it on the facts of the present case. It is possible that the learned primary judge took a similar view.

In my view, however, whether a wider or narrower definition of the scheme revealed by the present fact is adopted, it is clear that the definition of a scheme which did not include the loan itself and the incurring of interest under it could not stand on its own feet. It is the loan and the application of funds under it which gives rise to the deduction for interest, even if it is the way the loan is structured that is fastened upon by the Commissioner as indicating the tax avoidance conclusion.

While it is clear that it is possible to define the scheme here involved in a way that is narrower than the broader scheme propounded I would find that the relevant scheme was the broader scheme which commenced with the marketing of the 'Wealth Optimiser' loan to Mr and Mrs Hart and concluded with the incurring in the years of income in question of interest on Loan Account 1 and the repayment of capital and interest on Loan Account 2.

To like effect, Hely J said:[27]

> 'Scheme' is defined in s 177A in very broad terms, including a plan or proposal, without any pejorative innuendo or connotation of tax avoidance. Whether a scheme is one to which Part IVA applies is to be determined by reference to s 177D.
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> The definition of the relevant 'scheme' is important for the reasons which have been explained by Hill J. The more the scheme can be confined to the essential elements by which the tax benefit is obtained, the more likely it will be that the conclusion will be drawn that the dominant purpose for a person entering into a scheme so defined was to obtain the tax benefit.
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> Thus, if in the present case the 'scheme' were defined as the 'plan, proposal, action or course of conduct' whereby monies were borrowed on the terms of the 'Wealth Optimiser' structure, rather than on the terms of the 'Standard' loan package, or some other form of financing, then it might be easy to conclude that the dominant purpose of entering into the scheme so defined was to obtain a tax benefit in connection with the scheme.
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> That is, I think, the approach which was taken by the primary judge. But that approach effectively leaves out of account the fact that the 'scheme' necessarily included the borrowing of moneys for use in financing and refinancing the two properties. I say 'necessarily' because *Federal Commissioner of Taxation v Peabody* (1993-1994) 181 CLR 359 at 383-384 establishes that the relevant scheme cannot be so narrowly defined as to rob it of its practical context.

*Hart* is, at the time of writing, the subject of an application by the Commissioner for special leave to appeal to the High Court.

## The tax benefit obtained in connection with the scheme

In practice, this aspect of Part IVA carries the greatest difficulty for taxpayers in discharging the onus they carry to show that Part IVA has no application.

The terms of subsection 177C(1) make it clear that the task is to determine what would, or might reasonably be expected to, have happened if the scheme had not been entered into or carried out, and to identify and, in some cases, quantify, the tax benefit obtained in connection with the scheme by reference to that hypothetical construct.

27 At paras 84-87.

In *Peabody*, the High Court said:[28]

> A reasonable expectation requires more than a possibility. It involves a prediction as to events which would have taken place if the relevant scheme had not been entered into or carried out and the prediction must be sufficiently reliable for it to be regarded as reasonable.

The difficulty for taxpayers in this area is that if the Commissioner identifies an expectation which is reasonable, then in the absence of the taxpayer adducing evidence to show why the expectation is not reasonable, the taxpayer must fail on this aspect. The Commissioner does not have to show that the prediction upon which he relies is the most reasonable of a number of reasonable predictions, merely that it is a reasonable expectation as to what would have occurred but for the scheme.[29] It is for the taxpayer to show that the expectation is not reasonable because of matters in evidence before the court. In this regard, I speak from experience when I say that speculation, conjecture or surmise from the bar table carries no weight.

In many cases, taxpayers will enter into transactions without regard to what they might have done but for what they did. In such cases, there will be no evidence that can be adduced to rebut the Commissioner's reasonable expectation. Alternatively, there may be evidence of a range of alternatives all of which may be seen as reasonable expectations, but no one of which is more likely than the others. The Commissioner's selection of one of those alternatives, or some other reasonable expectation, will, more likely than not, withstand attack because of the state of that evidence.

A number of decided cases illustrate the point, but before going to them, and at the risk of repeating myself, it is important to bear in mind that the words of subsection 177C(1) are: 'the obtaining by a taxpayer of a tax benefit *in connection with* a scheme'. As the *CPH* case illustrates, it is not necessary that the tax benefit flow from a transaction which is part of the scheme relied upon by the Commissioner; it is necessary, however, that the tax benefit satisfy the criterion of having been obtained *in connection with* the scheme.

