Chapter 1 Outline of chapter

1.1 Schedule # to this Bill amends Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) to restore its effective operation as the income tax general anti-avoidance provision.

1.2 The principal role of Part IVA is to counter arrangements that, objectively viewed, are carried out with the sole or dominant purpose of securing a tax advantage for a taxpayer.

1.3 Broadly speaking, Part IVA operates to counter such arrangements by exposing the substance or reality of the arrangements to the ordinary operation of the taxation laws.

Context of amendments

1.4 A number of recent decisions of the Full Court of the Federal Court have revealed technical deficiencies in the way in which Part IVA determines whether or not a tax advantage has been obtained in connection with an arrangement. These deficiencies undermine the effective operation of Part IVA.

1.5 The amendments in Schedule # to this Bill address these deficiencies and ensure that Part IVA is effective to counter tax avoidance.

1.6 The introduction of the amendments was announced by the Government on 1 March 2012.

1.7 The amendments apply to schemes that are entered into or commenced to be carried out on or after 16 November 2012.

1.8 The amendments were designed in consultation with a roundtable of independent experts and with the benefit of formal advice from senior counsel.

Legislative history

1.9 Part IVA was enacted in 1981 to overcome deficiencies that judicial decisions had exposed in the operation of another anti-avoidance provision — section 260 of the ITAA 1936.

1.10 The Explanatory Memorandum accompanying Part IVA explained that Part IVA was 'designed to overcome' the difficulties with

section 260 and 'provide — with paramount force in the income tax law — an effective general measure against those tax avoidance arrangements that — inexact though the words may be in legal terms — are blatant, artificial or contrived' (see Explanatory Memorandum, Income Tax Laws Amendment Bill (No 2) 1981 (Cth)).

1.11 Further, the Explanatory Memorandum made it clear that the 'test for application' of Part IVA was 'intended to have the effect that arrangements of a normal business or family kind, including those of a tax planning nature' would be beyond the scope of Part IVA.

1.12 The distinction between tax avoidance and legitimate commercial and family planning was emphasised by the then Treasurer in his second reading speech on the Bill. There he stated that Part IVA was not intended to 'cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of opportunities available for the arrangement of their affairs'.

1.13 Part IVA gives effect to this distinction by requiring an examination of whether, having regard to eight objective matters, including the manner in which the arrangement was entered into, its form and substance, and the taxation results it produces, it could be concluded that the arrangement was entered into in the particular way it was for the sole or dominant purpose of obtaining a tax advantage.

1.14 As such, Part IVA does not inquire into the subjective motives of taxpayers and it does not therefore strike at every arrangement that is entered into with an eye to tax minimisation. That much has been established by the High Court. As their Honours Gleeson CJ and McHugh J said in *Commissioner of Taxation v Hart* (2004) 206 ALR 207 (*Hart*) at [15]:

> '… the fact that a particular commercial transaction is chosen from a number of possible alternative courses of action because of tax benefits associated with its adoption does not of itself mean that there must be an affirmative answer to the question posed by s 177D. Taxation is part of the cost of doing business, and business transactions are normally influenced by cost considerations. Furthermore, even if a particular form of transaction carried a tax benefit, it does not follow that obtaining the tax benefit is the dominant purpose of the taxpayer in entering into the transaction. A taxpayer wishing to obtain the right to occupy premises for the purpose of carrying on a business enterprise might decide to lease real estate rather than to buy it. Depending upon a variety of circumstances, the potential deductibility of the rent may be an important factor in the decision. Yet, if there were nothing more to it than that, it would ordinarily be impossible to conclude, having regard to the factors listed in s 177D, that the dominant purpose of the lessee in leasing the land was to obtain a tax benefit. The dominant

> purpose would be to gain the right to occupy the premises, not to obtain a tax deduction for the rent, even if the availability of the tax deduction meant that leasing the premises was more cost-effective than buying them.'

1.15 It does not follow, however, that Part IVA is incapable of applying to arrangements that also advance wider commercial objectives. There is no 'dichotomy' between a 'rational commercial decision' and 'the obtaining of a tax benefit' (see Gummow and Hayne JJ in *Hart* (2004) 206 ALR 207 at [64]).

1.16 As the High Court has confirmed on a number of occasions, Part IVA will apply to an arrangement if the particular form in which the arrangement is implemented evinces the requisite tax avoidance purpose (see *Federal Commissioner of Taxation v Spotless* (1996) 141 ALR 92 (*Spotless*) at 103 and 105, and *Hart (2004) 206 ALR 207* at [16][52]and [94]).

1.17 More particularly, as Callinan J observed in *Hart* (2004) 206 ALR 207 at [94], 'an aspect of' the direction in Part IVA to consider the 'form and substance' of a scheme 'is whether the substance of the transaction (tax implications apart) could more conveniently, or commercially, or frugally have been achieved by a different transaction or form of transaction.'

The statutory regime

1.18 The Commissioner may cancel a tax benefit obtained by a taxpayer in connection with a scheme, if the scheme is a scheme 'to which Part IVA applies' (see subsection 177F).

1.19 The concept of a scheme 'to which Part IVA applies' is elucidated in section 177D.

1.20 Section 177D provides that a scheme to which Part IVA applies is a scheme (entered into or commenced to be carried out after 27 May 1981) in respect of which:

- a taxpayer has obtained, or would but for section 177F obtain, a tax benefit in connection with the scheme (see paragraph 177D(a)); and
- one or more of the persons who participated in the scheme (or part of the scheme) did so with the sole or dominant purpose, objectively ascertained, of enabling the taxpayer to obtain a tax benefit in connection with the scheme (see paragraph 177D(b)).

