

The Riddle of the Sphinx

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G.T. Pagone^{*}

The invitation for me to speak at this conference came with a riddle about the operation of Part IVA. It seems that both the Commissioner and taxpayers are concerned about the difficulty in understanding and applying Part IVA. The Commissioner, it seems, believes the provisions have been misinterpreted and, in a recent application for special leave to appeal, his counsel contended that the recent construction of Part IVA “distorts the whole operation” of the provisions.¹ Taxpayers, it seems, are concerned, rather, that the way Part IVA has been applied goes too far. They do not seem to share the Commissioner’s view that Part IVA might be defective, but are concerned that it may be all too effective in applying to more than it should in the context of commercial transactions.

How is this riddle to be explained? The explanation may lay in different aspects of the application of Part IVA. Taxpayers’ concerns stem from the potential breadth of application of Part IVA to transactions which are commercial. The test in s 177D has been held to apply to commercial transactions² and those involved in commercial transactions must constantly

^{*} Judge of the Supreme Court of Victoria; Professorial Fellow, Law School, University of Melbourne.

¹ Quoted in *Commissioner of Taxation v Ashwick (Qld) No 127 Pty Ltd* [2011] FCAFC 49, [154] (Edmonds J).

² *Federal Commissioner of Taxation v Consolidated Press Holdings Ltd* (2001) 207 CLR 235, 264 (Gleeson CJ, Gaudron, Gummow, Hayne and Callinan JJ); *Federal Commissioner of Taxation v Spotless Services Pty Ltd* (1996) 186 CLR 404.

wrestle with the extent to which tax consequences shaping the transactions may trigger the application of the anti avoidance provisions. The Commissioner's concerns stem from the construction of s 177C which has made the application of Part IVA depend upon detailed factual inquiries into alternative postulates.

Conclusion about dominant purpose

In Greek mythology a Sphinx guarded the entrance to the City of Thebes. The Sphinx asked a riddle of travellers and strangled and devoured anyone unable to answer the riddle. The Sphinx was of foreign origin, a fact of some importance in Greek mythology, and asked all travellers: "which creature in the morning goes on four legs, at midday on two, and in the evening upon three, and the more legs it has, the weaker it be?". The application of Part IVA also depends upon the answer to a riddle. The riddle is that posed by the Sphinx in s 177D. It may be best to start with s 177D when considering Part IVA because it seems to me more and more that we are forgetting the importance of s 177D to an understanding to the operation of Part IVA as a whole.

The trigger to the operation of Part IVA is a conclusion about the purpose of a participant to a scheme. In contrast, s 260 of the *Income Tax Assessment Act 1936* (Cth) was expressed to operate upon the existence of a fact and not upon a conclusion about the purpose of a participant. Section 260 operated on its own terms to render void as against the Commissioner every "contract, agreement or arrangement" which had the purpose or effect of reducing the

tax that would otherwise be payable by a taxpayer. Section 260 presupposed that what had been done through the contract, agreement or arrangement was to have changed the tax that would otherwise have been obtained. Part IVA was intended to do much the same but it would do so by reference to the purpose to be ascribed to a participant in a scheme rather than to the scheme itself.

I focus upon the similarity between s 260 and Part IVA to draw attention to the riddle that both provisions required to be answered before the tax avoidance provisions could operate. The riddle was whether something was done which could be said to have avoided what would otherwise have occurred. The riddle was posed more directly by s 260 than by s 177D, but it is posed no less by s 177D in Part IVA. Much of the mystery about the “alternative postulate” may disappear if that is kept firmly in mind. The mystery may disappear because enquiries into alternative postulates are enquiries into the riddle upon which the conclusion required by s 177D depends.

It may be worth recalling how the issue of the “alternate postulate” arose in *Federal Commissioner of Taxation v Hart*.³ The case was about whether the conclusion required by s 177D was required to be drawn against the taxpayers on their particular facts. The issue in the case was not whether or not there was a tax benefit but, rather, whether the deductions obtained by Mr and Mrs Hart in the context in which they were obtained led to the conclusion that s 177D required for Part IVA to operate. The case was, in other words,

³ (2004) 217 CLR 216.

about the riddle posed by s 177D: how to determine whether the dominant purpose of the scheme by which the tax benefit was obtained was predominantly to obtain the tax benefit.

What is critical for an answer to the riddle is the implication embedded in both s 260 and Part IVA. Both provisions, as I have said, carried the implication that what was done by a taxpayer avoided something else that would otherwise have imposed a greater tax liability. Section 260 posed the riddle by reference to the predication test enunciated in *Federal Commissioner of Taxation v Newton*.⁴ The question in *Hart* was how the riddle was to be answered in the context of Part IVA. It, however, just like s 260, presupposes that but for the scheme a tax benefit would not have been obtained. That could be seen from s 177C. Section 177C presupposes that the scheme to which the Part will be subjected is the scheme which, but for it, would have achieved a less favourable tax outcome. It was in that context that the Commissioner had argued in *Hart* that an inquiry into the purpose directed by s 177D required an inquiry into a comparison between the scheme and an alternative. Section 177D required that because s 177C demanded that the scheme to be considered was the scheme which had produced the tax benefit. The combination of s 177C with s 177D was to ensure that the riddle posed by s 177D required a comparison between what was done with what would have occurred had the scheme not been entered into. How else could the riddle posed by s 177D be answered?

