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

Nicole Wilson-Rogers*

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

INTRODUCTION

Despite the existence of a substantial body of Part IVA case law, it can still be an extremely difficult task for a practitioner to determine if Part IVA will apply to a transaction. Many commentators have remarked on the significant uncertainty surrounding the application of Part IVA,[1] rendering taxpayers partially blindfolded when entering the self-assessment battleground. In what appears to be an attempt to

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

By targeting tax avoidance, Part IVA and GAARs in general occupy a unique position by aiming to tax amounts that "would otherwise not be caught" by the operative provisions of the relevant taxing act.[6] Furthermore, when a GAAR is enacted, the

Precondition One: A Scheme

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

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

It is also accepted that the Commissioner is entitled to advance a narrow scheme within the wider scheme, provided that, when the alternate formulation is introduced, it does not cause "undue embarrassment or surprise to the other party to the dispute."[22] PS LA 2005/24 interprets this requirement very liberally to mean that a reformulation of the scheme will only be impermissible after the close of evidence if it effects the evidence that the other party, to the dispute, might have presented.[23] This is a very biased interpretation of when the Commissioner changing the formulation of the scheme will result in unfairness to the taxpayer to the dispute. It would appear reasonably arguable that a taxpayer could assert that the point at which the Commissioner should be precluded from changing the formulation of the scheme arises at an earlier time in the litigation process. The taxpayer could argue that they

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

General guidance for formulating the counterfactual

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

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

More than one counterfactual

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

The counterfactual and discretion

The difficulties with identifying the counterfactual are intensified where discretionary powers are involved in the scheme. For example, in respect of

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

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

The "amount" of a tax benefit

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

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

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

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

> It is submitted that sec 177C(1)(a) does not apply to these characterisation schemes as they do not involve any overall reduction in a taxpayer's assessable income. This argument is based on the proposition that the

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

exception for taxpayers. Hartigan J referred to the section in *Case W58*[54] as the: "escape hatch to Pt IVA."

There has, however, been little judicial consideration of this exception. In *Case W58*[55] the Tribunal held that the mere recognition of trusts by the ITAA 1936 did not mean that the use of a trust to divert income was a choice "expressly provided for" by the Act. The recent AAT decision in *Case 1/2006*[56] also considers s 177C(2) briefly. In *Case 1/2006* the taxpayers argued that the tax benefit they obtained (an uplift in the cost base of their shares) was attributable to an election made under Division 122-A of the ITAA 1997 and therefore, was not an exception to the definition of a tax benefit under section 177C(2). The AAT, however, rejected this argument stating that the tax benefit resulted from the steps or arrangements entered into after the election was made. Thus, the decision in *Case 1/2006* appeared to focus on the words "attributed to" and the AAT held that the tax benefit could not be attributed to the election. The AAT were interpreting the words "attributed to" as requiring (not surprisingly) a nexus between the election made and the tax benefit. The exact strength of the nexus necessary between the election and the tax benefit may however be a matter for some debate in the future.

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

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

Purpose in s 177C(2)

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

> However, in contrast to the provisions of sec. 177D(b), there are no statutory directions as to what matters regard should be had in determining the purpose for which the scheme was entered into or carried out. It is thought, therefore that the "dominant purpose" in sec. 177C(2)(a)(ii) and (b)(ii) Purpeit ibs2

> taxpayer's own statements, because the conclusion which has to be reached is a conclusion having regard to certain specified matters that do not include any statements by the taxpayer.
>
> As pointed out in *Pascoe v FCT* by Fullager J (1956) 11 ATD 108 at p 111, where a person's purpose has to be determined, the statements of that person in a sense provide the best evidence but, for obvious reasons, they must be tested more closely and received with the greatest caution. Nevertheless, in the absence of specific provisions as to the matters to which regard has to be had in determining the purpose for which a person enters into or carries out a scheme, it is thought that it is the subjective purpose of that person which has to be determined…[59]

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

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

Precondition Three: Dominant Purpose Test – The Tunnel

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

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

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[59] Ibid, 45.