1.21 Whilst the Commissioner is entitled to put his case, in relation to the scheme and the tax benefit, in alternative ways, the existence of the Commissioner's discretion to cancel the tax benefit does not depend upon the Commissioner's opinion or satisfaction that there is a tax benefit or that, if there is a tax benefit, it was obtained in connection with a scheme. The existence of a scheme and a tax benefit must be established as matters of objective fact (see *Peabody v Commissioner of Taxation* (1994) 123 ALR 451 at pp458-459).

1.22 Moreover, the 'bare fact' that a taxpayer can be shown to have obtained a tax benefit in connection with a scheme does not in itself compel the application of Part IVA (per Gummow and Hayne JJ in *Hart* (2004) 206 ALR 207 at [53] and per Callinan J at [92]). The tax benefit must be obtained in connection with a scheme to which Part IVA applies.

1.23 In determining whether a scheme is one to which Part IVA applies, the critical question — indeed the fulcrum upon which Part IVA turns (per Callinan J in *Hart* (2004) 206 ALR 207 at [92]) — is whether a person or persons who participated in the scheme did so for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit that has been so identified. The relevant purpose must be established objectively based on an analysis of how the scheme was implemented, what the scheme actually achieved as a matter of substance or reality as distinct from legal form (that is, it's end effect) and the nature of any connection between the taxpayer and other parties (see paragraph 177D(b)). A person's motive is irrelevant.

1.24 As Gummow and Hayne JJ observed in *Hart* ((2004) 206 ALR 207 at [37]), each of the concepts of 'tax benefit', 'scheme' and 'scheme to which this Part applies' have their 'part to play' in deciding whether a determination is permitted and each of them 'must be given operation in the interrelated way which section 177F(1) requires'. Further (at [36]):

> 'Although it will often be convenient to begin any consideration of the application of the Part by attending to the operation of these elucidating and definitional provisions [that is sections 177A and 177C], approaching a particular case in this way must not be allowed to obscure the way in which the Part as a whole is evidently intended to operate.'

1.25 When read as a whole, it is evident that the inquiry directed by Part IVA is a single inquiry into whether a taxpayer has obtained a 'tax benefit', directly or indirectly, from a 'scheme' in which a person participated for the sole or dominant purpose of securing a 'tax benefit' for the taxpayer.

The role of an alternative postulate

1.26 Implicitly, the Part IVA inquiry 'requires [a] comparison between the scheme in question and an alternative postulate' (per Gummow and Hayne JJ in *Hart* (2004) 206 ALR 207 at [66]).

1.27 A comparison between the scheme and an alternative postulate serves the Part IVA inquiry in two ways:

- first, comparisons between the tax consequences of the scheme and the tax consequences of alternative postulates provide a basis for identifying (and quantifying) any tax advantages (of the relevant kind) that may have been obtained from the scheme; and

- second, a consideration of alternative postulates may, in the course of considering the paragraph 177D(b) matters, provide a basis upon which a conclusion about the purposes of the participants in the scheme can be drawn (per Gummow and Hayne JJ in *Hart* (2004) 206 ALR 207 at [66] — [68]) — a consideration of whether there were other ways that the participants in the scheme could have achieved their non-tax purposes facilitates a weighing of those purposes against any tax purposes that can be identified.

1.28 An alternative postulate could be that the scheme merely did not happen or it could be that the scheme did not happen but that something else did happen.

1.29 In so far, however, as a comparison between the scheme and an alternative postulate is to facilitate a conclusion about whether a person entered into or carried out a scheme for the sole or dominant purpose of securing a particular tax benefit for the taxpayer, it would be expected that the postulate would be consistent with what it was, if anything, that the participants objectively intended to achieve from the scheme (tax results aside). Further, it would be expected that the comparison would include a comparison with the same postulate (or postulates) as is relied upon for the identification of the particular tax benefit.

1.30 A comparison between the scheme and an alternative postulate would be meaningless if it were a comparison between arrangements directed to the achievement of different ends. The possibility that, had the scheme not been entered into, an arrangement directed to different ends might have been implemented in lieu of the scheme, would have nothing to say about whether or not the particular way that the scheme was carried out manifested a tax avoidance purpose.

1.31 The interrelationship between the section 177D inquiry and the tax benefit is best illustrated by a consideration of the facts in *Hart*.

1.32 In *Hart* a husband and wife borrowed money on unusual terms with advantageous taxation consequences. The Commissioner postulated that, absent the scheme, it was reasonably to be expected that the borrowing would have been arranged on standard terms and he cancelled that part of the interest which resulted from the special terms.

1.33 The Commissioner did not postulate that absent the scheme, the taxpayers would not have borrowed anything. The taxpayers required finance to fund a private dwelling and an investment property. Had the Commissioner sought to cancel the whole of the interest on the borrowing rather than the part of the interest that resulted from the non-standard features of the borrowing he would have risked the Court concluding that the requisite purpose did not exist.

Tax benefit

1.34 The purpose and function of section 177C is to define the kind of tax outcomes that a participant in the scheme must have had the purpose of securing for the taxpayer, and which must have been secured in connection with the scheme, if Part IVA is to apply.

1.35 The tax outcomes with which section 177C(1) is concerned, and which are labeled 'tax benefits', are:

- an amount not being included in assessable income;
- a deduction being allowed;
- a capital loss being incurred;
- a foreign income tax offset being allowed; and
- a liability to pay withholding tax being avoided.

1.36 In order to reach a conclusion that one of the specified outcomes has been secured, and to quantify it, it is necessary to compare the tax consequences of the scheme in question with the tax consequences that either would have arisen or might reasonably be expected to have arisen if the scheme had not been entered into or carried out. This is a comparison with an alternative postulate.

1.37 Any difference between those tax consequences, adverse to the revenue, is a tax benefit obtained in connection with the scheme.