⁴ (1958) 98 CLR 1.

It was in that context that Gummow and Haynes JJ said:

In the present matters, the respondents would obtain a tax benefit if, in the terms of s 177C(1)(b), had the scheme not been entered into or carried out, the deductions "might reasonably be expected not to have been allowable". When that is read with s 177D(b) it becomes apparent that the inquiry directed by Pt IVA requires comparison between the scheme in question and an alternative postulate. To draw a conclusion about purpose from the eight matters identified in s 177D(b) will require consideration of what other possibilities existed. To say, as Hill J did, that "the manner in which the scheme was formulated and thus entered into or carried out is certainly explicable only by the taxation consequences" assumes that there were other ways in which the borrowing of moneys for two purposes (one private and the other income producing) might have been effected. And it further assumes that those other ways of borrowing would have had less advantageous taxation consequences.⁵

Their Honours were plainly addressing their observations to answering the riddle posed by s 177D being the issue in the case. However, the passage has been taken as requiring that something may not be a "tax benefit" within the meaning of Part IVA unless there is *first* a factual inquiry into what the taxpayer might have done had the taxpayer not entered into the scheme.⁶ It is not surprising that both taxpayers and the Commissioner might seek to rely upon legal arguments legitimately suggested by passages from the decided cases. It is, however, essential that the passages be read in their context.

⁵ *Federal Commissioner of Taxation v Hart* (2004) 217 CLR 216, 243-4 [66] (Gummow and Hayne JJ).

⁶ *Epov v Federal Commissioner of Taxation* (2007) 65 ATR 399, [62] (Edmonds J).

The context of the passage quoted was to have posed the riddle upon which s 177D is made to depend for the purpose of cancelling the tax benefit and not by way of analysis of whether a tax benefit had been obtained.

Part IVA, like s 260 before it, is premised on a consideration of the scheme and what might reasonably be expected to have occurred otherwise. Part IVA is inapplicable where the result of the statutory inquiry, upon a consideration of the eight factors, viewed objectively, does not point to the conclusion that the transaction was entered into or carried out in that particular way so as to obtain the tax benefit, even though a reduction of tax was a substantial effect of the scheme. But Part IVA will apply if a consideration of the eight factors indicates that the particular scheme was entered into or carried out mainly or solely to obtain the tax benefit, even though the scheme was the means adopted for some further commercial goal. What is necessary, therefore, is to consider the eight matters listed in s 177D(b), which operate together to direct a structured inquiry extending beyond the effects of the scheme. It is clear from s 177D(b) that the manner in which a scheme is entered into or carried out, and its form and substance, are essential elements of the statutory process for determining the relevant “purpose”. Each of these factors directs consideration to how, or the way in which, the effects of the scheme are achieved. Further, as had been observed in *Federal Commissioner of Taxation v Spotless Services Ltd*,⁷ the considerations indicated by the subparagraphs in s 177D(b) also “throw further light upon the form and substance

⁷ (1996) 186 CLR 404, 420 (Brennan CJ, Dawson, Toohey, Gaudron, Gummow and Kirby JJ).

of the scheme ... and the manner in which the scheme was carried out". The other considerations directed by sub-section 177D(b) concern what would have been the taxpayer's position, or what might have been expected to have been the taxpayer's position, but for the scheme. In other words, the effects of the scheme are to be compared with something and not merely considered in isolation to determine whether the s 177D conclusion is to be reached.

The particular facts in *Hart* (like those in *Spotless* and *CPH*) showed a wider commercial objective to have been achieved by what the taxpayer had done than merely the obtaining of the tax benefit. In *Hart* the taxpayers secured funds for their properties; in *Spotless* the taxpayers lent money and received interest income. A wider commercial objective apart from tax, however, would not prevent the operation of Part IVA,⁸ if the commercial objective was achieved in a particular way which showed that the tax benefit was the main or predominant explanation for the scheme as entered into.

Justice Hill's lament

The concern of taxpayers that Part IVA may apply more broadly than it should, or perhaps was intended, may in part be seen by Justice Hill's lament in *Macquarie Finance Ltd v Federal Commissioner of Taxation*.⁹ In that case his Honour upheld the application of Part IVA but expressed the view that it

⁸ *Federal Commissioner of Taxation v Consolidated Press Holdings Ltd* (2001) 207 CLR 235, 264 (Gleeson CJ, Gaudron, Gummow, Hayne and Callinan JJ); *Federal Commissioner of Taxation v Spotless Services Pty Ltd* (1996) 186 CLR 404.