Before going to some of the cases as illustrations of the points made above, it goes without saying that a prediction as to events which would have occurred if the scheme had not been entered into or carried out which itself is susceptible to attack under Part IVA, would hardly advance the taxpayer's cause. In this

28 Above n 1, 385.

29 Of course, if a taxpayer can adduce evidence to show that an alternative hypothesis is a more reasonable expectation than that relied upon by the Commissioner, that may discharge the onus; on the other hand, it may not.

regard, the observations of Beaumont J when *Spotless* was in the Full Court,[30] and Sackville J in *WD & HO Wills*[31] are instructive.

It is convenient to go to the decision in *WD & HO Wills* as the first illustration of the points made above concerning the difficulty of taxpayers in discharging the onus they carry on this particular aspect of Part IVA. Having regard to his conclusion on the s 177D issue, it was not necessary for Sackville J to consider whether Wills obtained a tax benefit in connection with the scheme. Accordingly, what he said was obiter, however, what he did say illustrates the problem. His Honour said[32]:

> Mr Ellicott submitted that it was a reasonable expectation that Wills would have obtained coverage from another captive. However, as I understood him, he accepted that Wills' position would not have been advanced had that captive been located outside Australia. This is because there would simply have been a new scheme relevantly identical to the scheme actually implemented, with only the location of the captive being different.
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> Alternatively, Mr Ellicott submitted that, even if Wills had acted as a self-insurer, it 'may well' have claimed deductions by making allowances for the claims incurred but not reported and claiming deductions in respect of those allowances.
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> On the evidence before me, I would have concluded that a reasonable prediction, had the scheme not been entered into or carried out, is that Wills would have simply taken the risk of claims being made against it by persons claiming to be adversely effected by its cigarette products. The various alternatives posed by Mr Ellicott are all possibilities, but I could not regard any of them as a reliable prediction, at least in the absence of further evidence. It must be remembered that the options available to Wills and Amatol were limited, because the health risk was not insurable on the open market. There was no evidence to suggest that Wills would have made allowances for IBNRs if the proposal for a Singapore based captive did not proceed. Moreover, s 14ZZO of the *Taxation Administration Act* imposes upon an appellant the burden of proving that the taxation decision under challenge is excessive.
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> Accordingly, if it had been necessary to do so, I would have found that Wills obtained a taxation benefit in connection with the scheme.

30 (1995) 62 FCR 244 at 270F.
31 Ibid 339D.
32 Ibid 339.

The *CPH* case also illustrates the problem taxpayers face in this area. At first instance, Hill J said:[33]

> It is reasonable to expect that had the scheme as defined not been entered into or carried out ACP would have subscribed for shares in CPIL(UK) or made loans to that company. Neither alternative matters for the present analysis, although I should think it more likely than not that the investment would have been by way of shares, since that was the way the actual investment by MLG into CPIL(UK) was structured. Why would it be reasonable to expect anything else if ACP had invested directly?

There are number of difficulties with what his Honour says in this passage,[34] however, the fact remains that no evidence was adduced by the taxpayer as to what alternatives it had under consideration if it did not do what it actually did, viz, take up redeemable preference share in MLG. Consequently, there was no evidence to rebut the Commissioner's contention that it was a reasonable expectation that but for what ACP did, it would have taken up redeemable preference shares in CPIL(UK). I believe that this highlights the problem in its starkest form.

When the case went up to the Full Court, the Full Court dealt with it in the following way:[35]

> There is no doubt a large range of factual circumstances that may require consideration when hypothesizing under s 177C(1), the alternative to a scheme being entered into or carried out. If the scheme is a severable component of a larger array of transactions which have been arranged or executed, the fact that they were arranged or executed can offer support for the hypothesis that they would or might reasonably be expected to have stood absent the scheme. The condition that the scheme be severable assumes that the remaining transactions are commercially and legally possible. If that assumption is falsified, then the hypothesis as to what would or might reasonably be expected to have happened may have to cope with a wider range of possibilities. But that

33 At 40G.

34 With respect, the premise in the last sentence, viz, 'if ACP had invested directly?', is devoid of reality. Why is it a reasonable expectation that but for what the taxpayer did the taxpayer would have done something which clearly attracted the operation of s 79D, ie, by investing more directly. It was not as if there were no other indirect forms of investment available to the taxpayer and it ignored the taxpayer's argument that if its purpose, objectively discerned, was the avoidance of the quarantining operation of s 79D, why is it a reasonable expectation that the taxpayer would do something more likely to attract the operation of the section sought to be avoided? The Full Court acknowledged the argument but did not address it, while the High Court did not even acknowledge it.