1.38 A tax consequence of a scheme or of an alternative postulate encompasses any tax consequences that arise in connection with the scheme or with the alternative postulate. The inquiry is not confined to the immediate tax consequences of the steps that comprise the scheme or the alternative postulate (see *Commissioner of Taxation v Futuris Corporation* [2012] FCAFC 32 (*Futuris*) at [34]).

The two limbs of tax benefit

1.39 Subsection 177C(1) contains two bases upon which the existence of a tax benefit can be demonstrated. The first is that, absent the scheme, a relevant tax outcome 'would have been' secured. The second is that, absent the scheme, a relevant tax outcome 'might reasonably be expected to have been' secured.

1.40 These are alternatives (see *Peabody* ([1993] FCA 74 at [36]) and *Commissioner of Taxation v Consolidated Press Holdings* [1999] FCA 1199 at [85]).

1.41 The first limb requires a comparison of the tax consequences of the scheme with the tax consequences that 'would have' resulted if the scheme had not occurred.

1.42 The second limb requires a comparison of the tax consequences of the scheme with the tax consequences that 'might reasonably be expected to have' resulted if the scheme had not occurred.

1.43 Conventionally, the approach to the first limb has been to view it as satisfied in cases where no more is required to expose a relevant tax advantage than to apply the taxation law to the facts remaining once the statutory postulate has done its work in deleting the scheme. In those cases, a tax benefit exists if it can be demonstrated that the relevant tax advantage flows, as a matter of law, once the scheme is assumed not to have happened.

1.44 Cases that have concerned an application of the first limb include the decisions of the Full Court of the Federal Court in *Puzey v Commissioner of Taxation* [2003] FCAFC 197 (*Puzey*) and *Commissioner of Taxation v Sleight* [2004] FCAFC 94. For example, in *Puzey*, at [66], Hill and Carr JJ (with French J concurring) identified the tax benefit on the basis that 'had Puzey not entered into the scheme he would not have had the deductions which became available to him'.

1.45 The second limb is a qualitatively different test that may be satisfied notwithstanding an element of uncertainty in the postulate. For example, it has been applied in cases where the mere deletion of the

scheme would not necessarily make sense — where a prediction is required about facts not in existence and/or about facts which are in existence not being in existence. In other words, it contemplates a postulate based on a reasonable *reconstruction* of either the scheme, or of the scheme and things that happened in connection with the scheme.

1.46 The second limb has also been applied in cases where a first limb tax benefit, resting as it does on a postulate that the scheme merely would not have happened, would be inconsistent with the non-tax effects sought for the taxpayer by the participants in the scheme. In those cases a reconstruction of either the scheme, or of the scheme and things that happened in connection with the scheme, may expose other ways in which the non-tax effects of the scheme could have reasonably been achieved without the impugned tax advantages (see, for example, *Hart*).

1.47 Relevantly, the High Court decisions in *Peabody* (1994) 123 ALR 451, *Spotless* (1996) 141 ALR 92, and *Hart* each concerned an application of the second limb. In each of those cases, the postulate upon which the Commissioner relied to identify the tax benefit was based upon a reasonable expectation about how the scheme, or the scheme and things that happened in connection with the scheme, could have been done differently to achieve the same commercial ends.

1.48 As Hill J recognized in the Full Federal Court in *Peabody* ([1993] FCA 74 at [36]), the Commissioner had not there suggested 'that if the scheme had not been entered into or carried out there 'was' any amount which would have been included in Mrs Peabody's assessable income'. To the contrary, the Commissioner 'place[d] reliance upon the alternative set out in s. 177C(1)(a), namely, that an amount might reasonably be expected to have been included in Mrs Peabody's assessable income if the scheme had not been entered into or carried out'.

1.49 It was in that context that the High Court in *Peabody* ((1994) 123 ALR 451) went on to observe (at p461) that:

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

1.50 Similarly, in *Commissioner of Taxation v Consolidated Press Holdings* [1999] FCA 1199 (*Consolidated Press*), the Full Federal Court concluded (at [89]) that, absent the scheme, an amount of interest on a borrowing 'might reasonably be expected … not to have been allowable'. In so doing, it upheld the trial judge's hypothesis that, had the particular scheme not been entered into, it was reasonable to expect that the borrowed money would have been directly invested in a foreign

subsidiary and therefore subject to the operation of section 79D. The trial judge based his hypothesis on the way in which the actual investment had been structured ((1998) 98 ATC 4983 at 4998 per Hill J).

1.51 The approach taken in *Consolidated Press* was consistent with the approach taken by the High Court in *Spotless* (1996) 141 ALR 92 and *Hart* (2004) 206 ALR 207. In each of those cases, the reasonable expectation as to what would have happened absent the respective schemes was located in the commercial ends to which the schemes were directed.

1.52 In *Spotless* (1996) 141 ALR 92, the Court rejected a submission on behalf of the taxpayers, in relation to paragraph 177C(1)(a), that, had they not entered into the investment scheme there in issue there would have been no interest and no amount included in their assessable income that would satisfy the definition of 'tax benefit'. In so doing, the Court said (at pp103-104):

> In our view, the amount to which para (a) refers as not being included in the assessable income of the taxpayer is identified more generally than the taxpayers would have it. The paragraph speaks of the amount produced from a particular source or activity. In the present case, this was the investment of $40 million and its employment to generate a return to the taxpayers. It is sufficient that at least the amount in question might reasonably have been included in the assessable income had the scheme not been entered into or carried out.

1.53 In concluding (at p104) that a 'reasonable expectation' was that 'the taxpayers would have invested the funds, for the balance of the financial year, in Australia' the Court observed that '[a] particular application of the definition provision of 'tax benefit' in s 177C(1) thus involves consideration of the particular materials answering the various categories in par (b) of s 177D' for it was those materials which demonstrated 'that the taxpayers were determined to place the $40 million in short-term investment for the balance of the then current financial year'.