⁹ (2004) 57 ATR 115.

was unlikely to have been what those drafting the provisions had intended. A similar lament was perhaps revealed by what his Honour had said some years earlier in *CPH Property Pty Ltd v Commissioner of Taxation*.¹⁰ In that case his Honour considered the potential application of Part IVA in the context of a commercial transaction effected in part by the interposition of a company which, had it been successful, would have had the effect of preserving the tax deductibility of interest payments that would otherwise have been quarantined by operation of s 79D. In that context his Honour said:

It might perhaps be said that one of the problems in the present case lies in artificially dissecting part of a scheme from the 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 benefit leaves outside the structure both the borrowing of ACP and the subscription of moneys for shares by CPIL(UK). That, however, is a consequence of the decision of the High Court in *Spotless*.¹¹

In making the remark in the last sentence his Honour was referring to what the High Court had said in *Spotless* that the “fact that the transaction was commercial does not require the conclusion that the dominant purpose would fall outside the part, for there is no true dichotomy between schemes which are commercial and those which are tax driven”.¹² Perhaps those drafting the provisions had not subjectively intended the provisions to operate in that way, and perhaps that is why Hill J ascribed the result as “a consequence” of the

¹⁰ (1998) 88 FCR 21.

¹¹ Ibid 42.

¹² Ibid 41 citing *Spotless* at 415-6.

decision in *Spotless* rather than flowing transparently from the provisions. However interesting it may be to pursue these thoughts, the fact is that it is well established that the application of Part IVA will not be defeated merely because the scheme entered into was directed to, and in fact achieved, a wider commercial purpose than merely the tax benefit obtained.

It has repeatedly been held since *Spotless* that Part IVA may apply to transactions which have overall commercial objectives. *Spotless* was a case in which a taxpayer sought to derive interest income by a deposit of money at interest. The deposit was commercial; the interest received was real. Paradoxically, the taxpayer could have achieved the tax benefit it did achieve without the possibility of the application of Part IVA had it done no more than write and post a cheque to the Cook Islands' Bank for derivation of interest upon that deposit in the Cook Islands. *Hart* is the flipside of the coin. In *Spotless* the taxpayer lent money to derive real interest income, in *Hart* the taxpayers borrowed money and paid real interest on which they claimed deductions. In that case it is also probable that the taxpayer could have achieved the fiscal consequences had they been able to secure two loans with two different banks, or perhaps two loans even with the same bank, but which were not linked in the way in which they were in that case. In each case there were, paradoxically, aspects of the commercial transactions seeking to secure commercial objectives which were only made necessary to ensure the tax benefits would remain available. In each case it was those factors which explained the way in which the transaction (otherwise

commercial) was done to secure the tax consequences in fact secured. The elements of “artificiality” in the schemes were the commercial terms necessary to preserve the commercial objectives. The tax benefits could have been achieved easily (and with no possibility of the anti avoidance provisions applying) but the schemes were undertaken to secure the commercial objectives that obtaining the tax benefit alone might not preserve.

The Privy Council had made an attempt in *Newton v Federal Commissioner of Taxation*¹³ to enunciate a test to determine when a transaction would fall within the ambit of an anti avoidance provision. The test required an objective observer to look at the transactions and to be able to predicate that they were implemented in that particular way so as to avoid tax. The test was put in these terms:

In order to bring the arrangement within the section you must be able to predicate – by looking at the overt acts by which it was implemented – that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section. Thus, no one, by looking at a transfer of shares *cum* dividend, can predicate that the transfer was made to avoid tax. Nor can anyone, by seeing a private company turned into a non-private company, predicate that

¹³ (1958) 98 CLR 1.

it was done to avoid Div. 7 tax ... Nor could anyone, on seeing a declaration of trust made by a father in favour of his wife and daughter, predicate that it was done to avoid tax ...¹⁴

A critical textual comparison of this statement and the statutory provision might prompt the comment that little had been said by their Lordships beyond the words in s 260 themselves. Nonetheless, the dicta served for many years as the basis upon which impermissible tax avoidance was to be recognised and the anti avoidance provisions were to be applied. The Australian legislature appears clearly enough to have intended the enactment of Part IVA to have given legislative effect to the predication test which had been enunciated in *Newton v Federal Commissioner of Taxation*.¹⁵

The predication test in *Newton* required a consideration of the particular contract, agreement or arrangement which had been identified as an avoidance transaction to determine whether its objectively ascertainable purpose was to avoid tax. The inquiry called for was not into the actual motive or purpose (whether subjective or objective) of the participants to the transaction. It could be assumed that tax avoidance was a motive which any taxpayer may have had without the anti avoidance provisions applying. What the provision was thought to strike at, therefore, was not an intention to avoid tax but, rather, at transactions about which nothing could be said of them

¹⁴ (1958) 98 CLR 1, 8-9 (Lord Denning on behalf of the court).