35 At 550, paras 87-89.

> is not this case. His Honour properly relied upon the way in which the 'actual investment by MLG into CPIL(UK) was structured'.
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> ACP argues that having taken the steps it did so that, on the Commissioner's hypothesis, s 79D would not apply, it was not reasonable to suppose that, absent those steps, it would have chosen an alternative to which s 79D did apply. There were investment choices open to ACP which did not attract the operation of s 79D, the simplest example being a loan at interest by CPF direct to CPI(Sing) or a loan from ACP to CPI(Sing). The Commissioner on the other hand contended that, had the scheme not been entered into, ACP would have invested in shares in CPIL(UK) as the means by which it would have provided the necessary funds from it to CPIL(UK). Investment in share capital was the means adopted by ACP and by MLG for the provision of funds. It was reasonable to expect that the same method would have been adopted in the absence of the scheme. As to ACP's suggestion about other ways in which funds could have been provided which would have avoided the operation of s 79D, for example a loan from CPF to CPI(Sing) or a loan from ACP direct to CPI(Sing), *there was no evidentiary basis for those submissions. Those alternative ways of structuring the broader transaction were said by the Commissioner to be 'mere speculation'.* The Commissioner argued that it is not legitimate in considering what might reasonably be expected to have taken place had the scheme not been entered into, to take into account the taxpayer's purpose of obtaining the tax benefit to which the scheme was directed. He also submitted that *there was no evidentiary basis for the other ways suggested by ACP* in which funds could have been provided which would have avoided the operation of s 79D, such as loans to CPI(Sing) directly from CPF or ACP. Hill J's findings as to the reasonable expectation of what would have occurred had the scheme not been entered into was a valid inference from what did in fact happen.
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> In the event the hypothesis is probably justified that, absent the scheme, the outgoing by way of interest to CPF would have existed and would not have been allowable. The hypothesis is certainly justified that absent the scheme that deduction might reasonably be expected to have existed and not have been allowable. The condition set out in s 177D(a) for application of Part IVA to the scheme is satisfied, namely the taxpayer obtained or would, but for s 177F, have obtained a tax benefit in connection with the scheme. [Emphasis added]

I believe that these extracts from the reasons for judgment of Hill J at first instance, and the Full Court on appeal, illustrate the difficulties taxpayers face if they are not in a position to adduce evidence as to the alternatives they would have pursued had they not pursued the course being assailed, and for some evidence to exist as to the priority of those alternatives. In *CPH*, there was absolutely no evidence that could be adduced in that regard and, in consequence, the taxpayer failed on this particular issue. In the result, it was a fatal failure.

The final case I wish to refer to on this aspect is the recent decision of the Full Court in *Hart*. The relevant passage appears in the judgment of Hill J with whom Hely and Conti JJ agreed, where his Honour said:[36]

> It is submitted by senior counsel for Mr and Mrs Hart and indeed, it was accepted by the Commissioner and the learned primary judge that Mr and Mrs Hart would have proceeded with the borrowing of money to purchase the Fadden property and refinance the Jerrabomberra property. The Commissioner submitted, and the learned primary judge found, that they would have borrowed on the basis that (whether there was one borrowing or two) the borrowing would be on terms that Mr and Mrs Hart would have made monthly repayments of principal and interest, so that interest would have been spread rateably over the total of the borrowed monies in the proportion that these monies were used to purchase the Fadden property and refinance the Jerrabomberra property. The learned primary judge referred to such a borrowing as a 'credit foncier arrangement'. On behalf of Mr and Mrs Hart it was submitted that it could reasonably have been expected that Mr and Mrs Hart would have refinanced the Jerrabomberra property with an interest only loan if they had not proceeded with the Wealth Optimiser finance package.
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> His Honour said that it was more probably than not that any alternative financing would not have included the payment of interest upon capitalized interest upon a loan in relation to the Jerrabomberra property. Subject to substituting the word 'incurring' for 'payment' this is accepted by counsel for Mr and Mrs Hart. However, it was submitted that the learned primary judge erred in holding that there was no support in the evidence for holding that Mr and Mrs Hart would have refinanced the Jerrabomberra property with an interest only loan. It is pointed out that his Honour found that one of the alternatives available through the ANZ Bank, that is to say, the bankers for Mr and Mrs Hart, was an interest only loan. However, it is clear that Mr and Mrs Hart did not pursue alternatives open to them, whether through the Bank or other financiers because they were attracted by the Austral package.
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> In my view the evidence does not really allow one to predict on any reasonable basis whether Mr and Mrs Hart would have financed the two transactions which they wished to undertake both by a loan repayable with principal and interest or whether they would have financed the Fadden acquisition with a loan repayable with both principal and interest and the Jerrabomberra refinancing with an interest only loan. There would be advantages and disadvantages of both forms of financing. *Given that the onus of showing that the assessment was excessive lies upon the taxpayer it seems to me that the finding made by his Honour should not be disturbed. It was a finding open to him.* The difference between the two views is that the view propounded by senior