Recent decisions

1.54 A number of recent decisions of the Full Federal Court suggest there are some technical deficiencies in the way in which section 177C operates to determine whether or not a tax benefit has been obtained in connection with a scheme to which Part IVA applies. These deficiencies undermine the effective operation of Part IVA.

Unconstrained inquiry about alternative postulates

1.55 First, it appears that the enquiry permitted under section 177C(1) is a broad ranging enquiry into what might reasonably be expected to have happened absent the scheme, unconstrained by either the limits of the scheme (see *Commissioner of Taxation v Axa Asia Pacific Holdings Ltd* [2010] FCAFC 134 (*Axa Asia*) at [131]), or the matters prescribed under section 177D(b) (see *Epov v Federal Commissioner of Taxation* [2007] FCA 34 at [62]).

1.56 Put differently, it is an enquiry about what other alternatives were open to the participants in the scheme rather than a circumscribed enquiry about whether or not there were other ways in which the taxpayer might reasonably have achieved the non-tax effects (if any) that it achieved from, or in connection with, the scheme.

1.57 While a consideration of what the taxpayer did in the commercial circumstances that existed may shed light on what the taxpayer would have done in the absence of the scheme (*Commissioner of Taxation v Ashwick (Qld) No 127 Pty Ltd* (*Ashwick*) [2011] FCAFC 49 at [153]), the matters that can be taken into account in the enquiry are unlimited and can include evidence from the taxpayer as to what it would have done in the absence of the scheme (provided foundation facts are given to support what would otherwise be a bald speculative statement) (see *McCutcheon v Federal Commissioner of Taxation* [2008] FCA 318 (2008) 168 FCR 149 at [37], cited with approval in *Axa Asia* [2010] FCAFC 134 (at [140])).

1.58 The breadth of the permissible enquiry is a concern, not only because of the nature of the evidence that may be lead, but, more significantly, because it does not intrinsically support the paragraph 177D(b) inquiry into the purposes of those who participated in the scheme, in the interrelated and harmonious way envisaged by Gummow and Hayne JJ in *Hart* (2004) 206 ALR 207 at [36]-[37].

1.59 This is perhaps best illustrated by the decision at first instance in *Futuris* [2010] FCA 935. In *Futuris*, the taxpayer consolidated in a single subsidiary a business that it had carried on through a number of subsidiaries. The subsidiary was then floated. The Commissioner asserted that some but not all of the steps comprising the transaction constituted a scheme to which Part IVA applied.

1.60 Having undertaken the paragraph 177D(b) inquiry and determined that there was no evidence that the scheme itself served 'any commercial imperative' (as distinct from the broader transaction of which it was a part) (at [147]), the trial judge nonetheless rejected the Commissioner's submission that a tax benefit could be identified merely

by comparing the broader transaction to that transaction minus the steps comprising the scheme. Instead, the judge determined, as a matter of reasonable expectation based on the commercial disadvantages attending the broader transaction, that had the scheme not been entered into the business would have been consolidated in a different subsidiary which, in turn, would have been floated by its parent, yet another subsidiary. Because the alternative postulate involved a disposal by another member of the group, the taxpayer could not be said to have obtained a tax benefit. The decision was upheld on appeal (*Futuris* [2012] FCAFC 32).

1.61 The problem is also illustrated by the decision of the Full Federal Court in *Axa Asia* [2010] FCAFC 134. There (at [143]), the Court rejected the Commissioner's alternative postulate, involving a direct sale of Axa Health to MB Health, because a direct sale would have denied Macquarie Bank Limited its underwriting and sell down fees. Instead, the Court considered (at [146]) that a reasonable expectation was that, absent the scheme, there would have been a direct sale of the underlying business by Axa Health to MBF (that is, a disposal of a different asset by a different entity to a different purchaser).

1.62 Arguably, the effect of these decisions is that the section 177C 'tax benefit' inquiry has displaced the paragraph 177D(b) purpose inquiry as the 'fulcrum upon which Part IVA turns'.

1.63 In part, this may be an unintended consequence of the way that section 177D approaches the question of whether Part IVA applies to a scheme. The first question to be answered when determining whether Part IVA applies to a scheme is to ascertain whether a taxpayer has obtained a tax benefit in connection with the scheme (as elucidated in section 177C). If, and only if, that question is answered in the affirmative does attention then turn to the section 177D inquiry and the question of whether a participant in the scheme had the requisite purpose of securing a tax benefit for the taxpayer in connection with the scheme.

1.64 For instance, in *RCI Pty Ltd v Commissioner of Taxation* [2011] FCAFC 104 (*RCI*) (at [151) the Full Federal Court concluded it was 'strictly unnecessary', in disposing of that matter, for it to consider the paragraph 177D(b) issue as to purpose (although it did in fact go on to consider the issue out of 'deference to the primary judge's reasons and to the submissions on the hearing of the appeal'). Similarly, a differently constituted Full Federal Court in *Futuris* [2012] FCAFC 32 was able to dismiss the Commissioner's appeal (at [81]) without considering the question of whether any person had the relevant tax avoidance purpose.

1.65 This is undesirable. The inquiry in Part IVA should be a single, holistic, inquiry about whether a person participated in a scheme for the sole or dominant purpose of enabling the taxpayer to obtain a particular

tax benefit. The inquiry should begin with the paragraph 177D(b) analysis of how the scheme was implemented, what it achieved as a matter of substance or reality (that is, it's end effect) and the nature of any connection between the taxpayer and other parties. A consideration of alternative possibilities should form part of that inquiry. As Gummow and Hayne JJ said in *Hart* (2004) 206 ALR 207 [at 66] — subsection 177C(1) and paragraph 177D(b) must be read together.