¹⁵ GT Pagone, *Tax Avoidance in Australia* (2010) 27-8; Explanatory Memorandum, Income Tax Laws Amendment Bill (No 2) 1981 (Cth), 9553; Second Reading Speech, Income Tax Laws Amendment Bill (No 2) 1981 (Cth), 2684; See also *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 186 CLR 404, 408; Michael D'Ascenzo, 'Part IVA and the Common Sense of a Reasonable Person' (Paper presented at the Queensland Taxation Institute Convention, 17 May 2002) <www.ato.gov.au/corporate/content.asp?doc=/content/22809.htm>.

except that tax avoidance was their dominant purpose. The distinction is less subtle than it might sound, and in that distinction there may be the only sound and principled criterion by which anti avoidance provisions may sensibly, reliably and defensibly apply.

Amongst the many sound reasons why the anti avoidance provisions should not apply upon proof of a person's actual decision to avoid tax is that sound tax policy should not make the anti avoidance rules depend upon, and to vary as between, identical transactions. A wholly artificial tax avoidance scheme should be struck down whether or not a taxpayer can be shown to have a tax avoidance purpose.¹⁶ The converse is also sound tax policy: tax avoidance rules should not apply where a person takes advantage of a provision in the tax law designed to provide a tax benefit. These simple enough considerations might provide the basic outlines for how a tax avoidance provision must be applied. A focus upon purely artificial steps and transactions should reliably enable taxpayers, revenue officials, and the court to determine when to apply and when not to apply the anti avoidance rule.

The essence of the predication test was essentially an inquiry into whether something was done which had no function or explanation other than taxation. That, upon a careful consideration, would exclude from the operation of the anti avoidance rule many transactions which were motivated by tax but about which one could not say there was no explanation other than tax. A trustee's

¹⁶ *Federal Commissioner of Taxation v Consolidated Press Holdings Ltd* (2001) 207 CLR 235, 264 [95] (Gleeson CJ, Gaudron, Gummow, Hayne and Callinan JJ); see also *Federal Commissioner of Taxation v Sleight* (2004) 136 FCR 211; *Vincent v Federal Commissioner of Taxation* (2002) 124 FCR 350.

decision, for example, to make distributions in a discretionary trust to maximise the tax benefits between the beneficiaries may be motivated wholly, and exclusively, by the tax considerations flowing from the distributions made, but still not be caught by the anti avoidance provisions because, although tax may have been the motivation for the resolution, the resolution produced more than the tax consequences: the beneficiaries gain entitlements flowing from the resolutions which they would not otherwise have had. On such a basis the predication test as enunciated in *Newton* would not apply to conduct motivated by taxation (however entirely motivated by tax considerations that might be) where one looked at the transaction and found that the overt acts did something more than the tax consequence produced. That kind of analysis explains the examples found in the famous passage in *Newton*. No one could say that the private company which had been turned into a non private company in *WP Keighery Pty Ltd v Federal Commissioner of Taxation*¹⁷ was motivated by anything other than taxation. The beneficial tax consequences may be why the reconstruction occurred, but the reconstruction did occur in fact and that brought with it other commercial and legal consequences apart from tax. That situation was given as an example in *Newton* of one where the anti avoidance provision would not operate for the reason that, whatever the motivation may have been, the conversion of a company from a private company to a non private company did effect more than tax.

¹⁷ (1957) 100 CLR 66.

Seen in this way an anti avoidance provision provides a valuable adjunct to a taxing statute by ensuring that taxpayers do not embellish their transactions with curlicues that have no purpose beyond taxation. Such an approach to the interpretation of the anti avoidance rules also has the highly desirable consequence of confining its operation within predictable bounds. There might still be room for debate in particular cases about how the test is to be applied, but it would confine the debate to a principled one about analysing those elements of a transaction which produced the tax consequence to determine whether those elements had some function other than tax. The anti avoidance provisions could predictably apply where the non tax function was non-existent, immaterial or so overwhelmed by the tax purpose that the commerciality of the element is overshadowed.¹⁸

The same considerations that arose in *Newton* under the s 260 jurisprudence also arise in application of s 177D in Part IVA in the 1936 Act. Whatever else Part IVA may do, its application depends upon a conclusion about the dominant purpose of a taxpayer entering into the transaction in the particular way that it was entered into. The conclusion required by s 177D is not about the actual purpose of anyone. Section 177D does not call for an inquiry into the actual purpose of anyone. The section could have been made to turn upon a finding that one or more persons connected with a scheme was actuated by a purpose of a taxpayer obtaining a tax benefit. Alternatively, the section could have included the actual purpose of such a person amongst the list of factors required to be considered. The section plainly does neither.

¹⁸ *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 186 CLR 404, 408.

Indeed, it expressly contemplates the application of Part IVA to a taxpayer where some person other than the taxpayer (namely one of the many who may have entered into or carried out the scheme) may be concluded to have the relevant purpose without any requirement to link that person's presumed purpose to an actual, or even imputed, state of knowledge of the taxpayer obtaining the benefit.