36 At paras 47-49.

> counsel for Mr and Mrs Hart would leave the tax benefit in question as confined only to the compound interest – a relatively trivial amount. By contrast, the view of tax benefit propounded by senior counsel for the Commissioner would leave the tax benefit as not merely the tax on the compound interest but also the amount of interest representing the difference between the interest payable on the principal sum applied to refinancing Jerrabomberra calculated as if there had been rateable principal and interest payable on that sum and the interest in fact claimed as a deduction. [*Emphasis*]

## The s 177D conclusion

In *Spotless* the members of the High Court who delivered the joint judgment said:[37]

> The eight categories set out in par (b) of s 177D as matters to which regard is to be had 'are posited as objective facts' (*Peabody*). That construction is supported by the employment in s 177D of the phrase 'it would be concluded that …'. This phrase also indicates that the conclusion reached, having regard to the matters in par (b) as to the dominant purpose of a person or one of the persons who entered into or carried out the scheme or any part thereof, is the conclusion of a reasonable person. In the present case, the question is whether, having regard, as objective facts, to the matters answering the description in par (b) a reasonable person would conclude that the taxpayers entered into or carried out the scheme for the dominant purpose of enabling the taxpayers to obtain a tax benefit in connection with the scheme.

In short, this has been interpreted in subsequent cases, correctly in my view, as requiring a conclusion to be drawn under s 177D which depends entirely upon objective facts to the exclusion of subjective motivation of any of the parties to the scheme, which is irrelevant to the conclusion.

The conclusion to be reached must relate to the dominant purpose of a person who either entered into or carried out the scheme or part of it. According to the joint judgment in *Spotless*, a purpose will be dominant if it is 'the ruling, prevailing or most influential purpose'.[38]

37 Above n 12, 421, 422.
38 Above n 12, 416.

Moreover, the fact that the transaction was commercial does not require the conclusion that the dominant purpose would fall outside Part IVA, for there is no true dichotomy between schemes which are commercial and those which are tax driven. In the words of the joint judgment in *Spotless*: [39]

> A person may enter into or carry out a scheme, within the meaning of Part IVA, for the dominant purpose of enabling the relevant taxpayer to obtain a tax benefit where that dominant purpose is consistent with the pursuit of commercial gain in the course of carrying on a business …
>
> … The United States Supreme Court stated that it could not 'ignore the reality that the tax laws affect the shape of nearly every business transaction' (*Frank Lyon Co v United States* (1978) 435 US 561 at 580). In Australia, State and Territory stamp duty laws have been a particularly significant factor in the shaping of business transactions. However, the tax laws are one part of the legal order within which commerce is fostered and protected. Another part is Part IV of the *Trade Practices Act 1974* (Cth), which regulates or proscribes certain restrictive trade practices. In this broad sense, '[t]axes are what we pay for civilized society', (*Compania de Tabacos v Collector of Internal Revenue* (1927) 275 US 87 at 100 per Holmes J) including the conduct of commerce as an important element of that society.
>
> A taxpayer within the meaning of the Act may have a particular objective or requirement which is to be met or pursued by what, in general terms, would be called a transaction. The 'shape' of that transaction need not necessarily take only one form. The adoption of one particular form over another may be influenced by revenue considerations and this, as the Supreme Court of the United States pointed out, is only to be expected. A particular course of action may be, to use a phrase found in the Full Court judgments, both 'tax driven' and 'bear the character of a rational commercial decision'. The presence of the latter characteristic does not determine the answer to the question whether, within the meaning of Part IVA, a person entered into or carried out a 'scheme' for the 'dominant purpose' of enabling the taxpayer to obtain a tax benefit.
>
> Much turns upon the identification, among various purposes, of that which is 'dominant'. In its ordinary meaning, 'dominant' indicates that purpose which was the ruling, prevailing, or most influential purpose. In the present case, if the taxpayers took steps which maximized their after-tax return and they did so in a manner indicating the presence of the 'dominant purpose' to obtain a 'tax benefit', then the criteria which were to be met before the Commissioner might make determinations under s 177F were satisfied. That is, those criteria would be met if the dominant purpose was to achieve a result whereby there was not included in the assessable income an amount that might reasonably be expected to be included if the scheme was not entered into or carried out.