Relevance of potential tax costs to alternative postulates

1.66 Of particular concern, however, is the fact that alternative postulates suggested by the Commissioner have been rejected as being unreasonable postulates on the grounds that the tax costs involved in undertaking those postulates would have caused the parties to either abandon or indefinitely defer the schemes and the wider transactions of which they were a part (see, for example, *RCI* [2011] FCAFC 104 at [145]-[150]).

1.67 To construe section 177C in that way is to defeat the role Part IVA was intended to play in the scheme of the income tax laws. It allows the very thing that Part IVA was intended to counter — the obtaining of a tax advantage from a scheme designed for that purpose — to function as a shield that protects the taxpayer from the operation of Part IVA.

1.68 The fact that a taxpayer would not have entered into a transaction if it had known, in advance, that it would be subject to tax can be no answer to Part IVA. To accept such a proposition would be to accept that there are situations in which it is reasonable for a taxpayer to avoid the ordinary operation of the taxation law on the substance or reality of what they have actually done.

Blurring of the two limbs in section 177C

1.69 There may also be a suggestion, in some of the recent decisions, that the distinction between those cases in which the first limb of section 177C(1) will be satisfied by a straight forward application of the statutory assumption that the scheme did not happen, and those second limb cases in which the satisfaction of section 177C(1) would necessarily depend upon the making of a prediction about events or circumstances that have not in fact happened or that have happened but would not happen (see paragraphs 1.39 - 1.53), is not a valid distinction.

1.70 The decision in *Futuris* is an example of this. The reasoning there, both at first instance, and on appeal, makes no distinction between the two limbs of paragraph 177C(1)(a). The underlying suggestion seems to be that the reference in subsection 177C(1) to tax consequences that 'would have [occurred], or might reasonably be expected to have

[occurred], … if the scheme had not been entered into or carried out' is a composite phrase requiring, in every case, a postulate about what would have or might reasonably be expected to have happened in lieu of the scheme. On this view of the provision, 'would have' or 'might reasonably be expected to have' represent ends of a spectrum of certainty within which acceptable postulates must lie (see *Futuris* [2012] FCAFC 32 at [54], [59], [62] and [79] and *Commissioner of Taxation v Trail Brothers Steel & Plastics Pty Ltd* [2010] FCAFC 94 (*Trail Bros*) at [26] and [29]).

1.71 Seemingly, the competing constructions of section 177C have yet to be directly considered by a court. This is unfortunate as the alternative bases approach may provide a way to reconcile the apparent contradictions between the decision of the Full Federal Court in *Commissioner of Taxation v Lenzo* [2008] FCAFC 50 (*Lenzo*) and the decision of a differently constituted Full Federal Court in *Trail Bros*.

1.72 In *Lenzo,* Sackville J (at [121]) (with whom Heerey and Siopis JJ appear to have agreed) suggested that in assessing the alternative postulate 'the entirety of the scheme' must be 'ignored'. However, in *Trail Bros* [2010] FCAFC 94, Dowsett and Gordon JJ (at [29] - [30) (with whom Edmonds J agreed) took the view that the alternative postulate can include integers of the scheme so long as it does not comprise 'the same complete set of events giving rise to the scheme'.

1.73 The fact patterns in *Lenzo* and *Trail Bros* (as distinct from the reasons for decision) neatly illustrate the point that different circumstances may demand different approaches to the identification of a tax benefit. In *Lenzo*, the mere deletion of the scheme sufficed to identify the tax benefit which the taxpayer had a dominant purpose of securing. In *Trail Bros*, however, the requisite purpose only existed in respect of part of the deduction and so it was that the Court preferred an alternative postulate that depended upon a reconstruction of the scheme.

1.74 The view that subsection 177C(1) contains alternative bases for identifying tax benefits, is consistent with the legislative history of Part IVA. As the Explanatory Memorandum accompanying Part IVA explained, one of the 'limitations' of section 260, which Part IVA was intended to overcome, was that once section 260 had 'done its job of voiding an arrangement' it, did not 'provide a power to *reconstruct* what was done, so as to arrive at a taxable situation (emphasis added)'. There is no suggestion here that Parliament intended to remove the operation the general anti-avoidance rule has when it annihilates a scheme. Rather, a reasonable reading is that Parliament intended to augment that operation to correct the recognized defect that section 260 did not permit reconstruction in cases where annihilating the scheme did not leave a result amenable to tax.

1.75 The syntax of section 177C supports that conclusion. Paragraph 177C(1)(a) (the other paragraphs follow a similar structure) says that a tax benefit is 'an amount not being included in the assessable income of the taxpayer of a year of income where that amount would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out'. The disjunctive structure indicates that the paragraph is to be read as the compilation of two separate possibilities:

- first, an amount not being included in the taxpayer's assessable income that would have been included if the scheme had not been entered into; and

- second, an amount not being included in the taxpayer's assessable income that might reasonably be expected to have been included if the scheme had not been entered into.

1.76 The expectation element of this only applies to the second possibility. The plain language of the section does not therefore support the conclusion that the provision requires or allows the interpolation of a reasonable expectation about what might have happened when it is possible to say what *would have* happened if nothing more is done than annihilating the scheme.

1.77 The better view is that the 'would have' and 'might reasonably be expected to' limbs of each of the subsection 177C(1) paragraphs represent separate and distinct bases upon which the existence of a tax benefit can be demonstrated.

The Government's response

1.78 On 1 March 2012, the Government announced it would introduce amendments to ensure Part IVA continued to be effective in countering tax avoidance schemes.

1.79 The Government's announcement was made in response to a number of judicial decisions, including the decision of the Full Federal Court in *RCI*, handed down on 22 August 2011. The High Court denied the Commissioner of Taxation's application for special leave to appeal that decision on 10 February 2012.

1.80 The Government was concerned that some taxpayers had argued successfully that they did not get a 'tax benefit' because, absent the scheme, they would not have entered into an arrangement that attracted tax — for example — because they would have entered into a different

scheme that also avoided tax, because they would have deferred their arrangements indefinitely or because they would have done nothing at all.