A reason for making s 177D turn upon "the objective matters listed" in the section "was to avoid the consequence" of Part IVA depending on "the fiscal awareness of a taxpayer".¹⁹ In *Federal Commissioner of Taxation v Hart*²⁰ the Court made clear that an actual purpose of entering into or carrying out a transaction to secure a tax benefit would not trigger the operation of Part IVA.²¹ Gummow and Hayne JJ said in a joint judgment:

In these matters, it is, of course, true that the money was borrowed to finance and refinance the two properties. Of course the loan was structured in the way it was in order to achieve the most desirable taxation result. But those are statements about why *the respondents* acted as they did or about why the lender (or its agent) structured the loan in the way it was. They are not statements which provide an answer to the question posed by s 177D(b). That provision requires the drawing of a conclusion about purpose from the eight identified objective matters; it does not require, or even permit, any inquiry into the subjective motives

¹⁹ *Federal Commissioner of Taxation v Consolidated Press Holdings Ltd* (2001) 207 CLR 235, 264 [95] (Gleeson CJ, Gaudron, Gummow, Hayne and Callinan JJ).
²⁰ (2004) 217 CLR 216.

²¹ *Ibid* 222 [3], 227 [15] (Gleeson CJ and McHugh JJ), 243 [65] (Gummow and Hayne JJ).

of the relevant taxpayers or others who entered into or carried out the scheme or any part of it.²²

The conclusion called for by the inquiry required by s 177D is not whether someone actually entered into or carried out the scheme to enable the taxpayer to obtain the tax benefit, but rather whether a conclusion of that kind would be reached having regard to the particular, specific but limited, matters which s 177D(b) requires to be considered.

Gummow and Hayne JJ in their joint judgment expressed the general inquiry directed by Part IVA as requiring a comparison between the scheme in question and an alternative postulate.²³ To draw a conclusion about purpose from the eight matters will “require consideration of what other possibilities existed”.²⁴ In particular it will require an inquiry into what was done to determine whether to conclude that the way it was done is to be attributed to the tax benefit secured by that means. An inquiry into whether obtaining a tax benefit for a taxpayer was the dominant purpose of someone participating in a scheme requires an evaluation of the significance of the tax benefit produced by the scheme to the scheme being entered into or carried out. Whether the tax benefit is the explanation to be imputed to the participants to the scheme will depend on a precise identification of the scheme, of the tax benefit and of the connection between the scheme and the taxpayer obtaining the tax benefit.

²² Ibid 243 [65].

²³ Ibid 243 [66].

²⁴ Ibid.

In *Federal Commissioner of Taxation v Spotless Services Ltd*²⁵ the High Court considered that the requisite purpose was found in the particular means adopted by the taxpayer to obtain its commercial return.²⁶ In *Hart Gummow and Hayne JJ* found in the terms of the actual loans entered into matters that “were explicable *only* by the taxation consequences for” the taxpayer.²⁷ Their Honours did not undertake a factual inquiry about what alternative deal or arrangements might have been done, but about how else the commercial objective which was secured through the scheme would or might reasonably be expected to be achieved without the scheme. Their focus was on whether there was some element of the transaction which could only be explained by the tax benefits it secured. Seen in that way, the test in s 177D matches the predication test enunciated by the Privy Council in *Newton* and accords with the mischief, as explained in the Explanatory Memorandum when Part IVA was enacted, of applying to tax avoidance arrangements capable of being described as “blatant, artificial or contrived” and not to transactions of a kind “of a normal business or family kind, *including those of a tax planning nature*” (emphasis added).²⁸ The test so understood accords with the argument put for the Commissioner in *Federal Commissioner of Taxation v Spotless Services Ltd*²⁹ that, for the conclusion required by s 177D, the inquiry “must necessarily be whether the scheme is so attended with elements of artificiality

²⁵ (1996) 186 CLR 404.

²⁶ Ibid 423 (Brennan CJ, Dawson, Toohey, Gaudron, Gummow and Kirby JJ).

²⁷ *Federal Commissioner of Taxation v Hart* (2004) 217 CLR 216, 244 [68], emphasis as per quote.

²⁸ Explanatory Memorandum, Income Tax Laws Amendment Bill (No 2) 1981 (Cth), 9553; see also PJ Lanigan, ‘Interpretational Problems with Part IVA’ (Material presented in Melbourne, 15 September 1981) Taxation Institute of Australia Library archive box 638, 13-14, esp at 13 quoting from statement by Second Commissioner in NE Challoner and RJ Richardson, *Tax Avoidance, Implications of 1981 General Provisions (Part IVA)* (CCH Australia Ltd, 1981).

²⁹ (1996) 186 CLR 404.

or contrivance primarily directed to the obtaining of the tax benefit that any commerciality of the scheme is overshadowed".³⁰ It accords with the personal view expressed by the Commissioner of Taxation that the factors chosen for consideration by s 177D were the more exact and positive test to achieve the same purpose as limiting the Part to schemes that are blatant, artificial and contrived.³¹ It accords also with acceptance of the proposition that it is only to be expected that the adoption of one particular form over another may permissibly be influenced by revenue considerations.³²

Permissible structuring to secure tax advantages and permissible motivation to achieve a favourable tax outcome may be seen where what secures the tax benefit also secures other outcomes. In such cases what secures the tax benefit will not be explicable *only* by the taxation consequences for the taxpayers.³³ An example was given in the joint judgment of Gleeson CJ and McHugh J in *Hart* of a decision based on a desire to obtain a tax deduction to rent premises rather than to buy them.³⁴ Another example may be seen in the decision to sell and lease back plant and equipment.³⁵ In each case the elements of the transaction securing the tax benefit also secure more, or other, outcomes and not only the tax benefit. A lease creates different proprietary interests than ownership with different commercial and legal

³⁰ Ibid 408.