[60] PS LA 2005/24 provides at paragraph 86:

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

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

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

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

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

Group One: Scheme Implementation

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

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

Factor 2: Form and Substance

Factor two requires that the "substance of what is being done" be considered and compared to the form that the transaction takes. Where there is a discrepancy between the commercial or practical effect of the scheme and its legal form, this would point towards a conclusion that Part IVA would apply, particularly if the scheme could be achieved in a more straightforward or commercial manner. PS LA 2005/24 states that[67]:

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

Factor 3: Timing Issues

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

Group 2: Scheme Effect

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

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

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[66] See *Federal Commissioner of Taxation v Consolidated Press Holdings* 2001 ATC 4343; *Federal Commissioner of Taxation v Hart* (2004) 217 CLR 216; *Sleight* 2004 ATC 4477.
[67] See Paragraph 96 of PS LA 2005/24.
[68] *Federal Commissioner of Taxation v Sleight* 2004 ATC 4477.
[69] See paragraph 101 of PS LA 2005/24.
[70] See page 2 of the Guide.

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

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

> the change in the position of the taxpayer may mean little if there is an inverse change in the position of anothea5(ition-0.0017 Tc0.19a1.1437 3.7(ses to de4-5.3(ttle if)IVA qtsci6437oa

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

Issues regarding the balancing act

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

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

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

When should the question as to purpose be tested?

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

The Full Federal Court in *Vincent*[88] state:

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[78] Cooper above n 27.
[79] (2004) 55 ATR 183.
[80] 2005 ATC 5050.
[81] 2005 ATC 2254.
[82] (2004) 55 ATR 183.
[83] 2005 ATC 5050.
[84] 2005 ATC 2254.
[85] (2004) 55 ATR 183.
[86] See page 1 of the Guide.
[87] 2002 ATC 4742.

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

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

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

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

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

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

Conclusion of Fact

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

Conclusion of a Quasi Discretion

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

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[88] Ibid, 4760.

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

[90] Chang Ibid; Momsen Ibid.

[91] Chang above n 89, 154.

[92] 2003 ATC 4272.

[93] (1994) 181 CLR 359

[94] 2003 ATC 4272.

[95] Chang above n 89, 154. Chang states:

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

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

Conclusion of law

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

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

AN EXERCISE OF THE COMMISSIONER'S DISCRETION

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

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

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

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

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[96] Ibid.
[97] 2001 ATC 4164.
[98] (2004) 217 CLR 216.
[99] Chang above n 89.
[100] Cooper above n 29.

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

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

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

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

Finance Facilities involved the application of s 46(3) of the ITAA 1936. Section 46(3) sets out certain circumstances where the Commissioner "may allow" a shareholder a rebate for dividends. Subsection 46(3) states that the Commissioner "may allow" the 3 ha6(eTT4 1 d2i27-4.1 v7(Te52plmtn7)-TGhe1en(.14se1Ca9w(1 v7(Tei1a4x [hectTei1a4xitTei1g56a

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

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

Section 46(3), is structurally different and has a different intended operation, from Part IVA. Unlike s 46(3), s 177F is separate from the sections in Part IVA that deal with the preconditions. Accordingly, s 177F does not have any conditio5.6(yTJTsdingl)5.6(y)-7.2(re)8(r)-

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

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

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

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

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

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

[109] Brabazon above n 89, 34. Also see Murphy above n 103, 204.
[110] Murphy above n 103, 205.
[111] Murphy above n 103, 205.

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

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

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

Another factor the Commissioner may take into account when deciding whether to exercise his discretion under s 177F is the maintenance of "economic parity" between transactions. For example, in the recent case of *Cumins v Commissioner of Taxation*[112] Mr Cumins claimed a capital loss under Part 3-1 of the ITAA 1997 for a transaction that resembled an ordinary, widely accepted, profit washing transaction. Mr Cumins owned shares which were mortgaged to the bank. Under the terms of the agreement

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

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

THE COMPENSATING ADJUSTMENT PROVISIONS

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

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

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

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

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

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

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

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

Thus, it could be said that where it was found that it was "fair and reasonable" to do so the Commissioner would be compelled to make a compensating adjustment. If this is the case, it highlights the difficulties in applying

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

"Fair and reasonable"

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

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

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

Timing of a compensating adjustment

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

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

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

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

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

Similarly, Section 177B(4) states:

> Where a provision of this Act other than this Part is expressed to have effect where a deduction would otherwise be allowable to a taxpayer, that provision shall be deemed to be expressed to have effect where a deduction would, but for subsection 177F(1), be otherwise allowable to the taxpayer.

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

> Officers should be aware that Part IVA is a general anti-avoidance provision

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

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

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

The Guide emphasises that the arrangement

To explore the application of Part IVA to this scenario an analysis is undertaken

Precondition Three: Dominant Purpose

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

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

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

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

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

Case W58 stated:

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

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

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

There is no evidence pointing either way in re

> subject to a penalty. However as well as the underpaid tax, we may ask you to pay an interest charge[137]

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

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

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

[137] The first page of the Guide.