1.81 The Government was also concerned that Part IVA might not be working effectively in relation to schemes that were steps within broader commercial arrangements.

1.82 Mindful that any amendments should not interfere with genuine commercial transactions, the Government established a comprehensive consultation process for designing the amendments. That process involved the establishment of a roundtable of industry representatives, and legal academics and experts to assist Treasury identify and explore possible approaches to clarifying the law. It also involved the Government seeking advice on its different design options from senior tax counsel with particular expertise on Part IVA.

1.83 The role of the roundtable was not to revisit the policy decisions announced by the Government on 1 March 2012. The roundtable was established, in addition to the normal Treasury consultation processes, to improve the legislative response to the problems that have emerged with Part IVA because of the particular sensitivities associated with the operation of Part IVA.

1.84 The roundtable process was constructive and significantly deepened the Government's understanding of the problems with Part IVA. The exposure draft is much improved as a result.

1.85 As originally announced, the amendments were to apply from 2 March 2012. However, the Government has delayed the start date to the date of the exposure draft to allow for the additional time taken to progress the amendments to the exposure draft stage (time that was spent in consultation) and to recognise that the amendments are being proposed in a form the public may not have readily anticipated when the measure was first announced.

Summary of new law

1.86 Schedule # amends Part IVA of the ITAA 1936.

1.87 The amendments target deficiencies in section 177C, and the way it interacts with other elements of Part IVA, particularly section 177D, as revealed by recent decisions of the Full Federal Court.

1.88 The amendments are not intended to disturb the operation of Part IVA in any other respect.

1.89 Consistent with the policy underlying Part IVA, the amendments are intended to have the following effects:

- to allow Part IVA to operate as an integrated whole, by:
  - restoring the dominant purpose test in section 177D to its central role as the 'fulcrum' or 'pivot' around which Part IVA operates; and
  - ensuring that section 177C, whose role it is to elucidate when it is that a tax benefit has been obtained in connection with a scheme, is construed with section 177D in the inter-related way envisaged by Gummow and Hayne JJ in the High Court in *Hart*;
- to ensure that when a conclusion that a tax benefit has been obtained depends upon a hypothetical reconstruction of what would have happened absent the scheme (as distinct from a straight forward application of the statutory postulate that the scheme, in its entirety, did not happen), the hypothesis focuses on other ways in which the taxpayer might reasonably be expected to have achieved the same non-tax effects as it achieved from and in connection with the scheme; and
- to ensure that, in considering alternatives to the scheme, no consideration is given to the taxation implications of those alternatives.

Comparison of key features of new law and current law

New Law	***Current law***
The question of whether Part IVA applies to a scheme necessarily involves a single, holistic, inquiry into whether a person participated in the scheme with a sole or dominant purpose of securing for the taxpayer a particular tax benefit in connection with the scheme.	The question of whether Part IVA applies to a scheme starts with a consideration of whether a taxpayer has secured a particular tax benefit in connection with the scheme.

New Law	*Current law*
When hypothesising alternative postulates to a scheme, consideration should be given to other ways in which the taxpayer could reasonably be expected to achieve the same non-tax effects (if any) as it achieved from the scheme.	The question of what might reasonably be expected to have happened, absent the scheme, is answered by an unconstrained enquiry about what other alternatives were open to the participants in the scheme.
When hypothesising alternative postulates to a scheme, no consideration is to be given to the potential tax costs of those alternatives	The question of what might reasonably be expected to have happened, absent a scheme, can involve a consideration of potential tax costs.

Detailed explanation of new law

The object of Part IVA

1.90 Schedule # to this Bill inserts an objects clause into Part IVA. ***[Schedule #, item 2, subsection 177AA]***

1.91 The objects clause confirms that Part IVA is intended to counter schemes that are entered into with a relevant tax avoidance purpose.

1.92 It also confirms that Part IVA is intended to be able to apply to schemes that are steps within or towards other schemes. This would include schemes that are merely steps within broader commercial arrangements.

When does Part IVA apply?

1.93 Schedule # to this Bill amends section 177D to provide that the first question to be answered when determining whether Part IVA applies to a scheme is to ask whether a participant in the scheme had the requisite purpose of securing a tax benefit for the taxpayer in connection with the scheme. ***[Schedule #, item 6, subsections 177D(1) and (2)]***

1.94 The questions whether a tax benefit was obtained in connection with the scheme and whether the scheme was entered into or commenced to be carried out after 27 May 1981 follow as subsidiary questions. ***[Schedule #, item 6 , subsection 177D(3) and (4)]***

1.95 To support these amendments, an amendment is made to subsection 177F(1) to further emphasise that an examination of Part IVA

should commence with the question whether there is a scheme to which Part IVA applies. ***[Schedule #, item 8, subsection 177F(1)]***

1.96 These amendments allow Part IVA to operate as an integrated whole by restoring the dominant purpose test in section 177D to its central role as the 'fulcrum' around which Part IVA operates and by ensuring that section 177C, whose role it is to elucidate when a tax benefit has been obtained in connection with a scheme, is construed with section 177D in the inter-related way envisaged by Gummow and Hayne JJ in the High Court in *Hart*.

Assumptions relating to alternative postulates

1.97 Schedule # to this Bill inserts a new provision into Part IVA. ***[Schedule #, item 6, section 177CB]***

1.98 A conclusion that one of the paragraphs of subsection 177C(1) is satisfied requires a conclusion that one of the tax consequences specified in that subsection (for example, the non-inclusion of an amount of assessable income) would have, or might reasonably be expected to have, happened, absent a particular scheme.