³¹ Michael D'Ascenzo, 'Part IVA and the Common Sense of a Reasonable Person' (Paper presented at the Queensland Taxation Institute Convention, 17 May 2002) <www.ato.gov.au/corporate/content.asp?doc=/content/22809.htm>.

³² *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 186 CLR 404, 416 (Brennan CJ, Dawson, Toohey, Gaudron, Gummow and Kirby JJ); it is consistent with the view expressed by Edmonds J (Sundberg and Stone JJ agreeing) in *Federal Commissioner of Taxation v BHP Billiton Finance Ltd* (2010) 182 FCR 526, [70].

³³ See the emphasis in *Federal Commissioner of Taxation v Hart* (2004) 217 CLR 216, 244 [68], line 2 (Gummow and Hayne JJ).

³⁴ Ibid 227 [15].

³⁵ *Eastern Nitrogen Ltd v Federal Commissioner of Taxation* (2001) 108 FCR 27.

consequences, irrespective of tax benefits. Similarly the disposal of an income earning asset by gift may result in the non-derivation of assessable income by the donor but it also disposes of ownership by transfer to another. A distribution of income or corpus by a trustee of a discretionary trust may be calculated and wholly motivated by reference to fiscal advantages, but an effective distribution confers economic benefit on the object of the distribution in addition to any tax benefit secured.

Tax Benefit

An area of debate has emerged concerning the provisions dealing with tax benefit that create particular problems both for taxpayers and the Commissioner. On one view s 177C does no more than require a precise and careful identification of the scheme said to produce the tax benefit. That view does not depend upon a strained reading of the section but can, perhaps, more readily be seen in the GST equivalent to Part IVA in s 165-10(1). It provides:

- (1) An entity gets a ***GST benefit*** from a * scheme if:
 - (a) an amount that is payable by the entity under this Act apart from this Division is, or could reasonably be expected to be, smaller than it would be apart from the scheme or a part of the scheme; or
 - (b) an amount that is payable to the entity under this Act apart from this Division is, or could reasonably be expected to be, larger than it would be apart from the scheme or a part of the scheme; or
 - (c) all or part of an amount that is payable by the entity under this Act apart from this Division is, or could reasonably be expected to be, payable later than it would have been apart from the scheme or a part of the scheme; or

- (d) all or part of an amount that is payable to the entity under this Act apart from this Division is, or could reasonably be expected to be, payable earlier than it would have been apart from the scheme or a part of the scheme.³⁶

What the section does is to ensure that whatever is cancelled as the tax benefit is that which is directly produced by and from the scheme. The section operates as an analytical tool ensuring a clear logical link between tax benefit and scheme.

Section 165-10 deals with when an entity gets a GST benefit from a scheme. The heading does not describe the section as a definition. Both the heading, and the operative section, use the active verb “get”. The heading poses a question; namely, when does an entity “get a GST benefit from a scheme?”. The operative provision begins with identifying when “[a]n entity gets a GST benefit from a scheme”. The use of the active verb is important in identifying what the section is directed to. It is directed, not to defining benefits which may come within the ambit of the provision, but rather, to identifying when it may be said that an entity has “got” one. This same form of thinking may readily enough be seen in s 177C by use of the word “obtaining” rather than “get”. Lest there be any doubt, I am not suggesting in any way that the GST provision enacted after Part IVA is somehow intended to alter the meaning of Part IVA.³⁷

What s 165-10(1) and s 177C were each designed to do was to ensure that the anti avoidance provisions applied in a disciplined manner. The discipline

³⁶ *A New Tax System (Goods and Services Tax) Act 1999* (Cth) s 165-10(1).

³⁷ *Beckwith v R* (1976) 135 CLR 569, 578-83 (Mason J); *Palgo Holdings Pty Ltd v Gowans* (2005) 221 CLR 249, 256-8 (McHugh, Gummow, Hayne and Heydon JJ).

was found by requiring a link between the tax benefit (to be cancelled) and the scheme (which produced it). The analytical link was, in the case of Part IVA, that the tax benefit was “obtained” in connection with the scheme, and in the case of GST, that the tax benefit was “got” from a scheme.