39 At 415, 416.

In the result, the parties to the joint judgment concluded:[40]

> … a reasonable person would conclude that the taxpayers in entering into and carrying out the particular scheme had, as there most influential and prevailing or ruling purpose, and thus their dominant purpose, the obtaining thereby of a tax benefit in the statutory sense. The scheme was the particular means adopted by the taxpayers to obtain the maximum return on the money invested after payment of all applicable costs, including tax. The dominant purpose in the adoption of the particular scheme was the obtaining of a tax benefit. In reaching the contrary conclusion, or rather, placing the matter on a different footing, the majority of the Full Court fell into error. It is true that the taxpayers were concerned with obtaining what was regarded as adequate security for an investment made 'offshore'. However, the circumstance that the Midland Letter of Credit afforded the necessary assurance to the taxpayers does not detract from the conclusion that, viewed objectively, *it was the obtaining of the tax benefit which directed the taxpayers in taking steps they otherwise would not have taken by entering into the scheme* (*Emphasis*).

McHugh J reached a similar conclusion.[41]

The High Court had cause to reconsider what was said in *Spotless* in the *CPH* case. The relevant passage is extracted above, where the High Court emphasized that the fact the overall transaction was aimed at profit-making did 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. But there, the part of the structure of the transaction to be explained by reference to a s 177D purpose – the subscription by ACP for redeemable preference shares in MLG and the subscription by MLG for redeemable preference shares in CPIL(UK) – was capable of standing on its own feet without being 'robbed of all practical meaning', and therefore of constituting a scheme in itself without the need to be propped up by the borrowing by ACP. Absent that latter aspect from the scheme, it is difficult to see that the scheme as finally identified and confined had any non-fiscal purpose. Had it needed the prop of the borrowing by ACP to constitute a scheme capable of standing on its own feet, the s 177D conclusion that was drawn by the Federal Court, and upheld in the High Court, may have been very different.

In short, it is my opinion, that the *CPH* case was a special case where it was not only possible to identify a scheme which left outside it the very transaction giving rise to the tax benefit sought to be cancelled, but also the only

40 At 423.
41 At 425.

transaction capable of persuading a reasonable person to a different s 177D conclusion.

The contrast with the sale and leaseback cases of *Metal Manufactures* and *Eastern Nitrogen* illustrate the point. There the schemes relied upon by the Commissioner included both the sale and the leaseback with the consequence that the purpose of the raising of the funds by the sale had the potential to infect the s 177D conclusion. Had it been possible, and I am not suggesting it was, to exclude the sale from the scheme, a different s 177D conclusion might have been drawn.

In *Metal Manufactures* at first instance,[42] Emmett J analysed the principles flowing from the decision in *Spotless*, in particular, the acceptance that a person may enter into or carry out a scheme, within the meaning of Part IVA, for the dominant purpose of enabling the relevant taxpayer to obtain a tax benefit where the dominant purpose is consistent with the pursuit of commercial gain in the ordinary course of carrying on a business: *Spotless* at 415.