1.99 The new provision provides that where the satisfaction of subsection 177C(1) depends upon the making of a postulate that is an alternative to a scheme, then the postulate is to be made subject to certain assumptions. Those assumptions vary depending on the non-tax effects of the scheme. ***[Schedule #, item 6, section 177CB]***

1.100 The purpose of the statutory assumptions is to ensure that subsection 177C(1) performs its role of identifying and quantifying when it is that a tax consequence has been obtained in connection with a particular scheme — being a consequence that has a substantial, practical, relationship to the scheme.

Assume tax costs would be disregarded

1.101 The first assumption is that, in hypothesising whether a person would participate in an alternative to the scheme, the potential tax costs of the alternative, for that person, or any other person, would not be a factor in that person's, or any other person's, decision making. In other words, potential tax liabilities are not to be taken into account in assessing the likelihood or reasonableness of any alternative postulate ***[Schedule #, item 6, paragraph 177CB(1)(a)]***

1.102 The injunction that the potential liability of a person to tax should not be taken into account extends not just to taxpayers and

participants in schemes but to any person who might be a potential participant in an alternative to a scheme.

1.103 This amendment is intended to make it clear that alternative postulates should not be rejected as unreasonable postulates on the grounds that the tax costs involved in undertaking those postulates (including the tax benefit impugned by the Commissioner) would have caused the parties to either abandon or indefinitely defer the schemes and/or the wider transactions of which they were a part (compare *RCI* [2011] FCAFC 104 at [145]-[150] and *Futuris* [2012] FCAFC 32 at [71]).

Assumption to be made where the scheme achieves one or more non-tax effects

1.104 The second assumption is an assumption that applies where a scheme achieves (or would achieve) one or more non-tax effects for the taxpayer. In these cases a decision under a paragraph of subsection 177C(1) will likely rest on a hypothesis that involves a reasonable reconstruction of either the scheme, or of the scheme and things that happened in connection with the scheme, because the mere excision of the scheme could defeat the non-tax effects that had been sought. ***[Schedule #, item 6, paragraph 177CB(1)(b)]***

1.105 Where it applies, the assumption is that the participants would act with the intention of achieving for the taxpayer the same non-tax effects as the taxpayer achieved from and in connection with the scheme. ***[Schedule #, item 6, paragraph 177CB(1)(b)]***

1.106 This assumption ensures that the subsection 177C(1) comparison between the tax consequences of the scheme and the tax consequences of an alternative postulate involves a comparison between the scheme and a postulate that is a true alternative for the scheme.

1.107 In turn, this will facilitate the subsection 177C(1) inquiry into whether a particular tax advantage has been obtained in connection with the scheme.

1.108 A tax advantage cannot meaningfully be linked to a scheme by comparing the tax consequences of the scheme to the tax consequences that would have flowed if the parties had chosen to pursue some other objective. To provide a meaningful comparison, the tax consequences of the scheme should be compared with the tax consequences of an alternative reasonably capable of achieving for the taxpayer the same non-tax effects as the scheme.

Example 1.1 A postulate with the same non-tax effects

Assume Paul & Co placed $1 million dollars on deposit for 12 months for a return of $50,000, payable in arrears. The income produced by the investment is exempt for taxation purposes.

In hypothesizing an alternative to this transaction, it should be assumed that Paul & Co would seek to invest the same amount, for the same period at a comparable risk and for a comparable return. Paul & Co would not have considered investing in ordinary shares.

A non-tax effect

1.109 For these purposes, a ***non-tax effect*** is an effect other than an effect relating to the taxpayer's liability to income or withholding tax in respect of a year of income. ***[Schedule #, item 6, paragraph 177CB(3)(a)]***

1.110 The reference to an 'effect' is meant as a reference to an end that is accomplished or achieved as a result of concerted action to that end.

Example 1.2 An end effect

Gadget Co negotiates, with the assistance of its selling agent, Banker Co, to sell its Sydney factory to Widget Co for $500,000. However, rather than transferring the factory directly to Widget Co, Gadget Co enters into a complex transaction that involves the factory passing through the hands of Banker Co before it is finally transferred to Widget Co.

Gadget Co realizes $475,000 from the transaction and Banker Co takes the balance of $25,000. Gadget Co is not liable for capital gains tax in relation to the transaction.

From Gadget Co's perspective, the end result achieved by the transaction was the disposal of its factory to Widget Co for $500,000. A reasonable alternative to the transaction, that would have achieved the same non-tax effect for Gadget Co, would have been for Gadget Co to dispose of the factory directly to Widget Co for $500,000 and for Gadget Co to have paid Banker Co a fee of $25,000 for facilitating the sale.

1.111 The non-tax effects achieved for a taxpayer from and in connection with a scheme are the same non-tax effects that must be identified and examined as part of the section 177D inquiry into the purposes of those that participated in the scheme. ***[Schedule #, item 6, paragraph 177CB(2)].***

1.112 Relevantly, subsection 177D(2), as amended, requires consideration be given to eight matters, consisting of three overlapping sets:

- The first set is concerned with the way in which the scheme was implemented; how its results were obtained. It comprises the first three factors in paragraphs (a), (b) and (c) of subsection 177D(2) and deals with manner, form and substance, and timing.

- The second set comprises the next four factors in paragraphs (d), (e), (f) and (g) of subsection 177D(2) and deals with the effects of the scheme: the tax results, financial changes, and other consequences of the scheme.

- The third set is the eighth factor in paragraph (h) of subsection 177D(2), which deals with the nature of any connection between the taxpayer and other parties.

[Schedule #, item 6, subsection 177D(2)]

1.113 This assumption is included in response to cases such as *AXA Asia* and *Futuris* wherein commercial options not in fact pursued by the respective taxpayers were preferred by the courts as alternative postulates to the schemes impugned by the Commissioner.