This reading of s 177C and of s 165-10(1) does not require a factual inquiry into any alternative postulate as a precondition to the application of the respective anti avoidance provisions. It is, with respect to those who hold a different view, unsurprising that such an inquiry was not called for by the section because the anti avoidance provisions were supposed to operate on objective criteria and were not made to depend upon the fiscal awareness or subjective considerations of individual taxpayers. An anti avoidance provision designed to apply objectively without reference to fiscal awareness or subjective considerations is inconsistent with an inquiry into what a taxpayer might otherwise have done if the particular tax benefit obtained was not obtained through what was done. It is a fortiori inconsistent with an inquiry into what might reasonably be expected by the taxpayer to have done if the taxpayer had not done the scheme actually undertaken through which the tax benefit was in fact obtained.

Recent litigation has adopted an interpretation of s 177C which is different from that which I have just described but has done so without expressly rejecting or considering that construction. The basis for the recent line of authority appears to be the sentence in the decision in *Federal Commissioner*

*of Taxation v Hart*³⁸ in which Gummow and Hayne JJ considered s 177D and not s 177C to which I have already referred but I will repeat it again for convenience. The relevant sentence is that emphasised in the following passage:

In the present matters, the respondents would obtain a tax benefit if, in the terms of s 177C(1)(b), had the scheme not been entered into or carried out, the deductions "might reasonably be expected not to have been allowable". When that is read with s 177D(b) it becomes apparent that the inquiry directed by Pt IVA requires comparison between the scheme in question and an alternative postulate. To draw a conclusion about purpose from the eight matters identified in s 177D(b) will require consideration of what other possibilities existed. To say, as Hill J did, that "the manner in which the scheme was formulated and thus entered into or carried out is certainly explicable only by the taxation consequences" assumes that there were other ways in which the borrowing of moneys for two purposes (one private and the other income producing) might have been effected. And it further assumes that those other ways of borrowing would have had less advantageous taxation consequences (my emphasis).³⁹

It is important to read this passage carefully and, perhaps, to read it by reference to the actual submissions put by the Commissioner in that case. Even confining oneself only to the passage, however, it is clear that what their Honours were explaining was how s 177D applied and not how s 177C applied. Their Honours were explaining that in determining whether to draw

³⁸ (2004) 217 CLR 216.

³⁹ *Ibid* [66].

the conclusion required by s 177D it was necessary to consider what was done with how else it might have been done: it was, in effect, a guide to how the riddle of the Sphinx was to be answered. The conclusion that a particular transaction was entered into for the dominant purpose of enabling the taxpayer to obtain the tax benefit necessarily requires some conception of something else by reference to which the conclusion is to be reached. Indeed, the conclusion in s 177D is required to be reached having regards only to the eight matters stipulated in s 177D(b) and not by reference to facts and circumstances not found within the eight factors in s 177D(b). Their Honours in the passage in *Hart* did not say that the conclusion required by s 177D required or permitted an inquiry into facts and circumstances other than those listed in the eight matters identified in s 177D(b). Rather, the passage explained that to draw a conclusion from those factors carried the implication that what was done could have been done differently. The conclusion about tax avoidance (if any) was to be found in considering what was done with how else the same thing could have been achieved. It is in that difference that the conclusion about tax avoidance is to be found.

Helpful though this dicta may be, it has given rise to other questions and other debates. One such debate is about how and where the “alternative postulate” is to be determined. In the passage quoted above, their Honours referred to a consideration of “what other possibilities existed”. An inquiry into “what other possibilities existed” might seem to call for a factual inquiry based upon evidence.⁴⁰ Indeed, it might be thought that this factual inquiry (if a factual

⁴⁰ *Epov v Federal Commissioner of Taxation* (2007) 65 ATR 399.

inquiry was what their Honours intended) was the same as that to be undertaken for the purposes of determining whether a tax benefit had been obtained under section 177C. On that view, presumably, the comparison for 177D purposes is between the scheme which produced the tax benefit and something which (somehow) would not. Section 177C contemplates a comparison between the tax effect of the scheme with what “would have” or “might reasonably be expected” to have occurred had the scheme not been entered into or carried out.

The issue has been made more complicated for the Commissioner and taxpayers in a series of cases involving *Federal Commissioner of Taxation v Lenzo*,⁴¹ *Federal Commissioner of Taxation v Trail Bros Steel & Plastics Pty Ltd*,⁴² *RCI Pty Ltd v Federal Commissioner of Taxation*,⁴³ *Federal Commissioner of Taxation v AXA Asia Pacific Holdings Ltd*⁴⁴ and *Noza Holdings v Federal Commissioner of Taxation*.⁴⁵ The critical issue for present purposes in each of these cases is how the courts, encouraged by the parties, have interpreted s 177C. In each case the debate has been about whether the fiscal advantage in question was a fiscal advantage coming within s 177C. In each case the provision has been interpreted as requiring that the fiscal advantage obtained be measured as against what, in fact, would otherwise have happened or as against what, in fact, might reasonably otherwise have been expected to happen. In other words, s 177C has been treated as a precondition to enliven the anti avoidance provisions such that the anti

⁴¹ (2008) 167 FCR 255.

⁴² (2010) 186 FCR 410.

⁴³ (2010) 272 ALR 347.

⁴⁴ (2010) 189 FCR 204.