His Honour went on to say at paras 260, 261:

> Thus a taxpayer may have a particular objective or requirement that is to be met or pursued by a particular transaction. The shape of such a transaction need not necessarily take one form. It is only to be expected that the adoption of one form over another may be influenced by revenue considerations. However, the fact that a particular course of action may bear the character of a rational commercial decision does not determine the answer to the question of whether a person entered into or carried out a scheme for the dominant purpose of enabling a taxpayer to obtain a tax benefit – *Spotless* at 416. *Nor, in my opinion, does the fact that a taxpayer chooses one of two or more alternative courses of action, being the one that produces a tax benefit, determine the answer to that question.*
>
> Part IVA will be satisfied if it was the obtaining of a tax benefit that directed the relevant persons in taking steps they otherwise would not have taken by entering into the scheme – *Spotless* at 423; however, more is required than that a taxpayer has merely arranged its business or investments in a way that derives a tax benefit. The scheme must be examined in the light of the eight matters set out in s 177D(b). Further, that examination must give rise to the objective conclusion that some person entered into or carried out the scheme or part of the scheme for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit connection with the scheme. Such a conclusion will seldom, if ever, be drawn if no more appears than that a change of business or investment has produced a tax benefit for a taxpayer – *Spotless* at 425. Nor should such a conclusion be drawn if no more appears than that a

42 99 ATC 5229 at 5275, 5276.

> taxpayer adopted one of two or more alternative courses of action, being the alternative that produces a tax benefit.

With respect, his Honour's analysis of the principles to be extracted from the High Court's decision in *Spotless* is, in my view, absolutely correct. Certainly, Hely J thought so in *Hart* when he said:[43]

> A particular course of action may be both tax driven, and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine in favour of the taxpayer whether, within the meaning of Part IVA, a person entered into or carried out a 'scheme' for the dominant purpose of enabling a taxpayer to obtain a tax benefit: *Spotless* at 416. But nor does the fact that a taxpayer adopted one of two or more alternative courses of action, being the one that produces a tax benefit, determine the answer to that question in favour of the Commissioner: *Metal Manufactures* per Emmett J at 5275 (on appeal (2001) 108 FCR 150); *Spotless* at 425 per McHugh J; *IRC v Brebner*(1967) 2 AC 18 at 30 per Lord Upjohn.

In *Hart*, Hill J, with whom Hely J and Conti J agreed, summed up the s 177D conclusion in the following way:[44]

> There is no doubt that the Harts were aware of and wanted the tax deductions that were available for interest that was incurred on the Fadden loan. Others involved were similarly aware, and so far as they had any particular purpose in entering into or carrying out any part of the scheme, they played their part in ensuring that all the advantages of the scheme would be obtained. However, with all respect to his Honour, I do not think a reasonable person would conclude that any person entered into or carried out the scheme or any part of it for the dominant purpose of ensuring that Mr and Mrs Hart merely obtained a higher deduction for interest. On any view of the matter, the dominant purpose of the scheme which included the borrowing by the Harts of funds used to finance and refinance the two properties was the obtaining of funds to permit them to do so. In my view, the present case is similar to *Eastern Nitrogen* and distinguishable from *Spotless*. The scheme was directed to a commercial end, the borrowing of money for use in financing and refinancing the two properties. That is what a reasonable person would conclude was the ruling, prevailing or most influential purpose of the Harts in entering into or carrying out the scheme.

Some commentators[45] have suggested there is a tension between what his Honour here said and what was said by the High Court in the *CPH* case in the passage extracted at p 7, supra, particularly in the second last sentence of that extract. With respect, I disagree. At the risk of repeating myself, the scheme

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43 At para 81.

44 At para 73.

45 See paper by GT Pagone QC, above n 7.

identified in the *CPH* case was capable of standing on its own feet and did not need to be propped up by the borrowing by ACP. Absent that borrowing, the scheme had no commercial purpose and the fact that the wider transaction from which the scheme was identified was directed at a commercial end, did not prevent the Federal Court, and subsequently the High Court from drawing the conclusion that one or more of the persons who entered into the scheme did so for the dominant purpose of obtaining a tax benefit. The difference in *Hart* is that the Full Court concluded that any scheme identified absent the borrowing by the Harts could not stand on its own feet. Once that borrowing was identified and included as part of the scheme, it was inevitable, in my view, that the Full Court would come to the s 177D conclusion that it did.

As I noted earlier, the Full Court's decision in *Hart* is the subject of a special leave application by the Commissioner and, if that leave is granted, the prospect that a different conclusion might be reached is open. Beyond that, anything further I might say would be mere speculation.