Tax effects

1.114 A non-tax effect does not include an effect that relates to a taxpayer's liability to income tax or withholding tax (for example, an amount not being included in assessable income or a deduction being allowed). Nor does it include an effect that is incidental to a tax effect being achieved for the taxpayer. ***[Schedule #, item 6, paragraphs 177CB(3)(a) and (b)]***

1.115 An effect is incidental to the achievement of a tax effect if it can be regarded as a natural concomitant or accompaniment to the securing of a tax effect; if it is subordinate or subsidiary to the tax effect; if it occurs in the furtherance of, or consequential upon, the tax effect.

Example 1.3 Incidental effect

In order for Sandy to secure a large, up-front, tax deduction from entering into a scheme it is necessary for him to acquire a right to potential income. Accordingly, the scheme is structured so as to provide him with a highly contingent right to future income payable some years into the future. The potential investment returns are speculative and clearly subordinate to the tax deduction.

Objectively viewed, Sandy's acquisition of the contingent rights to income are merely incidental to his achieving the desired tax effect.

Assumption to be made where the scheme did not achieve any non-tax effects

1.116 In a case where the scheme did not (or would not) achieve any non-tax effects for the taxpayer, the assumption is that all events or circumstances that actually happened or existed but which did not form part of the scheme would still have happened or existed. ***[Schedule #, item 6, paragraph 177CB(1)(c)]***

1.117 Where it applies, this amendment ensures that a hypothesis about what might have happened absent the scheme cannot involve a reconstruction of the state of affairs that existed apart from the scheme.

1.118 Where the resulting hypothesis involves nothing more than the mere absence of the scheme it will equate with the statutory postulate in subsection 177C(1) (namely, that the scheme had not been entered into or carried out).

1.119 The statutory postulate does not involve any element of prediction about the state of affairs that might exist once the entirety of the scheme has been assumed away.

1.120 If the requisite connection between the tax benefit and the scheme is evident from a straightforward application of the tax law to the state of affairs that remains once a scheme has been assumed away, then subsection 177C(1) will have performed its role of identifying and quantifying a tax benefit obtained in connection with the scheme.

Example 1.4: Postulating the absence of the scheme

Carrying on from Example 1.3, assume that Sandy does not secure any non-tax effects from the scheme (the highly contingent right to income being an effect that is incidental to a tax effect).

A hypothesis about what might have happened, absent the scheme, could not involve speculation about circumstances that did not exist (for example, that Sandy would have done something else that would have also secured a tax deduction).

Sandy has therefore obtained a tax benefit in connection with the scheme.

Schemes within broader commercial transactions

1.121 Where a scheme forms part of a broader commercial transaction, an alternative postulate to the scheme is a postulate that performs the same role in relation to the broader transaction as the scheme itself performs. ***[Schedule #, item 6, paragraph 177CB(1)(b)(i)]***

1.122 Consequently, if the scheme itself has no non-tax effects and the broader transaction remains effective without the scheme, there would be no warrant for an alternative postulate to involve a reconstruction of the broader transaction (compare *Futuris*). ***[Schedule #, item 6, paragraph 177CB(1)(c)]***

1.123 Where, however, a scheme is integral to a broader transaction in the sense that it is entangled within the broader transaction and facilitates it in some way, then it would be reasonable for an alternative postulate to involve a reconstruction of the broader transaction providing the reconstruction produces the same non-tax effects as were in fact achieved by the broader transaction. ***[Schedule #, item 6, paragraph 177CB(3)(b)(ii)]***

1.124 The degree to which the broader transaction should be reconstructed should be informed by the role that the scheme plays in that transaction.

Example 1.5 A scheme that facilitates a broader transaction

In order for Kerry-Anne to secure a tax deduction for borrowing money to invest in an offshore company (Offshore Co) it is necessary for her to interpose a resident Australian company. This she does by using the borrowed funds to buy shares in an Australian shelf company (Oz Co). In turn, Oz Co buys ordinary shares in Offshore Co. Oz Co performs no other role.

The Commissioner identifies the interposition of Oz Co as a scheme to which Part IVA applies.

Objectively viewed, the interposition of Oz Co achieves two effects. One, securing a deduction for interest on the borrowing, and the other is the acquisition of shares in Offshore Co.

An alternative postulate should be another way in which Kerry-Anne could reasonably be expected to have acquired ordinary shares in Offshore Co. An alternative postulate that involved Kerry-Anne lending the borrowed monies to Offshore Co would be a postulate that achieves a different effect. So too would be a postulate that involved Kerry-Anne investing the borrowed monies in a completely different company.

Application provisions

1.125 The amendments in Schedule # apply in relation to schemes that were entered into, or that were commenced to be carried out, on or after 16 November 2012. ***[Schedule #, item 11]***

1.126 The 16 November 2012 is the date upon which an exposure draft of this Bill was released for public consultation.

1.127 The amendments apply from that date, rather than from some later date, such as the date of Royal Assent, because it minimizes the potential for taxpayers to obtain unintended tax advantages in the period before the amendments become law.

Consequential amendments

1.128 Section 177CA provides that a taxpayer who avoids paying withholding tax on an amount that it would have, or could reasonably be expected to have paid withholding tax, absent a scheme, is taken to have obtained a tax benefit.

1.129 The amendments bring the avoidance of withholding tax within the list of other tax benefits set out in section 177C. This ensures that the amendments concerning assumptions that can be made in relation to alternative postulates apply with equal force to withholding tax benefits. ***[Schedule #, items 3, 4, 5, 6, 9, and 10, paragraphs 177C(1)(bb), 177C(1)(bc) and 177C(1)(g), section 177CA, subsection 177F(2A), and paragraph 18-40(1)(a) in Schedule 1 of the Taxation Administration Act 1953)]***

1.130 A number of consequential amendments are also required by reason of the restructuring of section 177D. ***[Schedule #, items 1 and 7, paragraphs 45B(8(k), 177EA(17)(j), and 177EB(10)(f)]***