⁴⁵ [2011] ATC 20-241.

avoidance provisions will only be enlivened where, as a matter of fact and evidence, it is established that the fiscal advantage would otherwise have not been obtained in fact or might not otherwise reasonably be obtained in fact.

This reading of s 177C, and this potential reading of s 165-10(1), has had a necessarily dramatic shift in the way in which both the Commissioner and taxpayers analyse and argue about the application of the anti avoidance provisions. Ironically this search for the counterfactual is potentially to the advantage of neither Commissioner nor taxpayer. If the alternative postulate, or the counterfactual, is to be found not in a consideration of what was done by reference to how the same thing could have been done, but rather by reference to what in fact might have been done or what in fact might reasonably expected to have been done, then both taxpayer and Commissioner are directed to undertake very complicated analysis by reference to facts and circumstances which did not occur.⁴⁶ It would, curiously, place in centre stage an artificially created hypothesis into something that never happened.⁴⁷

⁴⁶ “Yesterday, upon the stair,
I met a man who wasn’t there
He wasn’t there again today
I wish, I wish he’d go away ...”

Hughes Mearns, *Antigonish* (“*The Little Man Who Wasn’t There*”).
⁴⁷ Some may recall the Monty Python sketch in which the words “nothing happened” assumed the power of mystery and drama when accompanied by strong dramatic music, mysterious looking figures and a prelude of suspense; see “The Day Nothing Happened” Monty Python at <http://www.wepsite.de/The%20Day%20Nothing%20Happened.htm>; “The Adventures of Ralph Mellinsh” in Monty Python *Free Record Given Away with the Monty Python Matching Tie and Handkerchief* (Audio LP Record or CD), 1975.

The practical difficulty that such an inquiry occasions may be seen by the facts in *Noza Holdings Pty Ltd v Federal Commissioner of Taxation*⁴⁸ where Gordon J was called upon by the parties' submissions to analyse in detail whether the commercial objectives achieved by the actual means adopted by a taxpayer were able to be achieved by the counterfactuals relied upon by the Commissioner. Her Honour concluded in that case that they were not.⁴⁹ The conclusion was reached by reference, not to whether the transaction itself exhibited signs of tax avoidance but, rather, to whether what was put as an alternative transaction was commercially able to achieve the same commercial outcomes as the one actually adopted by the taxpayer. In *Federal Commissioner of Taxation v AXA Asia Pacific Holdings Ltd*⁵⁰ Edmonds and Gordon JJ remarked upon the risk of artificiality occasioned by such enquiries:

The finding that it *might reasonably be expected* that the alternative postulate was a direct sale to MBF is a further example of the difficulties which now arise in litigation concerning Pt IVA where the focus is on the "scheme" and the "alternative postulate" identified by the parties. Of course, this is a direct result of the adversarial process. The problem is that it does run the risk of creating considerable artificiality often divorced from commercial reality.⁵¹

The taxpayer was successful in *AXA* and *Noza*, but advisers to taxpayers may not be able to take too much comfort by looking at the outcome. The outcome in both was achieved by complex, and to some extent (if not largely), artificial

⁴⁸ [2011] ATC 20-241.

⁴⁹ [2011] ATC [20-241], 12,054.

⁵⁰ (2010) 189 FCR 204.

⁵¹ (2010) 189 FCR 204, 243-4 [147].

analysis about necessarily hypothetical circumstances which did not occur. More unsettling, perhaps, for taxpayers might be the role in future litigation which may be played by the legal burden of proof upon the taxpayer to disprove what might reasonably have been expected.

Careful consideration must be given both by the Commissioner and by taxpayers about the consequence of the taxpayer having the burden of proof (including disproof) where one of the matters to be proved (or disproved) is that an alternative postulated might not “reasonably have been expected”. What is necessarily contemplated as something which is only “reasonably to be expected” is that it neither happened nor that it would have happened. What may be considered as being a reasonable expectation must therefore exclude and be different from both what did happen and what did not happen but what would have happened. What may reasonably have been expected is a lower order hypothetical than what “would” have occurred in the context of something which did not happen in fact. The ability of the Commissioner to rely upon something which did not happen, would not have happened, but which nonetheless might reasonably be expected to happen is likely in the future to become a more significant Achilles heel for taxpayers because of the legal burden of proof which falls upon the taxpayer. Taxpayers may find decision makers relying more upon the taxpayer not having discharged the burden of proof or disproof rather than concluding affirmatively that something affirmatively comes within the anti avoidance provisions. In that context the role played by intuitive decision making and the need to reconcile competing

policy objectives which I mentioned at the start become particularly significant, critically important and frequently disturbingly unpredictable.

Oedipus

The riddle posed by the Sphinx in Greek mythology was solved by Oedipus answering: “Man – who crawls on all fours as a baby, then walks on two feet as an adult, and then walks with a cane in old age”. Oedipus famously went on to marry his mother and gave us the name for a psychological complex identified by Sigmund Freud. Oedipus ended up rather badly in the story but all that may best be left for another day ...

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